

FINANCIAL INSTITUTIONS INC  
Form 10-K  
March 08, 2016  
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UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
Washington, D.C. 20549

(Mark One)

**Form 10-K**

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

For the fiscal year ended December 31, 2015

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**  
(State or other jurisdiction of incorporation or organization)

**220 LIBERTY STREET, WARSAW, NEW YORK**

**16-0816610**  
(I.R.S. Employer Identification No.)

**14569**

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(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
<b>Common stock, par value \$.01 per share</b>	<b>NASDAQ Global Select Market</b>
Securities registered under Section 12(g) of the Exchange Act:	<b>NONE</b>

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

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

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the past 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.  
Yes  No

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

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K (§ 229.405 of this chapter) is not contained herein, and will not be contained, to the best of the registrant's knowledge, in definitive proxy or information statements

incorporated by reference in Part III of this form 10-K or any amendment to this Form 10-K.

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

Large accelerated filer  Accelerated filer

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

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, 2015 closing price reported by NASDAQ, was approximately \$340,191,000.

As of February 29, 2016, there were outstanding, exclusive of treasury shares, 14,485,883 shares of the registrant's common stock.

**DOCUMENTS INCORPORATED BY REFERENCE**

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Portions of the registrant's proxy statement for the 2016 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, estimate, expect, intend, plan, projects, or similar expressions.

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

- If we experience greater credit losses than anticipated, earnings may be adversely impacted;
- Our tax strategies and the value of our deferred tax assets could adversely affect our operating results and regulatory capital ratios;
- Geographic concentration may unfavorably impact our operations;
- We depend on the accuracy and completeness of information about or from customers and counterparties;
- Our insurance brokerage subsidiary, SDN, is subject to risk related to the insurance industry;
- We are subject to environmental liability risk associated with our lending activities;
- Commercial real estate and business loans increase our exposure to credit risks;
- Our indirect lending involves risk elements in addition to normal credit risk;
- We accept deposits that do not have a fixed term and which may be withdrawn by the customer at any time for any reason;
- Any future FDIC insurance premium increases may adversely affect our earnings;
- We are highly regulated and may be adversely affected by changes in banking laws, regulations and regulatory practices;
- New or changing tax and accounting rules and interpretations could significantly impact our strategic initiatives, results of operations, cash flows, and financial condition;
- Legal and regulatory proceedings and related matters could adversely affect us and banking industry in general;
- A breach in security of our or third party information systems, including the occurrence of a cyber incident or a deficiency in cyber security, may subject us to liability, result in a loss of customer business or damage our brand image;
- We face competition in staying current with technological changes to compete and meet customer demands;

We rely on other companies to provide key components of our business infrastructure;  
We use financial models for business planning purposes that may not adequately predict future results;  
We may not be able to attract and retain skilled people;  
Acquisitions may disrupt our business and dilute shareholder value;  
We are subject to interest rate risk;  
Our business may be adversely affected by conditions in the financial markets and economic conditions generally;  
The fiscal and monetary policies of the federal government and its agencies have a significant impact on our earnings;  
The soundness of other financial institutions could adversely affect us;  
The value of our goodwill and other intangible assets may decline in the future;  
A potential proxy contest for the election of directors at our annual meeting or proposals arising out of shareholder initiatives could cause us to incur substantial costs and negatively affect our business;  
We operate in a highly competitive industry and market area;  
Severe weather, natural disasters, acts of war or terrorism, and other external events could significantly impact our business;  
Liquidity is essential to our businesses;  
We may need to raise additional capital in the future and such capital may not be available on acceptable terms or at all;  
We rely on dividends from our subsidiaries for most of our revenue;  
We may not pay or may reduce the dividends on our common stock;  
We may issue debt and equity securities or securities convertible into equity securities, any of which may be senior to our common stock as to distributions and in liquidation, which could dilute our current shareholders or negatively affect the value of our common stock;  
Our certificate of incorporation, our bylaws, and certain banking laws may have an anti-takeover effect; and  
The market price of our common stock may fluctuate significantly in response to a number of factors.

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

## **ITEM 1. BUSINESS**

### **GENERAL**

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

At December 31, 2015, the Company had consolidated total assets of \$3.38 billion, deposits of \$2.73 billion and shareholders' equity of \$293.8 million.

The Company's primary business is the operation of its subsidiaries. It does not engage in any other substantial business activities. At December 31, 2015, the Company had two direct wholly-owned subsidiaries: (1) the Bank, which provides a full range of banking services to consumer, commercial and municipal customers in Western and Central New York; and (2) SDN, which sells various premium-based insurance policies on a commission basis to commercial and consumer customers. At December 31, 2015, the Bank represented 99.3% and SDN represented 0.6% of the consolidated assets of the Company. Further discussion of our segments is included in Note 20 to the Company's Consolidated Financial Statements included under Item 8 of this Annual Report on Form 10-K.

### **Five Star Bank**

The Bank is a New York chartered bank that has its headquarters at 55 North Main Street, Warsaw, NY, and a total of 50 full-service banking offices in the New York State counties of Allegany, Cattaraugus, Cayuga, Chautauqua, Chemung, Erie, Genesee, Livingston, Monroe, Ontario, Orleans, Seneca, Steuben, Wyoming and Yates counties.

At December 31, 2015, the Bank had total assets of \$3.36 billion, investment securities of \$1.03 billion, net loans of \$2.06 billion, deposits of \$2.74 billion and shareholders' equity of \$302.6 million, compared to total assets of \$3.07 billion, investment securities of \$916.9 million, net loans of \$1.88 billion, deposits of \$2.46 billion and shareholders'



equity of \$256.3 million at December 31, 2014. The Bank offers deposit products, which include checking and NOW accounts, savings accounts, and certificates of deposit, as its principal source of funding. The Bank's deposits are insured up to the maximum permitted by the Bank Insurance Fund (the Insurance Fund) of the Federal Deposit Insurance Corporation (FDIC). The Bank offers a variety of loan products to its customers, including commercial and consumer loans and commercial and residential mortgage loans.

### **Scott Danahy Naylor, LLC**

Acquired in August 2014, SDN is a full-service insurance agency founded in 1923 and headquartered in Amherst, NY. SDN offers personal, commercial and financial services products and serves over 6,000 clients in 44 states. For the year ended December 31, 2015, SDN had total revenue of \$5.0 million.

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

### **Courier Capital**

Acquired in January 2016, Courier Capital, LLC is an SEC-registered investment advisory and wealth management firm based in Western New York, with offices in Buffalo and Jamestown. With \$1.2 billion in assets under management, Courier Capital offers customized investment management, investment consulting and retirement plan services to over 1,100 individuals, businesses and institutions.

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### **Other Subsidiaries**

In addition to the Bank and SDN, the Company had the following indirect wholly-owned subsidiary as of December 31, 2015:

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

### **Business Strategy**

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

A key aspect of our current business strategy is to foster a community-oriented culture where our customers and employees establish long-standing and mutually beneficial relationships. We believe that we are well-positioned to be a strong competitor within our market area because of our focus on community banking needs and customer service, our comprehensive suite of deposit, loan, insurance and wealth management products typically found at larger banks, our highly experienced management team and our strategically located banking centers. We believe that the foregoing factors all help to grow our core deposits, which supports a central element of our business strategy - the growth of a diversified and high-quality loan portfolio.

### **Acquisition Strategy**

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

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

financial services and banking businesses.

## **MARKET AREAS AND COMPETITION**

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

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

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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. Our industry frequently experiences merger activity, which affects competition by eliminating some institutions while potentially strengthening the franchises of others.

The following table presents the Bank's market share percentage for total deposits as of June 30, 2015, 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, 2015 and updates the information for any bank mergers and acquisitions completed subsequent to the reporting date.

<b>County</b>	<b>Market Share</b>	<b>Market Rank</b>	<b>Number of Branches<sup>(1)</sup></b>
Allegany	7.4%	3	1
Cattaraugus	28.1%	2	5
Cayuga	3.3%	10	1
Chautauqua	1.2%	8	1
Chemung	14.4%	3	3
Erie	0.4%	10	3
Genesee	21.7%	3	3
Livingston	37.0%	1	5
Monroe	1.4%	10	6
Ontario	13.9%	2	5
Orleans	23.5%	2	2
Seneca	24.6%	2	2
Steuben	27.9%	1	7
Wyoming	53.8%	1	4
Yates	43.6%	1	2

(1) Number of branches current as of December 31, 2015.

**INVESTMENT ACTIVITIES**

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

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

U.S. treasury securities;

U.S. government agency securities, which are securities issued by official Federal government bodies (e.g., the Government National Mortgage Association ( GNMA ) and the Small Business Administration ( SBA )), and U.S. government-sponsored enterprise securities, which are securities issued by independent organizations that are in part sponsored by the federal government (e.g., the Federal Home Loan Bank ( FHLB ) system, the Federal National Mortgage Association ( FNMA ), the Federal Home Loan Mortgage Corporation ( FHLMC ) and the Federal Farm Credit Bureau);

Mortgage-backed securities ( MBS ) include mortgage-backed pass-through securities, collateralized mortgage obligations and multi-family MBS issued by GNMA, FNMA and FHLMC;

Investment grade municipal securities, including revenue, tax and bond anticipation notes, statutory installment notes and general obligation bonds;

Certain creditworthy 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. We offer commercial business loans to customers in the agricultural industry for short-term crop production, farm equipment and livestock financing. As a general practice, where possible, a first position collateral lien is placed on any available real estate, equipment or other assets owned by the borrower and a personal guarantee of the owner is obtained. As of December 31, 2015, \$102.9 million, or 33%, of our aggregate commercial business loan portfolio were at fixed rates, while \$210.8 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, 2015, \$238.0 million, or 42%, of the loans in our aggregate commercial mortgage portfolio were at fixed rates, while \$328.1 million, or 58%, 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, 2015, we had loans with an aggregate principal balance of \$54.3 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 Federal Housing Administration, and service the loans in a manner that satisfies the secondary market agreements. As of December 31, 2015, our residential mortgage servicing portfolio totaled \$196.0 million, the majority of which has been sold to the FHLMC. As of December 31, 2015, our residential mortgage loan portfolio totaled \$98.3 million, or 5% of our total loan portfolio. We do not engage in sub-prime or other high-risk residential mortgage lending as a line-of-business.

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### **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 other types of secured and unsecured personal loans. At December 31, 2015, outstanding consumer loan balances were concentrated in indirect automobile loans and home equity products, which represented 61% and 37% of our outstanding consumer loan balances, respectively.

We originate indirect consumer loans for a mix of new and used vehicles through franchised new car dealers. The consumer indirect loan portfolio is primarily comprised of loans with terms that typically range from 36 to 84 months. We have developed relationships with franchised new car dealers in Western, Central and the Capital District of New York, and Northern and Central Pennsylvania. As of December 31, 2015, our consumer indirect portfolio totaled \$676.9 million, or 33% of our total loan portfolio. The consumer indirect loan portfolio primarily consists of fixed rate loans with relatively short durations.

We also originate, independently of the indirect loans described above, consumer automobile loans, recreational vehicle loans, boat loans, 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 240 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, 2015, \$286.5 million, or 70%, of the loans in our home equity portfolio were at fixed rates, while \$123.6 million, or 30%, were at variable rates. Approximately 82% of the loans in our home equity portfolio were in first lien positions at December 31, 2015. The other loans in our consumer portfolio totaled \$18.5 million as of December 31, 2015, all but \$895 thousand of which were fixed rate loans.

### **Credit Administration**

Our loan policy establishes standardized underwriting guidelines, as well as the loan approval process and the committee structures necessary to facilitate and ensure the highest possible loan quality decision-making in a timely and businesslike manner. The policy establishes requirements for extending credit based on the size, risk rating and type of credit involved. The policy also sets limits on individual 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 to:

Compete effectively and service the legitimate credit needs of our target market;

Enhance our reputation for superior quality and timely delivery of products and services;

Provide pricing that reflects the entire relationship and is commensurate with the risk profiles of our borrowers;



Retain, develop and acquire profitable, multi-product, value added relationships with high quality borrowers;

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

Comply with all relevant laws and regulations.

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

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

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

Identify deteriorating credits;

Reflect the probability that a given customer may default on its obligations; and

Assist with risk-based pricing.

Through the loan approval process, loan administration and loan review program, management seeks to continuously monitor our credit risk profile and 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 loss emergence and look-back periods;

Evaluation of the loan portfolio with loan reviews;

Levels and trends in delinquent and non-accruing loans;

Trends in volume and terms of loans;

Effects of changes in lending policy;

Experience, ability and depth of management;

National and local economic trends and conditions;

Concentrations of credit;

Interest rate environment;

Customer leverage;

Information (availability of timely financial information); and

Collateral values.

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

1. Impaired commercial business and commercial mortgage loans, 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 loss emergence periods and 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 mortgage, home equity (home equity loans and lines of credit), consumer indirect and other consumer. Allowance allocations for the retail loan portfolio are based on the average loss experience for the previous eight quarters, supplemented with loss emergence periods and qualitative factors similar to the elements described above.

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

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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 a choice of several delivery systems and channels, including telephone, mail, online, automated teller machines (ATMs), debit cards, point-of-sale transactions, automated clearing house transactions (ACH), remote deposit, and mobile banking via telephone or wireless devices. We also take advantage of the use of technology by offering business customers banking access via the Internet and various advanced cash management systems.

We had no traditional brokered deposits at December 31, 2015; 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 \$92.9 million and \$146.6 million, respectively, at December 31, 2015.

#### **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.

### **OPERATING SEGMENTS**

As of December 31, 2015 we had two reportable operating segments, banking and insurance, which are delineated by the subsidiaries of Financial Institutions, Inc. as of December 31, 2015. The banking segment includes all of the Company's retail and commercial banking operations. The insurance segment includes the activities of SDN, a full service insurance agency that provides a broad range of insurance services to both personal and business clients. The Company operated as one business segment until the acquisition of SDN on August 1, 2014, at which time the new Insurance segment was created for financial reporting purposes.

For a discussion of the segments included in our principal activities and certain financial information for each segment, see Note 20, Business Segments, of the notes to consolidated financial statements included in this Annual Report on Form 10-K.

### **OTHER INFORMATION**

We also make available, free of charge, through our website, all reports filed with 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](http://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](http://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.

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**SUPERVISION AND REGULATION**

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

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

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

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

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

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

Merging or consolidating with another bank holding company.

The BHC Act generally prohibits a bank holding company from acquiring direct or indirect ownership or control of more than 5% of the voting shares of any company which is not a bank or bank holding company, or from engaging directly or indirectly in activities other than those of banking, managing or controlling banks, or providing services for its subsidiaries. The principal exceptions to these prohibitions involve certain non-bank activities which, by statute or by FRB regulation or order, have been identified as activities closely related to the business of banking or managing or controlling banks. The list of activities permitted by the FRB includes, among other things: lending; operating a savings institution, mortgage company, finance company, credit card company or factoring company; performing

certain data processing operations; providing certain investment and financial advice; underwriting and acting as an insurance agent for certain types of credit related insurance; leasing property on a full-payout, non-operating basis; selling money orders, travelers checks and United States Savings Bonds; real estate and personal property appraising; providing tax planning and preparation services; and, subject to certain limitations, providing securities brokerage services for customers. These activities may also be affected by federal legislation.

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

**The Dodd-Frank Act.** The Dodd-Frank Wall Street Reform and Consumer Protection Act (the Dodd-Frank Act ), which was signed into law in 2010, significantly changes the regulation of financial institutions and the financial services industry. The Dodd-Frank Act includes provisions affecting large and small financial institutions alike, including several provisions that will profoundly affect how community banks, thrifts, and small bank and thrift holding companies will be regulated in the future. Among other things, these provisions abolish the Office of Thrift Supervision and transfer its functions to the other federal banking agencies, relax rules regarding interstate branching, allow financial institutions to pay interest on business checking accounts, and impose new capital requirements on bank and thrift holding companies. The Dodd-Frank Act also includes several corporate governance provisions that apply to all public companies, not just financial institutions. These include provisions mandating certain disclosures regarding executive compensation and provisions addressing proxy access by shareholders.

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The Dodd-Frank Act contains numerous other provisions affecting financial institutions of all types, including some that may affect our business in substantial and unpredictable ways. We have incurred higher operating costs in complying with the Dodd -Frank Act, and we expect that these higher costs will continue for the foreseeable future. Our management continues to monitor the ongoing implementation of the Dodd-Frank Act and as new regulations are issued, will assess their effect on our business, financial condition, and results of operations. See Item 1A, Risk Factors, for a more extensive discussion of this topic.

**The Volcker Rule.** The Dodd-Frank act prohibits banks and their affiliates from engaging in proprietary trading and from investing and sponsoring hedge funds and private equity funds. The statutory provision implementing these restrictions is commonly called the Volcker Rule. To implement the Volcker Rule, federal regulators issued final rules in December 2013 that were to become effective April 2014. The Federal Reserve subsequently issued an order extending the period that institutions have to conform their activities to the requirements of the Volcker Rule to July 21, 2015, and extended the compliance date for banks to conform their investments in certain legacy covered funds until July 21, 2016. These final rules exempt the Bank, as a bank with less than \$10 billion in total consolidated assets that does not engage in any covered activities other than trading in certain government, agency, state or municipal obligations, from any significant compliance obligations under the Volcker Rule; therefore, the Volcker rule will not have a material effect on our business, financial condition and results of operations.

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

Real estate lending standards, which provide guidelines concerning loan-to-value ratios for various types of real estate loans;

Risk-based capital rules, including accounting for interest rate risk, concentration of credit risk and the risks posed by non-traditional activities;

Rules requiring depository institutions to develop and implement internal procedures to evaluate and control credit and settlement exposure to their correspondent banks;

Rules restricting types and amounts of equity investments; and

Rules addressing various safety and soundness issues, including operations and managerial standards, standards for asset quality, earnings and compensation standards.

**Capital Requirements.** The Company and the Bank are each required to comply with applicable capital adequacy standards established by the Federal Reserve. The current risk-based capital standards applicable to the Company and the Bank, parts of which are currently in the process of being phased in, are based on the December 2010 final capital framework for strengthening international capital standards, known as Basel III, of the Basel Committee.

Prior to January 1, 2015, the risk-based capital standards applicable to the Company and the Bank (the general risk-based capital rules ) were based on the 1988 Capital Accord, known as Basel I, of the Basel Committee. In July 2013, the federal bank regulators approved the final Basel III Rules implementing the Basel III framework as



well as certain provisions of the Dodd-Frank Act. The Basel III Rules substantially revised the risk-based capital requirements applicable to BHCs and their depository institution subsidiaries, including the Company and the Bank, as compared to the general risk-based capital rules. The Basel III Rules became effective for the Company and the Bank on January 1, 2015 (subject to a phase-in period for certain provisions).

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

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

4.5% CET1 to risk-weighted assets;

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

8.0% Total capital (that is, Tier 1 capital plus Tier 2 capital) to risk-weighted assets.

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

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

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

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

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

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

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

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

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

respectively.

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

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

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

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The primary source of cash for dividends we pay is the dividends we receive from the Bank. The Bank is subject to various regulatory policies and requirements relating to the payment of dividends, including requirements to maintain capital above regulatory minimums. Approval of the New York State Department of Financial Services is required prior to paying a dividend if the dividend declared by the Bank exceeds the sum of the Bank's net profits for that year and its retained net profits for the preceding two calendar years. At January 1, 2016, the Bank could declare dividends of \$25.6 million from retained net profits of the preceding two years. The bank declared dividends of \$16.0 million in 2015 and \$20.0 million in 2014.

**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 2015, the FICO assessment was equal to 0.58 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.

**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 Fair Credit Reporting Act, the Truth in Lending Act, the Truth in Savings Act, the Electronic Funds Transfer Act, the Expedited Funds Availability Act, the Equal Credit Opportunity Act, the Fair Housing Act, the Home Mortgage Disclosure Act, the Real Estate Settlement Procedures Act, the Fair Debt Collection Practices Act, the Service Members Civil Relief Act and these laws' respective state-law counterparts, as well as state usury laws and laws regarding unfair and deceptive acts and practices. These and other federal laws, among other things, require disclosures of the cost of credit and terms of deposit accounts, provide substantive consumer rights, prohibit discrimination in credit transactions, regulate the use of credit report information, provide financial privacy protections, prohibit unfair, deceptive and abusive practices, restrict the Company's ability to raise interest rates and subject the Company to substantial regulatory oversight.

Violations of applicable consumer protection laws can result in significant potential liability from litigation brought by customers, including actual damages, restitution and attorneys' fees. Federal bank regulators, state attorneys general and state and local consumer protection agencies may also seek to enforce consumer protection requirements and obtain these and other remedies, including regulatory sanctions, customer rescission rights, action by the state and local attorneys general in each jurisdiction in which we operate and civil money penalties. Failure to comply with consumer protection requirements may also result in our failure to obtain any required bank regulatory approval for merger or acquisition transactions the Company may wish to pursue or our prohibition from engaging in such transactions even if approval is not required.

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

Risks to consumers and compliance with the federal consumer financial laws, when it evaluates the policies and practices of a financial institution.

The markets in which firms operate and risks to consumers posed by activities in those markets.

Depository institutions that offer a wide variety of consumer financial products and services; depository institutions with a more specialized focus.

Non-depository companies that offer one or more consumer financial products or services.

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

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

**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.

During January 2015 we signed an Assurance of Discontinuance with the NYS Attorney General's office related to an investigation into lending practices for minority residents within the City of Rochester. As part of the agreement, we paid NYS \$150 thousand to cover its costs. An additional \$750 thousand in dedicated funds spread over three-years has been earmarked for ongoing business efforts consistent with the Bank's growth initiatives in the Rochester market, and throughout Monroe County, including efforts focused on marketing to minority communities, as well as lending discounts and/or subsidies.

Examinations in 2011 by the New York Department of Financial Services and the Federal Reserve Bank of New York under the federal Community Reinvestment Act rated Five Star as outstanding.

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

**Anti-Money Laundering and the USA Patriot Act.** A major focus of governmental policy on financial institutions in recent years has been aimed at combating money laundering and terrorist financing. The USA PATRIOT Act of 2001, or the USA Patriot Act, substantially broadened the scope of United States anti-money laundering laws and regulations by imposing significant new compliance and due diligence obligations, creating new crimes and penalties and expanding the extra-territorial jurisdiction of the United States. Financial institutions are also prohibited from entering into specified financial transactions and account relationships and must use enhanced due diligence procedures in their dealings with certain types of high-risk customers and implement a written customer identification program. Financial institutions must take certain steps to assist government agencies in detecting and preventing money laundering and report certain types of suspicious transactions. Regulatory authorities routinely examine

financial institutions for compliance with these obligations, and failure of a financial institution to maintain and implement adequate programs to combat money laundering and terrorist financing, or to comply with all of the relevant laws or regulations, could have serious legal and reputational consequences for the institution, including causing applicable bank regulatory authorities not to approve merger or acquisition transactions when regulatory approval is required or to prohibit such transactions even if approval is not required. Regulatory authorities have imposed cease and desist orders and civil money penalties against institutions found to be violating these obligations.

**Interstate Branching.** Pursuant to the Dodd-Frank Act, national and state-chartered banks may open an initial branch in a state other than its home state (e.g., a host state) by establishing a de novo branch at any location in such host state at which a bank chartered in such host state could establish a branch. Applications to establish such branches must still be filed with the appropriate primary federal regulator.

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

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

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

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

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



Dodd-Frank requires the Federal banking agencies to establish joint regulations or guidelines prohibiting incentive-based payment arrangements at specified regulated entities having at least \$1 billion in total consolidated assets (which would include the Company and the Bank) that encourage inappropriate risks by providing an executive officer, employee, director or principal shareholder with excessive compensation, fees or benefits or that could lead to material financial loss to the entity. In addition, the agencies must establish regulations or guidelines requiring enhanced disclosure to regulators of incentive-based compensation arrangements. The initial version of these regulations was proposed by agencies in early 2011 but the regulations have not yet been finalized. The proposed regulations include the three key principles from the June 2010 regulatory guidance discussed above. If the regulations are adopted in the form initially proposed, they will impose limitations on the manner in which we may structure compensation for our executives.

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

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

## **Impact of Inflation and Changing Prices**

Our financial statements included herein have been prepared in accordance with GAAP, which requires us to measure financial position and operating results principally using historic dollars. Changes in the relative value of money due to inflation or recession are generally not considered. The primary effect of inflation on our operations is reflected in increased operating costs. We believe changes in interest rates affect the financial condition of a financial institution to a far greater degree than changes in the inflation rate. While interest rates are generally influenced by changes in the inflation rate, they do not necessarily change at the same rate or in the same magnitude. Interest rates are sensitive to many factors that are beyond our control, including changes in the expected rate of inflation, general and local economic conditions and the monetary and fiscal policies of the United States government, its agencies and various other governmental regulatory authorities.

## **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, 2015, we had 691 employees, none of whom are subject to a collective bargaining agreement. Management believes our relations with employees are good.

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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. This Annual Report on Form 10-K is qualified in its entirety by these risk factors. Further, to the extent that any of the information contained in this Annual Report on Form 10-K constitutes forward-looking statements, the risk factors set forth below also are cautionary statements identifying important factors that could cause our actual results to differ materially from those expressed in any forward-looking statements made by or on behalf of us.

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

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

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

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

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

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

**Geographic concentration may unfavorably impact our operations.**

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

increase loan delinquencies;

increase problem assets and foreclosures;

increase claims and lawsuits;

decrease the demand for our products and services; and

decrease the value of collateral for loans, especially real estate, 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.

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

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

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

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

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

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

**Commercial real estate and business loans increase our exposure to credit risks.**

At December 31, 2015, our portfolio of commercial real estate and business loans totaled \$879.9 million, or 42.2% of total loans. We plan to continue to emphasize the origination of these types of loans, which generally expose us to a greater risk of nonpayment and loss than residential real estate or consumer loans because repayment of such loans often depends on the successful operations and income stream of the borrowers. Additionally, such loans typically involve larger loan balances to single borrowers or groups of related borrowers compared to consumer loans or residential real estate loans. A sudden downturn in the economy could result in borrowers being unable to repay their loans, thus exposing us to increased credit risk.

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

A portion of our current lending involves the purchase of consumer automobile installment sales contracts from automobile dealers located in Western, Central and the Capital District of New York, and Northern and Central

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

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

At December 31, 2015, we had \$2.1 billion of deposit liabilities that have no maturity and, therefore, may be withdrawn by the depositor at any time. These deposit liabilities include our checking, savings, and money market deposit accounts.

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

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

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

If there are additional financial institution failures we may be required to pay even higher FDIC premiums than the recently increased levels. Such increases or required prepayments of FDIC insurance premiums may adversely impact our earnings. See Part I, Item 1 Business, Federal Deposit Insurance Assessments for more information about FDIC insurance premiums.

### **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, fair lending, 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.

We describe the significant federal and state banking regulations that affect us in the section captioned Supervision and Regulation included in Part I, Item 1, Business.

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

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

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

We have been, and may in the future be, subject to various legal and regulatory proceedings. It is inherently difficult to assess the outcome of these matters, and there can be no assurance that we will prevail in any proceeding or litigation. Legal and regulatory matters could result in substantial cost and diversion of our efforts, which by itself could have a material adverse effect on our financial condition and operating results. Further, adverse determinations in such matters could result in actions by our regulators that could materially adversely affect our business, financial condition or results of operations.

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



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**A breach in security of our or third party information systems, including the occurrence of a cyber incident or a deficiency in cyber security, may subject us to liability, result in a loss of customer business or damage our brand image.**

We rely heavily on communications, information systems (both internal and provided by third parties) and the internet to conduct our business. Our business depends on our ability to process and monitor a large volume of daily transactions in compliance with legal, regulatory and internal standards and specifications. In addition, a significant portion of our operations relies heavily on the secure processing, storage and transmission of personal and confidential information, 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.

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 types of attacks have had a material effect on our business or operations. Such security attacks can originate from a wide variety of sources, including persons who are involved with organized crime or who may be linked to terrorist organizations or hostile foreign governments. Those same parties may also attempt to fraudulently induce employees, customers or other users of our systems to disclose sensitive information in order to gain access to our data or that of our customers or clients. We are also subject to the risk that our employees may intercept and transmit unauthorized confidential or proprietary information. An interception, misuse or mishandling of personal, confidential or proprietary information being sent to or received from a customer or third party could result in legal liability, remediation costs, regulatory action and reputational harm, any of which could adversely affect our results of operations and financial condition.

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

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

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

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

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

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

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

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

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

### **Acquisitions may disrupt our business and dilute shareholder value.**

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

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

- difficulty in estimating the value of the target company;
- payment of a premium over book and market values that may dilute our tangible book value and earnings per share in the short and long term;
- potential exposure to unknown or contingent liabilities of the target company;
- exposure to potential asset quality issues of the target company;
- volatility in reported income as goodwill impairment losses could occur irregularly and in varying amounts;
- challenge and expense of integrating the operations and personnel of the target company;
- inability to realize the expected revenue increases, cost savings, increases in geographic or product presence, and / or other projected benefits;
- potential disruption to our business;
- potential diversion of our management's time and attention;
- the possible loss of key employees and customers of the target company;
- potential changes in banking or tax laws or regulations that may affect the target company; and
- additional regulatory burdens associated with new lines of business.

### **We are subject to interest rate risk.**

Our earnings and cash flows depend largely upon our net interest income. Interest rates are highly sensitive to many factors that are beyond our control, including general economic conditions and policies of governmental and

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

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

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

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

**The fiscal and monetary policies of the federal government and its agencies have a significant impact on our earnings.**

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

**The soundness of other financial institutions could adversely affect us.**

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

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

As of December 31, 2015, we had \$60.4 million of goodwill and \$6.5 million of other intangible assets. Significant and sustained declines in our stock price and market capitalization, significant declines in our expected future cash flows, significant adverse changes in the business climate or slower growth rates, any or all of which could be materially impacted by many of the risk factors discussed herein, may necessitate our taking charges in the future related to the impairment of our goodwill. Future regulatory actions could also have a material impact on assessments of goodwill for impairment. If the fair value of our net assets improves at a faster rate than the market value of our reporting units, or if we were to experience increases in book values of a reporting unit in excess of the increase in fair value of equity, we may also have to take charges related to the impairment of our goodwill. If we were to conclude that a future write-down of our goodwill is necessary, we would record the appropriate charge, which could have a material adverse effect on our results of operations.

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

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

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**A potential proxy contest for the election of directors at our annual meeting or proposals arising out of shareholder initiatives could cause us to incur substantial costs and negatively affect our business.**

Over the last few years, proxy contests and other forms of shareholder activism have been directed against numerous publicly-traded community banks. On December 16, 2015, Clover Partners, L.P. ( Clover ), a holder of approximately 5% of our outstanding common stock, wrote a letter to our Board of Directors raising concerns regarding our strategic direction, expressing Clover's desire to see the Company sold, expressing its desire for representation on our Board of Directors, and threatening a proxy contest. In the event that any significant investor makes proposals concerning our operations, governance or other matters, or seeks to change our Board of Directors, our review and consideration of such proposals may require the devotion of a significant amount of time by our management and employees and could require us to expend significant resources. Further, if our Board of Directors, in exercising its fiduciary duties, disagrees with or determines not to pursue the strategic direction suggested by an activist shareholder, our business could be adversely affected by responding to a costly and time-consuming proxy contest or other actions from an activist shareholder that will divert the attention of our management and employees, interfere with our ability to execute our strategic plan, result in the loss of business opportunities and customers, and make it more difficult for us to attract and retain qualified personnel and business partners.

**We operate in a highly competitive industry and market area.**

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

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

the ability to develop, maintain and build upon long-term customer relationships based on top quality service, high ethical standards and safe, sound assets;

the ability to expand our market position;

the scope, relevance and pricing of products and services offered to meet customer needs and demands;

the rate at which we introduce new products and services relative to our competitors;

customer satisfaction with our level of service; and

industry and general economic trends.

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

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

Severe weather, natural disasters, acts of war or terrorism, and other adverse external events could have a significant impact on our ability to conduct business. Such events could affect the stability of our deposit base, impair the ability of borrowers to repay outstanding loans, impair the value of collateral securing loans, cause significant property damage, result in loss of revenue, and/or cause us to incur additional expenses. The occurrence of any such event could have a material adverse effect on our business, which, in turn, could have a material adverse effect on our financial condition and results of operations.

**Liquidity is essential to our businesses.**

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



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

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

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

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

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

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

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

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

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

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

amount, timing or nature of our future offerings and debt financings. Further, market conditions could require us to accept less favorable terms for the issuance of our securities in the future. We may also issue additional shares of our common stock or securities convertible into or exchangeable for our common stock that could dilute our current shareholders and effect the value of our common stock.

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

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

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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.

**ITEM 1B. UNRESOLVED STAFF COMMENTS**

None.

## **ITEM 2. PROPERTIES**

We own a 27,400 square foot building in Warsaw, New York that serves as our headquarters, and principal executive and administrative offices. We lease a 22,200 square foot regional administrative facility located in Pittsford, New York. This lease expires in April 2017.

We are engaged in the banking business through 50 branch offices, of which 35 are owned and 15 are leased, in the following fifteen contiguous counties of Western and Central New York: Allegany, Cattaraugus, Cayuga, Chautauqua, Chemung, Erie, Genesee, Livingston, Monroe, Ontario, Orleans, Seneca, Steuben, Wyoming and Yates Counties. The operating leases for our branch offices expire at various dates through the year 2036 and generally include options to renew.

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

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.



**Table of Contents****PART II****ITEM 5. MARKET FOR REGISTRANT'S COMMON EQUITY, RELATED STOCKHOLDER MATTERS AND ISSUER PURCHASES OF EQUITY SECURITIES**

Our common stock is traded on the NASDAQ Global Select Market under the ticker symbol FISI. At February 29, 2016, 14,485,883 shares of our common stock were outstanding and held by approximately 4,600 shareholders of record. During 2015, the high sales price of our common stock was \$29.04 and the low sales price was \$21.67. The closing price per share of our common stock on December 31, 2015, the last trading day of our fiscal year, was \$28.00. We declared dividends of \$0.80 per common share during the year ended December 31, 2015. 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.

**Stock Performance Graph**

The stock performance graph below compares (a) the cumulative total return on our common stock for the period beginning December 31, 2010 as reported by the NASDAQ Global Select Market, through December 31, 2015, (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 LC ( SNL ), of Major Exchange (NYSE, NYSE MKT and NASDAQ) Banks with \$1 billion to \$5 billion in assets over the same period. Cumulative return assumes the reinvestment of dividends. The graph was prepared by SNL and is expressed in dollars based on an assumed investment of \$100.

Index	Period Ending					
	12/31/10	12/31/11	12/31/12	12/31/13	12/31/14	12/31/15
Financial Institutions, Inc.	100.00	87.62	104.55	143.79	151.22	173.96
NASDAQ Composite	100.00	99.21	116.82	163.75	188.03	201.40
SNL Bank \$1B-\$5B Index	100.00	91.20	112.45	163.52	170.98	191.39



**Table of Contents****ITEM 6. SELECTED FINANCIAL DATA***(Dollars in thousands, except per share data)*

	At or for the year ended December 31,				
	2015	2014	2013	2012	2011
<b>Selected financial condition data:</b>					
Total assets	\$ 3,381,024	\$ 3,089,521	\$ 2,928,636	\$ 2,763,865	\$ 2,336,353
Loans, net	2,056,677	1,884,365	1,806,883	1,681,012	1,461,516
Investment securities	1,030,112	916,932	859,185	841,701	650,815
Deposits	2,730,531	2,450,527	2,320,056	2,261,794	1,931,599
Borrowings	332,090	334,804	337,042	179,806	150,698
Shareholders equity	293,844	279,532	254,839	253,897	237,194
Common shareholders equity	276,504	262,192	237,497	236,426	219,721
Tangible common shareholders equity <sup>(1)</sup>	209,558	193,553	187,495	186,037	182,352
<b>Selected operations data:</b>					
Interest income	\$ 105,450	\$ 101,055	\$ 98,931	\$ 97,567	\$ 95,118
Interest expense	10,137	7,281	7,337	9,051	13,255
Net interest income	95,313	93,774	91,594	88,516	81,863
Provision for loan losses	7,381	7,789	9,079	7,128	7,780
Net interest income after provision for loan losses	87,932	85,985	82,515	81,388	74,083
Noninterest income	30,337	25,350	24,833	24,777	23,925
Noninterest expense	79,393	72,355	69,441	71,397	63,794
Income before income taxes	38,876	38,980	37,907	34,768	34,214
Income tax expense	10,539	9,625	12,377	11,319	11,415
Net income	\$ 28,337	\$ 29,355	\$ 25,530	\$ 23,449	\$ 22,799
Preferred stock dividends and accretion	1,462	1,462	1,466	1,474	3,182
Net income available to common shareholders	\$ 26,875	\$ 27,893	\$ 24,064	\$ 21,975	\$ 19,617



**Stock and related per share data:**

Earnings per common share:

Basic	\$ 1.91	\$ 2.01	\$ 1.75	\$ 1.60	\$ 1.50
Diluted	1.90	2.00	1.75	1.60	1.49
Cash dividends declared on common stock	0.80	0.77	0.74	0.57	0.47
Common book value per share	19.49	18.57	17.17	17.15	15.92
Tangible common book value per share <sup>(1)</sup>	14.77	13.71	13.56	13.49	13.21
Market price (NASDAQ: FISJ):					
High	29.04	27.02	26.59	19.52	20.36
Low	21.67	19.72	17.92	15.22	12.18
Close	28.00	25.15	24.71	18.63	16.14

**Performance ratios:**

Net income, returns on:

Average assets	0.87%	0.98%	0.91%	0.93%	1.00%
Average equity	9.78	10.80	10.10	9.46	9.82
Average common equity	9.87	10.96	10.23	9.53	9.47
Average tangible common equity <sup>(1)</sup>	13.16	14.12	13.00	11.74	11.55
Average tangible assets <sup>(1)</sup>	0.84	0.95	0.87	0.89	0.88
Common dividend payout ratio	41.88	38.31	42.29	35.63	31.33
Net interest margin (fully tax-equivalent)	3.28	3.50	3.64	3.95	4.04
Effective tax rate	27.1	24.7	32.7	32.6	33.4
Efficiency ratio <sup>(2)</sup>	61.58%	58.59%	58.48%	62.87%	60.55%

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

(2) Efficiency ratio equals noninterest expense less other real estate expense and amortization and impairment of goodwill and other intangible assets as a percentage of net revenue, defined as the sum of tax-equivalent net interest income and noninterest income before net gains on investment securities, adjustments to contingent liabilities and amortizations of tax credit investment.

**Table of Contents***(Dollars in thousands)*

	At or for the year ended December 31,				
	2015	2014	2013	2012	2011
<b>Capital ratios:</b>					
Leverage ratio <sup>(1)</sup>	7.41%	7.35%	7.63%	7.71%	8.63%
Common equity Tier 1 ratio <sup>(1)</sup>	9.77	n/a	n/a	n/a	n/a
Tier 1 capital ratio <sup>(1)</sup>	10.50	10.47	10.82	10.73	12.20
Total risk-based capital ratio <sup>(1)</sup>	13.35	11.72	12.08	11.98	13.45
Average equity to average assets	8.86	9.08	9.01	9.84	10.20
Common equity to assets	8.18	8.49	8.11	8.55	9.40
Tangible common equity to tangible assets <sup>(2)</sup>	6.32%	6.41%	6.51%	6.86%	7.93%
<b>Asset quality:</b>					
Non-performing loans	\$ 8,440	10,153	\$ 16,622	\$ 9,125	\$ 7,076
Non-performing assets	8,603	10,347	17,083	10,062	9,187
Allowance for loan losses	27,085	27,637	26,736	24,714	23,260
Net loan charge-offs	\$ 7,933	6,888	\$ 7,057	\$ 5,674	\$ 4,986
Non-performing loans to total loans	0.41%	0.53%	0.91%	0.53%	0.48%
Non-performing assets to total assets	0.25	0.33	0.58	0.36	0.39
Net charge-offs to average loans	0.40	0.37	0.40	0.36	0.36
Allowance for loan losses to total loans	1.30	1.45	1.46	1.45	1.57
Allowance for loan losses to non-performing loans	321%	272%	161%	271%	329%
<b>Other data:</b>					
Number of branches	50	49	50	52	50
Full time equivalent employees	660	622	608	628	575

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

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

**Table of Contents****GAAP to Non-GAAP Reconciliation***(In thousands, except per share data)*

	At or for the year ended December 31,				
	2015	2014	2013	2012	2011
<b>Computation of ending tangible common equity:</b>					
Common shareholders equity	\$ 276,504	\$ 262,192	\$ 237,497	\$ 236,426	\$ 219,721
Less: Goodwill and other intangible assets, net	66,946	68,639	50,002	50,389	37,369
Tangible common shareholders equity	\$ 209,558	\$ 193,553	\$ 187,495	\$ 186,037	\$ 182,352
<b>Computation of ending tangible assets:</b>					
Total assets	\$ 3,381,024	\$ 3,089,521	\$ 2,928,636	\$ 2,763,865	\$ 2,336,353
Less: Goodwill and other intangible assets, net	66,946	68,639	50,002	50,389	37,369
Tangible assets	\$ 3,314,078	\$ 3,020,882	\$ 2,878,634	\$ 2,713,476	\$ 2,298,984
Tangible common equity to tangible assets <sup>(1)</sup>	6.32%	6.41%	6.51%	6.86%	7.93%
Common shares outstanding	14,191	14,118	13,829	13,788	13,803
Tangible common book value per share <sup>(2)</sup>	\$ 14.77	\$ 13.71	\$ 13.56	\$ 13.49	\$ 13.21
<b>Computation of average tangible common equity:</b>					
Average common equity	\$ 272,367	\$ 254,533	\$ 235,290	\$ 230,527	\$ 207,189
Average goodwill and other intangible assets, net	68,138	57,039	50,201	43,399	37,369
Average tangible common equity	\$ 204,229	\$ 197,494	\$ 185,089	\$ 187,128	\$ 169,820
<b>Computation of average tangible common equity:</b>					
Average assets	\$ 3,269,890	\$ 2,994,604	\$ 2,803,825	\$ 2,519,258	\$ 2,277,149
Average goodwill and other intangible assets, net	68,138	57,039	50,201	43,399	37,369

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Average tangible assets	\$ 3,210,752	\$ 2,937,565	\$ 2,753,624	\$ 2,475,859	\$ 2,239,780
Net income available to common shareholders	\$ 26,875	\$ 27,893	\$ 24,064	\$ 21,975	\$ 19,617
Return on average tangible common equity <sup>(3)</sup>	13.16%	14.12%	13.00%	11.74%	11.55%
Return on average tangible assets <sup>(4)</sup>	0.84%	0.95%	0.87%	0.89%	0.88%

(1) Tangible common shareholders equity divided by tangible assets.

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

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

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

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**Table of Contents****SELECTED QUARTERLY DATA***(Dollars in thousands, except per share data)*

	<b>Fourth Quarter</b>	<b>Third Quarter</b>	<b>Second Quarter</b>	<b>First Quarter</b>
<b>2015</b>				
Interest income	\$ 27,487	27,007	25,959	24,997
Interest expense	2,856	2,876	2,555	1,850
Net interest income	24,631	24,131	23,404	23,147
Provision for loan losses	2,598	754	1,288	2,741
Net interest income, after provision for loan losses	22,033	23,377	22,116	20,406
Noninterest income	8,580	7,005	6,455	8,297
Noninterest expense	21,828	19,318	19,236	19,011
Income before income taxes	8,785	11,064	9,335	9,692
Income tax expense	2,150	2,748	2,750	2,891
Net income	\$ 6,635	8,316	6,585	6,801
Preferred stock dividends	365	366	366	365
Net income applicable to common shareholders	\$ 6,270	7,950	6,219	6,436
<b>Earnings per common share <sup>(1)</sup>:</b>				
Basic	\$ 0.44	0.56	0.44	0.46
Diluted	0.44	0.56	0.44	0.46
<b>Market price (NASDAQ: FISI):</b>				
High	\$ 29.04	25.21	25.50	25.38
Low	24.05	23.54	22.50	21.67
Close	28.00	24.78	24.84	22.93
Dividends declared	\$ 0.20	0.20	0.20	0.20
<b>2014</b>				
Interest income	\$ 25,984	25,129	24,883	25,059
Interest expense	1,846	1,871	1,780	1,784
Net interest income	24,138	23,258	23,103	23,275
Provision for loan losses	1,910	2,015	1,758	2,106
Net interest income, after provision for loan losses	22,228	21,243	21,345	21,169
Noninterest income	5,155	7,261	6,577	6,357
Noninterest expense	19,379	17,955	17,808	17,213
Income before income taxes	8,004	10,549	10,114	10,313

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Income tax expense	84	3,365	3,082	3,094
Net income	\$ 7,920	7,184	7,032	7,219
Preferred stock dividends	365	366	365	366
Net income applicable to common shareholders	\$ 7,555	6,818	6,667	6,853
Earnings per common share <sup>(1)</sup> :				
Basic	\$ 0.54	0.49	0.48	0.50
Diluted	0.54	0.49	0.48	0.50
Market price (NASDAQ: FISI):				
High	\$ 27.02	24.94	24.88	25.69
Low	22.45	21.71	22.17	19.72
Close	25.15	22.48	23.42	23.02
Dividends declared	\$ 0.20	0.19	0.19	0.19

(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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**2015 FOURTH QUARTER RESULTS**

Net income was \$6.6 million for the fourth quarter of 2015 compared with \$7.9 million for the fourth quarter of 2014. After preferred dividends, net income available to common shareholders for the fourth quarter of 2015 was \$6.3 million or \$0.44 per diluted share, compared to \$7.6 million or \$0.54 per share in the fourth quarter of 2014.

Net interest income for the fourth quarter of 2015 increased \$493 thousand compared to the fourth quarter of 2014. The increase was primarily related to an increase in average interest-earning assets of \$316.3 million, led by a \$172.3 million increase in investment securities and a \$144.0 million increase in loans. The increase was partially offset by a lower net interest margin, which decreased 30 basis points from the fourth quarter of 2014 to the fourth quarter of 2015.

The provision for loan losses was \$2.6 million for the fourth quarter of 2015 compared with \$1.9 million for the fourth quarter of 2014. Net charge-offs for the fourth quarter of 2015 were \$2.0 million, or 0.38% annualized, of average loans, compared to \$1.5 million, or 0.32% annualized, of average loans in the fourth quarter of 2014.

Noninterest income was \$8.6 million for the fourth quarter of 2015 compared to \$5.2 million in the fourth quarter of 2014. The increase was driven primarily by a non-cash fair value adjustment of the contingent consideration liability in the fourth quarter of 2015 that resulted in noninterest income of \$1.1 million related to the SDN acquisition and the amortization of a historic tax investment in a community-based project which reduced noninterest income by \$2.3 million in the fourth quarter of 2014. These types of investments are amortized in the first year the project is placed in service and we recognized the amortization as contra-income, included in noninterest income, with an offsetting tax benefit that reduced income tax expense.

Noninterest expense was \$21.8 million for the fourth quarter of 2015 compared to \$19.4 million in the fourth quarter of 2014. Salaries and employee benefits expense, the largest noninterest expense item, was up \$781 thousand from the fourth quarter of 2014, and reflects a combination of additional personnel to support organic growth as part of the Company's expansion initiatives and higher pension expense. Noninterest expense also included \$751 thousand of goodwill impairment in the fourth quarter of 2015 related to the SDN acquisition, an increase of \$176 thousand in professional service fees attributable to the acquisition of Courier Capital, and additional marketing services related to branding and the opening of our new CityGate branch in Rochester, NY.

Income tax expense was \$2.2 million in the fourth quarter of 2015 compared to \$84 thousand in the fourth quarter of 2014. The increase was driven by the favorable impact of \$3.0 million in Federal and New York State historic tax credits realized in the fourth quarter of 2014, as discussed above. As a result of the historic tax credits, the effective tax rate for the fourth quarter of 2014 was 1.0%, compared with an effective tax rate of 24.5% in the fourth quarter of 2015.

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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. (the **Parent** and together with all its subsidiaries, **we**, **our**, or **us**), is a financial holding company headquartered in New York State. We offer a broad array of deposit, lending, and other financial services to individuals, municipalities and businesses in Western and Central New York through our wholly-owned New York chartered banking subsidiary, Five Star Bank (the **Bank**). Our indirect lending network includes relationships with franchised automobile dealers in Western and Central New York, the Capital District of New York and Northern and Central Pennsylvania. We also offer insurance services through our wholly-owned insurance subsidiary, Scott Danahy Naylor, LLC ( **SDN** ), a full service insurance agency.

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

**EXECUTIVE OVERVIEW**

**Industry Overview**

By law, the Federal Reserve establishes monetary policy to achieve maximum employment, stable prices, and moderate long-term interest rates. Information indicates that economic activity is expanding at a moderate pace. Labor market conditions have improved and a range of labor market indicators suggests that underutilization of labor resources is gradually diminishing. At the same time, the Federal Open Market Committee ( **FOMC** ) determined that the likelihood of inflation running persistently below 2% has diminished somewhat since early in 2014 and survey-based measures of longer-term inflation expectations have remained stable.

On December 16, 2015, the FOMC raised the federal funds rate by 25 basis points, the first rate hike in over nine years. By the time this rate hike was announced, the market had already priced in much of the impact and we experienced higher borrowing costs in the fourth quarter of 2015 leading up to the Federal Reserve's anticipated action. The FOMC's decision was based on their view of the considerable improvement in labor market conditions in 2015 and an expectation that inflation will rise, over the medium term, to its 2% objective. In December, the FOMC indicated that it expects that economic conditions will warrant only gradual increases in the federal funds rate;



however, they also noted that inflation expectations still remain somewhat uncertain and the actual path of the federal funds rate will depend on the economic outlook as informed by incoming data.

The banking industry continues to be impacted by new legislative and regulatory reform proposals. Basel III became effective for non-advanced approaches banks, such as us, in 2015. Basel III raised both the quality and quantity requirements for regulatory capital. Overall, the total regulatory capital ratio for the industry fell in the first quarter of 2015.

The national unemployment rate decreased from 5.6% in December 2014 to 5.0% at December 2015. The unemployment rate has steadily decreased during 2015 and is at the lowest level since April 2008. The unemployment rate has now fallen below the maximum target level set by the FOMC, which supported the increase in the federal funds rate in December 2015.

Bank failures continued to slow, with six in 2015 (through September) following 18 in 2014, the lowest levels since 2007. From 2008 to 2014, 507 banks failed and went into receivership with the FDIC, causing estimated losses of \$74.01 billion to the Depository Insurance Fund. This compares to only 10 bank failures in the years from 2003 to 2007. The FDIC's problem list stood at 203 at September 30, 2015, down from a peak of 884 at the end of 2010.

In the third quarter of 2015, FDIC-insured banks reported industry revenue that was largely unchanged from the prior year. Earnings for the third quarter of 2015 were higher than the prior year quarter, driven primarily by a decrease in noninterest expense. The net interest margin for the industry remains near a historic low at 3.08% for the third quarter of 2015, a decline of 7 basis points from the prior-year quarter. A 30-year low on the net interest margin was set in the first quarter of 2015 at 3.02%. Industry-wide, provision for loan losses continued to trend upward with a five-quarter consecutive increase. Through September 2015, all FDIC-insured institutions reported a return on average assets of 1.05%, a return on average equity of 9.33%, a net charge-off ratio of 0.42% and an efficiency ratio of 60.0%.

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**MANAGEMENT'S DISCUSSION AND ANALYSIS**

**Issuance of Subordinated Notes**

In April 2015, the Parent issued \$40.0 million of 6.0% fixed to floating rate subordinated notes due April 15, 2030 (the Subordinated Notes) to certain accredited investors. The Subordinated Notes bear interest at a fixed rate of 6.0% per year, payable semi-annually, for the first 10 years. From April 15, 2025 to April 15, 2030, the interest rate will reset quarterly to an annual interest rate equal to the then current three-month London Interbank Offered Rate (LIBOR) plus 3.944%, payable quarterly. We may redeem the Subordinated Notes on any quarterly interest payment date beginning on April 15, 2025 to maturity at par, plus accrued and unpaid interest. We used the net proceeds from this offering for general corporate purposes, including but not limited to, contribution of capital to the Bank to support both organic growth as well as opportunistic acquisitions. The Parent contributed \$34.0 million of net proceeds from this offering to the Bank as capital to support general corporate purposes. The Subordinated Notes qualify as Tier 2 capital for regulatory purposes.

**2015 Financial Performance Review**

During 2015 we continued to execute on our growth and diversification strategy and saw progress in our core banking franchise with robust growth in both loans and deposits. We also continued to integrate the SDN insurance platform into our sales process and, during the fourth quarter, announced our agreement to purchase Courier Capital Corporation as our wealth management platform, which closed at the beginning of 2016.

Net income for 2015 was \$28.3 million, compared to \$29.4 million for 2014. This resulted in a 0.87% return on average assets and a 9.78% return on average equity. Net income available to common shareholders was \$26.9 million or \$1.90 per diluted share for 2015, compared to \$27.9 million or \$2.00 per diluted share for 2014. We declared cash dividends of \$0.80 during 2015, an increase of \$0.03 per common share or 4% compared to the prior year.

Fully-taxable equivalent net interest income was \$98.4 million in 2015, an increase of \$1.8 million, or 2%, compared with 2014. This reflected the impact of 9% growth in average interest-earning assets, offset by a 22 basis point decline in the net interest margin to 3.28%.

During the fourth quarter of 2015, we recognized a non-cash goodwill impairment charge of \$751 thousand and a non-cash fair value adjustment of the contingent consideration liability that resulted in noninterest income of \$1.1 million related to the SDN acquisition. The fair value of the consideration was recorded at the time of the SDN acquisition and was included in goodwill as a component of the purchase price.

Noninterest income totaled \$30.3 million for the full year 2015, an increase of \$5.0 million or 20% when compared to the prior year. Insurance income increased by \$2.8 million to \$5.2 million during the current year as 2015 reflects the benefit of a full year of revenue associated with the 2014 SDN acquisition. 2015 noninterest income reflects the \$1.1 million gain due to the reduction in the estimate of the fair value of the contingent consideration liability recorded for SDN as previously mentioned. Also included in noninterest income is the amortization of a historic tax investment in a community-based project which reduced noninterest income by \$390 thousand and \$2.3 million for the years ended December 31, 2015 and 2014, respectively. These types of investments are amortized in the first year the project is placed in service and we recognized the amortization as contra-income, included in noninterest income, with an offsetting tax benefit that reduced income tax expense. Adding to these increases was a \$1.2 million decline in service charges on deposits, due primarily to lower overdraft fees stemming from reduced activity.

Noninterest expense for the full year 2015 totaled \$79.4 million, a \$7.0 million increase compared to \$72.4 million in the prior year. Salaries and benefits expense increased \$3.8 million year-over-year, reflecting the full year impact of the addition of employees from SDN and increased staffing associated with the our expansion initiatives. A higher occupancy and equipment expense, computer and data processing expense, the previously mentioned goodwill impairment charge and other noninterest expense contributed to the increase.

Income tax expense for the year was \$10.5 million, representing an effective tax rate of 27.1% compared with an effective tax rate of 24.7% in 2014. The lower effective tax rate in 2014 reflects the historic tax credit benefit described above.

Non-performing loans decreased \$1.7 million compared to a year ago to \$8.4 million, or 0.41% of total loans. The provision for loan losses decreased \$408 thousand, or 5%, from 2014 as we continue to maintain the allowance for loan losses consistent with the growth in our loan portfolio and improving trends in asset quality. Net charge-offs increased \$1.0 million from the prior year to \$7.9 million in 2015. Net charge-offs were an annualized 0.40% of average loans in the current year compared to 0.37% in 2014.

The Company's leverage ratio was 7.41% at December 31, 2015 compared to 7.35% at December 31, 2014. The increase in the leverage ratio was due to higher regulatory capital, which excludes changes in accumulated other comprehensive income. During the second quarter of 2015, the Parent contributed \$34.0 million of net proceeds from the Subordinated Notes offering to the Bank as additional paid-in capital. The Bank's leverage ratio and total risk-based capital ratio were 8.09% and 12.66%, respectively, at December 31, 2015.

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**MANAGEMENT'S DISCUSSION AND ANALYSIS**

**2016 Outlook**

We begin 2016 in a strong financial condition and with positive momentum. Net interest income is expected to increase in 2016. We anticipate an increase in earning assets as we remain focused on loan growth, which will be primarily funded through deposit gathering. However, those benefits to net interest income are expected to be partially offset by slight 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 and flattening of the yield curve, while the opportunity for deposit repricing remains limited.

We expect our commercial loan portfolio to grow in a manner consistent with our strategic initiatives and continued support of middle market small business lending. Automobile loan originations remain strong, reflecting the positive impact from our investment in automotive dealer relationships. The residential real estate portfolio, which includes both first and junior lien residential real estate related products, is expected to increase as we remain focused on the customer experience and our convenient application process.

We anticipate the increase in total loans will modestly outpace growth in total deposits. This anticipated outcome reflects our continued focus on targeting loyal relationship-based deposit customers rather than those that are more price sensitive. We expect to continue managing the overall cost of funds using short-term borrowings, as well as our continued shift in mix of deposits towards low- and no-cost demand deposits and money market deposit accounts.

Noninterest income during 2016 is expected to be higher than 2015, reflecting our continued efforts to increase both account and transaction-based fee income, coupled with the benefit of revenue from our fee-based subsidiaries, SDN and Courier Capital. We anticipate this will further reduce our reliance on traditional spread-based net interest income, as fee-based activities are a relatively stable revenue source during periods of changing interest rates.

Noninterest expense is expected to be higher with the addition of Courier Capital, coupled with higher salaries and benefits costs associated with our expansion initiatives, namely the opening of our second financial solution center in Rochester, New York; otherwise, we remain committed to diligent expense control during 2016.

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

The effective tax rate for 2016 is expected to be slightly higher than 2015, as the lower effective tax rate in 2015 was partly driven by historic tax credits claimed in 2015. However, our 2016 effective tax rate will continue to reflect the positive impacts of tax-exempt income, tax advantaged investments, the formation of our real estate investment trust in early 2014 and benefits from New York State tax law changes that began going into effect during 2015.

***RESULTS OF OPERATIONS FOR THE YEARS ENDED***

***DECEMBER 31, 2015 AND DECEMBER 31, 2014***

**Net Interest Income and Net Interest Margin**

Net interest income is our primary source of revenue. Net interest income is the difference between interest income on interest-earning assets, such as loans and investment securities, and the interest expense on interest-bearing deposits

and other borrowings used to fund interest-earning and other assets or activities. Net interest income is affected by changes in interest rates and by the amount and composition of earning assets and interest-bearing liabilities, as well as the sensitivity of the balance sheet to changes in interest rates, including characteristics such as the fixed or variable nature of the financial instruments, contractual maturities and repricing frequencies.

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

The Federal Reserve influences the general market rates of interest, including the deposit and loan rates offered by many financial institutions. Our loan portfolio is significantly affected by changes in the prime interest rate. The prime interest rate, which is the rate offered on loans to borrowers with strong credit, increased to 3.50% in December 2015 after remaining at 3.25% since 2008. At about the same time, the intended federal funds rate, which is the cost of immediately available overnight funds, increased to a range of 0.25% to 0.50% after remaining at zero to 0.25% since 2008.

Table of Contents**MANAGEMENT'S DISCUSSION AND ANALYSIS****Net Interest Income and Net Interest Margin**

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

	<b>2015</b>	<b>2014</b>	<b>2013</b>
Interest income per consolidated statements of income	\$ 105,450	\$ 101,055	\$ 98,931
Adjustment to fully taxable equivalent basis	3,097	2,853	2,650
Interest income adjusted to a fully taxable equivalent basis	108,547	103,908	101,581
Interest expense per consolidated statements of income	10,137	7,281	7,337
Net interest income on a taxable equivalent basis	\$ 98,410	\$ 96,627	\$ 94,244

During the second quarter of 2015, we used the proceeds of short-term Federal Home Loan Bank ( FHLB ) advances to purchase high-quality investment securities of approximately \$50 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.

Net interest income on a taxable equivalent basis for 2015 increased \$1.8 million or 2%, compared to 2014. The increase was due to an increase in average interest-earning assets of \$241.4 million or 9% compared to 2014. The net interest margin was 3.28% for 2015 declined compared to 3.50% in 2014. This decrease was a function of a 23 basis point decrease in interest rate spread to 3.19% during 2015, partially offset by a 1 basis point higher contribution from net free funds. The lower interest rate spread was a net result of a 14 basis point decrease in the yield on earning assets and a 9 basis point increase in the cost of interest-bearing liabilities.

For the year ended December 31, 2015, the yield on average earning assets of 3.62% was 14 basis points lower than 2014. Loan yields decreased 17 basis points during 2015 to 4.21%. Commercial mortgage loan yields in particular, down 31 basis points, experienced lower yields because of competitive pricing pressures in a low interest rate environment. The yield on investment securities increased 2 basis points during 2015 to 2.46%. Overall, the earning asset rate changes reduced interest income by \$2.9 million during 2015, but that was more than offset by a favorable volume variance that increased interest income by \$7.5 million, which collectively drove a \$4.6 million increase in interest income.

Average interest-earning assets were \$3.00 billion for 2015, an increase of \$241.4 million or 9% from the prior year, with average loans up \$104.9 million and average securities up \$136.5 million. Average loans were \$1.99 billion for 2015, an increase of \$104.9 million or 6% from the prior year. The growth in average loans reflected increases in most loan categories, with commercial and consumer loans up \$65.1 million and \$49.4 million, respectively, partially offset by a \$9.6 million decrease in residential mortgage loans. Loans made up 66.2% of average interest-earning assets during 2015 compared to 68.2% during 2014. Loans generally have significantly higher yields compared to securities and federal funds sold and interest-bearing deposits and, as such, have a more positive effect on the net interest margin. The yield on average loans was 4.21% for 2015, a decrease of 17 basis points compared to 4.38% for

2014. The yield on average loans was negatively impacted by lower average spreads due to increased competition in loan pricing during 2015 compared to 2014. The increase in the volume of average loans resulted in a \$4.3 million increase in interest income, partially offset by a \$3.2 million decrease due to the unfavorable rate variance. Average securities were \$1.01 billion for 2015, an increase of \$136.5 million or 16% from the prior year. The growth in average securities was primarily a result of securities purchased with proceeds from our previously described leverage strategy and issuance of the Subordinated Notes. Securities made up 33.8% of average interest-earning assets in 2015 compared to 31.8% in 2014. The yield on average securities was 2.46% in 2015 compared to 2.44% in 2014. The increase in the volume of average securities resulted in a \$3.2 million increase in interest income, coupled with a \$268 thousand increase due to the favorable rate variance.

For the year ended December 31, 2015, the cost of average interest-bearing liabilities of 0.43% was 9 basis points higher than 2014. The cost of average interest-bearing deposits increased 2 basis points to 0.35% and the cost of short-term borrowings increased 4 basis points to 0.41% in 2015 compared to 2014. The cost of long-term borrowings for 2015 was 6.28% due to the issuance of the Subordinated Notes in April. Overall, interest-bearing liability rate and volume increases resulted in \$2.9 million of higher interest expense.

Average interest-bearing liabilities of \$2.36 billion in 2015 were \$198.8 million or 9% higher than 2014. On average, interest-bearing deposits grew \$156.4 million, while noninterest-bearing demand deposits (a principal component of net free funds) were up \$53.4 million. The increase in average deposits was due in part to successful business development efforts and an increase in deposits from our Certificate of Deposit Account Registry Service ( CDARS ) and Insured Cash Sweep ( ICS ) programs. For further discussion of the CDARS and ICS programs, refer to the Funding Activities - Deposits section of this Management's Discussion and Analysis. Overall, interest-bearing deposit rate and volume changes resulted in \$940 thousand of higher interest expense during 2015. Average short-term and long-term borrowings were \$290.4 million in 2015, \$42.4 million higher than in 2014, with the majority of the increase related to the issuance of the previously mentioned Subordinated Notes. Overall, short and long-term borrowing rate and volume changes resulted in \$1.9 million of higher interest expense during 2015.

Table of Contents**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,								
	2015			2014			2013		
	Average Balance	Interest	Average Rate	Average Balance	Interest	Average Rate	Average Balance	Interest	Average Rate
<b>Interest-earning assets:</b>									
Federal funds sold and other interest-earning deposits	\$ 37	\$ -	0.40%	\$ 114	\$ -	0.14%	\$ 191	\$ -	0.19%
<b>Investment securities:</b>									
Taxable	727,564	16,123	2.22	617,738	13,304	2.15	601,146	12,541	2.09
Tax-exempt	286,607	8,849	3.09	259,935	8,151	3.14	233,067	7,572	3.25
Total investment securities	1,014,171	24,972	2.46	877,673	21,455	2.44	834,213	20,113	2.41
<b>Loans:</b>									
Commercial business	286,019	11,774	4.12	269,877	11,471	4.25	256,236	11,311	4.41
Commercial mortgage	522,328	24,136	4.62	473,372	23,345	4.93	438,821	21,878	4.99
Residential mortgage	97,651	4,460	4.57	107,254	5,122	4.78	123,277	6,174	5.01
Home equity	396,906	15,262	3.85	359,511	14,149	3.94	304,868	12,446	4.08
Consumer indirect	665,454	25,746	3.87	651,279	25,970	3.99	604,148	26,976	4.47
Other consumer	18,969	2,197	11.58	21,094	2,396	11.36	24,089	2,683	11.14
Total loans	1,987,327	83,575	4.21	1,882,387	82,453	4.38	1,751,439	81,468	4.65
<b>Total interest-earning assets</b>	<b>3,001,535</b>	<b>108,547</b>	<b>3.62</b>	<b>2,760,174</b>	<b>103,908</b>	<b>3.76</b>	<b>2,585,843</b>	<b>101,581</b>	<b>3.93</b>



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Less: Allowance for loan losses	27,599			27,455			26,000		
Other noninterest-earning assets	295,954			261,885			243,982		
Total assets	\$ 3,269,890			\$ 2,994,604			\$ 2,803,825		
<b>Interest-bearing liabilities:</b>									
Deposits:									
Interest-bearing demand	\$ 543,690	754	0.14	\$ 504,584	607	0.12	\$ 488,047	729	0.15
Savings and money market	908,614	1,166	0.13	783,784	913	0.12	727,737	978	0.13
Time deposits	616,747	5,386	0.87	624,299	4,846	0.78	621,455	4,893	0.79
Total interest-bearing deposits	2,069,051	7,306	0.35	1,912,667	6,366	0.33	1,837,239	6,600	0.36
Short-term borrowings	262,494	1,081	0.41	247,956	915	0.37	190,310	737	0.39
Long-term borrowings	27,886	1,750	6.28	-	-	-	-	-	-
Total borrowings	290,380	2,831	0.98	247,956	915	0.37	190,310	737	0.39
Total interest-bearing liabilities	2,359,431	10,137	0.43	2,160,623	7,281	0.34	2,027,549	7,337	0.36
Noninterest-bearing deposits	599,334			545,904			509,383		
Other liabilities	21,418			16,203			14,207		
Shareholders equity	289,707			271,874			252,686		
Total liabilities and shareholders equity	\$ 3,269,890			\$ 2,994,604			\$ 2,803,825		
Net interest income (tax-equivalent)		\$ 98,410			\$ 96,627			\$ 94,244	
Interest rate spread			3.19%			3.42%			3.57%
Net earning assets	\$ 642,104			\$ 599,551			\$ 558,294		
Net interest margin (tax-equivalent)			3.28%			3.50%			3.64%
	127.21%			127.75%			127.54%		

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

Table of Contents**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):

Increase (decrease) in:	Change from 2015 to 2014			Change from 2014 to 2013		
	Volume	Rate	Total	Volume	Rate	Total
<b>Interest income:</b>						
Investment securities:						
Taxable	\$ 2,424	\$ 395	\$ 2,819	\$ 351	\$ 412	\$ 763
Tax-exempt	825	(127)	698	850	(271)	579
<b>Total investment securities</b>	<b>3,249</b>	<b>268</b>	<b>3,517</b>	<b>1,201</b>	<b>141</b>	<b>1,342</b>
Loans:						
Commercial business	672	(369)	303	589	(429)	160
Commercial mortgage	2,320	(1,529)	791	1,706	(239)	1,467
Residential mortgage	(446)	(216)	(662)	(775)	(277)	(1,052)
Home equity	1,444	(331)	1,113	2,164	(461)	1,703
Consumer indirect	558	(782)	(224)	2,009	(3,015)	(1,006)
Other consumer	(245)	46	(199)	(339)	52	(287)
<b>Total loans</b>	<b>4,303</b>	<b>(3,181)</b>	<b>1,122</b>	<b>5,354</b>	<b>(4,369)</b>	<b>985</b>
<b>Total interest income</b>	<b>7,552</b>	<b>(2,913)</b>	<b>4,639</b>	<b>6,555</b>	<b>(4,228)</b>	<b>2,327</b>
<b>Interest expense:</b>						
Deposits:						
Interest-bearing demand	49	98	147	24	(146)	(122)
Savings and money market	154	99	253	71	(136)	(65)
Time deposits	(60)	600	540	22	(69)	(47)
<b>Total interest-bearing deposits</b>	<b>143</b>	<b>797</b>	<b>940</b>	<b>117</b>	<b>(351)</b>	<b>(234)</b>
Short-term borrowings	56	110	166	214	(36)	178
Long-term borrowings	875	875	1,750	-	-	-
<b>Total borrowings</b>	<b>931</b>	<b>985</b>	<b>1,916</b>	<b>214</b>	<b>(36)</b>	<b>178</b>
<b>Total interest expense</b>	<b>1,074</b>	<b>1,782</b>	<b>2,856</b>	<b>331</b>	<b>(387)</b>	<b>(56)</b>
<b>Net interest income</b>	<b>\$ 6,478</b>	<b>\$ (4,695)</b>	<b>\$ 1,783</b>	<b>\$ 6,224</b>	<b>\$ (3,841)</b>	<b>\$ 2,383</b>

**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 \$7.4 million for the year ended December 31, 2015 compared with \$7.8 million for 2014. See the Allowance for Loan Losses section of this Management's Discussion and Analysis for further discussion.

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**Table of Contents****MANAGEMENT'S DISCUSSION AND ANALYSIS****Noninterest Income**

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

	<b>2015</b>	<b>2014</b>	<b>2013</b>
Service charges on deposits	\$ 7,742	\$ 8,954	\$ 9,948
Insurance income	5,166	2,399	262
ATM and debit card	5,084	4,963	5,098
Investment advisory	2,193	2,138	2,345
Company owned life insurance	1,962	1,753	1,706
Investments in limited partnerships	895	1,103	857
Loan servicing	503	568	570
Net gain on sale of loans held for sale	249	313	117
Net gain on disposal of investment securities	1,988	2,041	1,226
Net gain (loss) on sale and disposal of other assets	27	69	(103)
Amortization of tax credit investment	(390)	(2,323)	-
Other	4,918	3,372	2,807
<b>Total noninterest income</b>	<b>\$ 30,337</b>	<b>\$ 25,350</b>	<b>\$ 24,833</b>

Service charges on deposits were \$7.7 million for 2015, a decrease of \$1.2 million or 14%, compared to 2014. The decrease was primarily due to a decrease in the amount of checking account overdraft activity.

Insurance income increased by \$2.8 million to \$5.2 million during 2015. The increase reflects the contributions from SDN, which was acquired at the beginning of August last year as part of our strategy to diversify business lines and increase noninterest income through additional fee-based services.

Company owned life insurance increased by \$209 thousand or 12% in 2015. The increase was primarily due to new policies purchased during the third and fourth quarters of 2014.

We have investments in limited partnerships, primarily small business investment companies, and account for these investments under the equity method. Income from investments in limited partnerships was \$895 thousand and \$1.1 million for the years ended December 31, 2015 and 2014, respectively. The income from these equity method investments fluctuates based on the performance of the underlying investments.

During the year ended December 31, 2015 we recognized gains of \$2.0 million from the sale of AFS securities with an amortized cost totaling \$52.3 million. The securities sold were comprised of 5 agency securities and 13 mortgage backed securities. During the year ended December 31, 2014 we recognized gains of \$2.0 million from the sale of AFS securities with an amortized cost totaling \$79.6 million. The amount and timing of our sale of investments securities is dependent on a number of factors, including our efforts to realize gains while prudently managing duration, premium and credit risk.

We recognized \$390 thousand and \$2.3 million for the years ended December 31, 2015 and 2014, respectively, of amortization of a historic tax investment in a community-based project. The amortization was included in noninterest income, recorded as contra-income, with an offsetting tax benefit that reduced income tax expense. These types of investments are, for the most part, fully amortized in the first year the project is placed in service.

Other noninterest income increased \$1.5 million for the year ended December 31, 2015, compared to 2014. Included in other noninterest income is a \$1.1 million non-cash fair value adjustment of the contingent consideration liability related to the SDN acquisition. For additional discussion related to the fair value adjustment of the contingent consideration liability see Note 2, Business Combinations, of the notes to consolidated financial statements.

**Table of Contents****MANAGEMENT'S DISCUSSION AND ANALYSIS****Noninterest Expense**

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

	<b>2015</b>	<b>2014</b>	<b>2013</b>
Salaries and employee benefits	\$ 42,439	\$ 38,595	\$ 37,828
Occupancy and equipment	13,856	12,829	12,366
Professional services	4,502	4,760	3,836
Computer and data processing	3,186	3,016	2,848
Supplies and postage	2,155	2,053	2,342
FDIC assessments	1,719	1,592	1,464
Advertising and promotions	1,120	805	896
Goodwill impairment	751	-	-
Other	9,665	8,705	7,861
Total noninterest expense	\$ 79,393	\$ 72,355	\$ 69,441

Salaries and employee benefits increased by \$3.8 million or 10% when comparing 2015 to 2014. An increase of \$3.1 million in salaries expense was primarily due to the full year impact of the addition of employees from SDN and increased staffing associated with our expansion initiatives. An increase of \$757 thousand in employee benefits was primarily due to higher expense related to our defined benefit plans and payroll-related taxes. We recognized a combined net periodic pension and post-retirement expense of \$731 thousand during 2015 compared to \$222 thousand during 2014. The number of full time equivalent employees increased to 660 at December 31, 2015 from 622 at December 31, 2014.

Occupancy and equipment increased by \$1.0 million or 8% when comparing 2015 to 2014. The increase was primarily related to higher contractual service expenses and incremental expenses from the SDN facility.

Professional services expense of \$4.5 million in 2015 decreased \$258 thousand or 5% from 2014. The prior year included additional expense for professional services associated with the acquisition of SDN.

Computer and data processing increased by \$170 thousand or 6% when comparing 2015 to 2014. We continue to see an increase in this area due to ongoing regulatory compliance and information technology projects.

Advertising and promotions expense increased by \$315 thousand when comparing 2015 to 2014. The increase is primarily attributable to additional marketing services, including branding initiatives and the opening of our new CityGate branch in Rochester, NY. We proactively market our products but vary the timing based on projected benefits and needs.

FDIC assessments increased \$127 thousand or 8% for the year ended December 31, 2015 compared to 2014. The increase in assessments is a direct result of the growth in our balance sheet.

We recognized \$751 thousand of goodwill impairment in the fourth quarter of 2015 related to the SDN acquisition. For additional discussion related to the goodwill impairment see Note 7, Goodwill and Other Intangible Assets, of the notes to consolidated financial statements.

Other noninterest expense increased \$960 thousand or 11% when comparing 2015 to 2014. The increase was largely due to higher intangible asset amortization and other incremental expenses due to the full year impact of SDN.

The efficiency ratio for the year ended December 31, 2015 was 61.58% compared with 58.59% for 2014. The efficiency ratio is calculated by dividing total noninterest expense, excluding other real estate expense and amortization and impairment of goodwill and other intangible assets, by net revenue, defined as the sum of tax-equivalent net interest income and noninterest income before net gains on investment securities, adjustments to contingent liabilities and amortizations of tax credit investment. The broadening of our financial services and accompanying increased spending has resulted in a shift in our efficiency ratio as a measure of productivity. As we begin to provide more diversified financial services our efficiency ratio is expected to be in the low 60% range. This approach will decrease our sensitivity to traditional banking revenues which are subject to interest rate changes.



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**MANAGEMENT'S DISCUSSION AND ANALYSIS**

**Income Taxes**

We recorded income tax expense of \$10.5 million for 2015, compared to \$9.6 million for 2014. Our effective tax rate was 27.1% for 2015 compared to 24.7% for 2014. 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. In addition, the lower effective tax rate in 2014 reflects the previously mentioned historic tax credit benefit.

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

***RESULTS OF OPERATIONS FOR THE YEARS ENDED***

***DECEMBER 31, 2014 AND DECEMBER 31, 2013***

**Net Interest Income and Net Interest Margin**

Net interest income was \$93.8 million in 2014, compared to \$91.6 million in 2013. The taxable equivalent adjustments of \$2.8 million and \$2.6 million for 2014 and 2013, respectively, resulted in fully taxable equivalent net interest income of \$96.6 million in 2014 and \$94.2 million in 2013.

During the first quarter of 2014, we utilized the proceeds of short-term Federal Home Loan Bank ( FHLB ) advances to purchase investment securities of approximately \$50 million (the 2014 leverage strategy ). During the second quarter of 2014 we sold approximately \$42 million of securities purchased in the first quarter and utilized the proceeds to fund growth in our home equity portfolio. During the third quarter of 2014, we utilized the proceeds of short-term FHLB advances to purchase an additional \$25 million of investment securities. Our purchases of investment securities were comprised of high-quality 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.

Taxable-equivalent net interest income for 2014 increased \$2.4 million or 3%, compared to 2013. The increase primarily related to an increase in the average volume of interest-earning assets. The average volume of interest-earning assets for 2014 increased \$174.3 million or 7% compared to 2013. The increase in earning assets was primarily due to a \$130.9 million increase in average loans and a \$43.5 million increase in average investment securities.

The net interest margin for 2014 was 3.50% compared to 3.64% in 2013. The net interest margin during 2014 was positively impacted by an increase in the yield on average securities, which resulted from an increase in the relative proportion of higher-yielding tax-exempt municipal securities relative to lower-yielding taxable securities, combined

with a decrease in the cost of average interest-bearing liabilities. The net interest margin was negatively impacted by a decrease in the average yield on loans. These items are more fully discussed below. The yield on average interest-earning assets decreased 17 basis points to 3.76% during 2014 from 3.93% during 2013 while the cost of average interest-bearing liabilities decreased 2 basis points from 0.36% during 2013 to 0.34% during 2014. The yield on average interest-earning assets is primarily impacted by changes in market interest rates as well as changes in the volume and relative mix of interest-earning assets. As stated above, market interest rates have remained at historically low levels during the reported periods.

The average balance of securities increased \$43.5 million or 5% in 2014, compared to 2013. Securities made up 31.8% of average interest-earning assets in 2014 compared to 32.3% in 2013. The yield on average securities was 2.44% in 2014 compared to 2.41% in 2013. The yield on average securities increased 3 basis points during 2014 compared to 2013 as we increased the relative proportion of investments held in higher-yielding, tax-exempt municipal securities. The relative proportion of higher-yielding, tax-exempt municipal securities to total average securities totaled 29.6% in 2014 compared to 27.9% in 2013. The yield on average taxable securities was 2.15% in 2014 compared to 2.09% in 2013, while the taxable-equivalent yield on average tax-exempt securities was 3.14% in 2014 compared to 3.25% in 2013.

The average volume of loans increased \$130.9 million or 7% in 2014, compared to 2013. Loans made up 68.2% of average interest-earning assets during 2014 compared to 67.7% during 2013. Loans generally have significantly higher yields compared to securities and federal funds sold and interest-bearing deposits and, as such, have a more positive effect on the net interest margin. The yield on average loans was 4.38% during 2014 compared to 4.65% during 2013. The yield on average loans decreased 27 basis points during 2014 compared to 2013. The yield on average loans was negatively impacted by lower average spreads due to increased competition in loan pricing during 2014 compared to 2013.

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**MANAGEMENT'S DISCUSSION AND ANALYSIS**

Average deposits increased \$111.9 million or 5% in 2014, compared to 2013. Average interest-bearing deposits increased \$75.4 million in 2014 compared to 2013, while average non-interest-bearing deposits increased \$36.5 million in 2014 compared to 2013. The ratio of average interest-bearing deposits to total average deposits was 77.8% in 2014 compared to 78.3% in 2013. The cost of average interest-bearing deposits was 0.33% in 2014 compared to 0.36% in 2013. The decrease in the average cost of interest-bearing deposits during the comparable periods was primarily the result of decreases in interest rates offered on certain deposit products due to the low interest rate environment. Additionally, the relative proportion of higher-cost time deposits to total average interest-bearing deposits decreased to 32.6% in 2014 from 33.8% in 2013.

**Provision for Loan Losses**

The provision for loan losses was \$7.8 million for the year ended December 31, 2014 compared with \$9.1 million for 2013.

**Noninterest Income**

Service charges on deposits were \$9.0 million for 2014, a decrease of \$1.0 million or 10%, compared to 2013. Service charges on deposit accounts for 2013 reflected a retail checking account repositioning that involved simplifying the suite of products offered to customers and modifications to the fee structure for our accounts.

ATM and debit card income for 2014 decreased \$135 thousand or 3% compared to 2013. The decrease is primarily attributable to lower transaction volumes due to card reissuances associated with third-party security breaches.

Insurance income of \$2.4 million for 2014 was up \$2.1 million from 2013, reflecting 5 months of income from the SDN acquisition.

Investment advisory income was \$2.1 million for 2014, down \$207 thousand or 9%, compared to 2013, as fees and commissions fluctuate with sales volume. Sales volume during 2014 was negatively impacted by a longer-than-anticipated conversion to a new clearing platform that began in late 2013.

Income from investments in limited partnerships was \$1.1 million and \$857 thousand for the years ended December 31, 2014 and 2013, respectively.

Gains from the sale of loans held for sale increased \$196 thousand in 2014 compared to 2013. The increase was primarily due to higher margins due to the timing of sales and fluctuation of interest rates during the year.

During the year ended December 31, 2014 we recognized gains of \$2.0 million from the sale of AFS securities with an amortized cost totaling \$79.6 million. The securities sold were comprised of one pooled trust preferred security, three mortgage backed securities and 20 agency securities. During 2013, we recognized gains totaling \$1.2 million from the sale of four pooled trust-preferred securities.

During the fourth quarter of 2014 we recorded \$2.3 million for the amortization, recognized as contra-income, of a historic tax investment in a community-based project.

Other noninterest income increased \$565 thousand or 20% for the year ended December 31, 2014, compared to 2013. Merchant services income, dividends on FHLB stock and credit card correspondent income comprised the majority of the year-over-year increases.

### **Noninterest Expense**

Salaries and employee benefits increased by \$767 thousand or 2% when comparing 2014 to 2013. An increase of \$1.5 million in salaries expense was primarily due to the acquisition of SDN and the hiring of additional loan officers, partially offset by a decrease in severance expense. A decrease of \$765 thousand in employee benefits was primarily due to lower expense related to our defined benefit retirement plan, partially offset by higher medical expenses. We recognized a combined net periodic pension and post-retirement expense of \$222 thousand during 2014 compared to \$1.7 million during 2013. The number of full time equivalent employees increased to 622 at December 31, 2014 from 608 at December 31, 2013.

Occupancy and equipment increased by \$463 thousand or 4% when comparing 2014 to 2013. The increase was primarily related to higher contractual service expenses and incremental expenses from the SDN facility.

Professional services expense of \$4.8 million in 2014 increased \$924 thousand or 24% from 2013. The increases were largely due to professional services associated with the acquisition of SDN, the hiring of additional loan officers and related personnel as part of our expansion initiatives and other special projects.

Computer and data processing increased by \$168 thousand or 6% when comparing 2014 to 2013. During late 2013, we ceased operations of our broker-dealer subsidiary and transferred the existing business to an outsourced clearing platform, resulting in higher third-party processing expense.

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**MANAGEMENT'S DISCUSSION AND ANALYSIS**

Supplies and postage and advertising and promotions expense decreased, collectively, by \$380 thousand when comparing 2014 to 2013. The prior year amounts included expenses for additional print materials related to our retail checking account repositioning incurred during the first quarter of 2013.

FDIC assessments increased \$128 thousand or 9% for the year ended December 31, 2014, compared to 2013. The increase in assessments is a direct result of the growth in our balance sheet.

Other noninterest expense increased \$844 thousand or 11% when comparing 2014 to 2013. The increase was largely due to higher intangible asset amortization due to the SDN acquisition, combined with an increase in electronic banking activities and deposit expenses.

The efficiency ratio for the year ended December 31, 2014 was 58.59% compared with 58.48% for 2013.

**Income Taxes**

We recorded income tax expense of \$9.6 million for 2014, compared to of \$12.4 million for 2013. Our effective tax rate was 24.7% for 2014 compared to 32.7% for 2013. The lower effective tax rate in 2014 reflects the historic tax credit benefit described above combined with New York State tax savings generated by our real estate investment trust, which became effective during February 2014 and is discussed below.

During February 2014, the Bank formed a wholly-owned subsidiary, Five Star REIT, Inc. (the REIT), to acquire a portion of the Bank's assets, which were primarily qualifying mortgage related loans. The Bank made an initial contribution of mortgage related loans to the REIT in return for common stock of the REIT. The REIT has and expects to continue purchasing mortgage related loans from the Bank on a periodic basis going forward. The REIT entered into service agreements with the Bank for administrative and investment services. The formation of the REIT reduced 2014 tax expense by approximately \$950 thousand.

**Table of Contents****MANAGEMENT'S DISCUSSION AND ANALYSIS****ANALYSIS OF FINANCIAL CONDITION****OVERVIEW**

At December 31, 2015, we had total assets of \$3.38 billion, an increase of 9% from \$3.09 billion as of December 31, 2014, largely attributable to our continued loan growth and higher investment security balances. Net loans were \$2.06 billion as of December 31, 2015, up \$172.3 million or 9%, when compared to \$1.88 billion as of December 31, 2014. The increase in net loans was primarily attributable to organic growth in the commercial portfolio. Non-performing assets totaled \$8.6 million as of December 31, 2015, down \$1.7 million from a year ago. Total deposits amounted to \$2.73 billion as of December 31, 2015, up \$280.0 million or 11%, compared to December 31, 2014. As of December 31, 2015, borrowed funds totaled \$332.1 million, compared to \$334.8 million as of December 31, 2014. Common book value per common share was \$19.49 and \$18.57 as of December 31, 2015 and 2014, respectively. As of December 31, 2015 our total shareholders' equity was \$293.8 million compared to \$279.5 million a year earlier.

**INVESTING ACTIVITIES**

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

	<b>Investment Securities Portfolio Composition</b>					
	<b>2015</b>		<b>2014</b>		<b>2013</b>	
	<b>Amortized Cost</b>	<b>Fair Value</b>	<b>Amortized Cost</b>	<b>Fair Value</b>	<b>Amortized Cost</b>	<b>Fair Value</b>
<b>Securities available for sale:</b>						
U.S. Government agency and government-sponsored enterprise securities	\$ 260,748	\$ 260,863	\$ 160,334	\$ 160,475	\$ 135,840	\$ 134,452
<b>Mortgage-backed securities:</b>						
Agency mortgage-backed securities	282,873	282,505	458,959	460,570	482,308	473,082
Non-Agency mortgage-backed securities	-	809	-	1,218	-	1,467
Asset-backed securities	-	218	-	231	18	399
<b>Total available for sale securities</b>	<b>543,621</b>	<b>544,395</b>	<b>619,293</b>	<b>622,494</b>	<b>618,166</b>	<b>609,400</b>

**Securities held to maturity:**

State and political subdivisions	294,423	300,981	277,273	281,384	249,785	250,657
Mortgage-backed securities	191,294	189,083	17,165	17,311	-	-
<b>Total held to maturity securities</b>	<b>485,717</b>	<b>490,064</b>	<b>294,438</b>	<b>298,695</b>	<b>249,785</b>	<b>250,657</b>
Total investment securities	\$ 1,029,338	\$ 1,034,459	\$ 913,731	\$ 921,189	\$ 867,951	\$ 860,057

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 years ended December 31, 2015 and 2014, we transferred \$165.2 million and \$12.8 million, respectively, of available for sale ( AFS ) mortgage backed securities to the held to maturity ( HTM ) category, reflecting our intent to hold those securities to maturity. Transfers of investment securities into the held to maturity category from the available for sale category are made at fair value at the date of transfer. The related \$1.1 million and \$51 thousand of unrealized holding losses that were included in the transfers during the years ended December 31, 2015 and 2014, respectively, are retained in accumulated other comprehensive income and in the carrying value of the held to maturity securities. These amounts will be amortized as an adjustment to interest income over the remaining life of the securities. This will offset the impact of amortization of the net premium created in the transfers. There were no gains or losses recognized as a result of this transfer.

Our AFS investment securities portfolio decreased \$78.1 million to \$544.4 million at December 31, 2015 from \$622.5 million at December 31, 2014. The decrease was due to the transfer of securities from the AFS portfolio to the HTM portfolio described above. Our AFS portfolio had a net unrealized gain totaling \$774 thousand at December 31, 2015 compared to a net unrealized gain of \$3.2 million at December 31, 2014. The fair value of most of the investment securities in the AFS portfolio fluctuates as market interest rates change. The transfers of securities from AFS to HTM are expected to reduce the fair value fluctuations in the available for sale portfolio.

During the year ended December 31, 2015, we recognized gains of \$2.0 million from the sale of AFS securities with an amortized cost totaling \$52.3 million. The securities sold were comprised of 5 agency securities and 13 mortgage backed securities.

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**Table of Contents****MANAGEMENT'S DISCUSSION AND ANALYSIS****Impairment Assessment**

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

As of December 31, 2015, we do not have the intent to sell any of our securities in a loss position and we believe that it is not likely that we will be required to sell any such securities before the anticipated recovery of amortized cost. The unrealized losses are largely due to increases in market interest rates over the yields available at the time the underlying securities were purchased. The fair value is expected to recover as the bonds approach their maturity date, repricing date or if market yields for such investments decline. We do not believe any of the securities in a loss position are impaired due to reasons of credit quality. Accordingly, as of December 31, 2015, we concluded that unrealized losses on our investment securities are temporary and no further impairment loss has been realized in our consolidated statements of income. The following discussion provides further details of our assessment of the securities portfolio by investment category.

**U.S. Government Agencies and Government Sponsored Enterprises ( GSE ).** As of December 31, 2015, there were 29 securities in an unrealized loss position in the U.S. Government agencies and GSE portfolio with unrealized losses totaling \$1.0 million. Of these, 6 were in an unrealized loss position for 12 months or longer and had an aggregate fair value of \$26.3 million and unrealized losses of \$314 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, 2015.

**State and Political Subdivisions.** As of December 31, 2015, the state and political subdivisions ( municipal securities ) portfolio totaled \$294.4 million, all of which was classified as HTM. As of that date, each of the 7 municipal securities 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 \$3.1 million and unrealized losses totaling \$4 thousand.

The decline in fair value is attributable to changes in interest rates, and not credit quality, and because we do not have the intent to sell these securities and it is not likely that we will be required to sell the securities before their anticipated recovery, we do not consider these securities to be other-than-temporarily impaired at December 31, 2015.



**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, 2015, were issued by U.S. Government sponsored entities and agencies ( Agency MBS ), primarily FNMA and FHLMC. The contractual cash flows of our Agency MBS are guaranteed by FNMA, FHLMC or GNMA. The GNMA mortgage-backed securities are backed by the full faith and credit of the U.S. Government.

As of December 31, 2015, there were 52 securities in the AFS Agency MBS portfolio that were in an unrealized loss position. Of these, 4 were in an unrealized loss position for 12 months or longer and had an aggregate fair value of \$9.6 million and unrealized losses of \$199 thousand. As of December 31, 2015, each of the 64 securities in the HTM Agency MBS portfolio that were 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 \$164.3 million and unrealized losses totaling \$2.3 million.

Given the high credit quality inherent in Agency MBS, we do not consider any of the unrealized losses as of December 31, 2015 on such MBS to be credit related or other-than-temporary. As of December 31, 2015, we did not intend to sell any Agency MBS that were in an unrealized loss position, all of which were performing in accordance with their terms.

**Non-Agency Mortgage-backed Securities.** Our non-Agency MBS portfolio consists of positions in two privately issued whole loan collateralized mortgage obligations with a fair value and net unrealized gains of \$809 thousand as of December 31, 2015. 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.

**Asset-backed Securities ( ABS ).** Our ABS portfolio consisted of one security with a fair value and unrealized gain of \$218 thousand as of December 31, 2015. As of December 31, 2015, the ABS security was rated below investment grade.

**Table of Contents****MANAGEMENT'S DISCUSSION AND ANALYSIS**

**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, 2015, our ownership of FHLB and FRB stock totaled \$15.1 million and \$4.9 million, respectively and is included in other assets and recorded at cost, which approximates fair value.

**LENDING ACTIVITIES**

Total loans were \$2.08 billion at December 31, 2015, an increase of \$171.8 million or 9% from December 31, 2014. Commercial loans increased \$7.5 million and represented 38.9% of total loans at the end of 2014. Residential mortgage loans were \$100.1 million, down \$12.9 million or 11% and represented 5.2% of total loans at December 31, 2014, while consumer loans increased \$83.9 million to represent 55.9% of total loans at December 31, 2014. 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):

	<b>Loan Portfolio Composition</b>									
	<b>At December 31,</b>									
	<b>2015</b>		<b>2014</b>		<b>2013</b>		<b>2012</b>		<b>2011</b>	
	<b>Amount</b>	<b>Percent</b>	<b>Amount</b>	<b>Percent</b>	<b>Amount</b>	<b>Percent</b>	<b>Amount</b>	<b>Percent</b>	<b>Amount</b>	<b>Percent</b>
Commercial business	\$ 313,758	15.0%	\$ 267,409	14.0%	\$ 265,766	14.5%	\$ 258,675	15.2%	\$ 233,836	15.0%
Commercial mortgage	566,101	27.2	475,092	24.9	469,284	25.6	413,324	24.2	393,244	24.2
Commercial	879,859	42.2	742,501	38.9	735,050	40.1	671,999	39.4	627,080	39.4
Residential mortgage	98,309	4.7	100,101	5.2	113,045	6.2	133,520	7.8	113,911	7.8
Equity	410,112	19.7	386,615	20.2	326,086	17.8	286,649	16.8	231,766	16.8
Other indirect	676,940	32.5	661,673	34.6	636,368	34.7	586,794	34.4	487,713	34.4
Consumer	18,542	0.9	21,112	1.1	23,070	1.2	26,764	1.6	24,306	1.6
Consumer	1,105,594	53.1	1,069,400	55.9	985,524	53.7	900,207	52.8	743,785	52.8
Loans	2,083,762	100.0%	1,912,002	100.0%	1,833,619	100.0%	1,705,726	100.0%	1,484,776	100.0%
Provision for loan	27,085		27,637		26,736		24,714		23,260	
Loans, net	\$ 2,056,677		\$ 1,884,365		\$ 1,806,883		\$ 1,681,012		\$ 1,461,516	

Commercial loans increased during 2015 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, 2015, the principal balance of such loans (included in commercial loans) was \$54.3 million and the guaranteed portion amounted to \$35.9 million. Most of these loans were guaranteed by the SBA.

Commercial business loans were \$313.8 million at the end of 2015, up \$46.3 million or 17% since the end of 2014, and comprised 15.0% of total loans outstanding at December 31, 2015, compared to 14.0% at December 31, 2014. 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 7% of commercial business loans as of December 31, 2015. As of December 31, 2015, commercial business SBA loans accounted for a total of \$35.4 million or 11% of our commercial business loan portfolio.

Commercial mortgage loans totaled \$566.1 million at December 31, 2015, up \$91.0 million or 19% from December 31, 2014, and comprised 27.2% of total loans, compared to 24.9% at December 31, 2014. Commercial mortgage loans include both owner occupied and non-owner occupied commercial real estate loans. Approximately 41% and 45% of our commercial mortgage portfolio at December 31, 2015 and 2014, 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, 2015, commercial mortgage SBA loans accounted for a total of \$14.0 million or 2% of our commercial mortgage loan portfolio.

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

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**Table of Contents****MANAGEMENT'S DISCUSSION AND ANALYSIS**

Residential mortgage loans totaled \$98.3 million at the end of 2015, down \$1.8 million or 2% from the end of the prior year and comprised 4.7% of total loans outstanding at December 31, 2015 and 5.2% at December 31, 2014. Residential mortgage loans include conventional first lien home mortgages. We generally limit the maximum loan to 85% of collateral value without credit enhancement (e.g. personal mortgage 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.

As of December 31, 2015 and 2014, our residential mortgage portfolio included \$12.8 million and \$15.7 million, respectively, of loans acquired during the 2012 branch acquisitions and \$85.5 million and \$84.4 million of organic loans, respectively. Over the past several years we've placed less emphasis on expanding our residential mortgage loan portfolio while strategically increasing our consumer indirect and home equity loan portfolios. In addition, it has been our practice to sell the majority of our fixed-rate residential mortgages in the secondary market with servicing rights retained.

Consumer loans totaled \$1.11 billion at December 31, 2015, up \$36.2 million or 3% compared to 2014, and represented 53.1% of the 2015 year-end loan portfolio versus 55.9% at year-end 2014. 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.

The home equity portfolio consists of both lines of credit and loans. Home equities amounted to \$410.1 million at December 31, 2015 up \$23.5 million or 6% compared to 2014, and represented 19.7% of the 2015 year-end loan portfolio versus 20.2% at year-end 2014. The portfolio had a weighted average LTV at origination of approximately 58% and 57% at December 31, 2015 and 2014, respectively. Approximately 82% and 80% of the loans in the home equity portfolio were first lien positions at December 31, 2015 and 2014, 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 753 and 751 during the years ended December 31, 2015 and 2014, respectively.

Consumer indirect loans amounted to \$676.9 million at December 31, 2015 up \$15.3 million or 2% compared to 2014, and represented 32.5% of the 2015 year-end loan portfolio versus 34.6% at year-end 2014. The loans are primarily for the purchase of automobiles (both new and used) and light duty trucks primarily by individuals, but also by corporations and other organizations. The loans are originated through dealerships and assigned to us with terms that typically range from 36 to 84 months. During the year ended December 31, 2015, we originated \$296.9 million in indirect loans with a mix of approximately 40% new vehicles and 60% used vehicles. This compares with \$305.6 million in indirect loans with a mix of approximately 41% new vehicles and 59% used vehicles for the same period in

2014. We do business with over 400 franchised auto dealers located in Western, Central, and the Capital District of New York, and Northern and Central Pennsylvania. The average FICO score for new indirect loan production was 728 and 722 during the years ended December 31, 2015 and 2014, respectively. Other consumer loans totaled \$18.5 million at December 31, 2015, down \$2.6 million or 12% compared to 2014, and represented less than one percent of the 2015 year-end loan portfolio versus 1.1% at year-end 2014. Other consumer loans consist of personal loans (collateralized and uncollateralized) and deposit account collateralized loans.

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.

Our loan portfolio is widely diversified by types of borrowers, industry groups, and market areas within our core footprint. Significant loan concentrations are considered to exist for a financial institution when there are amounts loaned to numerous borrowers engaged in similar activities that would cause them to be similarly impacted by economic or other conditions. At December 31, 2015, no significant concentrations, as defined above, existed in our portfolio in excess of 10% of total loans.

**Table of Contents****MANAGEMENT'S DISCUSSION AND ANALYSIS**

**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 \$1.4 million and \$755 thousand as of December 31, 2015 and 2014, 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 \$196.0 million and \$215.2 million as of December 31, 2015 and 2014, respectively.

**Allowance for Loan Losses**

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

	<b>Loan Loss Analysis</b>				
	<b>Year Ended December 31,</b>				
	<b>2015</b>	<b>2014</b>	<b>2013</b>	<b>2012</b>	<b>2011</b>
Allowance for loan losses, beginning of year	\$ 27,637	\$ 26,736	\$ 24,714	\$ 23,260	\$ 20,466
Charge-offs:					
Commercial business	1,433	204	1,070	729	1,346
Commercial mortgage	895	304	553	745	751
Residential mortgage	175	190	411	326	152
Home equity	421	340	391	305	449
Consumer indirect	9,156	10,004	8,125	6,589	4,713
Other consumer	878	972	928	874	877
<b>Total charge-offs</b>	<b>12,958</b>	<b>12,014</b>	<b>11,478</b>	<b>9,568</b>	<b>8,288</b>
Recoveries:					
Commercial business	212	201	349	336	401
Commercial mortgage	146	143	319	261	245
Residential mortgage	82	39	54	130	90
Home equity	63	56	157	44	44
Consumer indirect	4,200	4,321	3,161	2,769	2,066
Other consumer	322	366	381	354	456
<b>Total recoveries</b>	<b>5,025</b>	<b>5,126</b>	<b>4,421</b>	<b>3,894</b>	<b>3,302</b>
Net charge-offs	7,933	6,888	7,057	5,674	4,986
Provision for loan losses	7,381	7,789	9,079	7,128	7,780
Allowance for loan losses, end of year	\$ 27,085	\$ 27,637	\$ 26,736	\$ 24,714	\$ 23,260

Net charge-offs to average loans	0.40%	0.37%	0.40%	0.36%	0.36%
Allowance to end of period loans	1.30%	1.45%	1.46%	1.45%	1.57%
Allowance to end of period non-performing loans	321%	272%	161%	271%	329%

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,**

	2015		2014		2013		2012		2011	
	Percentage of loans	Loan by Loss category to Allowancetotal loans	Percentage of loans	Loan by Loss category to Allowancetotal loans	Percentage of loans	Loan by Loss category to Allowancetotal loans	Percentage of loans	Loan by Loss category to Allowancetotal loans	Percentage of loans	Loan by Loss category to Allowancetotal loans
Commercial business	\$ 5,540	15.0%	\$ 5,621	14.0%	\$ 4,273	14.5%	\$ 4,884	15.2%	\$ 4,036	15.7%
Commercial mortgage	9,027	27.2	8,122	24.9	7,743	25.6	6,581	24.2	6,418	26.5
Residential mortgage	464	4.7	570	5.2	676	6.2	740	7.8	858	7.7
Home equity	1,228	19.7	1,485	20.2	1,367	17.8	1,282	16.8	1,242	15.6
Consumer indirect	10,458	32.5	11,383	34.6	12,230	34.7	10,715	34.4	10,189	32.9
Other consumer	368	0.9	456	1.1	447	1.2	512	1.6	517	1.6
<b>Total</b>	<b>\$ 27,085</b>	<b>100.0%</b>	<b>\$ 27,637</b>	<b>100.0%</b>	<b>\$ 26,736</b>	<b>100.0%</b>	<b>\$ 24,714</b>	<b>100.0%</b>	<b>\$ 23,260</b>	<b>100.0%</b>

**Table of Contents****MANAGEMENT'S DISCUSSION AND ANALYSIS**

Management believes that the allowance for loan losses at December 31, 2015 is adequate to cover probable losses in the loan portfolio at that date. Factors beyond our control, however, such as general national and local economic conditions, can adversely impact the adequacy of the allowance for loan losses. As a result, no assurance can be given that adverse economic conditions or other circumstances will not result in increased losses in the portfolio or that the allowance for loan losses will be sufficient to meet actual loan losses. See Part I, Item 1A Risk Factors for the risks impacting this estimate. Management presents a quarterly review of the adequacy of the allowance for loan losses to the Audit Committee of our Board of Directors based on the methodology that is described in further detail in Part I, Item I Business under the section titled Lending Activities. See also Critical Accounting Estimates for 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):

	<b>Non-performing Assets</b>				
	<b>At December 31,</b>				
	<b>2015</b>	<b>2014</b>	<b>2013</b>	<b>2012</b>	<b>2011</b>
<b>Non-accruing loans:</b>					
Commercial business	\$ 3,922	\$ 4,288	\$ 3,474	\$ 3,413	\$ 1,259
Commercial mortgage	947	3,020	9,663	1,799	2,928
Residential mortgage	1,325	1,194	1,078	2,040	1,644
Home equity	758	463	925	939	682
Consumer indirect	1,467	1,169	1,471	891	558
Other consumer	13	11	5	25	-
<b>Total non-accruing loans</b>	<b>8,432</b>	<b>10,145</b>	<b>16,616</b>	<b>9,107</b>	<b>7,071</b>
Restructured accruing loans	-	-	-	-	-
Accruing loans contractually past due over 90 days	8	8	6	18	5
<b>Total non-performing loans</b>	<b>8,440</b>	<b>10,153</b>	<b>16,622</b>	<b>9,125</b>	<b>7,076</b>
Foreclosed assets	163	194	333	184	475
Non-performing investment securities	-	-	128	753	1,636
<b>Total non-performing assets</b>	<b>\$ 8,603</b>	<b>\$ 10,347</b>	<b>\$ 17,083</b>	<b>\$ 10,062</b>	<b>\$ 9,187</b>
<b>Non-performing loans to total loans</b>	<b>0.41%</b>	<b>0.53%</b>	<b>0.91%</b>	<b>0.53%</b>	<b>0.48%</b>
<b>Non-performing assets to total assets</b>	<b>0.25%</b>	<b>0.33%</b>	<b>0.58%</b>	<b>0.36%</b>	<b>0.39%</b>



Non-performing assets include non-performing loans, foreclosed assets and non-performing investment securities. Non-performing assets at December 31, 2015 were \$8.6 million, a decrease of \$1.7 million from the \$10.3 million balance at December 31, 2014. The primary component of non-performing assets is non-performing loans, which were \$8.4 million or 0.41% of total loans at December 31, 2015, a decrease of \$1.7 million from \$10.1 million or 0.53% of total loans at December 31, 2014.

Approximately \$2.0 million, or 24%, of the \$8.4 million in non-performing loans as of December 31, 2015 were current with respect to payment of principal and interest, but were classified as non-accruing because repayment in full of principal and/or interest was uncertain. The amount of interest income forgone totaled \$432 thousand and \$527 thousand for non-accruing loans outstanding as of December 31, 2015 and 2014, respectively. Included in nonaccrual loans are troubled debt restructurings ( TDRs ) of \$2.4 million and \$3.0 million at December 31, 2015 and 2014, respectively. We had no TDRs that were accruing interest as of December 31, 2015 or 2014.

Foreclosed assets consist of real property formerly pledged as collateral for loans, which we have acquired through foreclosure proceedings or acceptance of a deed in lieu of foreclosure. Foreclosed asset holdings represented four properties totaling \$163 thousand at December 31, 2015 and four properties totaling \$194 thousand at December 31, 2014.

Potential problem loans are loans that are currently performing, but information known about possible credit problems of the borrowers causes us to have concern as to the ability of such borrowers to comply with the present loan payment terms and may result in disclosure of such loans as nonperforming at some time in the future. These loans remain in a performing status due to a variety of factors, including payment history, the value of collateral supporting the credits, and/or personal or government guarantees. We consider loans classified as substandard, which continue to accrue interest, to be potential problem loans. We identified \$12.1 million and \$13.7 million in loans that continued to accrue interest which were classified as substandard as of December 31, 2015 and 2014, respectively.

**Table of Contents****MANAGEMENT'S DISCUSSION AND ANALYSIS****FUNDING ACTIVITIES****Deposits**

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

	2015		At December 31, 2014		2013	
	Amount	Percent	Amount	Percent	Amount	Percent
Noninterest-bearing demand	\$ 641,972	23.5 %	\$ 571,260	23.3 %	\$ 535,472	23.1 %
Interest-bearing demand	523,366	19.2	490,190	20.0	470,733	20.3
Savings and money market	928,175	34.0	795,835	32.5	717,928	30.9
Time deposits < \$250,000	545,044	19.9	526,782	21.5	522,417	22.5
Time deposits of \$250,000 or more	91,974	3.4	66,460	2.7	73,506	3.2
Total deposits	\$ 2,730,531	100.0 %	\$ 2,450,527	100.0 %	\$ 2,320,056	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, 2015, total deposits were \$2.73 billion, representing an increase of \$280.0 million for the year. Time deposits were approximately 23% and 24% of total deposits at December 31, 2015 and 2014, 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 \$2.05 billion and \$1.84 billion at December 31, 2015 and 2014, respectively, and represented 75% of total deposits as of the end of each period. We have managed this segment of funding through a strategy of competitive pricing that minimizes the number of customer relationships that have only a single service high cost deposit account.

As an additional source of funding, we offer a variety of public (municipal) deposit products to the towns, villages, counties and school districts within our market. Public deposits generally range from 20% to 30% of our total deposits. There is a high degree of seasonality in this component of funding, because the level of deposits varies with the seasonal cash flows for these public customers. We maintain the necessary levels of short-term liquid assets to accommodate the seasonality associated with public deposits. Total public deposits were \$675.7 million and \$607.5 million at December 31, 2015 and December 31, 2014, respectively, and represented 25% of total deposits as of the end of each period. The increase in public deposits during 2015 was due largely to successful business development efforts.

We had no traditional brokered deposits at December 31, 2015 or December 31, 2014; however, we do participate in the CDARS and ICS programs, which enable depositors to receive FDIC insurance coverage for deposits otherwise

exceeding the maximum insurable amount. CDARS and ICS deposits are considered brokered deposits for regulatory reporting purposes. Through these programs, deposits in excess of the maximum insurable amount are placed with multiple participating financial institutions. Reciprocal CDARS deposits and ICS deposits totaled \$92.9 million and \$146.6 million, respectively, at December 31, 2015, compared to \$79.7 million and \$67.1 million, respectively, at December 31, 2014.

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**Table of Contents****MANAGEMENT'S DISCUSSION AND ANALYSIS****Borrowings**

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

	2015	2014
Short-term borrowings:		
Short-term FHLB borrowings	\$ 293,100	\$ 295,300
Repurchase agreements	-	39,504
Total short-term borrowings	293,100	334,804
Long-term borrowings:		
Subordinated notes, net	38,990	-
Total borrowings	\$ 332,090	\$ 334,804

**Short-term borrowings**

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. We discontinued the customer repurchase agreement product during the second quarter of 2015 and transferred most of those customers into the ICS deposit product. 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, 2015 consisted of \$116.8 million in overnight borrowings and \$176.3 million in short-term advances. Short-term FHLB borrowings at December 31, 2014 consisted of \$129.0 million in overnight borrowings and \$166.3 million in short-term advances. The FHLB borrowings are collateralized by securities from the Company's investment portfolio and certain qualifying loans. At December 31, 2015 and 2014, the Company's borrowings had a weighted average rate of 0.53% and 0.35%, respectively.

We have credit capacity with the FHLB and can borrow through facilities that include amortizing and term advances or repurchase agreements. We had approximately \$76 million of immediate credit capacity with the FHLB as of December 31, 2015. We had approximately \$497 million in secured borrowing capacity at the Federal Reserve Bank (FRB) discount window, none of which was outstanding at December 31, 2015. The FHLB and FRB credit capacity are collateralized by securities from our investment portfolio and certain qualifying loans. We had \$120 million of credit available under unsecured federal funds purchased lines with various banks as of December 31, 2015. Additionally, we had approximately \$237 million of unencumbered liquid securities available for pledging.

The Parent has a revolving line of credit with a commercial bank allowing borrowings up to \$20.0 million in total as an additional source of working capital. At December 31, 2015, no amounts have been drawn on the line of credit.

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

	<b>At or for the Year Ended December 31,</b>		
	<b>2015</b>	<b>2014</b>	<b>2013</b>
Year-end balance	\$ 293,100	\$ 334,804	\$ 337,042
Year-end weighted average interest rate	0.53 %	0.35 %	0.38 %
Maximum outstanding at any month-end	\$ 351,600	\$ 334,804	\$ 337,042
Average balance during the year	\$ 262,494	\$ 247,956	\$ 190,310
Average interest rate for the year	0.41 %	0.37 %	0.39 %

Long-term borrowings

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

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**Table of Contents****MANAGEMENT'S DISCUSSION AND ANALYSIS****Shareholders' Equity**

Total shareholders' equity was \$293.8 million at December 31, 2015, an increase of \$14.3 million from \$279.5 million at December 31, 2014. Net income for the year increased shareholders' equity by \$28.3 million, respectively, which were partially offset by common and preferred stock dividends declared of \$12.7 million. Accumulated other comprehensive loss included in shareholders' equity increased \$2.3 million during the year due primarily to lower net unrealized gains on securities available for sale. The decrease of \$1.3 million in treasury stock during 2015 was primarily due to the issuance of restricted stock awards with an aggregate grant date fair value of \$1.1 million. 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, 2015, both FII and the Bank exceeded all regulatory requirements. For detailed information on regulatory capital requirements, see Note 11, Regulatory Matters, of the notes to consolidated financial statements.

**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.

Cash and cash equivalents were \$60.1 million as of December 31, 2015, an increase of \$1.9 million from \$58.2 million as of December 31, 2014. Net cash provided by operating activities totaled \$43.1 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 \$305.9 million, which included outflows of \$180.1 million for net loan originations and \$118.6 million from net investment securities transactions. Net cash provided by financing activities of \$264.8 million was attributed to a \$280.0 million increase in deposits and net proceeds of \$38.9 million from the Subordinated Notes issuance, partly offset by \$12.7 million in dividend payments and a \$41.7 million decrease in short-term borrowings.

**Contractual Obligations and Other Commitments**

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

	At December 31, 2015				
	Within 1 year	Over 1 to 3 years	Over 3 to 5 Years	Over 5 years	Total
<b>On-Balance sheet:</b>					
Time deposits <sup>(1)</sup>	\$ 450,885	\$ 143,604	\$ 42,482	\$ 47	\$ 637,018
Supplemental executive retirement plans	309	736	661	987	2,693
Earn-out liabilities	-	2,200	-	-	2,200
<b>Off-Balance sheet:</b>					
Limited partnership investments <sup>(2)</sup>	\$ 266	\$ 532	\$ 267	\$ -	\$ 1,065
Commitments to extend credit <sup>(3)</sup>	514,818	-	-	-	514,818
Standby letters of credit <sup>(3)</sup>	8,254	2,963	529	-	11,746
Operating leases	1,644	2,291	1,752	3,160	8,847

(1) Includes the maturity of time deposits amounting to \$250 thousand or more as follows: \$50.3 million in three months or less; \$14.9 million between three months and six months; \$18.7 million between six months and one year; and \$8.1 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 \$4.9 million as of December 31, 2015, including \$122 thousand during 2015.

(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.

**Table of Contents****MANAGEMENT'S DISCUSSION AND ANALYSIS****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, 2015, 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.

**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, 2015. Mortgage-backed securities are included in maturity categories based on their stated maturity date. Actual maturities may differ from the contractual maturities presented because borrowers may have the right to call or prepay certain investments. No tax-equivalent adjustments were made to the weighted average yields (dollars in thousands).

	Due in 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
<b>Available for sale debt securities:</b>										
U.S. Government securities and government-sponsored enterprises	\$ 25,179	0.68%	\$ 58,575	1.52%	\$ 170,548	2.40%	\$ 6,446	0.98%	\$ 260,748	2.00%
Mortgage-backed securities	3	3.53	115,478	1.86	105,424	2.65	61,968	2.25	282,873	2.24
	25,182	0.68	174,053	1.74	275,972	2.50	68,414	2.13	543,621	2.12
<b>Fixed to maturity debt securities:</b>										
State and political divisions	22,188	1.49	172,094	1.95	100,141	2.08	-	-	294,423	1.90
Mortgage-backed securities	-	-	-	-	16,221	1.48	175,073	2.22	191,294	2.16
	22,188	1.49	172,094	1.95	116,362	1.99	175,073	2.22	485,717	2.03
	\$ 47,370	1.06%	\$ 346,147	1.84%	\$ 392,334	2.35%	\$ 243,487	2.19%	\$ 1,029,338	2.08%



**Contractual Loan Maturity Schedule**

The following table summarizes the contractual maturities of our loan portfolio at December 31, 2015. 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).

	<b>Due in less than one year</b>	<b>Due from one to five years</b>	<b>Due after five years</b>	<b>Total</b>
Commercial business	\$ 115,254	\$ 135,643	\$ 62,861	\$ 313,758
Commercial mortgage	138,643	280,262	147,196	566,101
Residential mortgage	17,717	41,080	39,512	98,309
Home equity	64,499	175,367	170,246	410,112
Consumer indirect	269,154	395,496	12,290	676,940
Other consumer	7,673	9,495	1,374	18,542
<b>Total loans</b>	<b>\$ 612,940</b>	<b>\$ 1,037,343</b>	<b>\$ 433,479</b>	<b>\$ 2,083,762</b>

Loans maturing after one year:

With a predetermined interest rate	\$ 748,822	\$ 218,835	\$ 967,657
With a floating or adjustable rate	288,521	214,644	503,165
<b>Total loans maturing after one year</b>	<b>\$ 1,037,343</b>	<b>\$ 433,479</b>	<b>\$ 1,470,822</b>

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The FRB has adopted a system using risk-based capital guidelines to evaluate the capital adequacy of bank holding companies on a consolidated basis. The final rules implementing the Basel Committee on Banking Supervision's (BCBS) capital guidelines for U.S. banks became effective for the Company on January 1, 2015, with full compliance with all of the final requirements phased in over a multi-year schedule, to be fully phased-in by January 1, 2019. As of December 31, 2015, the Company's capital levels remained characterized as well-capitalized under the new rules. We continue to evaluate the potential impact that regulatory rules may have on our liquidity and capital management strategies, including Basel III and those required under the Dodd-Frank Act. See Note 11, Regulatory Matters of the notes to consolidated financial statements and the Basel III Capital Rules section below for further discussion. The following table reflects the Company's ratios and their components as of December 31 (in thousands):

	<b>2015</b>	<b>2014</b>
Common shareholders' equity	\$ 276,504	\$ 262,192
Less: Goodwill and other intangible assets <sup>(1)</sup>	61,217	68,639
Net unrealized (loss) gain on investment securities <sup>(2)</sup>	(696)	1,625
Net periodic pension & postretirement benefits plan adjustments	(10,631)	(10,636)
Other	201	-
Common equity Tier 1 (CET1) capital	226,413	n/a
Plus: Preferred stock	17,340	17,340
Less: Other	301	-
Tier 1 Capital	243,452	219,904
Plus: Qualifying allowance for loan losses	27,085	26,262
Subordinated Notes	38,990	-
Total regulatory capital <sup>(3)</sup>	\$ 309,527	\$ 246,166
Adjusted average total assets (for leverage capital purposes) <sup>(3)</sup>	\$ 3,287,646	\$ 2,993,050
Total risk-weighted assets <sup>(3)</sup>	\$ 2,318,536	\$ 2,099,626
<b>Regulatory Capital Ratios <sup>(3)</sup></b>		
Tier 1 leverage (Tier 1 capital to adjusted average assets)	7.41%	7.35%
CET1 capital (CET1 capital to total risk-weighted assets)	9.77	n/a
Tier 1 capital (Tier 1 capital to total risk-weighted assets)	10.50	10.47
Total risk-based capital (Total regulatory capital to total risk-weighted assets)	13.35	11.72

<sup>(1)</sup> December 31, 2015 calculated net of deferred tax liabilities.

- (2) Includes unrealized gains and losses related to the Company's reclassification of available for sale investment securities to the held to maturity category.
- (3) December 31, 2015 calculated under Basel III rules, which became effective January 1, 2015.

**Basel III Capital Rules**

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

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

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**MANAGEMENT'S DISCUSSION AND ANALYSIS**

**CRITICAL ACCOUNTING ESTIMATES**

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

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

**Adequacy of the Allowance for Loan Losses**

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

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

statements.

### **Valuation of Goodwill**

Goodwill represents the excess of the purchase price over the fair value of net assets acquired in accordance with the purchase method of accounting for business combinations. Goodwill has an indefinite useful life and is not amortized, but is tested for impairment. GAAP requires goodwill to be tested for impairment at our reporting unit level on an annual basis and more frequently if events or circumstances indicate that there may be impairment. We test goodwill for impairment as of September 30 of each year.

Impairment exists when a reporting unit's carrying value of goodwill exceeds its implied fair value. In testing goodwill for impairment, GAAP permits us to first assess qualitative factors to determine whether it is more likely than not that the fair value of a reporting unit is less than its carrying value. 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.

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**Table of Contents****MANAGEMENT'S DISCUSSION AND ANALYSIS****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. We evaluate deferred tax assets on a quarterly basis and assess the need for a valuation allowance, if any. A valuation allowance is established when management believes that it is more likely than not that some portion of its deferred tax assets 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.

**Defined Benefit Pension Plan**

We have a defined benefit pension plan covering substantially all employees, subject to the limitations related to the plan closure effective December 31, 2006. Effective January 1, 2016, the defined benefit pension plan was amended to modify the current benefit formula and to open the plan up to eligible employees who were hired on and after January 1, 2007. Prior to January 1, 2016, benefits under the plan were generally based on years of service, age and compensation. Assumptions are made concerning future events that will determine the amount and timing of required benefit payments, funding requirements and defined benefit pension expense. The major assumptions are the weighted average discount rate used in determining the current benefit obligation, the weighted average expected long-term rate of return on plan assets, the rate of compensation increase and the estimated mortality rate. The weighted average discount rate was based upon the projected benefit cash flows and the market yields of high grade corporate bonds that are available to pay such cash flows as of the measurement date, December 31. The weighted average expected long-term rate of return is estimated based on current trends experienced by the assets in the plan as well as projected future rates of return on those assets and reasonable actuarial assumptions for long term inflation, and the real and nominal rate of investment return for a specific mix of asset classes. The current target asset allocation model for the plans is detailed in Note 17 to the consolidated financial statements. The expected returns on these various asset categories are blended to derive one long-term return assumption. The assets are invested in certain collective investment and mutual funds, common stocks, U.S. Treasury and other U.S. government agency securities, and corporate and municipal bonds and notes. The rate of compensation increase is based on reviewing the compensation increase practices of other plan sponsors in similar industries and geographic areas as well as the expectation of future increases. Mortality rate assumptions are based on mortality tables published by third-parties such as the Society of Actuaries ( SOA ), considering other available information including historical data as well as studies and publications from reputable sources. We review the pension plan assumptions on an annual basis with our actuarial consultants to determine if the assumptions are reasonable and adjust the assumptions to reflect changes in future expectations.

The assumptions used to calculate 2015 expense for the defined benefit pension plan were a weighted average discount rate of 3.86%, a weighted average long-term rate of return on plan assets of 6.50% and a rate of compensation increase of 3.00%. Defined benefit pension expense in 2016 is expected to increase to \$1.6 million from the \$778 thousand recorded in 2015, primarily driven by an increase in the number of plan participants, partially offset by an increase in the discount rate assumption.

Due to the long-term nature of pension plan assumptions, actual results may differ significantly from the actuarial-based estimates. Differences resulting in actuarial gains or losses are required to be recorded in shareholders equity as part of accumulated other comprehensive loss and amortized to defined benefit pension expense in future years. For 2015, the actual return on plan assets in the qualified defined benefit pension plan was a loss of \$480 thousand, compared to an expected return on plan assets of \$4.8 million. Total pretax losses recognized in accumulated other comprehensive loss at December 31, 2015 were \$17.7 million for the defined benefit pension plan. Actuarial pretax net gains recognized in other comprehensive income for the year ended December 31, 2015 were \$52 thousand for the defined benefit pension plan.

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

#### **RECENT ACCOUNTING PRONOUNCEMENTS**

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

**Table of Contents****ITEM 7A. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK****Asset-Liability Management**

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

**Portfolio Composition**

Our balance sheet assets are a mix of fixed and variable rate assets with consumer indirect loans, commercial loans, and MBSs comprising a significant portion of our assets. Our consumer indirect loan portfolio comprised 20% of assets and is primarily fixed rate loans with relatively short durations. Our commercial loan portfolio totaled 26% of assets and is a combination of fixed and variable rate loans, lines and mortgages. The MBS portfolio, including collateralized mortgage obligations, totaled 14% of assets with durations averaging three to five years.

Our liabilities are made up primarily of deposits, which account for 88% of total liabilities. Of these deposits, the majority, or 55%, is in nonpublic variable rate and noninterest bearing products including demand (both noninterest and interest-bearing), savings and money market accounts. In addition, fixed rate nonpublic certificate of deposit products make up 20% of total deposits. The bank also has a significant amount of public deposits, which represented 25% of total deposits as of December 31, 2015.

**Net Interest Income at Risk**

A primary tool used to manage interest rate risk is rate shock simulation to measure the rate sensitivity. Rate shock simulation is a modeling technique used to estimate the impact of changes in rates on net interest income as well as economic value of equity. At December 31, 2015, we were slightly asset sensitive, meaning that net interest income increases in rising rate conditions.

Net interest income at risk is measured by estimating the changes in net interest income resulting from instantaneous and sustained parallel shifts in interest rates of different magnitudes over a period of 12 months. The following table sets forth the estimated changes to net interest income over the 12-month period ending December 31, 2016 assuming instantaneous changes in interest rates for the given rate shock scenarios (dollars in thousands):

	<b>Changes in Interest Rate</b>			
	<b>-100 bp</b>	<b>+100 bp</b>	<b>+200 bp</b>	<b>+300 bp</b>
Estimated change in net interest income	\$ (1,555)	\$ 994	\$ 2,237	\$ 1,120



% Change	(1.56)%	1.00%	2.24%	1.12%
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In addition to the changes in interest rate scenarios listed above, other scenarios are typically modeled to measure interest rate risk. These scenarios vary depending on the economic and interest rate environment.

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

**Economic Value of Equity At Risk**

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

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

The analysis that follows presents the estimated EVE resulting from market interest rates prevailing at a given quarter-end ( Pre-Shock Scenario ), and under other interest rate scenarios (each a Rate Shock Scenario ) represented by immediate, permanent, parallel shifts in interest rates from those observed at December 31, 2015 and 2014. The analysis additionally presents a measurement of the interest rate sensitivity at December 31, 2015 and 2014. EVE amounts are computed under each respective Pre- Shock Scenario and Rate Shock Scenario. An increase in the EVE amount is considered favorable, while a decline is considered unfavorable.

Rate Shock Scenario:	December 31, 2015			December 31, 2014		
	EVE	Change	Percentage Change	EVE	Change	Percentage Change
Pre-Shock Scenario	\$ 497,349			\$ 476,735		
- 100 Basis Points	508,973	\$ 11,624	2.34%	489,184	\$ 12,449	2.61%
+ 100 Basis Points	480,888	(16,461)	(3.31)	466,983	(9,752)	(2.05)
+ 200 Basis Points	460,567	(36,782)	(7.40)	453,868	(22,867)	(4.80)

The Pre-Shock Scenario EVE was \$497.3 million at December 31, 2015, compared to \$476.7 million at December 31, 2014. The increase in the Pre-Shock Scenario EVE at December 31, 2015, compared to December 31, 2014 resulted primarily from a more favorable valuation of non-maturity deposits that reflected alternative funding rate changes used for discounting future cash flows.

The +200 basis point Rate Shock Scenario EVE increased from \$453.9 million at December 31, 2014 to \$460.6 million at December 31, 2015, reflecting the more favorable valuation of non-maturity deposits. The percentage change in the EVE amount from the Pre-Shock Scenario to the +200 basis point Rate Shock Scenario decreased from (4.80)% at December 31, 2014 to (7.40)% at December 31, 2015. The decrease in sensitivity resulted from a decreased benefit in the valuation of certain fixed rate assets in the +200 basis point Rate Shock Scenario EVE as of December 31, 2015, compared to December 31, 2014.

**Table of Contents****Interest Rate Sensitivity Gap**

The following table presents an analysis of our interest rate sensitivity gap position at December 31, 2015. All interest-earning assets and interest-bearing liabilities are shown based on the earlier of their contractual maturity or re-pricing date. The expected maturities are presented on a contractual basis or, if more relevant, based on projected call dates. Investment securities are at amortized cost for both securities available for sale and securities held to maturity. Loans, net of deferred loan origination costs, include principal amortization adjusted for estimated prepayments (principal payments in excess of contractual amounts) and non-accruing loans. Because the interest rate sensitivity levels shown in the table could be changed by external factors such as loan prepayments and liability decay rates or by factors controllable by us, such as asset sales, it is not an absolute reflection of our potential interest rate risk profile (in thousands).

	<b>At December 31, 2015</b>				
	<b>Three Months or Less</b>	<b>Over Three Months Through One Year</b>	<b>Over One Year Through Five Years</b>	<b>Over Five Years</b>	<b>Total</b>
<b>INTEREST-EARNING ASSETS:</b>					
Investment securities	\$ 67,682	\$ 88,037	\$ 458,891	\$ 414,728	\$ 1,029,338
Loans	604,677	357,385	890,836	232,294	2,085,192
Total interest-earning assets	\$ 672,359	\$ 445,422	\$ 1,349,727	\$ 647,022	3,114,530
Cash and due from banks					60,121
Other assets <sup>(1)</sup>					206,373
Total assets					\$ 3,381,024
<b>INTEREST-BEARING LIABILITIES:</b>					
Interest-bearing demand, savings and money market	\$ 1,451,541	\$ -	\$ -	\$ -	\$ 1,451,541
Time deposits	187,925	262,960	186,086	47	637,018
Borrowings	270,200	22,900	-	38,990	332,090
Total interest-bearing liabilities	\$ 1,909,666	\$ 285,860	\$ 186,086	\$ 39,037	2,420,649
Noninterest-bearing deposits					641,972
Other liabilities					24,559
Total liabilities					3,087,180
Shareholders' equity					293,844
Total liabilities and shareholders equity					\$ 3,381,024

Interest sensitivity gap	\$ (1,237,307)	\$ 159,562	\$ 1,163,641	\$ 607,985	\$ 693,881
Cumulative gap	\$ (1,237,307)	\$ (1,077,745)	\$ 85,896	\$ 693,881	
Cumulative gap ratio <sup>(2)</sup>	35.2 %	50.9 %	103.6 %	128.7 %	
Cumulative gap as a percentage of total assets	(36.6) %	(31.9) %	2.5 %	20.5 %	

(1) Includes net unrealized gain on securities available for sale and allowance for loan losses.

(2) Cumulative total interest-earning assets divided by cumulative total interest-bearing liabilities.

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

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**ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA**

**FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES**

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**Management's Report on Internal Control over Financial Reporting**

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

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

The Company's management has, including the Company's principal executive officer and principal financial officer as identified below, assessed the effectiveness of the Company's internal control over financial reporting as of December 31, 2015. To make this assessment, we used the criteria for effective internal control over financial reporting described in *Internal Control – Integrated Framework (2013)*, issued by the Committee of Sponsoring Organizations of the Treadway Commission. Based on our assessment and based on such criteria, we believe that, as of December 31, 2015, the Company's internal control over financial reporting was effective.

KPMG LLP, the Company's independent registered public accounting firm that audited the Company's consolidated financial statements has issued an attestation report on internal control over financial reporting as of December 31, 2015. That report appears herein.

*/s/ Martin K. Birmingham*  
President and Chief Executive Officer  
March 8, 2016

*/s/ Kevin B. Klotzbach*  
Executive Vice President and Chief Financial Officer  
March 8, 2016

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**Report of Independent Registered Public Accounting Firm**

The Board of Directors and Shareholders

Financial Institutions, Inc.:

We have audited Financial Institutions, Inc. and subsidiaries (the Company) internal control over financial reporting as of December 31, 2015, based on criteria established in *Internal Control - Integrated Framework (2013)* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). The Company's management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting, included in the accompanying Management's Report on Internal Control over Financial Reporting. Our responsibility is to express an opinion on the Company's internal control over financial reporting based on our audit.

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

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

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

In our opinion, Financial Institutions, Inc. and subsidiaries maintained, in all material respects, effective internal control over financial reporting as of December 31, 2015, based on criteria established in *Internal Control - Integrated Framework (2013)* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO).

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated statements of financial condition of Financial Institutions, Inc. and subsidiaries as of December 31, 2015 and 2014, and the related consolidated statements of income, comprehensive income, changes in shareholders' equity, and cash flows for each of the years in the three-year period ended December 31, 2015, and our report dated March 8, 2016 expressed an unqualified opinion on those consolidated financial statements.

*/s/ KPMG LLP*

Rochester, New York

March 8, 2016

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**Report of Independent Registered Public Accounting Firm**

The Board of Directors and Shareholders

Financial Institutions, Inc.:

We have audited the accompanying consolidated statements of financial condition of Financial Institutions, Inc. and subsidiaries (the Company) as of December 31, 2015 and 2014, and the related consolidated statements of income, comprehensive income, changes in shareholders' equity, and cash flows for each of the years in the three year period ended December 31, 2015. These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Financial Institutions, Inc. and subsidiaries as of December 31, 2015 and 2014, and the results of their operations and their cash flows for each of the years in the three year period ended December 31, 2015, in conformity with U.S. generally accepted accounting principles.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the Financial Institutions, Inc.'s internal control over financial reporting as of December 31, 2015, based on criteria established in *Internal Control - Integrated Framework (2013)* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO), and our report dated March 8, 2016 expressed an unqualified opinion on the effectiveness of the Company's internal control over financial reporting.

/s/ KPMG LLP

Rochester, New York

March 8, 2016

**Table of Contents****FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES****Consolidated Statements of Financial Condition***(Dollars in thousands, except share and per share data)*

	<b>December 31,</b>	
	<b>2015</b>	<b>2014</b>
<b>ASSETS</b>		
Cash and due from banks	\$ 60,121	\$ 58,151
Securities available for sale, at fair value	544,395	622,494
Securities held to maturity, at amortized cost (fair value of \$490,064 and \$298,695, respectively)	485,717	294,438
Loans held for sale	1,430	755
Loans (net of allowance for loan losses of \$27,085 and \$27,637, respectively)	2,056,677	1,884,365
Company owned life insurance	63,045	61,004
Premises and equipment, net	39,445	36,394
Goodwill and other intangible assets, net	66,946	68,639
Other assets	63,248	63,281
<b>Total assets</b>	<b>\$ 3,381,024</b>	<b>\$ 3,089,521</b>
<b>LIABILITIES AND SHAREHOLDERS EQUITY</b>		
Deposits:		
Noninterest-bearing demand	\$ 641,972	\$ 571,260
Interest-bearing demand	523,366	490,190
Savings and money market	928,175	795,835
Time deposits	637,018	593,242
<b>Total deposits</b>	<b>2,730,531</b>	<b>2,450,527</b>
Short-term borrowings	293,100	334,804
Long-term borrowings, net of issuance costs of \$1,010	38,990	-
Other liabilities	24,559	24,658
<b>Total liabilities</b>	<b>3,087,180</b>	<b>2,809,989</b>
Commitments and contingencies (Note 10)		
Shareholders equity:		
Series A 3% preferred stock, \$100 par value; 1,533 shares authorized; 1,492 shares issued	149	149
Series B-1 8.48% preferred stock, \$100 par value; 200,000 shares authorized; 171,906 shares issued	17,191	17,191
<b>Total preferred equity</b>	<b>17,340</b>	<b>17,340</b>
Common stock, \$0.01 par value; 50,000,000 shares authorized; 14,397,509 shares issued	144	144
Additional paid-in capital	72,690	72,955

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Retained earnings	218,920	203,312
Accumulated other comprehensive loss	(11,327)	(9,011)
Treasury stock, at cost 207,317 and 279,461 shares, respectively	(3,923)	(5,208)
Total shareholders' equity	293,844	279,532
Total liabilities and shareholders' equity	\$ 3,381,024	\$ 3,089,521

See accompanying notes to the consolidated financial statements.

**Table of Contents****FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES****Consolidated Statements of Income***(Dollars in thousands, except per share amounts)*

	Years ended December 31,		
	2015	2014	2013
<b>Interest income:</b>			
Interest and fees on loans	\$ 83,575	\$ 82,453	\$ 81,468
Interest and dividends on investment securities	21,875	18,602	17,463
<b>Total interest income</b>	<b>105,450</b>	<b>101,055</b>	<b>98,931</b>
<b>Interest expense:</b>			
Deposits	7,306	6,366	6,600
Short-term borrowings	1,081	915	737
Long-term borrowings	1,750	-	-
<b>Total interest expense</b>	<b>10,137</b>	<b>7,281</b>	<b>7,337</b>
<b>Net interest income</b>	<b>95,313</b>	<b>93,774</b>	<b>91,594</b>
<b>Provision for loan losses</b>	<b>7,381</b>	<b>7,789</b>	<b>9,079</b>
<b>Net interest income after provision for loan losses</b>	<b>87,932</b>	<b>85,985</b>	<b>82,515</b>
<b>Noninterest income:</b>			
Service charges on deposits	7,742	8,954	9,948
Insurance income	5,166	2,399	262
ATM and debit card	5,084	4,963	5,098
Investment advisory	2,193	2,138	2,345
Company owned life insurance	1,962	1,753	1,706
Investments in limited partnerships	895	1,103	857
Loan servicing	503	568	570
Net gain on sale of loans held for sale	249	313	117
Net gain on disposal of investment securities	1,988	2,041	1,226
Net gain (loss) on sale and disposal of other assets	27	69	(103)
Amortization of tax credit investment	(390)	(2,323)	-
Other	4,918	3,372	2,807
<b>Total noninterest income</b>	<b>30,337</b>	<b>25,350</b>	<b>24,833</b>
<b>Noninterest expense:</b>			
Salaries and employee benefits	42,439	38,595	37,828
Occupancy and equipment	13,856	12,829	12,366
Professional services	4,502	4,760	3,836
Computer and data processing	3,186	3,016	2,848
Supplies and postage	2,155	2,053	2,342

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FDIC assessments	1,719	1,592	1,464
Advertising and promotions	1,120	805	896
Goodwill impairment	751	-	-
Other	9,665	8,705	7,861
<b>Total noninterest expense</b>	<b>79,393</b>	<b>72,355</b>	<b>69,441</b>
Income before income taxes	38,876	38,980	37,907
Income tax expense	10,539	9,625	12,377
Net income	\$ 28,337	\$ 29,355	\$ 25,530
Preferred stock dividends	1,462	1,462	1,466
Net income available to common shareholders	\$ 26,875	\$ 27,893	\$ 24,064
<b>Earnings per common share (Note 16):</b>			
Basic	\$ 1.91	\$ 2.01	\$ 1.75
Diluted	\$ 1.90	\$ 2.00	\$ 1.75
Cash dividends declared per common share	\$ 0.80	\$ 0.77	\$ 0.74
<b>Weighted average common shares outstanding:</b>			
Basic	14,081	13,893	13,739
Diluted	14,135	13,946	13,784

See accompanying notes to the consolidated financial statements.

**Table of Contents****FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES****Consolidated Statements of Comprehensive Income***(Dollars in thousands)*

	<b>Years ended December 31,</b>		
	<b>2015</b>	<b>2014</b>	<b>2013</b>
Net income	\$ 28,337	\$ 29,355	\$ 25,530
Other comprehensive (loss) income, net of tax:			
Net unrealized (losses) gains on securities available for sale	(2,321)	6,962	(21,397)
Pension and post-retirement obligations	5	(5,786)	7,957
Total other comprehensive (loss) income, net of tax	(2,316)	1,176	(13,440)
Comprehensive income	\$ 26,021	\$ 30,531	\$ 12,090

See accompanying notes to the consolidated financial statements.

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**FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES**  
**Consolidated Statements of Changes in Shareholders' Equity**  
**Years ended December 31, 2015, 2014 and 2013**

*(Dollars in thousands,*

*except per share data)*

	Accumulated							Total
	Preferred	Common	Additional	Retained	Other	Treasury	Shareholders	
	Equity	Stock	Paid-in	Earnings	Income (Loss)	Stock	Equity	
<b>Balance at January 1, 2013</b>	\$ 17,471	\$ 142	\$ 67,710	\$ 172,244	\$ 3,253	\$ (6,923)	\$ 253,897	
Comprehensive income:								
Net income	-	-	-	25,530	-	-	25,530	
Other comprehensive loss, net of tax	-	-	-	-	(13,440)	-	(13,440)	
Purchases of common stock for treasury	-	-	-	-	-	(229)	(229)	
Repurchase of Series A 3% preferred stock	(1)	-	-	-	-	-	(1)	
Repurchase of Series B-1 8.48% preferred stock	(128)	-	(2)	-	-	-	(130)	
Share-based compensation plans:								
Share-based compensation	-	-	407	-	-	-	407	
Stock options exercised	-	-	16	-	-	432	448	
Restricted stock awards issued, net	-	-	(446)	-	-	446	-	
Excess tax expense	-	-	(118)	-	-	-	(118)	
Stock awards	-	-	7	-	-	105	112	
Cash dividends declared:								

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Series A 3% Preferred-\$3.00 per share	-	-	-	(5)	-	-	(5)
Series B-1 8.48% Preferred-\$8.48 per share	-	-	-	(1,461)	-	-	(1,461)
Common-\$0.74 per share	-	-	-	(10,171)	-	-	(10,171)

<b>Balance at December 31, 2013</b>	<b>\$ 17,342</b>	<b>\$ 142</b>	<b>\$ 67,574</b>	<b>\$ 186,137</b>	<b>\$ (10,187)</b>	<b>\$ (6,169)</b>	<b>\$ 254,839</b>
Comprehensive income:							
Net income	-	-	-	29,355	-	-	29,355
Other comprehensive income, net of tax	-	-	-	-	1,176	-	1,176
Common stock issued	-	2	5,398	-	-	-	5,400
Purchases of common stock for treasury	-	-	-	-	-	(194)	(194)
Repurchase of Series B-1 8.48% preferred stock	(2)	-	-	-	-	-	(2)
Share-based compensation plans:							
Share-based compensation	-	-	471	-	-	-	471
Stock options exercised	-	-	32	-	-	635	667
Restricted stock awards issued, net	-	-	(520)	-	-	520	-
Cash dividends declared:							
Series A 3% Preferred-\$3.00 per share	-	-	-	(4)	-	-	(4)
Series B-1 8.48% Preferred-\$8.48 per share	-	-	-	(1,458)	-	-	(1,458)
Common-\$0.77 per share	-	-	-	(10,718)	-	-	(10,718)

<b>Balance at December 31, 2014</b>	<b>\$ 17,340</b>	<b>\$ 144</b>	<b>\$ 72,955</b>	<b>\$ 203,312</b>	<b>\$ (9,011)</b>	<b>\$ (5,208)</b>	<b>\$ 279,532</b>
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*Continued on next page*

See accompanying notes to the consolidated financial statements.





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## FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES

## Consolidated Statements of Changes in Shareholders' Equity (Continued)

Years ended December 31, 2015, 2014 and 2013

*(Dollars in thousands,**Accumulated**except per share data)*

Additional

Other

Total

Preferred Common Paid-in Retained Comprehensive Treasury Shareholders

Equity Stock Capital Earnings Income (Loss) Stock Equity

**Balance at December 31, 2014**

	Equity	Stock	Capital	Earnings	Income (Loss)	Stock	Equity
<b>Balance at December 31, 2014</b>	<b>\$ 17,340</b>	<b>\$ 144</b>	<b>\$ 72,955</b>	<b>\$ 203,312</b>	<b>\$ (9,011)</b>	<b>\$ (5,208)</b>	<b>\$ 279,532</b>
<i>Balance carried forward</i>							
<b>Comprehensive income:</b>							
Net income	-	-	-	28,337	-	-	28,337
Other comprehensive loss, net of tax	-	-	-	-	(2,316)	-	(2,316)
Purchases of common stock for treasury	-	-	-	-	-	(202)	(202)
<b>Share-based compensation plans:</b>							
Share-based compensation	-	-	674	-	-	-	674
Stock options exercised	-	-	6	-	-	353	359
Restricted stock awards issued, net	-	-	(1,052)	-	-	1,052	-
Excess tax benefit	-	-	79	-	-	-	79
Stock awards	-	-	28	-	-	82	110
<b>Cash dividends declared:</b>							
Series A 3%							
Preferred-\$3.00 per share	-	-	-	(4)	-	-	(4)
Series B-1 8.48%							
Preferred-\$8.48 per share	-	-	-	(1,458)	-	-	(1,458)
Common-\$0.80 per share	-	-	-	(11,267)	-	-	(11,267)

*Balance carried forward***Comprehensive income:**

Net income - - - 28,337 - - 28,337

Other comprehensive loss, net of tax - - - - (2,316) - (2,316)

Purchases of common stock for treasury - - - - - (202) (202)

**Share-based compensation plans:**

Share-based compensation - - 674 - - - 674

Stock options exercised - - 6 - - 353 359

Restricted stock awards issued, net - - (1,052) - - 1,052 -

Excess tax benefit - - 79 - - - 79

Stock awards - - 28 - - 82 110

**Cash dividends declared:**

Series A 3%

Preferred-\$3.00 per share - - - (4) - - (4)

Series B-1 8.48%

Preferred-\$8.48 per share - - - (1,458) - - (1,458)

Common-\$0.80 per share - - - (11,267) - - (11,267)

<b>Balance at December 31, 2015</b>	<b>\$ 17,340</b>	<b>\$ 144</b>	<b>\$ 72,690</b>	<b>\$ 218,920</b>	<b>\$ (11,327)</b>	<b>\$ (3,923)</b>	<b>\$ 293,844</b>
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See accompanying notes to the consolidated financial statements.

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**Table of Contents****FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES****Consolidated Statements of Cash Flows***(Dollars in thousands)*

	<b>Years ended December 31,</b>		
	<b>2015</b>	<b>2014</b>	<b>2013</b>
<b>Cash flows from operating activities:</b>			
Net income	\$ 28,337	\$ 29,355	\$ 25,530
<b>Adjustments to reconcile net income to net cash provided by operating activities:</b>			
Depreciation and amortization	5,429	4,583	4,181
Net amortization of premiums on securities	3,150	3,241	4,532
Provision for loan losses	7,381	7,789	9,079
Share-based compensation	674	471	407
Deferred income tax expense	1,798	2,154	1,547
Proceeds from sale of loans held for sale	16,195	16,543	26,184
Originations of loans held for sale	(16,621)	(14,457)	(31,657)
Increase in company owned life insurance	(1,962)	(1,753)	(1,706)
Net gain on sale of loans held for sale	(249)	(313)	(117)
Net gain on disposal of investment securities	(1,988)	(2,041)	(1,226)
Amortization of tax credit investment	390	2,323	-
Goodwill impairment	751	-	-
Net (gain) loss on sale and disposal of other assets	(27)	(69)	103
Contributions to defined benefit pension plan	-	(8,000)	-
Increase in other assets	(545)	(1,606)	(6,640)
Increase (decrease) in other liabilities	376	(2,991)	6,981
<b>Net cash provided by operating activities</b>	<b>43,089</b>	<b>35,229</b>	<b>37,198</b>
<b>Cash flows from investing activities:</b>			
<b>Purchases of investment securities:</b>			
Available for sale	(271,899)	(236,043)	(246,874)
Held to maturity	(64,397)	(63,770)	(19,598)
<b>Proceeds from principal payments, maturities and calls on investment securities:</b>			
Available for sale	127,257	140,338	143,053
Held to maturity	36,162	31,026	14,784
Proceeds from sales of securities available for sale	54,277	81,600	1,327
Net increase in loans, excluding sales	(180,067)	(84,812)	(131,949)
Purchases of company owned life insurance	(79)	(10,080)	(79)
Proceeds from sales of other assets	365	1,576	555
Purchases of premises and equipment	(7,493)	(5,330)	(3,411)
Cash consideration paid for acquisition, net of cash acquired	-	(7,995)	-
<b>Net cash used in investing activities</b>	<b>(305,874)</b>	<b>(153,490)</b>	<b>(242,192)</b>

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<b>Cash flows from financing activities:</b>			
Net increase in deposits	280,004	130,471	58,262
Net (decrease) increase in short-term borrowings	(41,704)	(2,238)	157,236
Issuance of long-term debt	40,000	-	-
Debt issuance costs	(1,060)	-	-
Repurchase of preferred stock	-	(2)	(131)
Purchases of common stock for treasury	(202)	(194)	(229)
Proceeds from stock options exercised	359	667	448
Excess tax benefit (expense) on share-based compensation	79	-	(118)
Cash dividends paid to preferred shareholders	(1,462)	(1,463)	(1,468)
Cash dividends paid to common shareholders	(11,259)	(10,521)	(9,750)
Net cash provided by financing activities	264,755	116,720	204,250
Net increase (decrease) in cash and cash equivalents	1,970	(1,541)	(744)
Cash and cash equivalents, beginning of period	58,151	59,692	60,436
Cash and cash equivalents, end of period	\$ 60,121	\$ 58,151	\$ 59,692

See accompanying notes to the consolidated financial statements.

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**FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**December 31, 2015, 2014 and 2013**

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

Financial Institutions, Inc. (individually referred to herein as the Parent Company and together with all of its subsidiaries, collectively referred to herein as the Company) is a financial holding company organized in 1931 under the laws of New York State ( New York ). At December 31, 2015, the Company conducted its business through its two subsidiaries: Five Star Bank (the Bank ), a New York chartered bank; and Scott Danahy Naylor, LLC ( SDN ), a full service insurance agency. The Company provides a full range of banking and related financial services to consumer, commercial and municipal customers through its bank and nonbank subsidiaries.

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

The Company has evaluated events and transactions for potential recognition or disclosure through the day the financial statements were issued. Other than completing the acquisition of Courier Capital Corporation ( Courier ), as described below, the Company did not have any material recognizable subsequent events.

On January 5, 2016, the Company completed its acquisition of Courier, a leading SEC-registered investment advisory and wealth management firm based in western New York, with operations in Buffalo and Jamestown. Courier will operate as a subsidiary of Financial Institutions, Inc. and an affiliate of the Bank and SDN.

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

***(a.) Principles of Consolidation***

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

***(b.) Use of Estimates***

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

***(c.) Cash Flow Reporting***

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

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**FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
**December 31, 2015, 2014 and 2013**

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

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

	2015	2014	2013
Cash payments:			
Interest expense	\$ 9,323	\$ 6,826	\$ 7,750
Income taxes	7,494	13,665	8,095
Noncash investing and financing activities:			
Real estate and other assets acquired in settlement of loans	\$ 374	\$ 394	\$ 726
Accrued and declared unpaid dividends	3,185	3,177	2,981
(Decrease) increase in net unsettled security purchases	(478)	568	(51,112)
Securities transferred from available for sale to held to maturity	165,238	12,802	227,330
Loans transferred from held for sale to held for investment	-	853	3,727
Common stock issued for acquisition	-	5,400	-
Assets acquired and liabilities assumed in business combinations:			
Loans and other non-cash assets, excluding goodwill and core deposit intangible asset	-	1,007	-
Deposits and other liabilities	-	1,112	-

**(d.) Investment Securities**

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

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



or concerns, or the security is intended to be sold. The amount of impairment related to non-credit related factors is recognized in other comprehensive income. Gains and losses on the sale of securities are recorded on the trade date and are determined using the specific identification method.

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

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

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**FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
**December 31, 2015, 2014 and 2013**

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

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

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

***(f.) Loans***

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

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

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

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

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**FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
**December 31, 2015, 2014 and 2013**

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

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

***(g.) Off-Balance Sheet Financial Instruments***

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

The Company recognizes as liabilities the fair value of the obligations undertaken in issuing the guarantees under the standby letters of credit, net of the related amortization at inception. The fair value approximates the unamortized fees received from the customers for issuing the standby letters of credit. The fees are deferred and recognized on a straight-line basis over the commitment period. Standby letters of credit outstanding at December 31, 2015 had original terms ranging from one to five years. Fees received for providing loan commitments and letters of credit that result in loans are typically deferred and amortized to interest income over the life of the related loan, beginning with the initial borrowing. Fees on commitments and letters of credit are amortized to other income as banking fees and commissions over the commitment period when funding is not expected.

***(h.) Allowance for Loan Losses***

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

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

information becomes available.

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

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**FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
**December 31, 2015, 2014 and 2013**

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

A loan is considered impaired when, based on current information and events, it is probable that the Company will be unable to collect the scheduled payments of principal or interest when due according to the contractual terms of the loan agreement. Factors considered in determining impairment include payment status and the probability of collecting scheduled principal and interest payments when due. Loans that experience insignificant payment delays and payment shortfalls generally are not classified as impaired. The Company determines the significance of payment delays and payment shortfalls on a case-by-case basis, taking into consideration all of the circumstances surrounding the loan and the borrower, including the length of the delay, the reasons for the delay, the borrower's prior payment record, and the amount of the shortfall in relation to the principal and interest owed. Impairment is measured on a loan by loan basis by either the present value of expected future cash flows discounted at the loan's effective interest rate, the loans obtainable market price, or the fair value of the collateral if the loan is collateral dependent. Large groups of homogeneous loans are collectively evaluated for impairment. Accordingly, the Company does not separately identify individual consumer and residential loans for impairment disclosures unless the loan has been subject to a troubled debt restructure. At December 31, 2015, there were no commitments to lend additional funds to those borrowers whose loans were classified as impaired.

General allowances are established for loan losses on a portfolio basis for loans that do not meet the definition of impaired. The portfolio is grouped into similar risk characteristics, primarily loan type. The Company applies an estimated loss rate, which considers both look-back and loss emergence periods, to each loan group. The loss rate is based on historical experience, with look-back periods that range from 24 to 48 months depending on the loan type, and as a result can differ from actual losses incurred in the future. The historical loss rate is adjusted by the loss emergence periods that range from 12 to 24 months depending on the loan type and for qualitative factors such as; levels and trends of delinquent and non-accruing loans, trends in volume and terms, effects of changes in lending policy, the experience, ability and depth of management, national and local economic trends and conditions, concentrations of credit risk, interest rates, highly leveraged borrowers, information risk and collateral risk. The qualitative factors are reviewed at least quarterly and adjustments are made as needed.

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

***(i.) Other Real Estate Owned***

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

(defined as the fair value at initial foreclosure). At the time of foreclosure, or when foreclosure occurs in-substance, the excess, if any, of the loan over the fair market value of the assets received, less estimated selling costs, is charged to the allowance for loan losses and any subsequent valuation write-downs are charged to other expense. In connection with the determination of the allowance for loan losses and the valuation of other real estate owned, management obtains appraisals for properties. Operating costs associated with the properties are charged to expense as incurred. Gains on the sale of other real estate owned are included in income when title has passed and the sale has met the minimum down payment requirements prescribed by GAAP. The balance of other real estate owned was \$163 thousand and \$194 thousand at December 31, 2015 and 2014, respectively.

*(j.) Company Owned Life Insurance*

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

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

***(k.) Premises and Equipment***

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

***(l.) Goodwill and Other Intangible Assets***

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

Goodwill is not amortized but, instead, is subject to impairment tests on at least an annual basis, and more frequently if an event occurs or circumstances change that would more likely than not reduce the fair value of a reporting unit below its carrying amount. The impairment testing process is conducted by assigning net assets and goodwill to each reporting unit. An initial qualitative evaluation is made to assess the likelihood of impairment and determine whether further quantitative testing to calculate the fair value is necessary. When the qualitative evaluation indicates that impairment is more likely than not, quantitative testing is required whereby the fair value of each reporting unit is calculated and compared to the recorded book value, Step 1. If the calculated fair value of the reporting unit exceeds its carrying value, goodwill is not considered impaired and Step 2 is not considered necessary. If the carrying value of a reporting unit exceeds its calculated fair value, the impairment test continues ( Step 2 ) by comparing the carrying value of the reporting unit's goodwill to the implied fair value of goodwill. The implied fair value is computed by adjusting all assets and liabilities of the reporting unit to current fair value with the offset adjustment to goodwill. The adjusted goodwill balance is the implied fair value of the goodwill. An impairment charge is recognized if the carrying value of goodwill exceeds the implied fair value of goodwill. See Note 7 for additional information on goodwill and other intangible assets.



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

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

As a member of the FHLB system, the Company is required to maintain a specified investment in FHLB of New York ( FHLBNY ) stock in proportion to its volume of certain transactions with the FHLB. FHLBNY stock totaled \$15.1 million as of December 31, 2015 and 2014.

As a member of the FRB system, the Company is required to maintain a specified investment in FRB stock based on a ratio relative to the Company's capital. FRB stock totaled \$4.9 million and \$3.9 million as of December 31, 2015 and 2014, respectively.

***(n.) Equity Method Investments***

The Company has investments in limited partnerships, primarily Small Business Investment Companies, and accounts for these investments under the equity method. These investments are included in other assets in the consolidated statements of financial condition and totaled \$5.0 million and \$4.9 million as of December 31, 2015 and 2014, respectively.

***(o.) Treasury Stock***

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

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

***(p.) Employee Benefits***

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

The Company also participates in a non-contributory defined benefit pension plan for certain employees who previously met participation requirements. The Company also provides post-retirement benefits, principally health and dental care, to employees of a previously acquired entity. The Company has closed the pension and post-retirement plans to new participants. The actuarially determined pension benefit is based on years of service and the employee's highest average compensation during five consecutive years of employment. The Company's policy is to at least fund the minimum amount required by the Employment Retirement Income Security Act of 1974. The cost of the pension and post-retirement plans are based on actuarial computations of current and future benefits for employees, and is charged to noninterest expense in the consolidated statements of income.

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

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

***(q.) Share-Based Compensation Plans***

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

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

***(r.) Income Taxes***

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

*(s.) Comprehensive Income*

Comprehensive income includes all changes in shareholders' equity during a period, except those resulting from transactions with shareholders. In addition to net income, other components of the Company's comprehensive income include the after tax effect of changes in net unrealized gain / loss on securities available for sale and changes in net actuarial gain / loss on defined benefit post-retirement plans. Comprehensive income is reported in the accompanying consolidated statements of changes in shareholders' equity and consolidated statements of comprehensive income. See Note 13 - Accumulated Other Comprehensive Income (Loss) for additional information.

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

***(t.) Earnings Per Common Share***

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

Basic EPS is computed by dividing distributed and undistributed earnings available to common shareholders by the weighted average number of common shares outstanding for the period. Distributed and undistributed earnings available to common shareholders represent net income reduced by preferred stock dividends and distributed and undistributed earnings available to participating securities. Common shares outstanding include common stock and vested restricted stock awards. Diluted EPS reflects the assumed conversion of all potential dilutive securities. A reconciliation of the weighted-average shares used in calculating basic earnings per common share and the weighted average common shares used in calculating diluted earnings per common share for the reported periods is provided in Note 16 - Earnings Per Common Share.

***(u.) Reclassifications***

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

***(v.) Recent Accounting Pronouncements***

In May 2014, the Financial Accounting Standards Board ( FASB ) issued Accounting Standards Update ( ASU ) No. 2014-09, *Revenue from Contracts with Customers (Topic 606)*. ASU 2014-09 implements a common revenue standard that clarifies the principles for recognizing revenue. The core principle of ASU 2014-09 is that an entity should recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. To achieve that core principle, an entity should apply the following steps: (i) identify the contract(s) with a customer, (ii) identify the performance obligations in the contract, (iii) determine the transaction price, (iv) allocate the transaction price to the performance obligations in the contract and (v) recognize revenue when (or as) the entity satisfies a performance obligation. The effective date was recently deferred for one year to the interim and annual periods beginning on or after December 15, 2017. Early adoption is permitted as of the original effective date interim and annual periods beginning on or after December 15, 2016. The Company is evaluating the potential impact of ASU 2014-09 on the Company's financial statements.

In June 2014, the FASB issued ASU 2014-12, *Compensation - Stock Compensation (Topic 718)*. The pronouncement was issued to clarify the accounting for share-based payments when the terms of an award provide that a performance target could be achieved after the requisite service period. ASU 2014-12 is effective for the Company beginning January 1, 2016, though early adoption is permitted. The adoption of ASU 2014-12 is not expected to have a significant impact on the Company's financial statements.

In January 2015, the FASB issued ASU 2015-01, *Income Statement - Extraordinary and Unusual Items (Subtopic 225-20) - Simplifying Income Statement Presentation by Eliminating the Concept of Extraordinary Items*. ASU 2015-01 eliminates from U.S. GAAP the concept of extraordinary items, which, among other things, required an entity to segregate extraordinary items considered to be unusual and infrequent from the results of ordinary operations and show the item separately in the income statement, net of tax, after income from continuing operations. ASU 2015-01 is effective for the Company beginning January 1, 2016, though early adoption is permitted. ASU 2015-01 is not expected to have a significant impact on the Company's financial statements.

In April 2015, the FASB issued ASU 2015-03, *Simplifying the Presentation of Debt Issuance Costs*. Under ASU 2015-03, the Company will present debt issuance costs in the balance sheet as a reduction from the related debt liability rather than as an asset. Amortization of such costs will continue to be reported as interest expense. ASU 2015-03 will be effective for the Company beginning January 1, 2016, though early adoption is permitted. Retrospective adoption is required. The Company early adopted this standard during the quarter ended June 30, 2015, concurrent with the issuance of the Subordinated Notes described in Note 9. Unamortized debt issuance costs of \$1.0 million are included in the net balance of long-term borrowings reported on the Consolidated Statements of Financial Condition. Retrospective application of this standard did not impact previously issued financial statements.

**Table of Contents****FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****December 31, 2015, 2014 and 2013****(2.) BUSINESS COMBINATIONS*****SDN Acquisition***

On August 1, 2014, the Company completed the acquisition of Scott Danahy Naylon Co., Inc., a full service insurance agency located in Amherst, New York. The acquisition of Scott Danahy Naylon Co., Inc. enhances the Company's ability to offer clients unique, comprehensive solutions to meet their insurance and financial risk management needs. Consideration for the acquisition included both cash and stock totaling \$16.9 million, including future consideration.

The transaction was accounted for using the acquisition method of accounting and as such, assets acquired, liabilities assumed and consideration exchanged were recorded at their estimated fair value on the acquisition date. Goodwill from the acquisition represents the excess of the purchase price over the fair value of the net tangible and intangible assets acquired and is not deductible for tax purposes. As a result of the acquisition, the Company recorded goodwill of \$12.6 million and other intangible assets of \$6.6 million. Goodwill was assigned to the Company's Insurance reporting unit. Total goodwill and other intangible assets from the acquisition are inclusive of contingent earn-out payments based on revenue targets through 2017. The estimated fair value of the contingent earn-out liability at the date of acquisition was \$3.2 million. Since the date of acquisition, valuation adjustments have been made resulting in a contingent earn-out liability of \$2.2 million at December 31, 2015. The valuation adjustment is included in other noninterest income in the consolidated statements of income for the year ended December 31, 2015.

As more fully described in Note 7, the Company recorded a goodwill impairment charge related to the Insurance reporting unit of \$751 thousand during the quarter ended December 31, 2015. See Note 7 for additional information on goodwill and other intangible assets.

Pro forma results of operations for this acquisition have not been presented because the effect of this acquisition was not material to the Company's consolidated financial statements. The following table summarizes the consideration paid for Scott Danahy Naylon Co., Inc. and the amounts of the assets acquired and liabilities assumed as of the acquisition date.

<b>Consideration paid:</b>	
Cash	\$ 8,100
Stock	5,400
Contingent consideration	3,227
<b>Fair value of total consideration transferred</b>	<b>16,727</b>
<b>Fair value of assets acquired:</b>	
Cash	105
Identified intangible assets	6,640

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Premises and equipment, accounts receivable and other assets	1,094
<b>Total identifiable assets acquired</b>	<b>7,839</b>
Fair value of liabilities assumed:	
Deferred tax liability	2,556
Other liabilities	1,173
<b>Total liabilities assumed</b>	<b>3,729</b>
Fair value of net assets acquired	4,110
<b>Goodwill resulting from acquisition</b>	<b>\$ 12,617</b>

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**(3.) INVESTMENT SECURITIES**

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

	Amortized Cost	Unrealized Gains	Unrealized Losses	Fair Value
<b>December 31, 2015</b>				
<b>Securities available for sale:</b>				
U.S. Government agencies and government sponsored enterprises	\$ 260,748	\$ 1,164	\$ 1,049	\$ 260,863
Mortgage-backed securities:				
Federal National Mortgage Association	209,671	1,092	2,333	208,430
Federal Home Loan Mortgage Corporation	24,564	282	194	24,652
Government National Mortgage Association	26,465	943	4	27,404
Collateralized mortgage obligations:				
Federal National Mortgage Association	16,998	90	154	16,934
Federal Home Loan Mortgage Corporation	5,175	1	91	5,085
Privately issued	-	809	-	809
Total mortgage-backed securities	282,873	3,217	2,776	283,314
Asset-backed securities	-	218	-	218
Total available for sale securities	\$ 543,621	\$ 4,599	\$ 3,825	\$ 544,395
<b>Securities held to maturity:</b>				
State and political subdivisions	294,423	6,562	4	300,981
Mortgage-backed securities:				
Federal National Mortgage Association	9,242	14	79	9,177
Government National Mortgage Association	25,607	33	159	25,481
Collateralized mortgage obligations:				
Federal National Mortgage Association	56,791	-	818	55,973
Federal Home Loan Mortgage Corporation	80,570	-	1,120	79,450
Government National Mortgage Association	19,084	19	101	19,002
Total mortgage-backed securities	191,294	66	2,277	189,083
Total held to maturity securities	\$ 485,717	\$ 6,628	\$ 2,281	\$ 490,064



**December 31, 2014****Securities available for sale:**

U.S. Government agencies and government sponsored enterprises	\$ 160,334	\$ 1,116	\$ 975	\$ 160,475
Mortgage-backed securities:				
Federal National Mortgage Association	184,857	2,344	1,264	185,937
Federal Home Loan Mortgage Corporation	29,478	799	7	30,270
Government National Mortgage Association	48,800	2,022	-	50,822
Collateralized mortgage obligations:				
Federal National Mortgage Association	76,247	489	944	75,792
Federal Home Loan Mortgage Corporation	89,623	199	2,585	87,237
Government National Mortgage Association	29,954	598	40	30,512
Privately issued	-	1,218	-	1,218
Total mortgage-backed securities	458,959	7,669	4,840	461,788
Asset-backed securities	-	231	-	231
Total available for sale securities	\$ 619,293	\$ 9,016	\$ 5,815	\$ 622,494

**Securities held to maturity:**

State and political subdivisions	277,273	4,231	120	281,384
Mortgage-backed securities:				
Federal National Mortgage Association	3,279	24	-	3,303
Government National Mortgage Association	13,886	122	-	14,008
Total mortgage-backed securities	17,165	146	-	17,311
Total held to maturity securities	\$ 294,438	\$ 4,377	\$ 120	\$ 298,695

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**(3.) INVESTMENT SECURITIES (Continued)**

Investment securities with a total fair value of \$781.7 million and \$768.6 million at December 31, 2015 and 2014, respectively, were pledged as collateral to secure public deposits and for other purposes required or permitted by law.

During the years ended December 31, 2015 and 2014, the Company transferred \$165.2 million and \$12.8 million, respectively, of available for sale mortgage backed securities to the held to maturity category, reflecting the Company's intent to hold those securities to maturity. Transfers of investment securities into the held to maturity category from the available for sale category are made at fair value at the date of transfer. The related \$1.1 million and \$51 thousand of unrealized holding losses that were included in the transfers during the years ended December 31, 2015 and 2014, respectively, are retained in accumulated other comprehensive income and in the carrying value of the held to maturity securities. These amounts will be amortized as an adjustment to interest income over the remaining life of the securities. This will offset the impact of amortization of the net premium created in the transfers. There were no gains or losses recognized as a result of these transfers.

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

	<b>2015</b>	<b>2014</b>	<b>2013</b>
Taxable interest and dividends	\$ 16,123	\$ 13,304	\$ 12,541
Tax-exempt interest and dividends	5,752	5,298	4,922
<b>Total interest and dividends on securities</b>	<b>\$ 21,875</b>	<b>\$ 18,602</b>	<b>\$ 17,463</b>

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

	<b>2015</b>	<b>2014</b>	<b>2013</b>
Proceeds from sales	\$ 54,277	\$ 81,600	\$ 1,327
Gross realized gains	2,000	2,043	1,226
Gross realized losses	12	2	-

The scheduled maturities of securities available for sale and securities held to maturity at December 31, 2015 are shown below. Actual expected maturities may differ from contractual maturities because issuers may have the right to call or prepay obligations (in thousands).

	<b>Amortized Cost</b>	<b>Fair Value</b>
<b>Debt securities available for sale:</b>		
Due in one year or less	\$ 25,182	\$ 25,241
Due from one to five years	174,053	173,336
Due after five years through ten years	275,972	276,660
Due after ten years	68,414	69,158
	\$ 543,621	\$ 544,395
<b>Debt securities held to maturity:</b>		
Due in one year or less	\$ 22,188	\$ 22,261
Due from one to five years	172,094	175,650
Due after five years through ten years	116,362	119,183
Due after ten years	175,073	172,970
	\$ 485,717	\$ 490,064

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**(3.) INVESTMENT SECURITIES (Continued)**

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

	<b>Less than 12 months</b>		<b>12 months or longer</b>		<b>Total</b>	
	<b>Fair</b>	<b>Unrealized</b>	<b>Fair</b>	<b>Unrealized</b>	<b>Fair</b>	<b>Unrealized</b>
	<b>Value</b>	<b>Losses</b>	<b>Value</b>	<b>Losses</b>	<b>Value</b>	<b>Losses</b>
<b>December 31, 2015</b>						
<b>Securities available for sale:</b>						
U.S. Government agencies and government sponsored enterprises	\$ 82,298	\$ 735	\$ 26,302	\$ 314	\$ 108,600	\$ 1,049
Mortgage-backed securities:						
Federal National Mortgage Association	123,774	2,134	9,562	199	133,336	2,333
Federal Home Loan Mortgage Corporation	12,660	194	-	-	12,660	194
Government National Mortgage Association	1,405	4	-	-	1,405	4
Collateralized mortgage obligations:						
Federal National Mortgage Association	7,778	154	-	-	7,778	154
Federal Home Loan Mortgage Corporation	4,998	91	-	-	4,998	91
Total mortgage-backed securities	150,615	2,577	9,562	199	160,177	2,776
Total available for sale securities	232,913	3,312	35,864	513	268,777	3,825
<b>Securities held to maturity:</b>						

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State and political subdivisions	3,075	4	-	-	3,075	4
Mortgage-backed securities:						
Federal National Mortgage Association	5,666	79	-	-	5,666	79
Government National Mortgage Association	8,790	159	-	-	8,790	159
Collateralized mortgage obligations:						
Federal National Mortgage Association	55,973	818	-	-	55,973	818
Federal Home Loan Mortgage Corporation	79,323	1,120	-	-	79,323	1,120
Government National Mortgage Association	14,559	101	-	-	14,559	101
Total mortgage-backed securities	164,311	2,277	-	-	164,311	2,277
Total held to maturity securities	167,386	2,281	-	-	167,386	2,281
Total temporarily impaired securities	\$ 400,299	\$ 5,593	\$ 35,864	\$ 513	\$ 436,163	\$ 6,106

**December 31, 2014**

**Securities available for sale:**

U.S. Government agencies and government sponsored enterprises	\$ 34,995	\$ 77	\$ 41,070	\$ 898	\$ 76,065	\$ 975
Mortgage-backed securities:						
Federal National Mortgage Association	2,242	8	62,592	1,256	64,834	1,264
Federal Home Loan Mortgage Corporation	3,387	7	-	-	3,387	7
Collateralized mortgage obligations:						
Federal National Mortgage Association	11,228	24	25,644	920	36,872	944
Federal Home Loan Mortgage Corporation	-	-	76,126	2,585	76,126	2,585
Government National Mortgage Association	-	-	2,510	40	2,510	40
Total mortgage-backed securities	16,857	39	166,872	4,801	183,729	4,840
	51,852	116	207,942	5,699	259,794	5,815

Total available for sale  
securities

**Securities held to maturity:**

State and political subdivisions	18,036	120	-	-	18,036	120
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Total temporarily impaired securities	\$ 69,888	\$ 236	\$ 207,942	\$ 5,699	\$ 277,830	\$ 5,935
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**(3.) INVESTMENT SECURITIES (Continued)**

The total number of security positions in the investment portfolio in an unrealized loss position at December 31, 2015 was 152 compared to 122 at December 31, 2014. At December 31, 2015, the Company had positions in 10 investment securities with a fair value of \$35.9 million and a total unrealized loss of \$513 thousand that have been in a continuous unrealized loss position for more than 12 months. At December 31, 2015, there were a total of 142 securities positions in the Company's investment portfolio with a fair value of \$400.3 million and a total unrealized loss of \$5.6 million that had been in a continuous unrealized loss position for less than 12 months. At December 31, 2014, the Company had positions in 51 investment securities with a fair value of \$207.9 million and a total unrealized loss of \$5.7 million that have been in a continuous unrealized loss position for more than 12 months. At December 31, 2014, there were a total of 71 securities positions in the Company's investment portfolio with a fair value of \$69.9 million and a total unrealized loss of \$236 thousand that had been in a continuous unrealized loss position for less than 12 months. The unrealized loss on investment securities was predominantly caused by changes in market interest rates subsequent to purchase. The fair value of most of the investment securities in the Company's portfolio fluctuates as market interest rates change.

The Company reviews investment securities on an ongoing basis for the presence of other than temporary impairment ( OTTI ) with formal reviews performed quarterly. When evaluating debt securities for OTTI, management considers many factors, including: (1) the length of time and the extent to which the fair value has been less than cost, (2) the financial condition and near-term prospects of the issuer, (3) whether the market decline was affected by macroeconomic conditions, and (4) whether the Company has the intention to sell the debt security or whether it is more likely than not that it will be required to sell the debt security before its anticipated recovery. The assessment of whether OTTI exists involves a high degree of subjectivity and judgment and is based on the information available to management. No impairment was recorded during the years ended December 31, 2015, 2014 and 2013.

Based on management's review and evaluation of the Company's debt securities as of December 31, 2015, the debt securities with unrealized losses were not considered to be OTTI. As of December 31, 2015, the Company does not have the intent to sell any of the securities in a loss position and believes that it is not likely that it will be required to sell any such securities before the anticipated recovery of amortized cost. Accordingly, as of December 31, 2015, management has concluded that unrealized losses on its investment securities are temporary and no further impairment loss has been realized in the Company's consolidated statements of income.

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

Loans held for sale were entirely comprised of residential real estate mortgages and totaled \$1.4 million and \$755 thousand as of December 31, 2015 and 2014, respectively.

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The Company sells 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 \$196.0 million and \$215.2 million as of December 31, 2015 and 2014, respectively. In connection with these mortgage-servicing activities, the Company administered escrow and other custodial funds which amounted to approximately \$4.4 million and \$4.6 million as of December 31, 2015 and 2014, respectively.

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

	<b>2015</b>	<b>2014</b>	<b>2013</b>
Mortgage servicing assets, beginning of year	\$ 1,335	\$ 1,479	\$ 1,637
Originations	166	172	277
Amortization	(276)	(316)	(435)
Mortgage servicing assets, end of year	1,225	1,335	1,479
Valuation allowance	(1)	(6)	(3)
Mortgage servicing assets, net, end of year	\$ 1,224	\$ 1,329	\$ 1,476

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**(5.) LOANS**

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

	<b>Principal Amount Outstanding</b>	<b>Net Deferred Loan (Fees) Costs</b>	<b>Loans, Net</b>
<b>2015</b>			
Commercial business	\$ 313,475	\$ 283	\$ 313,758
Commercial mortgage	567,481	(1,380)	566,101
Residential mortgage	98,302	7	98,309
Home equity	402,487	7,625	410,112
Consumer indirect	652,494	24,446	676,940
Other consumer	18,361	181	18,542
<b>Total</b>	<b>\$ 2,052,600</b>	<b>\$ 31,162</b>	<b>2,083,762</b>
Allowance for loan losses			(27,085)
<b>Total loans, net</b>			<b>\$ 2,056,677</b>
<b>2014</b>			
Commercial business	\$ 267,377	\$ 32	\$ 267,409
Commercial mortgage	476,407	(1,315)	475,092
Residential mortgage	100,241	(140)	100,101
Home equity	379,774	6,841	386,615
Consumer indirect	636,357	25,316	661,673
Other consumer	20,915	197	21,112
<b>Total</b>	<b>\$ 1,881,071</b>	<b>\$ 30,931</b>	<b>1,912,002</b>
Allowance for loan losses			(27,637)
<b>Total loans, net</b>			<b>\$ 1,884,365</b>

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

Certain executive officers, directors and their business interests are customers of the Company. Transactions with these parties are based on the same terms as similar transactions with unrelated third parties and do not carry more than normal credit risk. Borrowings by these related parties amounted to \$3.5 million and \$11.9 million at December 31, 2015 and 2014, respectively. During 2015, new borrowings amounted to \$2.9 million (including borrowings of executive officers and directors that were outstanding at the time of their appointment), and repayments and other reductions were \$11.3 million.

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**(5.) LOANS (Continued)****Past Due Loans Aging**

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

	<b>30-59 Days Past Due</b>	<b>60-89 Days Past Due</b>	<b>Greater Than 90 Days</b>	<b>Total Past Due</b>	<b>Nonaccrual</b>	<b>Current</b>	<b>Total Loans</b>
<b>2015</b>							
Commercial business	\$ 321	\$ 612	\$ -	\$ 933	\$ 3,922	\$ 308,620	\$ 313,475
Commercial mortgage	68	146	-	214	947	566,320	567,481
Residential mortgage	203	-	-	203	1,325	96,774	98,302
Home equity	719	429	-	1,148	758	400,581	402,487
Consumer indirect	1,975	286	-	2,261	1,467	648,766	652,494
Other consumer	98	13	8	119	13	18,229	18,361
<b>Total loans, gross</b>	<b>\$ 3,384</b>	<b>\$ 1,486</b>	<b>\$ 8</b>	<b>\$ 4,878</b>	<b>\$ 8,432</b>	<b>\$ 2,039,290</b>	<b>\$ 2,052,600</b>
<b>2014</b>							
Commercial business	\$ 28	\$ -	\$ -	\$ 28	\$ 4,288	\$ 263,061	\$ 267,377
Commercial mortgage	83	-	-	83	3,020	473,304	476,407
Residential mortgage	321	-	-	321	1,194	98,726	100,241
Home equity	799	67	-	866	463	378,445	379,774
Consumer indirect	2,429	402	-	2,831	1,169	632,357	636,357
Other consumer	148	48	8	204	11	20,700	20,915
<b>Total loans, gross</b>	<b>\$ 3,808</b>	<b>\$ 517</b>	<b>\$ 8</b>	<b>\$ 4,333</b>	<b>\$ 10,145</b>	<b>\$ 1,866,593</b>	<b>\$ 1,881,071</b>

There were no loans past due greater than 90 days and still accruing interest as of December 31, 2015 and 2014. There were \$8 thousand in consumer overdrafts which were past due greater than 90 days as of December 31, 2015 and 2014. Consumer overdrafts are overdrawn deposit accounts which have been reclassified as loans but by their terms do not accrue interest.

Interest income on nonaccrual loans, if recognized, is recorded using the cash basis method of accounting. There was no interest income recognized on nonaccrual loans during the years ended December 31, 2015, 2014 and 2013. For the years ended December 31, 2015, 2014 and 2013, estimated interest income of \$432 thousand, \$527 thousand, and \$531 thousand, respectively, would have been recorded if all such loans had been accruing interest according to their original contractual terms.

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**(5.) LOANS (Continued)****Troubled Debt Restructurings**

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

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

	Number of Contracts	Pre- Modification Outstanding Recorded Investment	Post- Modification Outstanding Recorded Investment
<b>2015</b>			
Commercial business	2	\$ 1,342	\$ 1,342
Commercial mortgage	1	682	330
Total	3	\$ 2,024	\$ 1,672
<b>2014</b>			
Commercial business	1	\$ 1,381	\$ 1,381
Commercial mortgage	-	-	-
Total	1	\$ 1,381	\$ 1,381

The loans identified as TDRs by the Company during the years ended December 31, 2015 and 2014 were on nonaccrual status and reported as impaired loans prior to restructuring. The modifications during the year ended December 31, 2015 primarily related to extending amortization periods, forbearance agreements, requesting additional collateral and, in one instance, forgiveness of principal. For the year ended December 31, 2014, the

restructured loan modification related to extending the amortization period of the loan. All loans restructured during the years ended December 31, 2015 and 2014 were on nonaccrual status at the end of those respective years. Nonaccrual loans that are restructured remain on nonaccrual status, but may move to accrual status after they have performed according to the restructured terms for a period of time. The TDR classification did not have a material impact on the Company's determination of the allowance for loan losses because the modified loans were either classified as substandard, with an increased risk allowance allocation, or impaired and evaluated for a specific reserve both before and after restructuring.

There were two commercial business loans with an aggregate pre-default balance of \$1.3 million that went into default and were restructured during the year ended December 31, 2015. There were no loans modified as a TDR during the year ended December 31, 2014 that defaulted during the year ended December 31, 2014. For purposes of this disclosure, a loan modified as a TDR is considered to have defaulted when the borrower becomes 90 days past due.

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**(5.) LOANS (Continued)****Impaired Loans**

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

	Recorded Investment <sup>(1)</sup>	Unpaid Principal Balance <sup>(1)</sup>	Related Allowance	Average Recorded Investment	Interest Income Recognized
<b>2015</b>					
With no related allowance recorded:					
Commercial business	\$ 1,441	\$ 1,810	\$ -	\$ 1,352	\$ -
Commercial mortgage	937	1,285	-	1,013	-
	2,378	3,095	-	2,365	-
With an allowance recorded:					
Commercial business	2,481	2,481	996	1,946	-
Commercial mortgage	10	10	10	449	-
	2,491	2,491	1,006	2,395	-
	\$ 4,869	\$ 5,586	\$ 1,006	\$ 4,760	\$ -
<b>2014</b>					
With no related allowance recorded:					
Commercial business	\$ 1,408	\$ 1,741	\$ -	\$ 1,431	\$ -
Commercial mortgage	781	920	-	1,014	-
	2,189	2,661	-	2,445	-
With an allowance recorded:					
Commercial business	2,880	2,880	1,556	1,998	-
Commercial mortgage	2,239	2,239	911	1,560	-

	5,119	5,119	2,467	3,558	-
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	\$ 7,308	\$ 7,780	\$ 2,467	\$ 6,003	\$ -
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(1) Difference between recorded investment and unpaid principal balance represents partial charge-offs.

### Credit Quality Indicators

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

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

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

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

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



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**(5.) LOANS (Continued)**

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

	<b>Commercial Business</b>	<b>Commercial Mortgage</b>
<b>2015</b>		
Uncriticized	\$ 298,413	\$ 551,603
Special mention	4,916	9,015
Substandard	10,146	6,863
Doubtful	-	-
<b>Total</b>	<b>\$ 313,475</b>	<b>\$ 567,481</b>
<b>2014</b>		
Uncriticized	\$ 250,961	\$ 460,880
Special mention	5,530	5,411
Substandard	10,886	10,116
Doubtful	-	-
<b>Total</b>	<b>\$ 267,377</b>	<b>\$ 476,407</b>

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

	<b>Residential Mortgage</b>	<b>Home Equity</b>	<b>Consumer Indirect</b>	<b>Other Consumer</b>
<b>2015</b>				

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Performing	\$ 96,977	\$ 401,729	\$ 651,027	\$ 18,340
Non-performing	1,325	758	1,467	21
Total	\$ 98,302	\$ 402,487	\$ 652,494	\$ 18,361

**2014**

Performing	\$ 99,047	\$ 379,311	\$ 635,188	\$ 20,896
Non-performing	1,194	463	1,169	19
Total	\$ 100,241	\$ 379,774	\$ 636,357	\$ 20,915

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**(5.) LOANS (Continued)****Allowance for Loan Losses**

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

	<b>Commercial Business</b>	<b>Commercial Mortgage</b>	<b>Residential Mortgage</b>	<b>Home Equity</b>	<b>Consumer Indirect</b>	<b>Other Consumer</b>	<b>Total</b>
<b>2015</b>							
<b>Allowance for loan losses:</b>							
Beginning balance	\$ 5,621	\$ 8,122	\$ 570	\$ 1,485	\$ 11,383	\$ 456	\$ 27,637
Charge-offs	(1,433)	(895)	(175)	(421)	(9,156)	(878)	(12,958)
Recoveries	212	146	82	63	4,200	322	5,025
Provision (credit)	1,140	1,654	(13)	101	4,031	468	7,381
Ending balance	\$ 5,540	\$ 9,027	\$ 464	\$ 1,228	\$ 10,458	\$ 368	\$ 27,085
Evaluated for impairment:							
Individually	\$ 996	\$ 10	\$ -	\$ -	\$ -	\$ -	\$ 1,006
Collectively	\$ 4,544	\$ 9,017	\$ 464	\$ 1,228	\$ 10,458	\$ 368	\$ 26,079
<b>Loans:</b>							
Ending balance	\$ 313,475	\$ 567,481	\$ 98,302	\$ 402,487	\$ 652,494	\$ 18,361	\$ 2,052,600
Evaluated for impairment:							
Individually	\$ 3,922	\$ 947	\$ -	\$ -	\$ -	\$ -	\$ 4,869
Collectively	\$ 309,553	\$ 566,534	\$ 98,302	\$ 402,487	\$ 652,494	\$ 18,361	\$ 2,047,731

**2014****Allowance for  
loan losses:**

Beginning balance	\$ 4,273	\$ 7,743	\$ 676	\$ 1,367	\$ 12,230	\$ 447	\$ 26,736
Charge-offs	(204)	(304)	(190)	(340)	(10,004)	(972)	(12,014)
Recoveries	201	143	39	56	4,321	366	5,126
Provision	1,351	540	45	402	4,836	615	7,789
Ending balance	\$ 5,621	\$ 8,122	\$ 570	\$ 1,485	\$ 11,383	\$ 456	\$ 27,637

Evaluated for  
impairment:

Individually	\$ 1,556	\$ 911	\$ -	\$ -	\$ -	\$ -	\$ 2,467
Collectively	\$ 4,065	\$ 7,211	\$ 570	\$ 1,485	\$ 11,383	\$ 456	\$ 25,170

**Loans:**

Ending balance	\$ 267,377	\$ 476,407	\$ 100,241	\$ 379,774	\$ 636,357	\$ 20,915	\$ 1,881,071
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Evaluated for  
impairment:

Individually	\$ 4,288	\$ 3,020	\$ -	\$ -	\$ -	\$ -	\$ 7,308
Collectively	\$ 263,089	\$ 473,387	\$ 100,241	\$ 379,774	\$ 636,357	\$ 20,915	\$ 1,873,763

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**(5.) LOANS (Continued)**

	<b>Commercial Business</b>	<b>Commercial Mortgage</b>	<b>Residential Mortgage</b>	<b>Home Equity</b>	<b>Consumer Indirect</b>	<b>Other Consumer</b>	<b>Total</b>
<b>2013</b>							
<b>Allowance for loan losses:</b>							
Beginning balance	\$ 4,884	\$ 6,581	\$ 740	\$ 1,282	\$ 10,715	\$ 512	\$ 24,714
Charge-offs	(1,070)	(553)	(411)	(391)	(8,125)	(928)	(11,478)
Recoveries	349	319	54	157	3,161	381	4,421
Provision	110	1,396	293	319	6,479	482	9,079
Ending balance	\$ 4,273	\$ 7,743	\$ 676	\$ 1,367	\$ 12,230	\$ 447	\$ 26,736
Evaluated for impairment:							
Individually	\$ 201	\$ 1,057	\$ -	\$ -	\$ -	\$ -	\$ 1,258
Collectively	\$ 4,072	\$ 6,686	\$ 676	\$ 1,367	\$ 12,230	\$ 447	\$ 25,478
<b>Loans:</b>							
Ending balance	\$ 265,751	\$ 470,312	\$ 113,101	\$ 320,658	\$ 609,390	\$ 22,893	\$ 1,802,105
Evaluated for impairment:							
Individually	\$ 3,474	\$ 9,663	\$ -	\$ -	\$ -	\$ -	\$ 13,137
Collectively	\$ 262,277	\$ 460,649	\$ 113,101	\$ 320,658	\$ 609,390	\$ 22,893	\$ 1,788,968

**Risk Characteristics**

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

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

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

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

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**(6.) PREMISES AND EQUIPMENT, NET**

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

	<b>2015</b>	<b>2014</b>
Land and land improvements	\$ 5,917	\$ 4,797
Buildings and leasehold improvements	46,402	42,826
Furniture, fixtures, equipment and vehicles	31,868	29,853
Premises and equipment	84,187	77,476
Accumulated depreciation and amortization	(44,742)	(41,082)
Premises and equipment, net	\$ 39,445	\$ 36,394

Depreciation and amortization expense relating to premises and equipment, included in occupancy and equipment expense in the consolidated statements of income, amounted to \$4.4 million, \$4.0 million and \$3.8 million for the years ended December 31, 2015, 2014 and 2013, respectively.

**(7.) GOODWILL AND OTHER INTANGIBLE ASSETS****Goodwill**

Goodwill is not amortized but, instead, is subject to impairment tests on at least an annual basis, and more frequently if an event occurs or circumstances change that would more likely than not reduce the fair value of a reporting unit below its carrying amount. The Company performs its annual impairment test of goodwill as of September 30 of each year. See Note 1 for the Company's accounting policy for goodwill and other intangible assets.

The Company performed a qualitative assessment of goodwill to determine if it was more likely than not that the fair value of any of its reporting units was 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. Based on its assessment, the Company concluded it was more likely than not that the fair value of its Insurance reporting unit was less than its carrying value. Accordingly, the Company performed a Step 1 review for possible goodwill impairment.

Under Step 1 of the goodwill impairment review, the fair value of the Insurance reporting unit was calculated using income and market-based approaches. Under Step 1, it was determined that the carrying value of our Insurance reporting unit exceeded its fair value. For Step 2, the implied fair value of the Insurance reporting unit's goodwill was compared with the carrying amount of the goodwill for the Insurance reporting unit. Based on this assessment, the

Company recorded a goodwill impairment charge related to the Insurance reporting unit of \$751 thousand during the quarter ended December 31, 2015.

The results of the qualitative assessment for 2014 indicated that it was not more likely than not that the fair value of any of the Company's reporting units was less than its carrying value. Consequently, no additional quantitative two-step impairment test was required, and no impairment was recorded in 2014.

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

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

	<b>Banking</b>	<b>Insurance</b>	<b>Total</b>
Balance, January 1, 2014	\$ 48,536	\$ -	\$ 48,536
Acquisition	-	12,617	12,617
Balance, December 31, 2014	48,536	12,617	61,153
Impairment	-	(751)	(751)
Balance, December 31, 2015	\$ 48,536	\$ 11,866	\$ 60,402



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**(7.) GOODWILL AND OTHER INTANGIBLE ASSETS (Continued)****Other Intangible Assets**

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

	2015	2014
<b>Core deposit intangibles:</b>		
Gross carrying amount	\$ 2,042	\$ 2,042
Accumulated amortization	(1,213)	(917)
Net book value	\$ 829	\$ 1,125
Amortization during the year	\$ 296	\$ 341
<b>Other intangibles:</b>		
Gross carrying amount	\$ 6,640	\$ 6,640
Accumulated amortization	(925)	(279)
Net book value	\$ 5,715	\$ 6,361
Amortization during the year	\$ 646	\$ 279

Core deposit intangible amortization expense was \$387 thousand for the year ended December 31, 2013. Estimated amortization expense of other intangible assets for each of the next five years is as follows:

2016	\$ 864
2017	778
2018	689
2019	611
2020	533

**(8.) DEPOSITS**

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

	<b>2015</b>	<b>2014</b>
Noninterest-bearing demand	\$ 641,972	\$ 571,260
Interest-bearing demand	523,366	490,190
Savings and money market	928,175	795,835
Time deposits, due:		
Within one year	450,885	395,956
One to two years	97,059	122,819
Two to three years	46,545	11,448
Three to five years	42,482	62,991
Thereafter	47	28
 Total time deposits	 637,018	 593,242
 Total deposits	 \$ 2,730,531	 \$ 2,450,527

Time deposits in denominations of \$250,000 or more at December 31, 2015 and 2014 amounted to \$92.0 million and \$66.5 million, respectively.

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

	<b>2015</b>	<b>2014</b>	<b>2013</b>
Interest-bearing demand	\$ 754	\$ 607	\$ 729
Savings and money market	1,166	913	978
Time deposits	5,386	4,846	4,893
 Total interest expense on deposits	 \$ 7,306	 \$ 6,366	 \$ 6,600

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**(9.) BORROWINGS**

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

	2015	2014
Short-term borrowings:		
Short-term FHLB borrowings	\$ 293,100	\$ 295,300
Repurchase agreements	-	39,504
Total short-term borrowings	293,100	334,804
Long-term borrowings:		
Subordinated notes, net	38,990	-
Total borrowings	\$ 332,090	\$ 334,804

**Short-term borrowings**

Repurchase agreements are secured overnight borrowings with customers. Short-term FHLB borrowings have original maturities of less than one year and include overnight borrowings that we typically utilize to address short term funding needs as they arise. Short-term FHLB borrowings at December 31, 2015 consisted of \$116.8 million in overnight borrowings and \$176.3 million in short-term advances. Short-term FHLB borrowings at December 31, 2014 consisted of \$129.0 million in overnight borrowings and \$166.3 million in short-term advances. The FHLB borrowings are collateralized by securities from the Company's investment portfolio and certain qualifying loans. At December 31, 2015 and 2014, the Company's borrowings had a weighted average rate of 0.53% and 0.35%, respectively.

**Long-term borrowings**

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

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

## **(10.) COMMITMENTS AND CONTINGENCIES**

### **Financial Instruments with Off-Balance Sheet Risk**

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

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

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

	<b>2015</b>	<b>2014</b>
Commitments to extend credit	\$ 514,818	\$ 450,343
Standby letters of credit	11,746	8,578

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**(10.) COMMITMENTS AND CONTINGENCIES (Continued)**

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

The Company also extends rate lock agreements to borrowers related to the origination of residential mortgage loans. To mitigate the interest rate risk inherent in these rate lock agreements when the Company intends to sell the related loan, once originated, as well as closed residential mortgage loans held for sale, the Company enters into forward commitments to sell individual residential mortgages. Rate lock agreements and forward commitments are considered derivatives and are recorded at fair value. Forward sales commitments totaled \$1.3 million and \$1.2 million at December 31, 2015 and 2014, respectively. The net change in the fair values of these derivatives was recognized as other noninterest income or other noninterest expense in the consolidated statements of income.

**Lease Obligations**

The Company is obligated under a number of noncancellable operating lease agreements for land, buildings and equipment. Certain of these leases provide for escalation clauses and contain renewal options calling for increased rentals if the lease is renewed. Future minimum payments by year and in the aggregate, under the noncancellable leases with initial or remaining terms of one year or more, are as follows at December 31, 2015 (in thousands):

2016	\$	1,644
2017		1,271
2018		1,020
2019		942
2020		810
Thereafter		3,160
	\$	8,847

Rent expense relating to these operating leases, included in occupancy and equipment expense in the statements of income, was \$2.0 million, \$1.8 million and \$1.7 million in 2015, 2014 and 2013, respectively.

**Contingent Liabilities**

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

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**(11.) REGULATORY MATTERS**

**General**

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

**Capital**

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

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

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

Tier 1 capital includes Common Equity Tier 1 capital and additional Tier 1 capital. For the Company, additional Tier 1 capital at December 31, 2015 includes, subject to limitation, \$17.3 million of preferred stock.

Total capital includes Tier 1 capital and Tier 2 capital. Tier 2 capital for both the Company and the Bank includes a permissible portion of the allowance for loan losses. Tier 2 capital for the Company also includes qualified subordinated debt. At December 31, 2015, the Company's Tier 2 capital included \$39.0 million of Subordinated Notes.

Prior to January 1, 2015, under the capital rules then in effect, the Company's and the Bank's Tier 1 capital included total shareholders' equity excluding accumulated other comprehensive income and goodwill and other intangible

assets, net of associated deferred tax liabilities. Tier 1 capital for the Company also included \$17.3 million of preferred stock. The Company and the Bank's Total capital included Tier 1 capital for each entity plus a permissible portion of the allowance for loan losses.

The Common Equity Tier 1 (beginning in 2015), Tier 1 and Total capital ratios are calculated by dividing the respective capital amounts by risk-weighted assets. Risk-weighted assets are calculated based on regulatory requirements and include total assets, with certain exclusions, allocated by risk weight category, and certain off-balance-sheet items, among other things. The leverage ratio is calculated by dividing Tier 1 capital by adjusted quarterly average total assets, which exclude goodwill and other intangible assets, among other things.

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



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**(11.) REGULATORY MATTERS (Continued)**

The implementation of the capital conservation buffer will begin on January 1, 2016 at the 0.625% level and be phased in over a four-year period (increasing by that amount on each subsequent January 1, until it reaches 2.5% on January 1, 2019). The Basel III Capital Rules also provide for a countercyclical capital buffer that is applicable to only certain covered institutions and does not have any current applicability to the Company or the Bank. The capital conservation buffer is designed to absorb losses during periods of economic stress and, as detailed above, effectively increases the minimum required risk-weighted capital ratios. Banking institutions with a ratio of Common Equity Tier 1 capital to risk-weighted assets below the effective minimum (4.5% plus the capital conservation buffer and, if applicable, the countercyclical capital buffer) will face constraints on dividends, equity repurchases and compensation based on the amount of the shortfall.

The following table presents actual and required capital ratios as of December 31, 2015 for the Company and the Bank under the Basel III Capital Rules. The minimum required capital amounts presented include the minimum required capital levels as of December 31, 2015 based on the phase-in provisions of the Basel III Capital Rules and the minimum required capital levels as of January 1, 2019 when the Basel III Capital Rules have been fully phased-in. Capital levels required to be considered well capitalized are based upon prompt corrective action regulations, as amended to reflect the changes under the Basel III Capital Rules (in thousands):

	Actual		Minimum Capital Required Basel III Phase-in Schedule		Minimum Capital Required Basel III Fully Phased-in		Required to be Considered Well Capitalized	
	Amount	Ratio	Amount	Ratio	Amount	Ratio	Amount	Ratio
<b>2015</b>								
Tier 1 leverage:								
Company	\$ 243,452	7.41 %	\$ 131,506	4.00 %	\$ 131,506	4.00 %	\$ 164,382	5.00 %
Bank	265,487	8.09	131,188	4.00	131,188	4.00	163,985	5.00
CET1 capital:								
Company	226,413	9.77	104,334	4.50	162,297	7.00	150,705	6.50
Bank	265,487	11.49	103,971	4.50	161,733	7.00	150,180	6.50
Tier 1 capital:								
Company	243,452	10.50	139,112	6.00	197,076	8.50	185,483	8.00
Bank	265,487	11.49	138,628	6.00	196,389	8.50	184,837	8.00

Total  
capital:

Company	309,527	13.35	185,483	8.00	243,446	10.50	231,854	10.00
Bank	292,572	12.66	184,837	8.00	242,599	10.50	231,046	10.00

The Company's and the Bank's actual and required regulatory capital ratios of December 31, 2014 under the regulatory capital rules then in effect were as follows (in thousands):

		Actual		Minimum Required for Capital Adequacy Purposes		Required to be Considered Well Capitalized	
		Amount	Ratio	Amount	Ratio	Amount	Ratio
<b>2014</b>							
Tier 1 leverage:	Company	\$ 219,904	7.35 %	\$ 119,722	4.00 %	\$ 149,653	5.00 %
	Bank	215,672	7.21	119,671	4.00	149,588	5.00
Tier 1 capital:	Company	219,904	10.47	83,985	4.00	125,977	6.00
	Bank	215,672	10.28	83,889	4.00	125,834	6.00
Total risk-based capital:	Company	246,166	11.72	167,970	8.00	209,962	10.00
	Bank	241,905	11.53	167,779	8.00	209,723	10.00

As of December 31, 2015, the Company and Bank were considered well capitalized under all regulatory capital guidelines. Such determination has been made based on the Tier 1 leverage, CET1 capital, Tier 1 capital and total capital ratios.

#### Federal Reserve Requirements

As of December 31, 2015 and 2014, the Bank was not required to maintain a reserve balance at the FRB of New York. The reserve requirement was \$1.0 million as of December 31, 2013.

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**(11.) REGULATORY MATTERS (Continued)****Dividend Restrictions**

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

**(12.) SHAREHOLDERS EQUITY**

The Company's authorized capital stock consists of 50,210,000 shares of capital stock, 50,000,000 of which are common stock, par value \$0.01 per share, and 210,000 of which are preferred stock, par value \$100 per share, which is designated into two classes, Class A of which 10,000 shares are authorized, and Class B of which 200,000 shares are authorized. There are two series of Class A preferred stock: Series A 3% preferred stock and the Series A preferred stock. There is one series of Class B preferred stock: Series B-1 8.48% preferred stock. There were 173,398 shares of preferred stock issued and outstanding as of December 31, 2015 and 2014.

**Common Stock**

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

	Outstanding	Treasury	Issued
<b>2015</b>			
Shares outstanding at beginning of year	14,118,048	279,461	14,397,509
Restricted stock awards issued	59,834	(59,834)	-
Restricted stock awards forfeited	(3,490)	3,490	-
Stock options exercised	18,922	(18,922)	-
Treasury stock purchases	(7,523)	7,523	-
Stock awards	4,401	(4,401)	-
Shares outstanding at end of year	14,190,192	207,317	14,397,509

**2014**

Shares outstanding at beginning of year	13,829,355	332,242	14,161,597
Shares issued for the SDN acquisition	235,912	-	235,912
Restricted stock awards issued	43,242	(43,242)	-
Restricted stock awards forfeited	(15,441)	15,441	-
Stock options exercised	34,082	(34,082)	-
Treasury stock purchases	(9,102)	9,102	-
Shares outstanding at end of year	14,118,048	279,461	14,397,509

**Preferred Stock**

**Series A 3% Preferred Stock.** There were 1,492 shares of Series A 3% preferred stock issued and outstanding as of December 31, 2015 and 2014. Holders of Series A 3% preferred stock are entitled to receive an annual dividend of \$3.00 per share, which is cumulative and payable quarterly. Holders of Series A 3% preferred stock have no pre-emptive right in, or right to purchase or subscribe for, any additional shares of the Company's capital stock and have no voting rights. Dividend or dissolution payments to the Class A shareholders must be declared and paid, or set apart for payment, before any dividends or dissolution payments can be declared and paid, or set apart for payment, to the holders of Class B preferred stock or common stock. The Series A 3% preferred stock is not convertible into any other of the Company's securities.

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**(12.) SHAREHOLDERS EQUITY (Continued)**

**Series B-1 8.48% Preferred Stock.** There were 171,906 shares of Series B-1 8.48% preferred stock issued and outstanding as of December 31, 2015 and 2014. Holders of Series B-1 8.48% preferred stock are entitled to receive an annual dividend of \$8.48 per share, which is cumulative and payable quarterly. Holders of Series B-1 8.48% preferred stock have no pre-emptive right in, or right to purchase or subscribe for, any additional shares of the Company's common stock and have no voting rights. Accumulated dividends on the Series B-1 8.48% preferred stock do not bear interest, and the Series B-1 8.48% preferred stock is not subject to redemption. Dividend or dissolution payments to the Class B shareholders must be declared and paid, or set apart for payment, before any dividends or dissolution payments are declared and paid, or set apart for payment, to the holders of common stock. The Series B-1 8.48% preferred stock is not convertible into any other of the Company's securities.

**(13.) ACCUMULATED OTHER COMPREHENSIVE INCOME (LOSS)**

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

	<b>Pre-tax</b>		<b>Net-of-tax</b>
	<b>Amount</b>	<b>Tax Effect</b>	<b>Amount</b>
<b>2015</b>			
Securities available for sale and transferred securities:			
Change in unrealized gain/loss during the period	\$ (1,529)	\$ (591)	\$ (938)
Reclassification adjustment for net gains included in net income (1)	(2,251)	(868)	(1,383)
Total securities available for sale and transferred securities	(3,780)	(1,459)	(2,321)
Pension and post-retirement obligations:			
Net actuarial gains (losses) arising during the year	(887)	(342)	(545)
Amortization of net actuarial loss and prior service cost included in income	895	345	550
Total pension and post-retirement obligations	8	3	5
Other comprehensive loss	\$ (3,772)	\$ (1,456)	\$ (2,316)

**2014**

<b>Securities available for sale and transferred securities:</b>			
Change in unrealized gain/loss during the period	\$ 14,008	\$ 5,549	\$ 8,459
Reclassification adjustment for net gains included in net income (1)	(2,478)	(981)	(1,497)
<b>Total securities available for sale and transferred securities</b>	<b>11,530</b>	<b>4,568</b>	<b>6,962</b>
<b>Pension and post-retirement obligations:</b>			
Net actuarial gains (losses) arising during the year	(9,709)	(3,846)	(5,863)
Amortization of net actuarial loss and prior service cost included in income	128	51	77
<b>Total pension and post-retirement obligations</b>	<b>(9,581)</b>	<b>(3,795)</b>	<b>(5,786)</b>
<b>Other comprehensive income</b>	<b>\$ 1,949</b>	<b>\$ 773</b>	<b>\$ 1,176</b>

**2013**

<b>Securities available for sale and transferred securities:</b>			
Change in unrealized gain/loss during the period	\$ (34,135)	\$ (13,522)	\$ (20,613)
Reclassification adjustment for net gains included in net income (1)	(1,298)	(514)	(784)
<b>Total securities available for sale and transferred securities</b>	<b>(35,433)</b>	<b>(14,036)</b>	<b>(21,397)</b>
<b>Pension and post-retirement obligations:</b>			
Net actuarial gains (losses) arising during the year	11,860	4,698	7,162
Amortization of net actuarial loss and prior service cost included in income	1,316	521	795
<b>Total pension and post-retirement obligations</b>	<b>13,176</b>	<b>5,219</b>	<b>7,957</b>
<b>Other comprehensive loss</b>	<b>\$ (22,257)</b>	<b>\$ (8,817)</b>	<b>\$ (13,440)</b>

- (1) Includes amounts related to the amortization/accretion of unrealized net gains and losses related to the Company's reclassification of available for sale investment securities to the held to maturity category. The unrealized net gains/losses will be amortized/accreted over the remaining life of the investment securities as an adjustment of yield.

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**(13.) ACCUMULATED OTHER COMPREHENSIVE INCOME (LOSS) (Continued)**

Activity in accumulated other comprehensive income (loss), net of tax, was as follows (in thousands):

	<b>Securities Available for Sale and Transferred Securities</b>	<b>Pension and Post- retirement Obligations</b>	<b>Accumulated Other Comprehensive Income (Loss)</b>
Balance at January 1, 2015	\$ 1,625	\$ (10,636)	\$ (9,011)
Other comprehensive income (loss) before reclassifications	(938)	(545)	(1,483)
Amounts reclassified from accumulated other comprehensive income	(1,383)	550	(833)
Net current period other comprehensive (loss) income	(2,321)	5	(2,316)
Balance at December 31, 2015	\$ (696)	\$ (10,631)	\$ (11,327)
Balance at January 1, 2014	\$ (5,337)	\$ (4,850)	\$ (10,187)
Other comprehensive income (loss) before reclassifications	8,459	(5,863)	2,596
Amounts reclassified from accumulated other comprehensive income	(1,497)	77	(1,420)
Net current period other comprehensive (loss) income	6,962	(5,786)	1,176
Balance at December 31, 2014	\$ 1,625	\$ (10,636)	\$ (9,011)
Balance at January 1, 2013	\$ 16,060	\$ (12,807)	\$ 3,253
Other comprehensive income (loss) before reclassifications	(20,613)	7,162	(13,451)
Amounts reclassified from accumulated other comprehensive income	(784)	795	11
Net current period other comprehensive income (loss)	(21,397)	7,957	(13,440)

Balance at December 31, 2013	\$	(5,337)	\$	(4,850)	\$	(10,187)
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The following table presents the amounts reclassified out of each component of accumulated other comprehensive income (loss) for the years ended December 31 (in thousands):

Details About Accumulated Other Comprehensive Income Components	Amount Reclassified from Accumulated Other Comprehensive Income		Affected Line Item in the Consolidated Statement of Income
	2015	2014	
Realized gain on sale of investment securities	\$ 1,988	\$ 2,041	Net gain on disposal of investment securities
Amortization of unrealized holding gains (losses) on investment securities transferred from available for sale to held to maturity	263	437	Interest income
	2,251	2,478	Total before tax
	(868)	(981)	Income tax expense
	1,383	1,497	Net of tax
Amortization of pension and post-retirement items:			
Prior service credit <sup>(1)</sup>	48	48	Salaries and employee benefits
Net actuarial losses <sup>(1)</sup>	(943)	(176)	Salaries and employee benefits
	(895)	(128)	Total before tax
	345	51	Income tax benefit
	(550)	(77)	Net of tax
Total reclassified for the period	\$ 833	\$ 1,420	

<sup>(1)</sup> These items are included in the computation of net periodic pension expense. See Note 17 Employee Benefit Plans for additional information.



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**(14.) SHARE-BASED COMPENSATION**

The Company maintains certain stock-based compensation plans, approved by the Company's shareholders that are administered by the Management Development and Compensation Committee (the Compensation Committee) of the Board. In May 2015, the Company's shareholders approved the 2015 Long-Term Incentive Plan (the 2015 Plan) to replace the 2009 Management Stock Incentive Plan and the 2009 Directors' Stock Incentive Plan (collectively, the 2009 Plans). A total of 438,076 shares transferred from the 2009 Plans were available for grant pursuant to the 2015 Plan as of May 6, 2015, the date of approval of the 2015 Plan. In addition, any shares subject to outstanding awards under the 2009 Plans that are canceled, expired, forfeited or otherwise not issued or are settled in cash on or after May 6, 2015, will become available for future award grants under the 2015 Plan. As of December 31, 2015, there were approximately 424,000 shares available for grant under the 2015 Plan.

Under the Plan, the Compensation Committee may establish and prescribe grant guidelines including various terms and conditions for the granting of stock-based compensation. For stock options, the exercise price of each option equals the market price of the Company's stock on the date of the grant. All options expire after a period of ten years from the date of grant and generally become fully exercisable over a period of 3 to 5 years from the grant date. When an option recipient exercises their options, the Company issues shares from treasury stock and records the proceeds as additions to capital. Shares of restricted stock granted to employees generally vest over 2 to 3 years from the grant date. Fifty percent of the shares of restricted stock granted to non-employee directors generally vests on the date of grant and the remaining fifty percent generally vests one year from the grant date. Vesting of the shares may be based on years of service, established performance measures or both. If restricted stock grants are forfeited before they vest, the shares are reacquired into treasury stock.

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

The Company awarded grants of 36,384 shares of restricted common stock to certain members of management during the year ended December 31, 2015. Thirty percent of the shares subject to each grant will be earned based upon achievement of an EPS performance requirement for the Company's fiscal year ended December 31, 2015. The remaining seventy percent of the shares will be earned based on the Company's achievement of a relative total shareholder return (TSR) performance requirement, on a percentile basis, compared to the SNL Small Cap Bank & Thrifts Index over a three-year performance period ended December 31, 2017. The shares earned based on the achievement of the EPS and TSR performance requirements, if any, will vest on February 25, 2018 assuming the recipient's continuous service to the Company.

The grant-date fair value of the TSR portion of the award granted during the year ended December 31, 2015 was determined using the Monte Carlo simulation model on the date of grant, assuming the following (i) expected term of 2.85 years, (ii) risk free interest rate of 0.92%, (iii) expected dividend yield of 3.53% and (iv) expected stock price volatility over the expected term of the TSR award of 26.8%. The grant-date fair value of all other restricted stock

awards is equal to the closing market price of the Company's common stock on the date of grant.

The Company granted 12,700 additional shares of restricted common stock to management during the year ended December 31, 2015. These shares will vest after completion of a three-year service requirement. The average market price of the restricted stock awards on the date of grant was \$22.79.

During the year ended December 31, 2015, the Company granted a total of 10,750 restricted shares of common stock to non-employee directors, of which 5,380 shares vested immediately and 5,370 shares will vest after completion of a one-year service requirement. The market price of the restricted stock on the date of grant was \$23.25. In addition, the Company issued a total of 4,401 shares of common stock in-lieu of cash for the annual retainer of three non-employee directors during the year ended December 31, 2015. The weighted average market price of the stock on the date of grant was \$24.96.

The restricted stock awards granted to management and directors in 2015 do not have rights to dividends or dividend equivalents.

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**(14.) SHARE-BASED COMPENSATION (Continued)**

The Company uses the Black-Scholes valuation method to estimate the fair value of its stock option awards. There were no stock options awarded during 2015, 2014 or 2013. There was no unrecognized compensation expense related to unvested stock options as of December 31, 2015. The following is a summary of stock option activity for the year ended December 31, 2015 (dollars in thousands, except per share amounts):

	Number of Options	Weighted Average Exercise Price	Weighted Average Remaining Contractual Term	Aggregate Intrinsic Value
Outstanding at beginning of year	135,416	\$ 19.25		
Granted	-	-		
Exercised	(18,922)	18.99		
Forfeited	-	-		
Expired	(14,245)	19.87		
Outstanding and exercisable at end of period	102,249	\$ 19.21	1.3 years	\$ 899

The aggregate intrinsic value (the amount by which the market price of the stock on the date of exercise exceeded the market price of the stock on the date of grant) of option exercises for the years ended December 31, 2015, 2014 and 2013 was \$106 thousand, \$161 thousand, and \$106 thousand, respectively. The total cash received as a result of option exercises under stock compensation plans for the years ended December 31, 2015, 2014 and 2013 was \$359 thousand, \$667 thousand, and \$448 thousand, respectively. The tax benefits realized in connection with these stock option exercises were not significant.

The following is a summary of restricted stock award activity for the year ended December 31, 2015:

	Number of Shares	Weighted Average Market Price at Grant Date
Outstanding at beginning of year	59,113	\$ 17.24
Granted	59,834	17.66

Vested	(32,549)	17.80
Forfeited	(3,490)	19.32
Outstanding at end of period	82,908	\$ 17.23

As of December 31, 2015, there was \$737 thousand of unrecognized compensation expense related to unvested restricted stock awards that is expected to be recognized over a weighted average period of 1.8 years.

The Company amortizes the expense related to restricted stock awards over the vesting period. Share-based compensation expense is recorded as a component of salaries and employee benefits in the consolidated statements of income for awards granted to management and as a component of other noninterest expense for awards granted to directors. The share-based compensation expense for the years ended December 31 was as follows (in thousands):

	2015	2014	2013
Salaries and employee benefits	\$ 431	\$ 270	\$ 236
Other noninterest expense	243	201	171
Total share-based compensation expense	\$ 674	\$ 471	\$ 407

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**(15.) INCOME TAXES**

The income tax expense for the years ended December 31 consisted of the following (in thousands):

	<b>2015</b>	<b>2014</b>	<b>2013</b>
Current tax expense (benefit):			
Federal	\$ 8,720	\$ 7,546	\$ 8,917
State	21	(75)	1,913
Total current tax expense	8,741	7,471	10,830
Deferred tax expense (benefit):			
Federal	1,440	2,538	1,251
State	358	(384)	296
Total deferred tax expense	1,798	2,154	1,547
Total income tax expense	\$ 10,539	\$ 9,625	\$ 12,377

Income tax expense differed from the statutory federal income tax rate for the years ended December 31 as follows:

	<b>2015</b>	<b>2014</b>	<b>2013</b>
Statutory federal tax rate	35.0%	35.0%	35.0%
Increase (decrease) resulting from:			
Tax exempt interest income	(6.1)	(5.1)	(4.8)
Tax credits and adjustments	(0.7)	(3.5)	-
Non-taxable earnings on company owned life insurance	(1.8)	(1.6)	(1.6)
State taxes, net of federal tax benefit	0.7	(0.8)	3.8
Nondeductible expenses	0.3	0.5	0.2
Goodwill and contingent consideration adjustments	(0.3)	-	-
Other, net	-	0.2	0.1
Effective tax rate	27.1%	24.7%	32.7%

Total income tax expense (benefit) was allocated as follows for the years ended December 31 (in thousands):

	<b>2015</b>	<b>2014</b>	<b>2013</b>
Income tax expense	\$ 10,539	\$ 9,625	\$ 12,377
Shareholder's equity	(1,456)	925	(8,817)

The Company recognizes deferred income taxes for the estimated future tax effects of differences between the tax and financial statement bases of assets and liabilities considering enacted tax laws. These differences result in deferred tax assets and liabilities, which are included in other assets in the Company's consolidated statements of condition. The Company also assesses the likelihood that deferred tax assets will be realizable based on, among other considerations, future taxable income and establishes, if necessary, a valuation allowance for those deferred tax assets determined to not likely be realizable. A deferred tax asset valuation allowance is recognized if, based on the weight of available evidence (both positive and negative), it is more likely than not that some portion or all of the deferred tax assets will not be realized. The future realization of deferred tax benefits depends upon the existence of sufficient taxable income within the carry-back and carry-forward periods. Management's judgment is required in determining the appropriate recognition of deferred tax assets and liabilities, including projections of future taxable income.

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**(15.) INCOME TAXES (Continued)**

The Company's net deferred tax asset is included in other assets in the consolidated statements of condition. The tax effects of temporary differences that give rise to the deferred tax assets and deferred tax liabilities are as follows at December 31 (in thousands):

	2015	2014
Deferred tax assets:		
Allowance for loan losses	\$ 10,452	\$ 10,666
Deferred compensation	972	938
Investment in limited partnerships	954	953
SERP agreements	767	704
Interest on nonaccrual loans	615	664
Benefit of tax credit carryforwards	502	569
Share-based compensation	538	565
Net unrealized loss on securities available for sale	420	-
Other than temporary impairment of investment securities	-	1,917
Other	328	520
Gross deferred tax assets	15,548	17,496
Deferred tax liabilities:		
Prepaid pension costs	5,065	5,346
Intangible assets	2,667	2,662
Depreciation and amortization	1,004	1,249
Net unrealized gain on securities available for sale	-	1,039
Loan servicing assets	479	525
Gross deferred tax liabilities	9,215	10,821
Net deferred tax asset	\$ 6,333	\$ 6,675

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

Based upon the Company's historical and projected future levels of pre-tax and taxable income, the scheduled reversals of taxable temporary differences to offset future deductible amounts, and prudent and feasible tax planning strategies, management believes it is more likely than not that the deferred tax assets will be realized. As such, no valuation allowance has been recorded as of December 31, 2015 or 2014.

The Company and its subsidiaries are primarily subject to federal and New York income taxes. The federal income tax years currently open for audit are 2013 through 2015. The New York income tax years currently open for audit are 2012 through 2015.

At December 31, 2015, the Company had no federal or New York net operating loss carryforwards. The Company has New York tax credits of approximately \$800 thousand which have an unlimited carryforward period.

The Company's unrecognized tax benefits and changes in unrecognized tax benefits were not significant as of or for the years ended December 31, 2015, 2014 and 2013. There were no material interest or penalties recorded in the income statement in income tax expense for the years ended December 31, 2015, 2014 and 2013. As of December 31, 2015 and 2014, there were no amounts accrued for interest or penalties related to uncertain tax positions.



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**(16.) EARNINGS PER COMMON SHARE**

The following table presents a reconciliation of the earnings and shares used in calculating basic and diluted EPS for each of the years ended December 31 (in thousands, except per share amounts). All outstanding unvested share-based payment awards that contain rights to nonforfeitable dividends are considered participating securities.

	<b>2015</b>	<b>2014</b>	<b>2013</b>
Net income available to common shareholders for EPS	\$ 26,875	\$ 27,893	\$ 24,064
Weighted average common shares outstanding:			
Total shares issued	14,398	14,261	14,162
Unvested restricted stock awards	(93)	(64)	(69)
Treasury shares	(224)	(304)	(354)
Total basic weighted average common shares outstanding	14,081	13,893	13,739
Incremental shares from assumed:			
Exercise of stock options	24	26	13
Vesting of restricted stock awards	30	27	32
Total diluted weighted average common shares outstanding	14,135	13,946	13,784
Basic earnings per common share	\$ 1.91	\$ 2.01	\$ 1.75
Diluted earnings per common share	\$ 1.90	\$ 2.00	\$ 1.75

For each of the periods presented, average shares subject to the following instruments were excluded from the computation of diluted EPS because the effect would be antidilutive:

Stock options	-	3	122
Restricted stock awards	1	1	2
Total	1	4	124

There were no participating securities outstanding for the years ended December 2015, 2014 and 2013; therefore, the two-class method of calculating basic and diluted EPS was not applicable for the years presented.

**(17.) EMPLOYEE BENEFIT PLANS**

**Defined Contribution Plan**

Employees that meet specified eligibility conditions are eligible to participate in the Company sponsored 401(k) plan. Under the plan, participants may make contributions, in the form of salary deferrals, up to the maximum Internal Revenue Code limit. Until December 31, 2015, the Company matched a participant's contributions up to 4.5% of compensation, calculated at 100% of the first 3% of compensation and 50% of the next 3% of compensation deferred by the participant. The Company was also permitted to make additional discretionary matching contributions, although no such additional discretionary contributions were made in 2015, 2014 or 2013. The expense included in salaries and employee benefits in the consolidated statements of income for this plan amounted to \$1.3 million in 2015 and \$1.1 million in 2014 and 2013. Effective January 1, 2016, the 401(k) Plan was amended to discontinue the Company's matching contribution.

**Defined Benefit Pension Plan**

The Company participates in The New York State Bankers Retirement System (the Plan), a defined benefit pension plan covering substantially all employees, subject to the limitations related to the plan closure effective December 31, 2006. Prior to January 1, 2016, the benefits were generally based on years of service and the employee's highest average compensation during five consecutive years of employment. The defined benefit plan was closed to new participants effective December 31, 2006. Only employees hired on or before December 31, 2006 and who met participation requirements on or before January 1, 2008 were eligible to receive benefits.

Effective January 1, 2016, the Plan was amended to open the Plan up to eligible employees who were hired on and after January 1, 2007, discontinue the Plan's prior formula and provide all eligible participants with a cash balance benefit formula.

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**(17.) EMPLOYEE BENEFIT PLANS (Continued)**

The following table provides a reconciliation of the Company's changes in the Plan's benefit obligations, fair value of assets and a statement of the funded status as of and for the year ended December 31 (in thousands):

	2015	2014
<b>Change in projected benefit obligation:</b>		
Projected benefit obligation at beginning of period	\$ 61,732	\$ 48,991
Service cost	2,324	1,918
Interest cost	2,328	2,291
Actuarial (gain) loss	(4,406)	10,938
Benefits paid and plan expenses	(2,746)	(2,406)
<b>Projected benefit obligation at end of period</b>	<b>59,232</b>	<b>61,732</b>
<b>Change in plan assets:</b>		
Fair value of plan assets at beginning of period	75,584	64,603
Actual return on plan assets	(480)	5,387
Employer contributions	-	8,000
Benefits paid and plan expenses	(2,746)	(2,406)
<b>Fair value of plan assets at end of period</b>	<b>72,358</b>	<b>75,584</b>
<b>Funded status at end of period</b>	<b>\$ 13,126</b>	<b>\$ 13,852</b>

The accumulated benefit obligation was \$53.5 million and \$54.9 million at December 31, 2015 and 2014, respectively.

The Company's funding policy is to contribute, at a minimum, an actuarially determined amount that will satisfy the minimum funding requirements determined under the appropriate sections of Internal Revenue Code. The Company had no minimum required contribution for the 2016 fiscal year.

Estimated benefit payments under the Plan over the next ten years at December 31, 2015 are as follows (in thousands):

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2016	\$	2,127
2017		2,288
2018		2,346
2019		2,472
2020		2,666
2021 - 2025		15,627

Net periodic pension cost consists of the following components for the years ended December 31 (in thousands):

	<b>2015</b>	<b>2014</b>	<b>2013</b>
Service cost	\$ 2,324	\$ 1,918	\$ 2,063
Interest cost on projected benefit obligation	2,328	2,291	2,017
Expected return on plan assets	(4,820)	(4,117)	(3,684)
Amortization of unrecognized loss	926	159	1,344
Amortization of unrecognized prior service cost	20	20	20
Net periodic pension cost	\$ 778	\$ 271	\$ 1,760

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**(17.) EMPLOYEE BENEFIT PLANS (Continued)**

The actuarial assumptions used to determine the net periodic pension cost were as follows:

	<b>2015</b>	<b>2014</b>	<b>2013</b>
Weighted average discount rate	3.86%	4.80%	3.84%
Rate of compensation increase	3.00%	3.00%	3.00%
Expected long-term rate of return	6.50%	6.50%	6.50%

The actuarial assumptions used to determine the projected benefit obligation were as follows:

	<b>2015</b>	<b>2014</b>	<b>2013</b>
Weighted average discount rate	4.21%	3.86%	4.80%
Rate of compensation increase	3.00%	3.00%	3.00%

The weighted average discount rate was based upon the projected benefit cash flows and the market yields of high grade corporate bonds that are available to pay such cash flows.

The weighted average expected long-term rate of return is estimated based on current trends in the Plan's assets as well as projected future rates of return on those assets and reasonable actuarial assumptions based on the guidance provided by Actuarial Standard of Practice No. 27, "Selection of Economic Assumptions for Measuring Pension Obligations" for long term inflation, and the real and nominal rate of investment return for a specific mix of asset classes. The following assumptions were used in determining the long-term rate of return:

Equity securities	Dividend discount model, the smoothed earnings yield model and the equity risk premium model
Fixed income securities	Current yield-to-maturity and forecasts of future yields
Other financial instruments	Comparison of the specific investment's risk to that of fixed income and equity instruments and using judgment

The long term rate of return considers historical returns. Adjustments were made to historical returns in order to reflect expectations of future returns. These adjustments were due to factor forecasts by economists and long-term U.S. Treasury yields to forecast long-term inflation. In addition, forecasts by economists and others for long-term GDP growth were factored into the development of assumptions for earnings growth and per capita income.

The Plan's overall investment strategy is to achieve a mix of approximately 97% of investments for long-term growth and 3% for near-term benefit payments with a wide diversification of asset types, fund strategies, and fund managers. The target allocations for Plan assets are shown in the table below. Cash equivalents consist primarily of government issues (maturing in less than three months) and short term investment funds. Equity securities primarily include investments in common stock, depository receipts, preferred stock, commingled pension trust funds, exchange traded funds and real estate investment trusts. Fixed income securities include corporate bonds, government issues, credit card receivables, mortgage backed securities, municipals, commingled pension trust funds and other asset backed securities. Other investments are real estate interests and related investments held within a commingled pension trust fund.

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**(17.) EMPLOYEE BENEFIT PLANS (Continued)**

The Plan currently prohibits its investment managers from purchasing any security greater than 5% of the portfolio at the time of purchase or greater than 8% at market value in any one issuer. Effective June 2013, the issuer of any security purchased must be located in a country in the Morgan Stanley Capital International World Index. In addition, the following are prohibited:

Equity securities

Short sales

Unregistered stocks

Margin purchases

Fixed income securities

Mortgage backed derivatives that have an inverse floating rate coupon or that are interest only securities

Any ABS that is not issued by the U.S. Government or its agencies or its instrumentalities

Generally securities of less than Baa2/BBB quality may not be purchased

Securities of less than A-quality may not in the aggregate exceed 13% of the investment manager's portfolio.

An investment manager's portfolio of commercial MBS and ABS shall not exceed 10% of the portfolio at the time of purchase.

Other financial instruments    Unhedged currency exposure in countries not defined as high income economies by the World Bank

All other investments not prohibited by the Plan are permitted. At December 31, 2015 and 2014, the Plan held certain investments which are no longer deemed acceptable to acquire. These positions will be liquidated when the investment managers deem that such liquidation is in the best interest of the Plan.

The target allocation range below is both historic and prospective in that it has not changed since prior to 2013. It is the asset allocation range that the investment managers have been advised to adhere to and within which they may make tactical asset allocation decisions.

Asset category:	2015		Percentage of Plan Assets		Weighted
	Target		at December 31,		Average
	Allocation		2015	2014	Expected
					Long-term
					Rate of Return
Cash equivalents	0	20%	5.2%	8.7%	0.16%
Equity securities	40	60	47.2	48.2	3.97
Fixed income securities	40	60	43.9	43.1	2.01
Other financial instruments	0	5	3.7	-	0.28

Assets are segregated by the level of the valuation inputs within the fair value hierarchy established by ASC Topic 820 utilized to measure fair value (see Note 18 - Fair Value Measurements).

In instances in which the inputs used to measure fair value fall into different levels of the fair value hierarchy, the fair value measurement has been determined based on the lowest level input that is significant to the fair value measurement in its entirety. Investments valued using the NAV (Net Asset Value) are classified as level 2 if the Plan can redeem its investment with the investee at the NAV at the measurement date. If the Plan can never redeem the investment with the investee at the NAV, it is considered a level 3. If the Plan can redeem the investment at the NAV at a future date, the Plan's assessment of the significance of a particular item to the fair value measurement in its entirety requires judgment, including the consideration of inputs specific to the asset.



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**(17.) EMPLOYEE BENEFIT PLANS (Continued)**

The Plan uses the Thomson Reuters Pricing Service to determine the fair value of equities excluding commingled pension trust funds, the pricing service of IDC Corporate USA to determine the fair value of fixed income securities excluding commingled pension trust funds and JP Morgan Chase Bank, N.A. ( JPMorgan ) to determine the fair value of commingled pension trust funds.

The following is a table of the pricing methodology and unobservable inputs used by JPMorgan in pricing commingled pension trust funds ( CPTF ):

	<b>Principal Valuation Technique(s) Used</b>	<b>Unobservable Inputs</b>
<b>CPTF - Fixed Income:</b>		
CPTF (Corporate High Yield) of JPMorgan	Market	None
CPTF (High Yield) of JPMorgan	Market Comparables Companies	EBITDA multiple and discounts for lack of marketability
CPTF (Extended Duration) of JPMorgan	Market and Income	Constant prepayment rate, Constant default rate and Yield
CPTF (Long Duration Investment Grade) of JPMorgan	Market	None
CPTF (Emerging Markets Currency Debt) of JPMorgan	Market	None
CPTF (Emerging Markets - Fixed Income) of JPMorgan	Market	None
<b>CPTF Other:</b>		
CPTF (Strategic Property) of JPMorgan	Market, Income, Debt Service and Sales Comparison	Credit Spreads, Discount Rate, Loan to Value Ratio, Terminal Capitalization Rate and Value per Square Foot

When valuing Commingled Pension Trust Funds (Equity) JPMorgan uses a market methodology and does not rely on unobservable inputs in those valuations.

The following table sets forth a summary of the changes in the Plan's level 3 assets for the year ended December 31, 2015:

Level 3 assets, beginning of year	\$	-
Purchases		2,334
Unrealized gains		336
Level 3 assets, end of year	\$	2,670

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**(17.) EMPLOYEE BENEFIT PLANS (Continued)**

The major categories of Plan assets measured at fair value on a recurring basis as of December 31 are presented in the following tables (in thousands).

	Level 1 Inputs	Level 2 Inputs	Level 3 Inputs	Total Fair Value
<b>2015</b>				
Cash equivalents:				
Foreign currencies	\$ 35	\$ -	\$ -	\$ 35
Short term investment funds	-	3,745	-	3,745
<b>Total cash equivalents</b>	<b>35</b>	<b>3,745</b>	<b>-</b>	<b>3,780</b>
Equity securities:				
Common stock	13,083	-	-	13,083
Depository receipts	336	-	-	336
Commingled pension trust funds	-	10,557	-	10,557
Exchange traded funds	10,190	-	-	10,190
<b>Total equity securities</b>	<b>23,609</b>	<b>10,557</b>	<b>-</b>	<b>34,166</b>
Fixed income securities:				
Collateralized mortgage obligations	-	608	-	608
Commingled pension trust funds	-	17,889	-	17,889
Corporate bonds	-	3,439	-	3,439
FHLMC	-	276	-	276
FNMA	-	1,966	-	1,966
GNMA II	-	384	-	384
Government issues	-	7,180	-	7,180
<b>Total fixed income securities</b>	<b>-</b>	<b>31,742</b>	<b>-</b>	<b>31,742</b>
Other investments:				
Commingled pension trust funds Realty	-	-	2,670	2,670
<b>Total Plan investments</b>	<b>\$ 23,644</b>	<b>\$ 46,044</b>	<b>\$ 2,670</b>	<b>\$ 72,358</b>

At December 31, 2015, the portfolio was managed by two investment firms, with control of the portfolio split approximately 58% and 38% under the control of the investment managers with the remaining 4% under the direct control of the Plan. A portfolio concentration in two of the commingled pension trust funds, an exchange traded fund and a short term investment fund of 11%, 7%, 7% and 5%, respectively, existed at December 31, 2015.

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**(17.) EMPLOYEE BENEFIT PLANS (Continued)**

	Level 1 Inputs	Level 2 Inputs	Level 3 Inputs	Total Fair Value
<b>2014</b>				
Cash equivalents:				
Foreign currencies	\$ 31	\$ -	\$ -	\$ 31
Government issues	-	249	-	249
Short term investment funds	-	6,327	-	6,327
<b>Total cash equivalents</b>	<b>31</b>	<b>6,576</b>	<b>-</b>	<b>6,607</b>
Equity securities:				
Common stock	14,732	-	-	14,732
Depository receipts	185	-	-	185
Commingled pension trust funds	-	10,802	-	10,802
Exchange traded funds	10,573	-	-	10,573
Preferred stock	140	-	-	140
<b>Total equity securities</b>	<b>25,630</b>	<b>10,802</b>	<b>-</b>	<b>36,432</b>
Fixed income securities:				
Auto loan receivable	-	330	-	330
Collateralized mortgage obligations	-	682	-	682
Commingled pension trust funds	-	21,083	-	21,083
Corporate bonds	-	2,971	-	2,971
FHLMC	-	73	-	73
FNMA	-	1,951	-	1,951
GNMA II	-	123	-	123
Government issues	-	5,139	-	5,139
Other asset backed securities	-	160	-	160
Other securities	-	33	-	33
<b>Total fixed income securities</b>	<b>-</b>	<b>32,545</b>	<b>-</b>	<b>32,545</b>
<b>Total Plan investments</b>	<b>\$ 25,661</b>	<b>\$ 49,923</b>	<b>\$ -</b>	<b>\$ 75,584</b>

At December 31, 2014, the portfolio was managed by two investment firms, with control of the portfolio split approximately 57% and 39% under the control of the investment managers with the remaining 4% under the direct control of the Plan. A portfolio concentration in two of the commingled pension trust funds and a short term

investment fund of 13%, 9% and 8%, respectively, existed at December 31, 2014.

### **Postretirement Benefit Plan**

An entity acquired by the Company provided health and dental care benefits to retired employees who met specified age and service requirements through a postretirement health and dental care plan in which both the acquired entity and the retirees shared the cost. The plan provided for substantially the same medical insurance coverage as for active employees until their death and was integrated with Medicare for those retirees aged 65 or older. In 2001, the plan's eligibility requirements were amended to curtail eligible benefit payments to only retired employees and active employees who had already met the then-applicable age and service requirements under the Plan. In 2003, retirees under age 65 began contributing to health coverage at the same cost-sharing level as that of active employees. Retirees ages 65 or older were offered new Medicare supplemental plans as alternatives to the plan historically offered. The cost sharing of medical coverage was standardized throughout the group of retirees aged 65 or older. In addition, to be consistent with the administration of the Company's dental plan for active employees, all retirees who continued dental coverage began paying the full monthly premium. The accrued liability included in other liabilities in the consolidated statements of financial condition related to this plan amounted to \$107 thousand and \$124 thousand as of December 31, 2015 and 2014, respectively. The postretirement expense for the plan that was included in salaries and employee benefits in the consolidated statements of income was not significant for the years ended December 31, 2015, 2014 and 2013. The plan is not funded.

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**(17.) EMPLOYEE BENEFIT PLANS (Continued)**

The components of accumulated other comprehensive loss related to the defined benefit plan and postretirement benefit plan as of December 31 are summarized below (in thousands):

	2015	2014
<b>Defined benefit plan:</b>		
Net actuarial loss	\$ (17,715)	\$ (17,747)
Prior service cost	(32)	(52)
	(17,747)	(17,799)
<b>Postretirement benefit plan:</b>		
Net actuarial loss	(162)	(186)
Prior service credit	304	372
	142	186
	(17,605)	(17,613)
Deferred tax benefit	6,974	6,977
<b>Amounts included in accumulated other comprehensive loss</b>	<b>\$ (10,631)</b>	<b>\$ (10,636)</b>

Changes in plan assets and benefit obligations recognized in other comprehensive income on a pre-tax basis during the years ended December 31 are as follows (in thousands):

	2015	2014
<b>Defined benefit plan:</b>		
Net actuarial (loss) gain	\$ (894)	\$ (9,669)
Amortization of net loss	926	159
Amortization of prior service cost	20	20
	52	(9,490)
<b>Postretirement benefit plan:</b>		
Net actuarial (loss) gain	7	(40)

Amortization of net loss	17	17
Amortization of prior service credit	(68)	(68)
	(44)	(91)
<b>Total recognized in other comprehensive income</b>	<b>\$ 8</b>	<b>\$ (9,581)</b>

For the year ending December 31, 2016, the estimated net loss and prior service credit for the plan that will be amortized from accumulated other comprehensive income into net periodic benefit cost is \$955 thousand and \$47 thousand, respectively.

### **Supplemental Executive Retirement Agreements**

The Company has non-qualified Supplemental Executive Retirement Agreements ( SERPs ) covering one current and four former executives. The unfunded pension liability related to the SERPs was \$2.3 million and \$2.2 million at December 31, 2015 and 2014, respectively. SERP expense was \$408 thousand, \$295 thousand, and \$95 thousand for 2015, 2014 and 2013, respectively.



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**(18.) FAIR VALUE MEASUREMENTS**

**Determination of Fair Value    Assets Measured at Fair Value on a Recurring and Nonrecurring Basis**

**Valuation Hierarchy**

The fair value of an asset or liability is the price that would be received to sell that asset or paid to transfer that liability in an orderly transaction occurring in the principal market (or most advantageous market in the absence of a principal market) for such asset or liability. ASC Topic 820, Fair Value Measurements and Disclosures, establishes a fair value hierarchy for valuation inputs that gives the highest priority to quoted prices in active markets for identical assets or liabilities and the lowest priority to unobservable inputs. The fair value hierarchy is as follows:

**Level 1** - Unadjusted quoted prices in active markets for identical assets or liabilities that the reporting entity has the ability to access at the measurement date.

**Level 2** - Inputs other than quoted prices included in Level 1 that are observable for the asset or liability, either directly or indirectly. These might include quoted prices for similar assets or liabilities in active markets, quoted prices for identical or similar assets or liabilities in markets that are not active, inputs other than quoted prices that are observable for the asset or liability (such as interest rates, volatilities, prepayment speeds, credit risks, etc.) or inputs that are derived principally from or corroborated by market data by correlation or other means.

**Level 3** - Unobservable inputs for determining the fair values of assets or liabilities that reflect an entity's own assumptions about the assumptions that market participants would use in pricing the assets or liabilities.

In general, fair value is based upon quoted market prices, where available. If such quoted market prices are not available, fair value is based upon internally developed models that primarily use, as inputs, observable market-based parameters. Valuation adjustments may be made to ensure that financial instruments are recorded at fair value. These adjustments may include amounts to reflect counterparty credit quality and the company's creditworthiness, among other things, as well as unobservable parameters. Any such valuation adjustments are applied consistently over time. The Company's valuation methodologies may produce a fair value calculation that may not be indicative of net realizable value or reflective of future fair values. While management believes the Company's valuation methodologies are appropriate and consistent with other market participants, the use of different methodologies or assumptions to determine the fair value of certain financial instruments could result in a different estimate of fair value at the reporting date. Furthermore, the reported fair value amounts have not been comprehensively revalued since the presentation dates, and therefore, estimates of fair value after the balance sheet date may differ significantly from the amounts presented herein. A more detailed description of the valuation methodologies used for assets and liabilities measured at fair value, as well as the general classification of such instruments pursuant to the valuation hierarchy, is

set forth below.

**Securities available for sale:** Securities classified as available for sale are reported at fair value utilizing Level 2 inputs. For these securities, the Company obtains fair value measurements from an independent pricing service. The fair value measurements consider observable data that may include dealer quotes, market spreads, cash flows, the U.S. Treasury yield curve, live trading levels, trade execution data, market consensus prepayment speeds, credit information and the bond's terms and conditions, among other things.

**Loans held for sale:** The fair value of loans held for sale is determined using quoted secondary market prices and investor commitments. Loans held for sale are classified as Level 2 in the fair value hierarchy.

**Collateral dependent impaired loans:** Fair value of impaired loans with specific allocations of the allowance for loan losses is measured based on the value of the collateral securing these loans and is classified as Level 3 in the fair value hierarchy. Collateral may be real estate and/or business assets including equipment, inventory and/or accounts receivable and collateral value is determined based on appraisals performed by qualified licensed appraisers hired by the Company. These appraisals may utilize a single valuation approach or a combination of approaches including comparable sales and the income approach. Appraised and reported values may be discounted based on management's historical knowledge, changes in market conditions from the time of valuation, and/or management's expertise and knowledge of the client and the client's business. Such discounts are typically significant and result in a Level 3 classification of the inputs for determining fair value. Impaired loans are reviewed and evaluated on at least a quarterly basis for additional impairment and adjusted accordingly, based on the same factors identified above.

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**(18.) FAIR VALUE MEASUREMENTS (Continued)**

**Loan servicing rights:** Loan servicing rights do not trade in an active market with readily observable market data. As a result, the Company estimates the fair value of loan servicing rights by using a discounted cash flow model to calculate the present value of estimated future net servicing income. The assumptions used in the discounted cash flow model are those that we believe market participants would use in estimating future net servicing income, including estimates of loan prepayment rates, servicing costs, ancillary income, impound account balances, and discount rates. The significant unobservable inputs used in the fair value measurement of the Company's loan servicing rights are the constant prepayment rates and weighted average discount rate. Significant increases (decreases) in any of those inputs in isolation could result in a significantly lower (higher) fair value measurement. Although the constant prepayment rate and the discount rate are not directly interrelated, they will generally move in opposite directions. Loan servicing rights are classified as Level 3 measurements due to the use of significant unobservable inputs, as well as significant management judgment and estimation.

**Other real estate owned (Foreclosed assets):** Nonrecurring adjustments to certain commercial and residential real estate properties classified as other real estate owned are measured at the lower of carrying amount or fair value, less costs to sell. Fair values are generally based on third party appraisals of the property, resulting in a Level 3 classification. The appraisals are sometimes further discounted based on management's historical knowledge, changes in market conditions from the time of valuation, and/or management's expertise and knowledge of the client and client's business. Such discounts are typically significant and result in a Level 3 classification of the inputs for determining fair value. In cases where the carrying amount exceeds the fair value, less costs to sell, an impairment loss is recognized.

**Commitments to extend credit and letters of credit:** Commitments to extend credit and fund letters of credit are principally at current interest rates, and, therefore, the carrying amount approximates fair value. The fair value of commitments is not material.

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**(18.) FAIR VALUE MEASUREMENTS (Continued)****Assets Measured at Fair Value**

The following table presents for each of the fair-value hierarchy levels the Company's assets that are measured at fair value on a recurring and non-recurring basis as of December 31 (in thousands):

	<b>Quoted Prices</b>			
	<b>in Active</b>			
	<b>Markets for</b>	<b>Significant</b>		
	<b>Identical</b>	<b>Other</b>	<b>Significant</b>	
	<b>Assets or</b>	<b>Observable</b>	<b>Unobservable</b>	
	<b>Liabilities</b>	<b>Inputs</b>	<b>Inputs</b>	<b>Total</b>
	<b>(Level 1)</b>	<b>(Level 2)</b>	<b>(Level 3)</b>	
<b>2015</b>				
<b>Measured on a recurring basis:</b>				
Securities available for sale:				
U.S. Government agencies and government sponsored enterprises	\$ -	\$ 260,863	\$ -	\$ 260,863
Mortgage-backed securities	-	283,314	-	283,314
Asset-backed securities	-	218	-	218
	\$ -	\$ 544,395	\$ -	\$ 544,395
<b>Measured on a nonrecurring basis:</b>				
Loans:				
Loans held for sale	\$ -	\$ 1,430	\$ -	\$ 1,430
Collateral dependent impaired loans	-	-	1,485	1,485
Other assets:				
Loan servicing rights	-	-	1,241	1,241
Other real estate owned	-	-	163	163

	\$ -	\$ 1,430	\$ 2,889	\$ 4,319
<b>2014</b>				
<b>Measured on a recurring basis:</b>				
Securities available for sale:				
U.S. Government agencies and government sponsored enterprises	\$ -	\$ 160,475	\$ -	\$ 160,475
Mortgage-backed securities	-	461,788	-	461,788
Asset-backed securities	-	231	-	231
	\$ -	\$ 622,494	\$ -	\$ 622,494
<b>Measured on a nonrecurring basis:</b>				
Loans:				
Loans held for sale	\$ -	\$ 755	\$ -	\$ 755
Collateral dependent impaired loans	-	-	2,652	2,652
Other assets:				
Loan servicing rights	-	-	1,359	1,359
Other real estate owned	-	-	194	194
	\$ -	\$ 755	\$ 4,205	\$ 4,960

There were no transfers between Levels 1 and 2 during the years ended December 31, 2015 and 2014. There were no liabilities measured at fair value on a recurring or nonrecurring basis during the years ended December 31, 2015 and 2014.

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**(18.) FAIR VALUE MEASUREMENTS (Continued)**

The following table presents additional quantitative information about assets measured at fair value on a recurring and nonrecurring basis for which the Company has utilized Level 3 inputs to determine fair value (dollars in thousands).

Asset	Fair Value	Valuation Technique	Unobservable Input	Unobservable Input Value or Range
Collateral dependent impaired loans	\$ 1,485	Appraisal of collateral <sup>(1)</sup>	Appraisal adjustments <sup>(2)</sup>	0% - 100% discount
Loan servicing rights	\$ 1,241	Discounted cash flow	Discount rate	5.0% <sup>(3)</sup>
			Constant prepayment rate	12.4% <sup>(3)</sup>
Other real estate owned	\$ 163	Appraisal of collateral <sup>(1)</sup>	Appraisal adjustments <sup>(2)</sup>	9% - 58% discount

<sup>(1)</sup> Fair value is generally determined through independent appraisals of the underlying collateral, which generally include various Level 3 inputs which are not identifiable.

<sup>(2)</sup> Appraisals may be adjusted by management for qualitative factors such as economic conditions and estimated liquidation expenses.

<sup>(3)</sup> Weighted averages.

**Changes in Level 3 Fair Value Measurements**

There were no assets measured at fair value on a recurring basis using significant unobservable inputs (Level 3) as of or during the years ended December 31, 2015 and 2014.

**Disclosures about Fair Value of Financial Instruments**

The assumptions used below are expected to approximate those that market participants would use in valuing these financial instruments.

Fair value estimates are made at a specific point in time, based on available market information and judgments about the financial instrument, including estimates of timing, amount of expected future cash flows and the credit standing of the issuer. Such estimates do not consider the tax impact of the realization of unrealized gains or losses. In some

cases, the fair value estimates cannot be substantiated by comparison to independent markets. In addition, the disclosed fair value may not be realized in the immediate settlement of the financial instrument. Care should be exercised in deriving conclusions about our business, its value or financial position based on the fair value information of financial instruments presented below.

The estimated fair value approximates carrying value for cash and cash equivalents, FHLB and FRB stock, accrued interest receivable, non-maturity deposits, short-term borrowings and accrued interest payable. Fair value estimates for other financial instruments not included elsewhere in this disclosure are discussed below.

**Securities held to maturity:** The fair value of the Company's investment securities held to maturity is primarily measured using information from a third-party pricing service. The fair value measurements consider observable data that may include dealer quotes, market spreads, cash flows, the U.S. Treasury yield curve, live trading levels, trade execution data, market consensus prepayment speeds, credit information and the bond's terms and conditions, among other things.

**Loans:** The fair value of the Company's loans was estimated by discounting the expected future cash flows using the current interest rates at which similar loans would be made for the same remaining maturities. Loans were first segregated by type such as commercial, residential mortgage, and consumer, and were then further segmented into fixed and variable rate and loan quality categories. Expected future cash flows were projected based on contractual cash flows, adjusted for estimated prepayments.

**Time deposits:** The fair value of time deposits was estimated using a discounted cash flow approach that applies prevailing market interest rates for similar maturity instruments. The fair values of the Company's time deposit liabilities do not take into consideration the value of the Company's long-term relationships with depositors, which may have significant value.

**Long-term borrowings:** Long-term borrowings consist of \$40 million of subordinated notes issued during the second quarter of 2015. The subordinated notes are publicly traded and are valued based on market prices, which are characterized as Level 2 liabilities in the fair value hierarchy.

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**(18.) FAIR VALUE MEASUREMENTS (Continued)**

The following presents the carrying amount, estimated fair value, and placement in the fair value measurement hierarchy of the Company's financial instruments as of December 31 (in thousands):

	Level in Fair Value Measurement Hierarchy	2015 Carrying Amount	2015 Estimated Fair Value	2014 Carrying Amount	2014 Estimated Fair Value
<b>Financial assets:</b>					
Cash and cash equivalents	Level 1	\$ 60,121	\$ 60,121	\$ 58,151	\$ 58,151
Securities available for sale	Level 2	544,395	544,395	622,494	622,494
Securities held to maturity	Level 2	485,717	490,064	294,438	298,695
Loans held for sale	Level 2	1,430	1,430	755	755
Loans	Level 2	2,055,192	2,046,235	1,881,713	1,887,959
Loans <sup>(1)</sup>	Level 3	1,485	1,485	2,652	2,652
Accrued interest receivable	Level 1	8,609	8,609	8,104	8,104
FHLB and FRB stock	Level 2	19,991	19,991	19,014	19,014
<b>Financial liabilities:</b>					
Non-maturity deposits	Level 1	2,093,513	2,093,513	1,857,285	1,857,285
Time deposits	Level 2	637,018	636,159	593,242	593,793
Short-term borrowings	Level 1	293,100	293,100	334,804	334,804
Long-term borrowings	Level 2	38,990	40,313	-	-
Accrued interest payable	Level 1	4,676	4,676	3,862	3,862

<sup>(1)</sup> Comprised of collateral dependent impaired loans.

**(19.) PARENT COMPANY FINANCIAL INFORMATION**

Condensed financial statements pertaining only to the Parent are presented below (in thousands).



**Condensed Statements of Condition**

	<b>December 31,</b>	
	<b>2015</b>	<b>2014</b>
<b>Assets:</b>		
Cash and due from subsidiary	\$ 15,787	\$ 9,559
Investment in and receivables due from subsidiary	318,928	273,237
Other assets	4,451	3,433
<b>Total assets</b>	<b>\$ 339,166</b>	<b>\$ 286,229</b>
<b>Liabilities and shareholders' equity:</b>		
Long-term borrowings, net of issuance costs of \$1,010	\$ 38,990	\$ -
Other liabilities	6,332	6,697
Shareholders' equity	293,844	279,532
<b>Total liabilities and shareholders' equity</b>	<b>\$ 339,166</b>	<b>\$ 286,229</b>

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**(19.) PARENT COMPANY FINANCIAL INFORMATION (Continued)**

<b>Condensed Statements of Income</b>	<b>Years ended December 31,</b>		
	<b>2015</b>	<b>2014</b>	<b>2013</b>
Dividends from subsidiary and associated companies	\$ 16,000	\$ 20,920	\$ 15,000
Management and service fees from subsidiary	599	417	368
Other income	1,175	74	71
<b>Total income</b>	<b>17,774</b>	<b>21,411</b>	<b>15,439</b>
Interest expense	1,750	-	-
Operating expenses	3,509	3,437	2,906
<b>Total expense</b>	<b>5,259</b>	<b>3,437</b>	<b>2,906</b>
Income before income tax benefit and equity in undistributed earnings of subsidiary	12,515	17,974	12,533
Income tax benefit	1,814	1,120	1,020
Income before equity in undistributed earnings of subsidiary	14,329	19,094	13,553
Equity in undistributed earnings of subsidiary	14,008	10,261	11,977
<b>Net income</b>	<b>\$ 28,337</b>	<b>\$ 29,355</b>	<b>\$ 25,530</b>

<b>Condensed Statements of Cash Flows</b>	<b>Years ended December 31,</b>		
	<b>2015</b>	<b>2014</b>	<b>2013</b>
<b>Cash flows from operating activities:</b>			
Net income	\$ 28,337	\$ 29,355	\$ 25,530
Adjustments to reconcile net income to net cash provided by operating activities:			
Equity in undistributed earnings of subsidiary	(14,008)	(10,261)	(11,977)
Depreciation and amortization	97	48	47
Share-based compensation	674	471	407
(Increase) decrease in other assets	(1,069)	5,661	166
Decrease in other liabilities	(258)	(5,717)	(17)
<b>Net cash provided by operating activities</b>	<b>13,773</b>	<b>19,557</b>	<b>14,156</b>

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Cash flows from investing activities:			
Capital investment in Five Star Bank	(34,000)	-	-
Net cash paid for acquisition	-	(7,995)	-
Net cash used in investing activities	(34,000)	(7,995)	-
Cash flows from financing activities:			
Issuance of long-term debt, net of issuance costs	38,940	-	-
Purchase of preferred and common shares	(202)	(196)	(360)
Proceeds from stock options exercised	359	667	448
Dividends paid	(12,721)	(11,984)	(11,218)
Other	79	-	(118)
Net cash provided by (used in) financing activities	26,455	(11,513)	(11,248)
Net increase in cash and cash equivalents	6,228	49	2,908
Cash and cash equivalents as of beginning of year	9,559	9,510	6,602
Cash and cash equivalents as of end of the year	\$ 15,787	\$ 9,559	\$ 9,510

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**(20.) SEGMENT REPORTING**

The Company has two reportable operating segments, banking and insurance, which are delineated by the consolidated subsidiaries of Financial Institutions, Inc. The banking segment includes all of the Company's retail and commercial banking operations. The insurance segment includes the activities of SDN, a full service insurance agency that provides a broad range of insurance services to both personal and business clients. The Company operated as one business segment until the acquisition of SDN on August 1, 2014, at which time the new Insurance segment was created for financial reporting purposes. Holding company amounts are the primary differences between segment amounts and consolidated totals, and are reflected in the Holding Company and Other column below, along with amounts to eliminate balances and transactions between segments.

The following tables present information regarding the Company's business segments as of and for the periods indicated (in thousands).

	Banking	Insurance	Holding Company and Other	Consolidated Totals
<b>December 31, 2015</b>				
Goodwill	\$ 48,536	\$ 11,866	\$ -	\$ 60,402
Other intangible assets, net	829	5,715	-	6,544
Total assets	3,356,987	20,315	3,722	3,381,024

<b>December 31, 2014</b>				
Goodwill	\$ 48,536	\$ 12,617	\$ -	\$ 61,153
Other intangible assets, net	1,125	6,361	-	7,486
Total assets	3,065,109	20,368	4,044	3,089,521

	Banking	Insurance <sup>(1)</sup>	Holding Company and Other	Consolidated Totals
<b>Year ended December 31, 2015</b>				
Net interest income (expense)	\$ 97,063	\$ -	\$ (1,750)	\$ 95,313
Provision for loan losses	(7,381)	-	-	(7,381)
Noninterest income	24,734	4,969	634	30,337
Noninterest expense <sup>(2)</sup>	(71,599)	(5,426)	(2,368)	(79,393)

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Income (loss) before income taxes	42,817	(457)	(3,484)	38,876
Income tax (expense) benefit	(12,230)	(121)	1,812	(10,539)
Net income (loss)	\$ 30,587	\$ (578)	\$ (1,672)	\$ 28,337

**Year ended December 31, 2014**

Net interest income	\$ 93,774	\$ -	\$ -	\$ 93,774
Provision for loan losses	(7,789)	-	-	(7,789)
Noninterest income	23,602	2,073	(325)	25,350
Noninterest expense	(67,857)	(1,877)	(2,621)	(72,355)
Income (loss) before income taxes	41,730	196	(2,946)	38,980
Income tax (expense) benefit	(10,735)	(9)	1,119	(9,625)
Net income (loss)	\$ 30,995	\$ 187	\$ (1,827)	\$ 29,355

(1) Reflects activity from SDN since August 1, 2014, the date of acquisition.

(2) Insurance segment includes goodwill impairment of \$751 thousand.

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**ITEM 9. CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE**

None.

**ITEM 9A. CONTROLS AND PROCEDURES**

**Effectiveness of Controls and Procedures**

As of the end of the period covered by this report, the Company carried out an evaluation, under the supervision and with the participation of the Company's management, including the Company's Chief Executive Officer (Principal Executive Officer) and Chief Financial Officer (Principal Accounting Officer), of the effectiveness of the design and operation of the Company's disclosure controls and procedures pursuant to Rule 13a-15(b), as adopted by the Securities and Exchange Commission (SEC) under the Securities Exchange Act of 1934 (Exchange Act). Based upon that evaluation, the Chief Executive Officer and Chief Financial Officer concluded that the Company's disclosure controls and procedures were effective as of the end of the period covered by this Annual Report on Form 10-K.

Disclosure controls and procedures are the controls and other procedures that are designed to ensure that information required to be disclosed in the reports that the Company files or submits under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms. Disclosure controls and procedures include, without limitation, controls and procedures designed to ensure that information required to be disclosed in the reports that the Company files or submits under the Exchange Act is accumulated and communicated to management, including the Chief Executive Officer and Chief Financial Officer, as appropriate, to allow timely decisions regarding required disclosure.

**Management Report on Internal Control over Financial Reporting and Attestation Report of Independent Registered Public Accounting Firm**

Management of the Company is responsible for establishing and maintaining adequate internal control over financial reporting. Management assessed the Company's internal control over financial reporting based on criteria established in the *Internal Control Integrated Framework (2013)* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). Based on this assessment, management has concluded that, as of December 31, 2015, the Company maintained effective internal control over financial reporting. Management's Report on Internal Control over Financial Reporting is included under Item 8 Financial Statements and Supplementary Data in Part II of this Form 10-K.

KPMG LLP, an independent registered public accounting firm, has audited the consolidated financial statements included in this Annual Report on Form 10-K, and has issued an attestation report on the effectiveness of the

Company's internal control over financial reporting. The Report of Independent Registered Public Accounting Firm that attests the effectiveness of internal control over financial reporting is included under Item 8 Financial Statements and Supplementary Data in Part II of this Form 10-K.

**Changes in Internal Control over Financial Reporting**

There were no changes in the Company's internal control over financial reporting that occurred during the quarter ended December 31, 2015 that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

**ITEM 9B. OTHER INFORMATION**

Not applicable.

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**PART III**

**ITEM 10. DIRECTORS, EXECUTIVE OFFICERS AND CORPORATE GOVERNANCE**

In response to this Item, the information set forth in the Company's Proxy Statement for its 2016 Annual Meeting of Shareholders (the 2016 Proxy Statement) to be filed within 120 days following the end of the Company's fiscal year, under the headings Proposal 1 - Election of Directors, Business Experience and Qualification of Directors, Our Executive Officers, and Section 16(a) Beneficial Ownership Reporting Compliance is incorporated herein by reference.

Information concerning the Company's Audit Committee and the Audit Committee's financial expert is set forth under the caption Board Meetings and Committees in the 2016 Proxy Statement and is incorporated herein by reference.

Information concerning the Company's Code of Business Conduct and Ethics is set forth under the caption Code of Ethics in the 2016 Proxy Statement and is incorporated herein by reference.

**ITEM 11. EXECUTIVE COMPENSATION**

In response to this Item, the information set forth in the 2016 Proxy Statement under the headings Compensation Discussion and Analysis, Executive Compensation Tables, Management Development and Compensation Committee Interlocks and Insider Participation, Director Compensation, and Management Development and Compensation Committee Report is incorporated herein by reference.

**ITEM 12. SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT AND RELATED STOCKHOLDER MATTERS**

In response to this Item, the information set forth in the 2016 Proxy Statement under the heading Security Ownership of Certain Beneficial Owners and Management is incorporated herein by reference.

**Equity Compensation Plan Information**



The following table sets forth, as of December 31, 2015, information about our equity compensation plans that have been approved by our shareholders, including the number of shares of our common stock exercisable under all outstanding options, warrants and rights, the weighted average exercise price of all outstanding options, warrants and rights and the number of shares available for future issuance under our equity compensation plans. We have no equity compensation plans that have not been approved by our shareholders.

<b>Plan Category</b>	<b>Number of securities to be issued upon exercise of outstanding options, warrants and rights (a)</b>	<b>Weighted average exercise price of outstanding options, warrants and rights (b)</b>	<b>Number of securities remaining for future issuance under equity compensation plans (excluding securities reflected in column (a)) (c)</b>
Equity compensation plans approved by shareholders	102,249	\$ 19.21	424,144
Equity compensation plans not approved by shareholders	-	\$ -	-

### **ITEM 13. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS, AND DIRECTOR INDEPENDENCE**

In response to this Item, the information set forth in the 2016 Proxy Statement under the headings **Certain Relationships and Related Transactions** and **Board Independence** is incorporated herein by reference.

### **ITEM 14. PRINCIPAL ACCOUNTING FEES AND SERVICES**

In response to this Item, the information set forth in the 2016 Proxy Statement under the heading **Independent Registered Public Accounting Firm** is incorporated herein by reference.

**Table of Contents****PART IV****ITEM 15. EXHIBITS AND FINANCIAL STATEMENT SCHEDULES****(a) FINANCIAL STATEMENTS**

Reference is made to the Index to Consolidated Financial Statements of Financial Institutions, Inc. and subsidiaries under Item 8 Financial Statements and Supplementary Data in Part II of this Annual Report on Form 10-K.

**(b) EXHIBITS**

The following is a list of all exhibits filed or incorporated by reference as part of this Report.

<b>Exhibit</b>		
<b>Number</b>	<b>Description</b>	<b>Location</b>
3.1	Amended and Restated Certificate of Incorporation of the Company	Incorporated by reference to Exhibits 3.1, 3.2 and 3.3 of the Form 10-K for the year ended December 31, 2008, dated March 12, 2009
3.2	Amended and Restated Bylaws of the Company	Incorporated by reference to Exhibit 3.4 of the Form 10-K for the year ended December 31, 2008, dated March 12, 2009
4.1	Subordinated Indenture, dated as of April 15, 2015, between Financial Institutions, Inc. and Wilmington Trust, National Association, as Trustee	Incorporated by reference to Exhibit 4.1 of the Form 8-K, dated April 15, 2015
4.2	First Supplemental Indenture, dated as of April 15, 2015, between Financial Institutions, Inc. and Wilmington Trust, National Association, as Trustee	Incorporated by reference to Exhibit 4.2 of the Form 8-K, dated April 15, 2015

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4.3	Form of Global Note to represent the 6.00% Fixed-to-Floating Rate Subordinated Notes due April 15, 2030	Incorporated by reference to Exhibit A of Exhibit 4.2 of the Form 8-K, dated April 15, 2015
10.1	1999 Management Stock Incentive Plan	Incorporated by reference to Exhibit 10.1 of the S-1 Registration Statement
10.2	Amendment Number One to the 1999 Management Stock Incentive Plan	Incorporated by reference to Exhibit 10.1 of the Form 8-K, dated July 28, 2006
10.3	Form of Non-Qualified Stock Option Agreement Pursuant to the 1999 Management Stock Incentive Plan	Incorporated by reference to Exhibit 10.2 of the Form 8-K, dated July 28, 2006
10.4	1999 Directors Stock Incentive Plan	Incorporated by reference to Exhibit 10.2 of the S-1 Registration Statement
10.5	Amendment to the 1999 Director Stock Incentive Plan	Incorporated by reference to Exhibit 10.7 of the Form 10-K for the year ended December 31, 2008, dated March 12, 2009
10.6	2009 Management Stock Incentive Plan	Incorporated by reference to Exhibit 10.8 of the Form 10-Q for the quarterly period ended June 30, 2009, dated August 5, 2009
10.7	2009 Directors Stock Incentive Plan	Incorporated by reference to Exhibit 10.9 of the Form 10-Q for the quarterly period ended June 30, 2009, dated August 5, 2009
10.8	Form of Restricted Stock Award Agreement Pursuant to the 2009 Management Stock Incentive Plan (LTIP Award)	Incorporated by reference to Exhibit 10.2 of the Form 8-K, dated March 1, 2010
10.9	Form of Service Based Restricted Stock Award Agreement Pursuant to the 2009 Management Stock Incentive Plan	Incorporated by reference to Exhibit 10.12 of the Form 10-K for the year ended December 31, 2011, dated March 9, 2012



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<b>Exhibit</b>		
<b>Number</b>	<b>Description</b>	<b>Location</b>
10.10	Form of 2013 Performance Program Master Agreement	Incorporated by reference to Exhibit 10.16 of the Form 10-K for the year ended December 31, 2012, dated March 18, 2013
10.11	Form of 2013 Performance Program Award Certificate	Incorporated by reference to Exhibit 10.17 of the Form 10-K for the year ended December 31, 2012, dated March 18, 2013
10.12	Amended and Restated Executive Agreement between Financial Institutions, Inc. and Martin K. Birmingham	Incorporated by reference to Exhibit 10.1 of the Form 8-K, dated May 23, 2013
10.13	Executive Agreement between Financial Institutions, Inc. and Kevin B. Klotzbach	Incorporated by reference to Exhibit 10.2 of the Form 8-K, dated May 23, 2013
10.14	Executive Agreement between Financial Institutions, Inc. and Richard J. Harrison	Incorporated by reference to Exhibit 10.3 of the Form 8-K, dated May 23, 2013
10.15	Executive Agreement between Financial Institutions, Inc. and Ronald Mitchell McLaughlin	Incorporated by reference to Exhibit 10.4 of the Form 8-K, dated July 5, 2012
10.16	Executive Agreement between Financial Institutions, Inc. and Kenneth V. Winn	Incorporated by reference to Exhibit 10.5 of the Form 8-K, dated July 5, 2012
10.17	Voluntary Retirement Agreement with Ronald A. Miller	Incorporated by reference to Exhibit 10.2 of the Form 8-K, dated September 26, 2008
10.18	Amendment to Voluntary Retirement Agreement with Ronald A. Miller	Incorporated by reference to Exhibit 10.1 of the Form 8-K, dated March 3, 2010
10.19	Supplemental Executive Retirement Agreement between Financial Institutions, Inc. and Peter G. Humphrey	Incorporated by reference to Exhibit 10.3 of the Form 10-Q for the quarterly period ended September 30, 2012, dated November 6, 2012

10.20	Supplemental Executive Retirement Agreement between Financial Institutions, Inc. and Richard J. Harrison	Incorporated by reference to Exhibit 10.1 of the Form 10-Q for the quarterly period ended June 30, 2014, dated August 5, 2014
10.21	Separation and release agreement between Financial Institutions, Inc. and Kenneth V. Winn	Incorporated by reference to Exhibit 10.1 of the Form 10-Q for the quarterly period ended September 30, 2014, dated November 4, 2014
10.22	Financial Institutions, Inc. 2015 Long-Term Incentive Plan	Incorporated by reference to Exhibit 10.1 of the Form 10-Q for the quarterly period ended June 30, 2015, dated August 5, 2015
10.23	Form of Director Annual Restricted Stock Award Agreement Pursuant to the Financial Institutions, Inc. 2015 Long-Term Incentive Plan	Incorporated by reference to Exhibit 10.2 of the Form 10-Q for the quarterly period ended June 30, 2015, dated August 5, 2015
10.24	Form of Director In Lieu of Cash Fees Stock Award Agreement Pursuant to the Financial Institutions, Inc. 2015 Long-Term Incentive Plan	Incorporated by reference to Exhibit 10.3 of the Form 10-Q for the quarterly period ended June 30, 2015, dated August 5, 2015
10.25	Form of Restricted Stock Award Agreement Pursuant to the Financial Institutions, Inc. 2015 Long-Term Incentive Plan	Incorporated by reference to Exhibit 10.4 of the Form 10-Q for the quarterly period ended June 30, 2015, dated August 5, 2015
10.26	Form of Performance Stock Award Agreement Pursuant to the Financial Institutions, Inc. 2015 Long-Term Incentive Plan	Incorporated by reference to Exhibit 10.5 of the Form 10-Q for the quarterly period ended June 30, 2015, dated August 5, 2015
10.27	Form of Restricted Stock Unit Award Agreement Pursuant to the Financial Institutions, Inc. 2015 Long-Term Incentive Plan	Incorporated by reference to Exhibit 10.6 of the Form 10-Q for the quarterly period ended June 30, 2015, dated August 5, 2015

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<b>Exhibit</b>		
<b>Number</b>	<b>Description</b>	<b>Location</b>
10.28	Form of Performance Stock Unit Award Agreement Pursuant to the Financial Institutions, Inc. 2015 Long-Term Incentive Plan	Incorporated by reference to Exhibit 10.7 of the Form 10-Q for the quarterly period ended June 30, 2015, dated August 5, 2015
21	Subsidiaries of Financial Institutions, Inc.	Filed Herewith
23	Consent of Independent Registered Public Accounting Firm	Filed Herewith
31.1	Certification pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 - Principal Executive Officer	Filed Herewith
31.2	Certification pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 - Principal Financial Officer	Filed Herewith
32	Certification pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002	Filed Herewith
101.INS	XBRL Instance Document	
101.SCH	XBRL Taxonomy Extension Schema Document	
101.CAL	XBRL Taxonomy Extension Calculation Linkbase Document	
101.LAB	XBRL Taxonomy Extension Label Linkbase Document	
101.PRE	XBRL Taxonomy Extension Presentation Linkbase Document	

101.DEF XBRL Taxonomy Extension Definition Linkbase  
Document

All material agreements consist of management contracts, compensatory plans or arrangements.

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**Table of Contents****SIGNATURES**

Pursuant to the requirements of Section 13 or 15(d) of the Exchange Act, the registrant caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

**FINANCIAL INSTITUTIONS, INC.**

March 8, 2016

By: */s/ Martin K. Birmingham*

Martin K. Birmingham  
President and Chief Executive Officer

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the registrant and in the capacities and on the dates indicated.

<b>Signatures</b>	<b>Title</b>	<b>Date</b>
<i>/s/ Martin K. Birmingham</i> Martin K. Birmingham	Director, President and Chief Executive Officer (Principal Executive Officer)	March 8, 2016
<i>/s/ Kevin B. Klotzbach</i> Kevin B. Klotzbach	Executive Vice President and Chief Financial Officer (Principal Financial Officer)	March 8, 2016
<i>/s/ Michael D. Grover</i> Michael D. Grover	Senior Vice President and Chief Accounting Officer (Principal Accounting Officer)	March 8, 2016
<i>/s/ Karl V. Anderson, Jr.</i> Karl V. Anderson, Jr.	Director	March 8, 2016
<i>/s/ John E. Benjamin</i> John E. Benjamin	Director	March 8, 2016
<i>/s/ Andrew W. Dorn, Jr.</i> Andrew W. Dorn, Jr.	Director	March 8, 2016
<i>/s/ Robert M. Glaser</i> Robert M. Glaser	Director	March 8, 2016
<i>/s/ Samuel M. Gullo</i>	Director	March 8, 2016

Samuel M. Gullo

<i>/s/ Susan R. Holliday</i> Susan R. Holliday	Director	March 8, 2016
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<i>/s/ Erland E. Kailbourne</i> Erland E. Kailbourne	Director	March 8, 2016
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<i>/s/ Robert N. Latella</i> Robert N. Latella	Director, Chairman	March 8, 2016
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<i>/s/ James L. Robinson</i> James L. Robinson	Director	March 8, 2016
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<i>/s/ James H. Wyckoff</i> James H. Wyckoff	Director	March 8, 2016
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