FINANCIAL INSTITUTIONS INC
Form 10-Q
November 07, 2018
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

Form 10-Q

(Mark One)

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the quarterly period ended September 30, 2018

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

(Exact name of registrant as specified in its charter)

NEW YORK	16-0816610
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)

220 LIBERTY STREET, WARSAW, NEW YORK	14569
(Address of principal executive offices)	(Zip Code)

Registrant's telephone number, including area code: (585) 786-1100

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

Indicate by check mark whether the registrant has submitted electronically every Interactive Data File required to be submitted 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 such files). Yes No

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

Large accelerated filer	Accelerated filer
Non-accelerated filer	Smaller reporting company
	Emerging Growth Company

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

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

The registrant had 15,924,959 shares of Common Stock, $0.01 par value, outstanding as of October 31, 2018.

FINANCIAL INSTITUTIONS, INC.

Form 10-Q

For the Quarterly Period Ended September 30, 2018

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PART I. FINANCIAL INFORMATION

ITEM 1. Financial Statements

FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES

Consolidated Statements of Financial Condition (Unaudited)

(Dollars in thousands, except share and per share data)	September 30, 2018	December 31, 2017
ASSETS		
Cash and due from banks	$ 117,331	$ 99,195
Securities available for sale, at fair value	458,310	524,973
Securities held to maturity, at amortized cost (fair value of $447,718 and $512,983, respectively)	459,623	516,466
Loans held for sale	3,166	2,718
Loans (net of allowance for loan losses of $33,955 and $34,672, respectively)	2,954,376	2,700,345
Company owned life insurance	66,628	65,288
Premises and equipment, net	43,309	45,189
Goodwill and other intangible assets, net	78,853	74,703
Other assets	76,789	76,333
Total assets	$ 4,258,385	$ 4,105,210
LIABILITIES AND SHAREHOLDERS' EQUITY		
Deposits:		
Noninterest-bearing demand	$ 748,167	$ 718,498
Interest-bearing demand	711,321	634,203
Savings and money market	988,486	1,005,317
Time deposits	1,037,755	852,156
Total deposits	3,485,729	3,210,174
Short-term borrowings	308,200	446,200
Long-term borrowings, net of issuance costs of $816 and $869, respectively	39,184	39,131
Other liabilities	33,118	28,528
Total liabilities	3,866,231	3,724,033
Shareholders' equity:		
Series A 3% preferred stock, $100 par value; 1,533 shares authorized; 1,439 shares issued	144	144
Series B-1 8.48% preferred stock, $100 par value; 200,000 shares authorized; 171,847 shares issued	17,185	17,185
Total preferred equity	17,329	17,329
Common stock, $0.01 par value; 50,000,000 shares authorized; 16,056,178 shares issued	161	161
Additional paid-in capital	122,478	121,058
Retained earnings	276,563	257,078

Accumulated other comprehensive loss	(21,820)	(11,916)
Treasury stock, at cost – 131,219 and 131,240 shares, respectively	(2,557)	(2,533)
Total shareholders’ equity	392,154	381,177
Total liabilities and shareholders’ equity	$ 4,258,385	$ 4,105,210

See accompanying notes to the consolidated financial statements.

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FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES

Consolidated Statements of Income (Unaudited)

(In thousands, except per share amounts)	Three months ended		Nine months ended	
	September 30,		September 30,	
	2018	2017	2018	2017
Interest income:				
Interest and fees on loans	$33,750	$27,455	$94,851	$77,540
Interest and dividends on investment securities	5,283	5,941	16,449	17,736
Other interest income	2	-	6	67
Total interest income	39,035	33,396	111,306	95,343
Interest expense:				
Deposits	5,163	3,089	12,872	7,820
Short-term borrowings	2,434	1,251	6,047	2,815
Long-term borrowings	617	618	1,853	1,853
Total interest expense	8,214	4,958	20,772	12,488
Net interest income	30,821	28,438	90,534	82,855
Provision for loan losses	2,061	2,802	5,050	9,415
Net interest income after provision for loan losses	28,760	25,636	85,484	73,440
Noninterest income:				
Service charges on deposits	1,813	1,901	5,254	5,486
Insurance income	1,501	1,488	3,918	4,052
ATM and debit card	1,557	1,445	4,509	4,230
Investment advisory	2,245	1,497	5,934	4,357
Company owned life insurance	440	449	1,333	1,367
Investments in limited partnerships	328	(14)	1,019	91
Loan servicing	78	105	396	348
Net gain on sale of loans held for sale	303	150	530	270
Net (loss) gain on investment securities	(95)	184	(88)	600
Net gain on derivative instruments	354	127	606	127
Net gain on other assets	37	21	49	25
Contingent consideration liability adjustment	—	—	—	1,200
Other	1,337	1,221	3,971	3,590
Total noninterest income	9,898	8,574	27,431	25,743
Noninterest expense:				
Salaries and employee benefits	13,970	12,348	40,270	35,703
Occupancy and equipment	4,337	4,087	12,911	12,235
Professional services	1,353	1,157	3,132	3,229
Computer and data processing	1,291	1,208	3,884	3,691
Supplies and postage	485	492	1,545	1,496
FDIC assessments	498	440	1,486	1,366
Advertising and promotions	949	344	2,647	1,451
Amortization of intangibles	334	288	927	876

Goodwill impairment	—	—	—	1,575
Other	2,304	2,103	6,271	5,728
Total noninterest expense	25,521	22,467	73,073	67,350
Income before income taxes	13,137	11,743	39,842	31,833
Income tax expense	2,560	3,464	7,807	9,365
Net income	$ 10,577	$ 8,279	$ 32,035	$ 22,468
Preferred stock dividends	365	366	1,096	1,097
Net income available to common shareholders	$ 10,212	$ 7,913	$ 30,939	$ 21,371
Earnings per common share (Note 3):				
Basic	$ 0.64	$ 0.52	$ 1.95	$ 1.44
Diluted	$ 0.64	$ 0.52	$ 1.94	$ 1.44
Cash dividends declared per common share	$ 0.24	$ 0.21	$ 0.72	$ 0.63

See accompanying notes to the consolidated financial statements.

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FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES

Consolidated Statements of Comprehensive Income (Unaudited)

(Dollars in thousands)	Three months ended		Nine months ended	
	September 30,		September 30,	
	2018	2017	2018	2017
Net income	$ 10,577	$ 8,279	$ 32,035	$ 22,468
Other comprehensive (loss) income, net of tax:				
Securities available for sale and transferred securities	(1,736)	284	(10,493)	2,600
Hedging derivative instruments	85	—	208	—
Pension and post-retirement obligations	127	171	381	513
Total other comprehensive (loss) income, net of tax	(1,524)	455	(9,904)	3,113
Comprehensive income	$ 9,053	$ 8,734	$ 22,131	$ 25,581

See accompanying notes to the consolidated financial statements.

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FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES

Consolidated Statements of Changes in Shareholders' Equity (Unaudited)

Nine months ended September 30, 2018 and 2017

(Dollars in thousands, except per share data)	Preferred Equity	Common Stock	Additional Paid-in Capital	Retained Earnings	Accumulated Other Comprehensive Loss	Treasury Stock	Total Shareholders' Equity
Balance at December 31, 2016	$ 17,340	$ 147	$ 81,755	$ 237,687	$ (13,951)	$ (2,924)	$ 320,054
Cumulative-effect adjustment	—	—	(279)	279	—	—	—
Balance at January 1, 2017	$ 17,340	$ 147	$ 81,476	$ 237,966	$ (13,951)	$ (2,924)	$ 320,054
Comprehensive income:							
Net income	—	—	—	22,468	—	—	22,468
Other comprehensive income, net of tax	—	—	—	—	3,113	—	3,113
Common stock issued	—	11	29,653	—	—	—	29,664
Purchases of common stock for treasury	—	—	—	—	—	(148)	(148)
Repurchase of Series B-1 8.48% preferred stock	(6)	—	—	—	—	—	(6)
Share-based compensation plans:							
Share-based compensation	—	—	885	—	—	—	885
Stock options exercised	—	—	5	—	—	408	413
Restricted stock awards issued, net	—	—	29	—	—	(29)	—
Stock awards	—	—	39	—	—	76	115
Cash dividends declared:							
Series A 3% Preferred-$2.25 per share	—	—	—	(3)	—	—	(3)
Series B-1 8.48% Preferred-$6.36 per share	—	—	—	(1,094)	—	—	(1,094)
Common-$0.63 per share	—	—	—	(9,459)	—	—	(9,459)
Balance at September 30, 2017	$ 17,334	$ 158	$ 112,087	$ 249,878	$ (10,838)	$ (2,617)	$ 366,002
Balance at December 31, 2017	$ 17,329	$ 161	$ 121,058	$ 257,078	$ (11,916)	$ (2,533)	$ 381,177
Comprehensive income:							
Net income	—	—	—	32,035	—	—	32,035
Other comprehensive loss, net of tax	—	—	—	—	(9,904)	—	(9,904)
	—	—	—	—	—	(113)	(113)

Purchases of common stock for treasury							
Share-based compensation plans:							
Share-based compensation	—	—	1,097	—	—	—	1,097
Stock options exercised	—	—	(19)	—	—	339	320
Restricted stock awards issued, net	—	—	303	—	—	(303)	—
Stock awards	—	—	39	—	—	53	92
Cash dividends declared:							
Series A 3% Preferred-$2.25 per share	—	—	—	(3)	—	—	(3)
Series B-1 8.48% Preferred-$6.36 per share	—	—	—	(1,093)	—	—	(1,093)
Common-$0.72 per share	—	—	—	(11,454)	—	—	(11,454)
Balance at September 30, 2018	$ 17,329	$ 161	$ 122,478	$ 276,563	$ (21,820)	$ (2,557)	$ 392,154

See accompanying notes to the consolidated financial statements.

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FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES

Consolidated Statements of Cash Flows (Unaudited)

(Dollars in thousands)	Nine months ended September 30, 2018	2017
Cash flows from operating activities:		
Net income	$32,035	$22,468
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	4,855	4,613
Net amortization of premiums on securities	1,931	2,473
Provision for loan losses	5,050	9,415
Share-based compensation	1,097	885
Deferred income tax benefit	(2,979)	(527)
Proceeds from sale of loans held for sale	20,906	9,439
Originations of loans held for sale	(20,824)	(10,526)
Income on company owned life insurance	(1,333)	(1,367)
Net gain on sale of loans held for sale	(530)	(270)
Net loss (gain) on investment securities	88	(600)
Net gain on other assets	(49)	(25)
Goodwill impairment	—	1,575
Decrease (increase) in other assets	6,549	(874)
Increase (decrease) in other liabilities	4,013	(1,266)
Net cash provided by operating activities	50,809	35,413
Cash flows from investing activities:		
Purchases of available for sale securities	—	(86,434)
Purchases of held to maturity securities	(24,919)	(70,610)
Proceeds from principal payments, maturities and calls on available for sale securities	24,693	29,291
Proceeds from principal payments, maturities and calls on held to maturity securities	80,445	74,205
Proceeds from sales of securities available for sale	27,238	49,424
Net loan originations	(259,677)	(282,455)
Purchases of company owned life insurance, net of proceeds received	(7)	(7)
Proceeds from sales of other assets	460	189
Purchases of premises and equipment	(1,999)	(6,966)
Cash consideration paid for acquisition, net of cash acquired	(4,447)	(676)
Net cash used in investing activities	(158,213)	(294,039)
Cash flows from financing activities:		
Net increase in deposits	275,555	286,286
Net decrease in short-term borrowings	(138,000)	(20,700)
Repurchases of preferred stock	—	(6)
Proceeds from issuance of common stock	—	29,664
Purchases of common stock for treasury	(113)	(148)
Proceeds from stock options exercised	320	413

Cash dividends paid to common and preferred shareholders	(12,222)	(10,322)
Net cash provided by financing activities	125,540	285,187
Net increase in cash and cash equivalents	18,136	26,561
Cash and cash equivalents, beginning of period	99,195	71,277
Cash and cash equivalents, end of period	$117,331	$97,838

See accompanying notes to the consolidated financial statements.

FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements (Unaudited)

(1.)BASIS OF PRESENTATION AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Nature of Operations

Financial Institutions, Inc. (the “Company”) is a financial holding company organized in 1931 under the laws of New York State (“New York”). The Company provides diversified financial services through its subsidiaries, Five Star Bank, Scott Danahy Naylon, LLC (“SDN”), Courier Capital, LLC (“Courier Capital”) and HNP Capital, LLC (“HNP Capital”). The Company offers a broad array of deposit, lending and other financial services to individuals, municipalities and businesses in Western and Central New York through its wholly-owned New York chartered banking subsidiary, Five Star Bank (the “Bank”). The Bank also has indirect lending network relationships with franchised automobile dealers in the Capital District of New York and Northern and Central Pennsylvania. SDN provides a broad range of insurance services to personal and business clients across 45 states. Courier Capital and HNP Capital provide customized investment management, investment consulting and retirement plan services to individuals, businesses, institutions, foundations and retirement plans.

Basis of Presentation

The consolidated financial statements include the accounts of the Company and its subsidiaries. All significant intercompany accounts and transactions have been eliminated in consolidation. The accounting and reporting policies conform to U.S. generally accepted accounting principles (“GAAP”). Certain information and footnote disclosures normally included in financial statements prepared in conformity with GAAP have been condensed or omitted pursuant to such rules and regulations. However, in the opinion of management, the accompanying consolidated financial statements reflect all adjustments of a normal and recurring nature necessary for a fair presentation of the consolidated statements of financial condition, income, comprehensive income, changes in shareholders’ equity and cash flows for the periods indicated and contain adequate disclosure to make the information presented not misleading. These consolidated financial statements should be read in conjunction with the Company’s 2017 Annual Report on Form 10-K for the year ended December 31, 2017. The results of operations for any interim periods are not necessarily indicative of the results which may be expected for the entire year.

Reclassifications

Certain reclassifications of previously reported amounts have been made to conform to the current year presentation. Such reclassifications did not impact net income or shareholders’ equity as previously reported.

Subsequent Events

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

Use of Estimates

The preparation of these financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the amounts reported in the financial statements and accompanying notes. Actual results could differ from those estimates. Material estimates relate to the determination of the allowance for loan losses, the carrying value of goodwill and deferred tax assets, and assumptions used in the defined benefit pension plan accounting.

Cash Flow Reporting

Supplemental cash flow information is summarized as follows for the nine months ended September 30 (in thousands):

	2018	2017
Supplemental information:		
Cash paid for interest	$19,803	$10,189
Cash paid for income taxes	3,790	8,677
Noncash investing and financing activities:		
Real estate and other assets acquired in settlement of loans	596	379
Accrued and declared unpaid dividends	4,187	3,637
Increase in net unsettled security purchases	—	75
Assets acquired and liabilities assumed in business combinations:		
Fair value of assets acquired	2,561	812
Fair value of liabilities assumed	128	44

FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements (Unaudited)

(1.)BASIS OF PRESENTATION AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

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 deferred for one year to the interim and annual periods beginning on or after December 15, 2017. Early adoption was permitted as of the original effective date – interim and annual periods beginning on or after December 15, 2016. The Company's largest source of revenue is net interest income on financial assets and liabilities, which is explicitly excluded from the scope of ASU 2014-09. Revenue streams that are within the scope of ASU 2014-09 include insurance income, investment advisory fees, service charges on deposits and ATM and debit card fees. The adoption of ASU 2014-09, as of January 1, 2018, did not have a significant impact on the Company's financial statements. The Company adopted ASU 2014-09 using the modified retrospective transition method with no cumulative effect adjustment to opening retained earnings as of January 1, 2018. See "Revenue Recognition" below for additional information related to revenue generated from contracts with customers.

In January 2016, the FASB issued ASU No. 2016-01, Financial Instruments - Overall (Subtopic 825-10) - Recognition and Measurement of Financial Assets and Financial Liabilities. ASU 2016-01 is intended to improve the recognition and measurement of financial instruments by requiring equity investments to be measured at fair value with changes in fair value recognized in net income; requiring entities to use the exit price notion when measuring the fair value of financial instruments for disclosure purposes; requiring separate presentation of financial assets and financial liabilities by measurement category and form of financial asset on the balance sheet or the accompanying notes to the financial statements; eliminating the requirement for entities to disclose the method(s) and significant assumptions used to estimate the fair value that is required to be disclosed for financial instruments measured and amortized at cost on the balance sheet; and requiring an entity to present separately in other comprehensive income the portion of the total change in the fair value of a liability resulting from a change in the instrument-specific credit risk when the entity has elected to measure the liability at fair value in accordance with the fair value option for financial instruments. ASU 2016-01 is effective for annual periods and interim periods within those annual periods, beginning after December 15, 2017. The amendments should be applied by means of a cumulative-effect adjustment to the balance sheet as of the beginning of the fiscal year of adoption. The amendments related to equity securities without readily determinable fair values (including disclosure requirements) should be applied prospectively to equity investments that exist as of the date of adoption. The adoption of ASU 2016-01, as of January 1, 2018, did not have a significant impact on the Company's financial statements, except for the fair value disclosures as presented in Note 13 – Fair Value Measurements.

In February 2016, the FASB issued ASU No. 2016-02, Leases (Topic 842). ASU 2016-02 establishes a right of use model that requires a lessee to record a right of use asset and a lease liability for all leases with terms longer than 12 months. Leases will be classified as either finance or operating, with classification affecting the pattern of expense recognition in the income statement. For lessors, the guidance modifies the classification criteria and the accounting for sales-type and direct financing leases. A lease will be treated as a sale if it transfers all of the risks and rewards, as well as control of the underlying asset, to the lessee. If risks and rewards are conveyed without the transfer of control, the lease is treated as a financing. If the lessor doesn't convey risks and rewards or control, an operating lease results. The amendments are effective for fiscal years beginning after December 15, 2018, including interim periods within those fiscal years. Entities are required to use a modified retrospective approach for leases that exist or are entered into after the beginning of the earliest comparative period in the financial statements, with certain practical expedients available. Early adoption is permitted. The Company is assessing the impact of ASU 2016-02 on its financial statements. The Company expects an increase in assets and liabilities as a result of recording additional lease contracts where the Company is a leasee.

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

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FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements (Unaudited)

(1.)BASIS OF PRESENTATION AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

In August 2016, the FASB issued ASU No. 2016-15, Statement of Cash Flows (Topic 230) – Classification of Certain Cash Receipts and Cash Payments. ASU 2016-15 provides guidance on the following eight specific cash flow issues: 1) debt prepayment or debt extinguishment costs; 2) settlement of zero-coupon debt instruments or other debt instruments with coupon interest rates that are insignificant in relation to the effective interest rate of the borrowing; 3) contingent consideration payments made after a business combination; 4) proceeds from the settlement of insurance claims; 5) proceeds from the settlement of corporate-owned life insurance policies, including bank-owned life insurance policies; 6) distributions received from equity method investees; 7) beneficial interests in securitization transactions; and 8) separately identifiable cash flows and application of the predominance principle. The guidance is effective for fiscal years beginning after December 15, 2017, including interim periods within those fiscal years. Early adoption was permitted, including adoption in an interim period. The adoption of ASU 2016-15, as of January 1, 2018, did not have a significant impact on the Company’s financial statements.

In March 2017, the FASB issued ASU No. 2017-07, Compensation – Retirement Benefits (Topic 715) – Improving the Presentation of Net Periodic Pension Cost and Net Periodic Postretirement Benefit Cost, which provides additional guidance on the presentation of net periodic pension and postretirement benefit costs in the income statement and on the components eligible for capitalization. The amendments in this ASU require that an employer report the service cost component of the net periodic benefit costs in the same income statement line item as other compensation costs arising from services rendered by employees during the period. The non-service-cost components of net periodic benefit costs are to be presented in the income statement separately from the service cost components and outside a subtotal of income from operations. The ASU also allows for the capitalization of the service cost components, when applicable (i.e., as a cost of internally manufactured inventory or a self-constructed asset). The amendments are effective for annual periods beginning after December 15, 2017, including interim periods within those annual periods; early adoption was permitted as of the beginning of an annual period for which financial statements (interim or annual) have not been issued or made available for issuance. The amendments in this ASU were to be applied retrospectively. The adoption of ASU 2017-07, as of January 1, 2018, did not have a significant impact on the Company’s financial statements.

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

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

In February 2018, the FASB issued ASU No. 2018-02, Income Statement-Reporting Comprehensive Income (Topic 220) – Reclassification of Certain Tax Effects from Accumulated Other Comprehensive Income. ASU 2018-02 permits a reclassification from accumulated other comprehensive income to retained earnings for stranded tax effects resulting from the Tax Cuts and Jobs Act (the “TCJ Act”). The guidance is effective for fiscal years beginning after December 15, 2018, including interim periods within those fiscal years. Early adoption is permitted, including adoption in any interim period. The amendments should be applied either in the period of adoption or retrospectively to each period (or periods) in which the effect of the change in the federal corporate income tax rate in the TCJ Act is recognized. The Company expects to reclass approximately $2.8 million from accumulated other comprehensive loss to retained earnings when ASU 2018-02 is adopted.

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FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements (Unaudited)

(1.)BASIS OF PRESENTATION AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Revenue Recognition

Accounting Standards Codification (“ASC”) 606, Revenue from Contracts with Customers (“ASC 606”), establishes principles for reporting information about the nature, amount, timing and uncertainty of revenue and cash flows arising from the entity’s contracts to provide goods or services to customers. The core principle requires an entity to recognize revenue to depict the transfer of goods or services to customers in an amount that reflects the consideration that it expects to be entitled to receive in exchange for those goods or services recognized as performance obligations are satisfied.

The majority of our revenue-generating transactions are not subject to ASC 606, including revenue generated from financial instruments, such as our loans, letters of credit, derivatives and investment securities, as well as revenue related to our loan servicing activities, as these activities are subject to other GAAP. Descriptions of our primary revenue-generating activities that are within the scope of ASC 606, which are presented in our income statements as components of noninterest income are as follows:

- Transactions and service-based revenues - these include service charges on deposits, investment advisory, and ATM and debit card fees. Revenue is recognized when the transactions occur or as services are performed over primarily monthly or quarterly periods. Payment is typically received in the period the transactions occur or, in some cases, within 90 days of the service period. Fees may be fixed or, where applicable, based on a percentage of transaction size or managed assets.
- Insurance income - Insurance commissions are received on the sale of insurance products, and revenue is recognized upon the placement date of the insurance policies. Payment is normally received within the policy period. In addition to placement, SDN also provides insurance policy related risk management services. Revenue is recognized as these services are provided.

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FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements (Unaudited)

(2.)BUSINESS COMBINATIONS

2018 Activity – HNP Capital Acquisition

On June 1, 2018, the Company completed the acquisition of HNP Capital, a Securities and Exchange Commission (“SEC”)-registered investment advisor with approximately $344 million in assets under management as of June 30, 2018. Consideration for the acquisition totaled $5.1 million in cash. As a result of the acquisition, the Company recorded goodwill of $2.6 million and other intangible assets of $2.5 million. The goodwill and other intangible assets are expected to be deductible for income tax purposes. The allocation of acquisition cost to the assets acquired and liabilities assumed and pro forma results of operations for this acquisition have not been presented because the effect of this acquisition was not material to the Company’s consolidated financial statements.

2017 Activity - Robshaw & Julian Acquisition

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

(3.)EARNINGS PER COMMON SHARE (“EPS”)

The following table presents a reconciliation of the earnings and shares used in calculating basic and diluted EPS (in thousands, except per share amounts).

	Three months ended September 30,		Nine months ended September 30,	
	2018	2017	2018	2017
Net income available to common shareholders	$10,212	$7,913	$30,939	$21,371
Weighted average common shares outstanding:				
Total shares issued	16,056	15,448	16,056	15,002
Unvested restricted stock awards	(4)	(44)	(9)	(48)
Treasury shares	(131)	(136)	(141)	(148)
Total basic weighted average common shares outstanding	15,921	15,268	15,906	14,806
Incremental shares from assumed:				
Exercise of stock options	—	7	3	11

Vesting of restricted stock awards	43	27	42	30
Total diluted weighted average common shares outstanding	15,964	15,302	15,951	14,847
Basic earnings per common share	$ 0.64	$ 0.52	$ 1.95	$ 1.44
Diluted earnings per common share	$ 0.64	$ 0.52	$ 1.94	$ 1.44

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	—	—	—	—
Restricted stock awards	7	—	6	2
Total	7	—	6	2

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FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements (Unaudited)

(4.)INVESTMENT SECURITIES

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

	Amortized Cost	Unrealized Gains	Unrealized Losses	Fair Value
September 30, 2018				
Securities available for sale:				
U.S. Government agency and government sponsored enterprises	$ 157,786	—	$ 5,977	$ 151,809
Mortgage-backed securities:				
Federal National Mortgage Association	275,416	39	10,778	264,677
Federal Home Loan Mortgage Corporation	37,088	10	1,847	35,251
Government National Mortgage Association	5,650	21	126	5,545
Collateralized mortgage obligations:				
Federal National Mortgage Association	139	—	—	139
Federal Home Loan Mortgage Corporation	39	—	—	39
Privately issued	—	850	—	850
Total mortgage-backed securities	318,332	920	12,751	306,501
Total available for sale securities	$ 476,118	$ 920	$ 18,728	$ 458,310
Securities held to maturity:				
State and political subdivisions	241,637	519	2,192	239,964
Mortgage-backed securities:				
Federal National Mortgage Association	12,032	—	467	11,565
Federal Home Loan Mortgage Corporation	4,616	—	272	4,344
Government National Mortgage Association	35,708	—	1,253	34,455
Collateralized mortgage obligations:				
Federal National Mortgage Association	65,130	—	3,270	61,860
Federal Home Loan Mortgage Corporation	81,676	—	4,103	77,573
Government National Mortgage Association	18,824	—	867	17,957
Total mortgage-backed securities	217,986	—	10,232	207,754
Total held to maturity securities	$ 459,623	$ 519	$ 12,424	$ 447,718
December 31, 2017				
Securities available for sale:				
U.S. Government agency and government sponsored enterprises	$ 163,025	$ 122	$ 1,258	$ 161,889
Mortgage-backed securities:				
Federal National Mortgage Association	311,830	313	3,220	308,923
Federal Home Loan Mortgage Corporation	41,290	76	675	40,691
Government National Mortgage Association	12,051	193	12	12,232
Collateralized mortgage obligations:				
Federal National Mortgage Association	217	1	1	217
Federal Home Loan Mortgage Corporation	45	—	—	45

Privately issued	—	976	—	976
Total mortgage-backed securities	365,433	1,559	3,908	363,084
Total available for sale securities	$ 528,458	$ 1,681	$ 5,166	$ 524,973

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FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements (Unaudited)

(4.)INVESTMENT SECURITIES (Continued)

	Amortized Cost	Unrealized Gains	Unrealized Losses	Fair Value
December 31, 2017 (continued)				
Securities held to maturity:				
State and political subdivisions	283,557	2,317	662	285,212
Mortgage-backed securities:				
Federal National Mortgage Association	9,732	16	88	9,660
Federal Home Loan Mortgage Corporation	3,213	—	119	3,094
Government National Mortgage Association	26,841	—	330	26,511
Collateralized mortgage obligations:				
Federal National Mortgage Association	76,432	—	1,958	74,474
Federal Home Loan Mortgage Corporation	93,810	3	2,165	91,648
Government National Mortgage Association	22,881	5	502	22,384
Total mortgage-backed securities	232,909	24	5,162	227,771
Total held to maturity securities	$516,466	$ 2,341	$ 5,824	$512,983

Investment securities with a total fair value of $788.9 million and $838.4 million at September 30, 2018 and December 31, 2017, respectively, were pledged as collateral to secure public deposits and for other purposes required or permitted by law.

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

	Three months ended September 30,		Nine months ended September 30,	
	2018	2017	2018	2017
Proceeds from sales	$21,470	$24,117	$27,238	$49,424
Gross realized gains	64	190	73	606
Gross realized losses	159	6	161	6

The scheduled maturities of securities available for sale and securities held to maturity at September 30, 2018 are shown below (in thousands). Actual expected maturities may differ from contractual maturities because issuers may have the right to call or prepay obligations.

	Amortized Cost	Fair Value
Debt securities available for sale:		
Due in one year or less	$ 35,676	$ 35,471
Due from one to five years	139,223	135,043
Due after five years through ten years	214,640	204,681
Due after ten years	86,579	83,115
Total available for sale securities	$ 476,118	$ 458,310
Debt securities held to maturity:		
Due in one year or less	$ 49,829	$ 49,878
Due from one to five years	150,749	150,479
Due after five years through ten years	83,277	79,898
Due after ten years	175,768	167,463
Total held to maturity securities	$ 459,623	$ 447,718

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FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements (Unaudited)

(4.)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, were as follows (in thousands):

	Less than 12 months		12 months or longer		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
September 30, 2018						
Securities available for sale:						
U.S. Government agency and government sponsored enterprises	$88,647	$ 2,621	$63,162	$ 3,356	$151,809	$ 5,977
Mortgage-backed securities:						
Federal National Mortgage Association	54,316	1,380	208,371	9,398	262,687	10,778
Federal Home Loan Mortgage Corporation	2,374	80	32,041	1,767	34,415	1,847
Government National Mortgage Association	4,125	121	742	5	4,867	126
Collateralized mortgage obligations:						
Federal National Mortgage Association	—	—	58	—	58	—
Federal Home Loan Mortgage Corporation	—	—	6	—	6	—
Total mortgage-backed securities	60,815	1,581	241,218	11,170	302,033	12,751
Total available for sale securities	149,462	4,202	304,380	14,526	453,842	18,728
Securities held to maturity:						
State and political subdivisions	105,290	858	28,646	1,334	133,936	2,192
Mortgage-backed securities:						
Federal National Mortgage Association	5,467	151	6,098	316	11,565	467
Federal Home Loan Mortgage Corporation	1,455	30	2,889	242	4,344	272
Government National Mortgage Association	17,258	374	17,197	879	34,455	1,253
Collateralized mortgage obligations:						
Federal National Mortgage Association	1,982	41	59,878	3,229	61,860	3,270
Federal Home Loan Mortgage Corporation	9,845	390	67,728	3,713	77,573	4,103
Government National Mortgage Association	1,020	15	16,937	852	17,957	867
Total mortgage-backed securities	37,027	1,001	170,727	9,231	207,754	10,232
Total held to maturity securities	142,317	1,859	199,373	10,565	341,690	12,424

Total temporarily impaired securities	$291,779	$ 6,061	$503,753	$ 25,091	$795,532	$ 31,152
December 31, 2017						
Securities available for sale:						
U.S. Government agencies and government sponsored enterprises	$95,046	$ 571	$31,561	$ 687	$126,607	$ 1,258
Mortgage-backed securities:						
Federal National Mortgage Association	201,754	1,855	67,383	1,365	269,137	3,220
Federal Home Loan Mortgage Corporation	20,446	192	15,601	483	36,047	675
Government National Mortgage Association	2,432	—	880	12	3,312	12
Collateralized mortgage obligations:						
Federal National Mortgage Association	—	—	119	1	119	1
Federal Home Loan Mortgage Corporation	—	—	8	—	8	—
Total mortgage-backed securities	224,632	2,047	83,991	1,861	308,623	3,908
Total available for sale securities	319,678	2,618	115,552	2,548	435,230	5,166

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FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements (Unaudited)

(4.)INVESTMENT SECURITIES (Continued)

	Less than 12 months		12 months or longer		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
December 31, 2017 (continued)						
Securities held to maturity:						
State and political subdivisions	36,368	295	14,492	367	50,860	662
Mortgage-backed securities:						
Federal National Mortgage Association	3,766	29	2,694	59	6,460	88
Federal Home Loan Mortgage Corporation	—	—	3,094	119	3,094	119
Government National Mortgage Association	17,327	136	9,184	194	26,511	330
Collateralized mortgage obligations:						
Federal National Mortgage Association	16,830	202	57,645	1,756	74,475	1,958
Federal Home Loan Mortgage Corporation	23,727	337	66,467	1,828	90,194	2,165
Government National Mortgage Association	15,401	340	5,635	162	21,036	502
Total mortgage-backed securities	77,051	1,044	144,719	4,118	221,770	5,162
Total held to maturity securities	113,419	1,339	159,211	4,485	272,630	5,824
Total temporarily impaired securities	$433,097	$ 3,957	$274,763	$ 7,033	$707,860	$ 10,990

The total number of security positions in the investment portfolio in an unrealized loss position at September 30, 2018 was 750 compared to 411 at December 31, 2017. At September 30, 2018, the Company had positions in 308 investment securities with a fair value of $503.8 million and a total unrealized loss of $25.1 million that have been in a continuous unrealized loss position for more than 12 months. At September 30, 2018, there were a total of 442 securities positions in the Company’s investment portfolio with a fair value of $291.8 million and a total unrealized loss of $6.1 million that had been in a continuous unrealized loss position for less than 12 months. At December 31, 2017, the Company had positions in 172 investment securities with a fair value of $274.8 million and a total unrealized loss of $7.0 million that had been in a continuous unrealized loss position for more than 12 months. At December 31, 2017, there were a total of 239 securities positions in the Company’s investment portfolio with a fair value of $433.1 million and a total unrealized loss of $4.0 million that had been in a continuous unrealized loss position for less than 12 months. 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 then available to management. There was no impairment recorded during the nine months ended September 30, 2018 and 2017.

Based on management's review and evaluation of the Company's debt securities as of September 30, 2018, the debt securities with unrealized losses were not considered to be OTTI. As of September 30, 2018, the Company did not intend 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 September 30, 2018, management has concluded that unrealized losses on its investment securities are temporary and no further impairment loss has been realized in the Company's consolidated statements of income.

FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements (Unaudited)

(5.)LOANS

The Company’s loan portfolio consisted of the following as of the dates indicated (in thousands):

	Principal Amount Outstanding	Net Deferred Loan (Fees) Costs	Loans, Net
September 30, 2018			
Commercial business	$537,160	$782	$537,942
Commercial mortgage	907,107	(2,096)	905,011
Residential real estate loans	498,883	8,715	507,598
Residential real estate lines	108,227	2,977	111,204
Consumer indirect	878,316	31,118	909,434
Other consumer	16,975	167	17,142
Total	$2,946,668	$41,663	2,988,331
Allowance for loan losses			(33,955)
Total loans, net			$2,954,376
December 31, 2017			
Commercial business	$449,763	$563	$450,326
Commercial mortgage	810,851	(1,943)	808,908
Residential real estate loans	457,761	7,522	465,283
Residential real estate lines	113,422	2,887	116,309
Consumer indirect	845,682	30,888	876,570
Other consumer	17,443	178	17,621
Total	$2,694,922	$40,095	2,735,017
Allowance for loan losses			(34,672)
Total loans, net			$2,700,345

Loans held for sale (not included above) were comprised entirely of residential real estate mortgages and totaled $3.2 million and $2.7 million as of September 30, 2018 and December 31, 2017, respectively.

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 the dates indicated (in thousands):

	30-59 Days Past Due	60-89 Days Past Due	Greater Than 90 Days	Total Past Due	Nonaccrual	Current	Total Loans
September 30, 2018							
Commercial business	$364	$—	$ —	$364	$ 2,203	$534,593	$537,160
Commercial mortgage	916	—	—	916	1,900	904,291	907,107
Residential real estate loans	871	55	—	926	2,057	495,900	498,883
Residential real estate lines	185	—	—	185	297	107,745	108,227
Consumer indirect	2,327	544	—	2,871	1,385	874,060	878,316
Other consumer	118	6	8	132	—	16,843	16,975
Total loans, gross	$4,781	$605	$ 8	$5,394	$ 7,842	$2,933,432	$2,946,668
December 31, 2017							
Commercial business	$64	$36	$ —	$100	$ 5,344	$444,319	$449,763
Commercial mortgage	56	375	—	431	2,623	807,797	810,851
Residential real estate loans	1,908	56	—	1,964	2,252	453,545	457,761
Residential real estate lines	349	—	—	349	404	112,669	113,422
Consumer indirect	2,806	672	—	3,478	1,895	840,309	845,682
Other consumer	174	15	11	200	2	17,241	17,443
Total loans, gross	$5,357	$1,154	$ 11	$6,522	$ 12,520	$2,675,880	$2,694,922

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FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements (Unaudited)

(5.)LOANS (Continued)

There were no loans past due greater than 90 days and still accruing interest as of September 30, 2018 and December 31, 2017. There were $8 thousand and $11 thousand in consumer overdrafts which were past due greater than 90 days as of September 30, 2018 and December 31, 2017, respectively. Consumer overdrafts are overdrawn deposit accounts which have been reclassified as loans but by their terms do not accrue interest.

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.

There were no loans modified as a TDR during the nine months ended September 30, 2018 and 2017. There were no loans modified as a TDR within the previous 12 months that defaulted during the nine months ended September 30, 2018 and 2017. For purposes of this disclosure, a loan modified as a TDR is considered to have defaulted when the borrower becomes 90 days past due.

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 the recorded investment, unpaid principal balance and related allowance of impaired loans as of the dates indicated and average recorded investment and interest income recognized on impaired loans for the nine months ended September 30, 2018 and twelve-month period ended December 31, 2017 (in thousands):

	Recorded Investment (1)	Unpaid Principal Balance (1)	Related Allowance	Average Recorded Investment	Interest Income Recognized
September 30, 2018					
With no related allowance recorded:					
Commercial business	$ 1,155	$ 2,090	$ —	$ 1,307	$ —
Commercial mortgage	525	525	—	568	—
	1,680	2,615	—	1,875	—
With an allowance recorded:					
Commercial business	1,183	1,183	431	2,931	—

Commercial mortgage	1,838	1,838	460	2,132	—
	3,021	3,021	891	5,063	—
	$ 4,701	$ 5,636	$ 891	$ 6,938	$ —
December 31, 2017					
With no related allowance recorded:					
Commercial business	$ 1,635	$ 2,370	$ —	$ 853	$ —
Commercial mortgage	584	584	—	621	—
	2,219	2,954	—	1,474	—
With an allowance recorded:					
Commercial business	3,853	3,853	2,056	4,468	—
Commercial mortgage	2,528	2,528	115	1,516	—
	6,381	6,381	2,171	5,984	—
	$ 8,600	$ 9,335	$ 2,171	$ 7,458	$ —

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

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FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements (Unaudited)

(5.)LOANS (Continued)

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 that do not meet 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.

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

	Commercial Business	Commercial Mortgage
September 30, 2018		
Uncriticized	$ 505,865	$ 889,608
Special mention	21,141	10,221
Substandard	10,154	7,278
Doubtful	—	—
Total	$ 537,160	$ 907,107
December 31, 2017		
Uncriticized	$ 429,692	$ 791,127

Special mention	7,120	12,185
Substandard	12,951	7,539
Doubtful	—	—
Total	$ 449,763	$ 810,851

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 the dates indicated (in thousands):

	Residential Real Estate Loans	Residential Real Estate Lines	Consumer Indirect	Other Consumer
September 30, 2018				
Performing	$ 496,826	$ 107,930	$ 876,931	$ 16,967
Non-performing	2,057	297	1,385	8
Total	$ 498,883	$ 108,227	$ 878,316	$ 16,975
December 31, 2017				
Performing	$ 455,509	$ 113,018	$ 843,787	$ 17,430
Non-performing	2,252	404	1,895	13
Total	$ 457,761	$ 113,422	$ 845,682	$ 17,443

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FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements (Unaudited)

(5.)LOANS (Continued)

Allowance for Loan Losses

Loans and the related allowance for loan losses are presented below as of the dates indicated (in thousands):

	Commercial Business	Commercial Mortgage	Residential Real Estate Loans	Residential Real Estate Lines	Consumer Indirect	Other Consumer	Total
September 30, 2018							
Loans:							
Ending balance	$ 537,160	$ 907,107	$ 498,883	$ 108,227	$ 878,316	$ 16,975	$ 2,946,668
Evaluated for impairment:							
Individually	$ 2,338	$ 2,363	$ —	$ —	$ —	$ —	$ 4,701
Collectively	$ 534,822	$ 904,744	$ 498,883	$ 108,227	$ 878,316	$ 16,975	$ 2,941,967
Allowance for loan losses:							
Ending balance	$ 14,231	$ 5,422	$ 1,305	$ 212	$ 12,355	$ 430	$ 33,955
Evaluated for impairment:							
Individually	$ 431	$ 460	$ —	$ —	$ —	$ —	$ 891
Collectively	$ 13,800	$ 4,962	$ 1,305	$ 212	$ 12,355	$ 430	$ 33,064
September 30, 2017							
Loans:							
Ending balance	$ 418,873	$ 759,898	$ 438,936	$ 114,747	$ 827,154	$ 17,460	$ 2,577,068
Evaluated for impairment:							
Individually	$ 7,126	$ 2,459	$ —	$ —	$ —	$ —	$ 9,585
Collectively	$ 411,747	$ 757,439	$ 438,936	$ 114,747	$ 827,154	$ 17,460	$ 2,567,483
Allowance for loan losses:							
Ending balance	$ 15,749	$ 3,727	$ 1,161	$ 157	$ 13,217	$ 336	$ 34,347
Evaluated for impairment:							
Individually	$ 2,658	$ 171	$ —	$ —	$ —	$ —	$ 2,829
Collectively	$ 13,091	$ 3,556	$ 1,161	$ 157	$ 13,217	$ 336	$ 31,518

The following table sets forth the changes in the allowance for loan losses for the three and nine-month periods ended September 30, 2018 (in thousands):

Commercial Business	Commercial Mortgage	Residential	Residential	Consumer Indirect	Other Consumer	Total

			Real Estate Loans	Real Estate Lines			
Three months ended September 30, 2018							
Beginning balance	$ 14,242	$ 5,371	$ 1,255	$ 248	$ 12,520	$ 319	$ 33,955
Charge-offs	(672)	(113)	(24)	(23)	(2,474)	(301)	(3,607)
Recoveries	241	3	8	2	1,228	64	1,546
Provision (credit)	420	161	66	(15)	1,081	348	2,061
Ending balance	$ 14,231	$ 5,422	$ 1,305	$ 212	$ 12,355	$ 430	$ 33,955
Nine months ended September 30, 2018							
Beginning balance	$ 15,668	$ 3,696	$ 1,322	$ 180	$ 13,415	$ 391	$ 34,672
Charge-offs	(1,113)	(117)	(53)	(124)	(8,089)	(969)	(10,465)
Recoveries	438	11	140	17	3,862	230	4,698
Provision (credit)	(762)	1,832	(104)	139	3,167	778	5,050
Ending balance	$ 14,231	$ 5,422	$ 1,305	$ 212	$ 12,355	$ 430	$ 33,955

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FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements (Unaudited)

(5.)LOANS (Continued)

The following table sets forth the changes in the allowance for loan losses for the three and nine-month periods ended September 30, 2017 (in thousands):

	Commercial Business	Commercial Mortgage	Residential Real Estate Loans	Residential Real Estate Lines	Consumer Indirect	Other Consumer	Total
Three months ended September 30, 2017							
Beginning balance	$ 14,622	$ 3,906	$ 1,247	$ 232	$ 12,833	$ 319	$ 33,159
Charge-offs	(130)	—	(198)	(21)	(2,330)	(230)	(2,909)
Recoveries	86	5	37	2	1,086	79	1,295
Provision (credit)	1,171	(184)	75	(56)	1,628	168	2,802
Ending balance	$ 15,749	$ 3,727	$ 1,161	$ 157	$ 13,217	$ 336	$ 34,347
Nine months ended September 30, 2017							
Beginning balance	$ 7,225	$ 10,315	$ 1,478	$ 303	$ 11,311	$ 302	$ 30,934
Charge-offs	(1,908)	(10)	(298)	(64)	(7,343)	(620)	(10,243)
Recoveries	332	257	85	58	3,259	250	4,241
Provision (credit)	10,100	(6,835)	(104)	(140)	5,990	404	9,415
Ending balance	$ 15,749	$ 3,727	$ 1,161	$ 157	$ 13,217	$ 336	$ 34,347

Risk Characteristics

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

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

Residential real estate loans (comprised of conventional mortgages and home equity loans) and residential real estate lines (comprised of home equity lines) are generally made based on 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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FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements (Unaudited)

(6.)GOODWILL AND OTHER INTANGIBLE ASSETS

Goodwill

The carrying amount of goodwill totaled $68.4 million and $65.8 million as of September 30, 2018 and December 31, 2017, respectively. The Company performs a goodwill impairment test on an annual basis as of October 1st or more frequently if events and circumstances warrant.

	Banking	Non-Banking	Total
Balance, December 31, 2017	$48,536	$ 17,304	$65,840
Acquisition	—	2,572	2,572
Balance, September 30, 2018	$48,536	$ 19,876	$68,412

Goodwill and other intangible assets added during the period relates to the acquisition of HNP Capital, which was completed on June 1, 2018. See Note 2 – Business Combinations for additional information.

Other Intangible Assets

The Company has other intangible assets that are amortized, consisting of core deposit intangibles and other intangibles (primarily related to customer relationships). Gross carrying amount, accumulated amortization and net book value, were as follows (in thousands):

	September 30, 2018	December 31, 2017
Other intangibles assets:		
Gross carrying amount	$ 15,925	$ 13,420
Accumulated amortization	(5,484)	(4,557)
Net book value	$ 10,441	$ 8,863

Amortization expense for total other intangible assets was $334 thousand and $927 thousand for the three and nine months ended September 30, 2018, and $288 thousand and $876 thousand for the three and nine months ended September 30, 2017, respectively. As of September 30, 2018, the estimated amortization expense of other intangible assets for the remainder of 2018 and each of the next five years is as follows (in thousands):

2018 (remainder of year)	$330

2019	1,250
2020	1,134
2021	1,014
2022	923
2023	852

FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements (Unaudited)

(7.)DERIVATIVE INSTRUMENT AND HEDGING ACTIVITIES

Risk Management Objective of Using Derivatives

The Company is exposed to certain risks arising from both its business operations and economic conditions. The Company principally manages its exposures to a wide variety of business and operational risks through management of its core business activities. The Company manages economic risks, including interest rate, liquidity and credit risk, primarily by managing the amount, sources, and duration of its assets and liabilities, and the use of derivative financial instruments. Specifically, the Company enters into derivative financial instruments to manage exposures that arise from business activities that result in the receipt or payment of future known and uncertain cash amounts, the value of which are determined by interest rates. The Company's derivative financial instruments are used to manage differences in the amount, timing, and duration of the Company's known or expected cash receipts and its known or expected cash payments.

Cash Flow Hedges of Interest Rate Risk

The Company's objectives in using interest rate derivatives are to add stability to interest expense and to manage its exposure to interest rate movements. To accomplish this objective, the Company primarily uses interest rate caps as part of its interest rate risk management strategy. Interest rate caps designated as cash flow hedges involve the receipt of variable amounts from a counterparty if interest rates rise above the strike rate on the contract in exchange for an up-front premium. During 2018, such derivatives were used to hedge the variable cash flows associated with short-term borrowings.

For derivatives designated and that qualify as cash flow hedges of interest rate risk, the gain or loss on the derivative is recorded in accumulated other comprehensive income (loss) and subsequently reclassified into interest expense in the same period(s) during which the hedged transaction affects earnings. Amounts reported in accumulated other comprehensive income (loss) related to derivatives will be reclassified to interest expense as interest payments are made on the Company's borrowings. The ineffective portion of the change in fair value of the derivatives is recognized directly in earnings. The Company's cash flow hedge derivatives did not have any hedge ineffectiveness recognized in earnings during the three and nine months ended September 30, 2018 and 2017. During the next twelve months, the Company estimates that an additional $29 thousand will be reclassified as a decrease to interest expense.

Interest Rate Swaps

The Company executes interest rate swaps with commercial banking customers to facilitate their respective risk management strategies. These interest rate swaps are simultaneously hedged by offsetting interest rate swaps that the Company executes with a third party, such that the Company minimizes its net risk exposure resulting from such transactions. As the interest rate swaps associated with this program do not meet hedge accounting requirements, changes in the fair value of both the customer swaps and the offsetting swaps are recognized directly in earnings.

Credit-risk-related Contingent Features

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

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FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements (Unaudited)

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

Fair Values of Derivative Instruments on the Balance Sheet

The table below presents the notional amounts, respective fair values of the Company’s derivative financial instruments, as well as their classification on the balance sheet as of September 30, 2018 and December 31, 2017 (in thousands):

	Gross notional amount		Asset derivatives			Liability derivatives		
			Balance	Fair value		Balance	Fair value	
	Sept. 30, 2018	Dec. 31, 2017	sheet line item	Sept. 30, 2018	Dec. 31, 2017	sheet line item	Sept. 30, 2018	Dec. 31, 2017
Derivatives designated as hedging instruments								
Cash flow hedges	$100,000	$—	Other assets	$1,305	$ —	Other liabilities	$—	$ —
Total derivatives	$100,000	$—		$1,305	$ —		$—	$ —
Derivatives not designated as hedging instruments								
Interest rate swaps	$35,915	$—	Other assets	$298	$ —	Other liabilities	$348	$ —
Credit contracts	34,741	12,282	Other assets	—	—	Other liabilities	8	4
Total derivatives	$70,656	$12,282		$298	$ —		$356	$ 4

Effect of Derivative Instruments on the Income Statement

The table below presents the effect of the Company’s derivative financial instruments on the income statement for the three and nine months ended September 30, 2018 and 2017 (in thousands):

		Gain (loss) recognized in income Three months ended		Gain (loss) recognized in income Nine months ended	
	Line item of gain (loss)	September 30,		September 30,	
Undesignated derivatives	recognized in income	2018	2017	2018	2017
Interest rate swaps	Net gain on derivative instruments	$ 349	$ —	$ 419	$ —

Credit contracts	Net gain on derivative instruments	5	127	187	127
Total undesignated		$ 354	$ 127	$ 606	$ 127

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FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements (Unaudited)

(8.)SHAREHOLDERS’ EQUITY

Common Stock

The changes in shares of common stock were as follows for the nine months ended September 30, 2018 and 2017:

	Outstanding	Treasury	Issued
September 30, 2018			
Shares at December 31, 2017	15,924,938	131,240	16,056,178
Restricted stock awards issued	7,370	(7,370)	—
Restricted stock awards forfeited	(23,901)	23,901	—
Stock options exercised	17,450	(17,450)	—
Stock awards	2,724	(2,724)	—
Treasury stock purchases	(3,622)	3,622	—
Shares at September 30, 2018	15,924,959	131,219	16,056,178
September 30, 2017			
Shares at December 31, 2016	14,537,597	154,617	14,692,214
Common stock issued for "at-the-market" equity offering	1,069,635	—	1,069,635
Restricted stock awards issued	8,510	(8,510)	—
Restricted stock awards forfeited	(10,359)	10,359	—
Stock options exercised	21,320	(21,320)	—
Stock awards	3,914	(3,914)	—
Treasury stock purchases	(4,323)	4,323	—
Shares at September 30, 2017	15,626,294	135,555	15,761,849

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FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements (Unaudited)

(9.)ACCUMULATED OTHER COMPREHENSIVE INCOME (LOSS)

The following table presents the components of other comprehensive income (loss) for the three and nine months ended September 30, 2018 and 2017 (in thousands):

	Pre-tax Amount	Tax Effect	Net-of-tax Amount
Three months ended September 30, 2018			
Securities available for sale and transferred securities:			
Change in unrealized gain/loss during the period	$(2,532)	$(639)	$(1,893)
Reclassification adjustment for net gains included in net income [1]	209	52	157
Total securities available for sale and transferred securities	(2,323)	(587)	(1,736)
Hedging derivative instruments:			
Change in unrealized gain/loss during the period	114	29	85
Pension and post-retirement obligations:			
Amortization of prior service credit included in income	(18)	(4)	(14)
Amortization of net actuarial loss included in income	188	47	141
Total pension and post-retirement obligations	170	43	127
Other comprehensive loss	$(2,039)	$(515)	$(1,524)
Nine months ended September 30, 2018			
Securities available for sale and transferred securities:			
Change in unrealized gain/loss during the period	$(14,411)	$(3,633)	$(10,778)
Reclassification adjustment for net gains included in net income [1]	381	96	285
Total securities available for sale and transferred securities	(14,030)	(3,537)	(10,493)
Hedging derivative instruments:			
Change in unrealized gain/loss during the period	278	70	208
Pension and post-retirement obligations:			
Amortization of prior service credit included in income	(54)	(14)	(40)
Amortization of net actuarial loss included in income	563	142	421
Total pension and post-retirement obligations	509	128	381
Other comprehensive loss	$(13,243)	$(3,339)	$(9,904)

(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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FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements (Unaudited)

(9.)ACCUMULATED OTHER COMPREHENSIVE INCOME (LOSS) (Continued)

	Pre-tax Amount	Tax Effect	Net-of-tax Amount
Three months ended September 30, 2017			
Securities available for sale and transferred securities:			
Change in unrealized gain/loss during the period	$ 589	$ 226	$ 363
Reclassification adjustment for net gains included in net income [1]	(127)	(48)	(79)
Total securities available for sale and transferred securities	462	178	284
Hedging derivative instruments:			
Change in unrealized gain/loss during the period	—	—	—
Pension and post-retirement obligations:			
Amortization of prior service credit included in income	(12)	(4)	(8)
Amortization of net actuarial loss included in income	291	112	179
Total pension and post-retirement obligations	279	108	171
Other comprehensive income	$ 741	$ 286	$ 455
Nine months ended September 30, 2017			
Securities available for sale and transferred securities:			
Change in unrealized gain/loss during the period	$ 4,747	$ 1,831	$ 2,916
Reclassification adjustment for net gains included in net income [1]	(514)	(198)	(316)
Total securities available for sale and transferred securities	4,233	1,633	2,600
Hedging derivative instruments:			
Change in unrealized gain/loss during the period	—	—	—
Pension and post-retirement obligations:			
Amortization of prior service credit included in income	(38)	(14)	(24)
Amortization of net actuarial loss included in income	874	337	537
Total pension and post-retirement obligations	836	323	513
Other comprehensive income	$ 5,069	$ 1,956	$ 3,113

(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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FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements (Unaudited)

(9.)ACCUMULATED OTHER COMPREHENSIVE INCOME (LOSS) (Continued)

Activity in accumulated other comprehensive income (loss), net of tax, for the three and nine months ended September 30, 2018 and 2017 was as follows (in thousands):

	Hedging Derivative Instruments	Securities Available for Sale and Transferred Securities	Pension and Post-retirement Obligations	Accumulated Other Comprehensive Income (Loss)
Three months ended September 30, 2018				
Balance at beginning of period	$ 123	$ (12,032)	$ (8,387)	$ (20,296)
Other comprehensive income (loss) before reclassifications	85	(1,893)	—	(1,808)
Amounts reclassified from accumulated other comprehensive income (loss)	—	157	127	284
Net current period other comprehensive income (loss)	85	(1,736)	127	(1,524)
Balance at end of period	$ 208	$ (13,768)	$ (8,260)	$ (21,820)
Nine months ended September 30, 2018				
Balance at beginning of period	$ —	$ (3,275)	$ (8,641)	$ (11,916)
Other comprehensive income (loss) before reclassifications	208	(10,778)	—	(10,570)
Amounts reclassified from accumulated other comprehensive income (loss)	—	285	381	666
Net current period other comprehensive income (loss)	208	(10,493)	381	(9,904)
Balance at end of period	$ 208	$ (13,768)	$ (8,260)	$ (21,820)
Three months ended September 30, 2017				
Balance at beginning of period	$ —	$ (1,413)	$ (9,880)	$ (11,293)
Other comprehensive income (loss) before reclassifications	—	363	—	363
Amounts reclassified from accumulated other comprehensive income (loss)	—	(79)	171	92
Net current period other comprehensive income (loss)	—	284	171	455

Balance at end of period	$	—	$	(1,129	)	$	(9,709	)	$	(10,838	)
Nine months ended September 30, 2017											
Balance at beginning of period	$	—	$	(3,729	)	$	(10,222	)	$	(13,951	)
Other comprehensive income (loss) before reclassifications		—		2,916			—			2,916	
Amounts reclassified from accumulated other comprehensive income (loss)		—		(316	)		513			197	
Net current period other comprehensive income (loss)		—		2,600			513			3,113	
Balance at end of period	$	—	$	(1,129	)	$	(9,709	)	$	(10,838	)

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FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements (Unaudited)

(9.)ACCUMULATED OTHER COMPREHENSIVE INCOME (LOSS) (Continued)

The following table presents the amounts reclassified out of each component of accumulated other comprehensive income (loss) for the three and nine months ended September 30, 2018 and 2017 (in thousands):

Details About Accumulated Other Comprehensive Income (Loss) Components	Amount Reclassified from Accumulated Other Comprehensive Income (Loss)		Affected Line Item in the Consolidated Statement of Income
	Three months ended September 30,		
	2018	2017	
Realized (loss) gain on sale of investment securities	$ (95)	$ 184	Net gain on investment securities
Amortization of unrealized holding gains (losses) on investment securities transferred from available for sale to held to maturity	(114)	(57)	Interest income
	(209)	127	Total before tax
	52	(48)	Income tax benefit (expense)
	(157)	79	Net of tax
Amortization of pension and post-retirement items:			
Prior service credit [(1)]	18	12	Salaries and employee benefits
Net actuarial losses [(1)]	(188)	(291)	Salaries and employee benefits
	(170)	(279)	Total before tax
	43	108	Income tax benefit
	(127)	(171)	Net of tax
Total reclassified for the period	$ (284)	$ (92)	
	Nine months ended September 30,		
	2018	2017	
Realized (loss) gain on sale of investment securities	$ (88)	$ 600	Net gain on investment securities
Amortization of unrealized holding gains (losses)	(293)	(86)	Interest income

on investment securities transferred from available for sale to held to maturity			
	(381)	514	Total before tax
	96	(198)	Income tax benefit (expense)
	(285)	316	Net of tax
Amortization of pension and post-retirement items:			
Prior service credit (1)	54	38	Salaries and employee benefits
Net actuarial losses (1)	(563)	(874)	Salaries and employee benefits
	(509)	(836)	Total before tax
	128	323	Income tax benefit
	(381)	(513)	Net of tax
Total reclassified for the period	$ (666)	$ (197)	

(1) These items are included in the computation of net periodic pension expense. See Note 11 – Employee Benefit Plans for additional information.

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FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements (Unaudited)

(10.)SHARE-BASED COMPENSATION PLANS

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 "MD&C Committee") of the Board. The share-based compensation plans were established to allow for the grant 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 MD&C Committee approved the grant of restricted stock units ("RSUs") and performance share units ("PSUs") shown in the table below to certain members of management during the nine months ended September 30, 2018.

	Number of Underlying Shares	Weighted Average Per Share Grant Date Fair Value
RSUs	32,655	$ 28.50
PSUs	14,855	27.25

The grant-date fair value for the RSUs granted during the nine months ended September 30, 2018 is equal to the closing market price of our common stock on the date of grant reduced by the present value of the dividends expected to be paid on the underlying shares.

The number of PSUs that ultimately vest is contingent on achieving specified total shareholder return ("TSR") targets relative to the SNL Small Cap Bank & Thrift Index, a market index the MD&C Committee has selected as a peer group for this purpose. The shares will be earned based on the Company's achievement of a relative TSR performance requirement, on a percentile basis, compared to the SNL Small Cap Bank & Thrift Index over a three-year performance period ended December 31, 2020. The shares earned based on the achievement of the TSR performance requirement, if any, will vest on February 27, 2021 assuming the recipient's continuous service to the Company.

The grant-date fair value of the PSUs granted during the nine months ended September 30, 2018 was determined using the Monte Carlo simulation model on the date of grant, assuming the following (i) expected term of 2.84 years, (ii) risk free interest rate of 2.39%, (iii) expected dividend yield of 2.83% and (iv) expected stock price volatility over the expected term of the TSR award of 21.2%. The Monte Carlo simulation model is a risk analysis method that selects a random value from a range of estimates.

During the nine months ended September 30, 2018, the company issued a total of 2,724 shares of common stock in-lieu of cash for the annual retainer of five non-employee directors and granted a total of 7,370 restricted shares of common stock to non-employee directors, of which 3,690 shares vested immediately and 3,680 shares will vest after completion of a one-year service requirement. The market price of the stock and restricted stock on the date of grant was $33.90.

The following is a summary of restricted stock awards and restricted stock units activity for the nine months ended September 30, 2018:

	Number of Shares	Weighted Average Market Price at Grant Date
Outstanding at beginning of year	130,586	$ 24.32
Granted	54,880	28.89
Vested	(23,836)	25.74
Forfeited	(25,251)	11.61
Outstanding at end of period	136,379	$ 28.26

At September 30, 2018, there was $2.0 million of unrecognized compensation expense related to unvested restricted stock awards and restricted stock units that is expected to be recognized over a weighted average period of 1.9 years.

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FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements (Unaudited)

(10.)SHARE-BASED COMPENSATION PLANS (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 the first nine months of 2018 or 2017. There was no unrecognized compensation expense related to unvested stock options as of September 30, 2018. The following is a summary of stock option activity for the nine months ended September 30, 2018 (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	22,199	$ 18.40		
Exercised	(17,450)	18.38		
Expired	(4,749)	18.50		
Outstanding and exercisable at end of period	—	$ —	—	$ —

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 nine months ended September 30, 2018 and 2017 was $236 thousand and $297 thousand, respectively. The total cash received as a result of option exercises under stock compensation plans for the nine months ended September 30, 2018 and 2017 was $320 thousand and $413 thousand, respectively.

The Company amortizes the expense related to stock-based compensation 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 included in the consolidated statements of income, is as follows (in thousands):

	Three months ended September 30,		Nine months ended September 30,	
	2018	2017	2018	2017
Salaries and employee benefits	$ 306	$ 248	$ 872	$ 676

Other noninterest expense	32	32	225	209
Total share-based compensation expense	$ 338	$ 280	$ 1,097	$ 885

(11.)EMPLOYEE BENEFIT PLANS

The components of the Company’s net periodic benefit expense for its pension and post-retirement obligations were as follows (in thousands):

	Three months ended September 30,		Nine months ended September 30,	
	2018	2017	2018	2017
Service cost	$ 836	$ 785	$ 2,509	$ 2,355
Interest cost on projected benefit obligation	598	613	1,793	1,840
Expected return on plan assets	(1,321)	(1,193)	(3,963)	(3,581)
Amortization of unrecognized prior service credit	(18)	(12)	(54)	(38)
Amortization of unrecognized net actuarial loss	188	291	563	874
Net periodic benefit expense	$ 283	$ 484	$ 848	$ 1,450

The net periodic benefit expense is recorded as a component of salaries and employee benefits in the consolidated statements of income. 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 the Internal Revenue Code. The Company has no minimum required contribution for the 2018 fiscal year.

(12.)COMMITMENTS AND CONTINGENCIES

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 consist of the following (in thousands):

	September 30, 2018	December 31, 2017
Commitments to extend credit	$ 664,138	$ 661,021
Standby letters of credit	12,707	12,181

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 which 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 $6.0 million and $566 thousand at September 30, 2018 and December 31, 2017, 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.

(13.)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. There have been no changes in the valuation techniques used during the current period. 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.

Transfers between levels of the fair value hierarchy are recorded as of the end of the reporting period.

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FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements (Unaudited)

(13.)FAIR VALUE MEASUREMENTS (Continued)

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.

Derivative instruments: The fair value of derivative instruments is determined using quoted secondary market prices for similar financial instruments and are classified as Level 2 in the fair value hierarchy.

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.

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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FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements (Unaudited)

(13.)FAIR VALUE MEASUREMENTS (Continued)

Assets Measured at Fair Value

The following tables present 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 the dates indicated (in thousands).

	Quoted Prices in Active Markets for Identical Assets or Liabilities (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Total
September 30, 2018				
Measured on a recurring basis:				
Securities available for sale:				
U.S. Government agency and government sponsored enterprises	$ —	$ 151,809	$ —	$ 151,809
Mortgage-backed securities	—	306,501	—	306,501
Other assets:				
Hedging derivative instruments	—	1,305	—	1,305
Fair value adjusted through comprehensive income	$ —	$ 459,615	$ —	$ 459,615
Other assets:				
Derivative instruments - interest rate products	$ —	$ 298	$ —	$ 298
Other liabilities:				
Derivative instruments - credit contracts	—	(8)	—	(8)
Derivative instruments - interest rate products	—	(348)	—	(348)
Fair value adjusted through net income	$ —	$ (58)	$ —	$ (58)
Measured on a nonrecurring basis:				
Loans:				
Loans held for sale	$ —	$ 3,166	$ —	$ 3,166
Collateral dependent impaired loans	—	—	3,810	3,810
Other assets:				

Loan servicing rights		—	—		999		999
Other real estate owned		—	—		290		290
Total	$	—	$ 3,166	$	5,099	$	8,265
December 31, 2017							
Measured on a recurring basis:							
Securities available for sale:							
U.S. Government agency and government sponsored enterprises	$	—	$ 161,889	$	—	$	161,889
Mortgage-backed securities		—	363,084		—		363,084
Fair value adjusted through comprehensive income	$	—	$ 524,973	$	—	$	524,973
Other liabilities:							
Derivative instruments - credit contracts	$	—	$ 4	$	—	$	4
Fair value adjusted through net income	$	—	$ 4	$	—	$	4
Measured on a nonrecurring basis:							
Loans:							
Loans held for sale	$	—	$ 2,718	$	—	$	2,718
Collateral dependent impaired loans		—	—		3,847		3,847
Other assets:							
Loan servicing rights		—	—		990		990
Other real estate owned		—	—		148		148
Total	$	—	$ 2,718	$	4,985	$	7,703

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FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements (Unaudited)

(13.)FAIR VALUE MEASUREMENTS (Continued)

There were no transfers between Levels 1 and 2 during the nine months ended September 30, 2018 and 2017. There were no liabilities measured at fair value on a nonrecurring basis during the nine months ended September 30, 2018 and 2017.

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	$3,810	Appraisal of collateral (1)	Appraisal adjustments (2)	10% - 50% discount
Loan servicing rights	999	Discounted cash flow	Discount rate	10.3% (3)
			Constant prepayment rate	12.8% (3)
Other real estate owned	290	Appraisal of collateral (1)	Appraisal adjustments (2)	26% - 44% discount

(1) Fair value is generally determined through independent appraisals of the underlying collateral, which generally include various Level 3 inputs which are not identifiable.
(2) Appraisals may be adjusted by management for qualitative factors such as economic conditions and estimated liquidation expenses.
(3) 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 nine months ended September 30, 2018.

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, Federal Home Loan Bank ("FHLB") and Federal Reserve Bank ("FRB") stock, accrued interest receivable, non-maturity deposits, short-term borrowings and accrued interest payable.

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FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements (Unaudited)

(13.)FAIR VALUE MEASUREMENTS (Continued)

The following presents (in thousands) the carrying amount, estimated fair value, and placement in the fair value measurement hierarchy of the Company's financial instruments as of the dates indicated.

	Level in Fair Value Measurement Hierarchy	September 30, 2018		December 31, 2017	
		Carrying Amount	Estimated Fair Value	Carrying Amount	Estimated Fair Value
Financial assets:					
Cash and cash equivalents	Level 1	$117,331	$117,331	$99,195	$99,195
Securities available for sale	Level 2	458,310	458,310	524,973	524,973
Securities held to maturity	Level 2	459,623	447,718	516,466	512,983
Loans held for sale	Level 2	3,166	3,166	2,718	2,718
Loans	Level 2	2,950,566	2,904,727	2,696,498	2,660,936
Loans (1)	Level 3	3,810	3,810	3,847	3,847
Accrued interest receivable	Level 1	12,559	12,559	10,776	10,776
FHLB and FRB stock	Level 2	21,997	21,997	27,730	27,730
Derivative instruments – cash flow hedge	Level 2	1,305	1,305	—	—
Derivative instruments – interest rate products	Level 2	298	298	—	—
Financial liabilities:					
Non-maturity deposits	Level 1	2,447,974	2,447,974	2,358,018	2,358,018
Time deposits	Level 2	1,037,755	1,030,548	852,156	848,055
Short-term borrowings	Level 1	308,200	308,200	446,200	446,200
Long-term borrowings	Level 2	39,184	39,451	39,131	41,485
Accrued interest payable	Level 1	9,008	9,008	8,038	8,038
Derivative instruments – credit contracts	Level 2	8	8	4	4
Derivative instruments – interest rate products	Level 2	348	348	—	—

(1) Comprised of collateral dependent impaired loans.

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FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements (Unaudited)

(14.)SEGMENT REPORTING

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

The Banking segment includes all of the Company's retail and commercial banking operations. The Non-Banking segment includes the activities of SDN, a full-service insurance agency that provides a broad range of insurance services to both personal and business clients, and Courier Capital and HNP Capital, our investment advisor and wealth management firms that provide customized investment management, investment consulting and retirement plan services to individuals, businesses, institutions, foundations and retirement plans. 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 our business segments as of and for the periods indicated (in thousands).

	Banking	Non-Banking	Holding Company and Other	Consolidated Totals
September 30, 2018				
Goodwill	$48,536	$ 19,876	$ —	$ 68,412
Other intangible assets, net	249	10,192	—	10,441
Total assets	4,221,168	37,389	(172)	4,258,385
December 31, 2017				
Goodwill	$48,536	$ 17,304	$ —	$ 65,840
Other intangible assets, net	373	8,490	—	8,863
Total assets	4,069,086	31,466	4,658	4,105,210

	Banking	Non-Banking (1)	Holding Company and Other	Consolidated Totals
Three months ended September 30, 2018				

Net interest income (expense)	$31,438	$ —	$ (617)	$ 30,821
Provision for loan losses	(2,061)	—	—	(2,061)
Noninterest income	6,949	3,118	(169)	9,898
Noninterest expense	(22,050)	(2,832)	(639)	(25,521)
Income (loss) before income taxes	14,276	286	(1,425)	13,137
Income tax (expense) benefit	(2,797)	(76)	313	(2,560)
Net income (loss)	$11,479	$ 210	$ (1,112)	$ 10,577
Nine months ended September 30, 2018				
Net interest income (expense)	$92,387	$ —	$ (1,853)	$ 90,534
Provision for loan losses	(5,050)	—	—	(5,050)
Noninterest income	19,754	8,127	(450)	27,431
Noninterest expense	(62,710)	(7,647)	(2,716)	(73,073)
Income (loss) before income taxes	44,381	480	(5,019)	39,842
Income tax (expense) benefit	(8,933)	(127)	1,253	(7,807)
Net income (loss)	$35,448	$ 353	$ (3,766)	$ 32,035

(1) Reflects activity from the acquisition of HNP Capital since June 1, 2018 (the date of acquisition).

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FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements (Unaudited)

(14.)SEGMENT REPORTING (Continued)

	Banking	Non-Banking (2)	Holding Company and Other	Consolidated Totals
Three months ended September 30, 2017				
Net interest income (expense)	$29,056	$ —	$ (618)	$ 28,438
Provision for loan losses	(2,802)	—	—	(2,802)
Noninterest income	6,410	2,315	(151)	8,574
Noninterest expense	(19,939)	(1,947)	(581)	(22,467)
Income (loss) before income taxes	12,725	368	(1,350)	11,743
Income tax (expense) benefit	(3,923)	(144)	603	(3,464)
Net income (loss)	$8,802	$ 224	$ (747)	$ 8,279
Nine months ended September 30, 2017				
Net interest income (expense)	$84,708	$ —	$ (1,853)	$ 82,855
Provision for loan losses	(9,415)	—	—	(9,415)
Noninterest income	18,203	6,760	780	25,743
Noninterest expense	(58,263)	(7,209)	(1,878)	(67,350)
Income (loss) before income taxes	35,233	(449)	(2,951)	31,833
Income tax (expense) benefit	(10,544)	(440)	1,619	(9,365)
Net income (loss)	$24,689	$ (889)	$ (1,332)	$ 22,468

(2) Reflects activity from the acquisition of the assets of Robshaw & Julian since August 31, 2017 (the date of acquisition).

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

This Quarterly Report on Form 10-Q should be read in conjunction with the more detailed and comprehensive disclosures included in our Annual Report on Form 10-K for the year ended December 31, 2017. In addition, please read this section in conjunction with our Consolidated Financial Statements and Notes to Consolidated Financial Statements contained herein.

FORWARD LOOKING INFORMATION

Statements and financial analysis contained in this Quarterly Report on Form 10-Q that are based on other than historical data are forward-looking statements 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") and its subsidiaries (collectively, the "Company," "we," "our" or "us"); and
- statements preceded by, followed by or that include the words "may," "could," "should," "would," "believe," "anticipate," "estimate," "expect," "intend," "plan," "projects," or similar expressions.

These forward-looking statements are not guarantees of future performance, nor should they be relied upon as representing management's views as of any subsequent date. Forward-looking statements involve significant risks and uncertainties and actual results may differ materially from those presented, either expressed or implied, in this Quarterly Report on Form 10-Q and our Annual Report on Form 10-K for the fiscal year ended December 31, 2017 (the "Form 10-K"), including, but not limited to, those presented in the Management's Discussion and Analysis of Financial Condition and Results of Operations. Factors that might cause such material differences include, but are not limited to:

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

new or changing accounting rules and interpretations, and the failure by us to correctly interpret or apply these evolving rules and interpretations could have a material adverse effect;

- Legal and regulatory proceedings and related matters could adversely affect us;
- A breach in security of our or third-party information systems, including the occurrence of a cyber incident or a deficiency in cybersecurity, or a failure by us to comply with New York State cybersecurity regulations, may subject us to liability, result in a loss of customer business or damage our brand image;
- We face competition in staying current with technological changes to compete and meet customer demands;
- We rely on other companies to provide key components of our business infrastructure;
- We use financial models for business planning purposes that may not adequately predict future results;
- We may not be able to attract and retain skilled people;

MANAGEMENT'S DISCUSSION AND ANALYSIS

- Acquisitions may disrupt our business and dilute shareholder value;
- We are subject to interest rate risk;
- Our business may be adversely affected by conditions in the financial markets and economic conditions generally;
- The policies of the Federal Reserve have a significant impact on our earnings;
- The soundness of other financial institutions could adversely affect us;
- The value of our goodwill and other intangible assets may decline in the future;
- We operate in a highly competitive industry and market area;
- Severe weather, natural disasters, acts of war or terrorism, and other external events could significantly impact our business;
- Liquidity is essential to our businesses;
- We may need to raise additional capital in the future and such capital may not be available on acceptable terms or at all;
- We rely on dividends from our subsidiaries for most of our revenue;
- We may not pay or may reduce the dividends on our common stock;
- We may issue debt and equity securities or securities convertible into equity securities, any of which may be senior to our common stock as to distributions and in liquidation, which could dilute our current shareholders or negatively affect the value of our common stock;
- Our certificate of incorporation, our bylaws, and certain banking laws may have an anti-takeover effect; and
- The market price of our common stock may fluctuate significantly in response to a number of factors.

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

GENERAL

The Parent is a financial holding company headquartered in New York State, providing diversified financial services through its subsidiaries, Five Star Bank (the "Bank"), Scott Danahy Naylon, LLC ("SDN"), Courier Capital, LLC ("Courier Capital") and HNP Capital, LLC ("HNP Capital"). The Company offers a broad array of deposit, lending and other financial services to individuals, municipalities and businesses in Western and Central New York through its wholly-owned New York-chartered banking subsidiary, 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. SDN provides a broad range of insurance services to personal and business clients across 45 states. Courier Capital and HNP Capital provide customized investment management, investment consulting and retirement plan services to individuals, businesses, institutions, foundations and retirement plans.

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

Our business strategy has been to maintain a community bank philosophy, which consists of focusing on and understanding the individualized banking and other financial 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 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.

EXECUTIVE OVERVIEW

Summary of 2018 Third Quarter Results

Net income increased $2.3 million, or 28%, to $10.6 million for the third quarter of 2018 compared to $8.3 million for the third quarter of 2017. Net income available to common shareholders for the third quarter of 2018 was $10.2 million, or $0.64 per diluted share, compared with $7.9 million, or $0.52 per diluted share, for the third quarter of last year. Return on average common equity was 10.82% and return on average assets was 1.00% for the third quarter of 2018 compared to 9.21% and 0.83%, respectively, for the third quarter of 2017.

Net interest income totaled $30.8 million in the third quarter of 2018, up from $28.4 million in the third quarter of 2017 and the increase was driven by growth in interest-earning assets. Average interest-earning assets were up $231.9 million, led by a $374.3 million increase in average loans in the third quarter of 2018 compared to the same quarter in 2017.

The provision for loan losses was $2.1 million in the third quarter of 2018 compared to $2.8 million in the third quarter of 2017. Net charge-offs during the recent quarter were $2.1 million, up from $1.6 million in the third quarter of 2017. Net charge-offs expressed as an annualized percentage of average loans outstanding were 0.28% during the third quarter of 2018 compared with 0.25% in the third quarter of 2017. See the "Allowance for Loan Losses" and "Non-Performing Assets and Potential Problem Loans" sections of this Management's Discussion and Analysis for further discussion regarding the decrease in the provision for loan losses and the increase in net-charge-offs.

Noninterest income totaled $9.9 million in the third quarter of 2018, compared to $8.6 million in the third quarter of 2017. The increase is primarily attributed to increases in investment advisory income, income from investments in limited partnerships, net gain on sale of loans held for sale and net gain on derivative instruments. Investment advisory income was $2.2 million in the third quarter of 2018, $748 thousand higher than the third quarter of 2017. The increase was primarily driven by the HNP Capital acquisition, the third quarter of 2017 acquisition of the assets of Robshaw & Julian and growth in assets under management at Courier Capital. Income from investments in limited partnerships was $342 thousand higher in the third quarter of 2018, compared to the third quarter of 2017. Income from these investments fluctuate based on the maturity and performance of the underlying investments. The increases in net gain on sale of loans held for sale and net gain on derivative instruments was driven by an increase in the number and value of transactions executed in the quarter.

Noninterest expense in the third quarter of 2018 totaled $25.5 million compared with $22.5 million in the third quarter of 2017. The increase in noninterest expense was primarily the result of increases in salaries and employee benefits, occupancy and equipment, professional services and advertising and promotions expenses. The increase in salaries and employee benefits was a result of investments in Bank personnel and the two wealth management subsidiary acquisitions. The increase in occupancy and equipment was primarily the result of investments in software and facilities. The increase in professional services expense was primarily related to a shelf registration statement filed in August 2018 and professional search services related to the addition of talent. The increase in advertising and promotions expense was related to the Five Star Bank brand campaign that was launched in February 2018.

The regulatory Common Equity Tier 1 Ratio and Total Risk-Based Capital Ratio were 9.81%, and 12.58%, respectively, for the third quarter of 2018. See the “Liquidity and Capital Management” section of this Management’s Discussion and Analysis for further discussion regarding regulatory capital and the Basel III capital rules.

RESULTS OF OPERATIONS

Net Interest Income and Net Interest Margin

Net interest income is our primary source of revenue, comprising 77% of revenue during the nine months ended September 30, 2018. 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.

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MANAGEMENT'S DISCUSSION AND ANALYSIS

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 stockholders' equity, also support earning assets. To compare tax-exempt asset yields to taxable yields, the yield on tax-exempt investment securities is computed on a taxable equivalent basis. Net interest income, interest rate spread, and net interest margin are discussed on a taxable equivalent basis.

The following table reconciles interest income per the consolidated statements of income to interest income adjusted to a fully taxable equivalent basis (dollars in thousands):

	Three months ended		Nine months ended	
	September 30,		September 30,	
	2018	2017	2018	2017
Interest income per consolidated statements of income	$ 39,035	$ 33,396	$ 111,306	$ 95,343
Adjustment to fully taxable equivalent basis	320	776	1,045	2,395
Interest income adjusted to a fully taxable equivalent basis	39,355	34,172	112,351	97,738
Interest expense per consolidated statements of income	8,214	4,958	20,772	12,488
Net interest income on a taxable equivalent basis	$ 31,141	$ 29,214	$ 91,579	$ 85,250

Analysis of Net Interest Income for the Three Months Ended September 30, 2018 and 2017

Net interest income on a taxable equivalent basis for the three months ended September 30, 2018, was $31.1 million, an increase of $1.9 million versus the comparable quarter last year of $29.2 million. The increase in net interest income was due to an increase in average earning assets of $231.9 million or 6% compared to the third quarter of 2017.

The net interest margin for the third quarter of 2018 was 3.18%, one-basis point higher than 3.17% for the same period in 2017. This comparable period increase was a function of a ten-basis point higher contribution from net free funds, partially offset by a nine-basis point decrease in interest rate spread. The lower interest rate spread was a result of a 30-basis point increase in the yield on average interest-earning assets and a 39-basis point increase in the cost of average interest-bearing liabilities.

For the third quarter of 2018, the yield on average earning assets of 4.01% was 30 basis points higher than the third quarter of 2017 of 3.71%. Loan yields increased 31 basis points during the third quarter of 2018 to 4.55% from 4.24%. The yield on investment securities decreased ten basis points during the third quarter of 2018 to 2.35% from 2.45%. Overall, the earning asset rate changes increased interest income by $1.8 million during the third quarter of 2018 and a favorable volume variance increased interest income by $3.4 million, which collectively drove a $5.2 million increase in interest income.

Average interest-earning assets were $3.90 billion for the third quarter 2018 compared to $3.67 billion for the third quarter of 2017, an increase of $231.9 million or 6% from the comparable quarter last year, with average loans up $374.3 million from $2.57 billion to $2.95 billion and average securities down $142.3 million from $1.10 billion to $954.0 million. The growth in average loans reflected increases in most loan categories. Commercial loans, in particular, were up $257.3 million from $1.16 billion to $1.42 billion or 22% from the third quarter of 2017. Loans represented 75.5% of average interest-earning assets during the third quarter of 2018 compared to 70.1% during the third quarter of 2017. The increase in the volume of average loans resulted in a $4.3 million increase in interest income, in addition to a $2.0 million increase due to the favorable rate variance. Securities represented 24.5% of average interest-earning assets during third quarter of 2018 compared to 29.9% during the third quarter of 2017. The decrease in the volume of average securities resulted in a $872 thousand decrease in interest income, in addition to a $242 thousand decrease due to the unfavorable rate variance.

The cost of average interest-bearing liabilities of 1.07% in the third quarter of 2018 compared to 0.68% in the third quarter of 2017 was 39-basis points higher than the third quarter of 2017. The cost of average interest-bearing deposits increased 30 basis points from 0.50% to 0.80% and the cost of short-term borrowings increased 95 basis points from 1.29% to 2.24% in the third quarter of 2018 compared to the same quarter of 2017. The increase in the cost of short-term borrowings was a result of increases in the federal funds rate. The cost of long-term borrowings for the third quarter of 2018 decreased one basis point from 6.32% to 6.31% in the third quarter of 2018 compared to the same quarter of 2017. Overall, interest-bearing liability rate and volume increases resulted in $3.3 million of higher interest expense.

Average interest-bearing liabilities of $3.04 billion in the third quarter of 2018 were $146.0 million or 5% higher than the third quarter of 2017. On average, interest-bearing deposits grew $100.8 million from $2.47 billion to $2.57 billion, while noninterest-bearing demand deposits (a principal component of net free funds) were up $51.7 million from $679.3 million to $731.0 million. The increase in average deposits was due to successful business development efforts in municipal and retail banking, 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 $2.1 million of higher interest expense during the third quarter of 2018. Average borrowings increased $45.3 million from $424.6 million to $469.9 million compared to the third quarter of 2017. Overall, short and long-term borrowing rate and volume changes resulted in $1.2 million of higher interest expense during the third quarter of 2018.

Analysis of Net Interest Income for the Nine Months Ended September 30, 2018 and 2017

Net interest income on a taxable equivalent basis for the nine months ended September 30, 2018, was $91.6 million, an increase of $6.3 million versus the comparable period last year of $85.3 million. The increase in net interest income was due to an increase in average earning assets of $281.4 million or 8% compared to the first nine months of 2017.

The net interest margin for the first nine months of 2018 was 3.18%, one-basis point lower than 3.19% for the same period in 2017. The majority of the reduction in net interest margin was attributed to the lower tax-equivalent adjustment on tax-exempt securities as a result of the lower Federal corporate tax rate in 2018 due to the TCJ Act. This comparable period decrease was a function of a nine-basis point decrease in interest rate spread, partially offset by an eight-basis point higher contribution from net free funds. The lower interest rate spread was a result of a 24-basis point increase in the yield on average interest-earning assets and a 33-basis point increase in the cost of average interest-bearing liabilities.

For the first nine months of 2018, the yield on average earning assets of 3.90% was 24 basis points higher than the first nine months of 2017 of 3.66%. Loan yields increased 25 basis points during the first nine months of 2018 to 4.45% from 4.20%. The yield on investment securities decreased 13 basis points during the first nine months of 2018 to 2.33% from 2.46%. Overall, the earning asset rate changes increased interest income by $3.7 million during the first nine months of 2018 and a favorable volume variance increased interest income by $10.9 million, which collectively drove a $14.6 million increase in interest income.

Average interest-earning assets were $3.85 billion for the first nine months of 2018 compared to $3.57 billion for the first nine months of 2017, an increase of $281.4 million or 8% from the comparable period last year, with average loans up $380.5 million from $2.47 billion to $2.85 billion and average securities down $90.5 million from $1.09 billion to $1.00 billion. The growth in average loans reflected increases in most loan categories. Commercial loans, in particular, were up $242.6 million from $1.10 billion to $1.34 billion or 22% from the first nine months of 2017. Loans represented 74.0% of average interest-earning assets during first nine months of 2018 compared to 69.2% during the first nine months of 2017. The increase in the volume of average loans resulted in a $12.7 million increase in interest income, in addition to a $4.6 million increase due to the favorable rate variance. Securities represented 26.0% of average interest-earning assets during first nine months of 2018 compared to 30.6% during the first nine months of 2017. The decrease in the volume of average securities resulted in a $1.7 million decrease in interest income, in addition to a $958 thousand decrease due to the unfavorable rate variance.

The cost of average interest-bearing liabilities of 0.92% in the first nine months of 2018 compared to 0.59% in the first nine months of 2017 was 33 basis points higher than the first nine months of 2017. The cost of average interest-bearing deposits increased 24 basis points from 0.43% to 0.67% and the cost of short-term borrowings increased 89 basis points from 1.09% to 1.98% in the first nine months of 2018 compared to the same period of 2017. The increase in the cost of short-term borrowings was a result of increases in the federal funds rate. The cost of long-term borrowings for the first nine months of 2018 decreased one basis point from 6.32% to 6.31% in the first nine months of 2018 compared to the same period of 2017. Overall, interest-bearing liability rate and volume increases resulted in $8.3 million of higher interest expense.

Average interest-bearing liabilities of $3.02 billion in the first nine months of 2018 were $196.7 million or 7% higher than the first nine months of 2017. On average, interest-bearing deposits grew $134.3 million from $2.44 billion to $2.58 billion, while noninterest-bearing demand deposits (a principal component of net free funds) were up $41.0 million from $665.2 million to $706.2 million. The increase in average deposits was due to successful business development efforts in municipal and retail banking, and an increase in deposits from our CDARS and 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 $5.1 million of higher interest expense during the first nine months of 2018. Average borrowings increased $62.3 million from $384.7 million to $447.1 million compared to the first nine months of 2017. Overall, short and long-term borrowing rate and volume changes resulted in $3.2 million of higher interest expense during the first nine months of 2018.

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MANAGEMENT'S DISCUSSION AND ANALYSIS

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

	Three months ended September 30,					
	2018			2017		
	Average Balance	Interest	Average Rate	Average Balance	Interest	Average Rate
Interest-earning assets:						
Federal funds sold and interest-earning deposits	$—	$2	0.00 %	$—	$—	0.00 %
Investment securities (1):						
Taxable	708,005	4,080	2.31	803,814	4,501	2.24
Tax-exempt (2)	246,022	1,523	2.48	292,560	2,216	3.03
Total investment securities	954,027	5,603	2.35	1,096,374	6,717	2.45
Loans:						
Commercial business	519,114	6,590	5.04	405,308	4,586	4.49
Commercial mortgage	896,159	11,275	4.99	752,634	8,876	4.68
Residential real estate loans	498,371	4,769	3.83	438,436	4,080	3.72
Residential real estate lines	111,762	1,358	4.82	117,597	1,241	4.19
Consumer indirect	904,480	9,239	4.05	841,081	8,145	3.84
Other consumer	16,633	519	12.36	17,184	527	12.17
Total loans	2,946,519	33,750	4.55	2,572,240	27,455	4.24
Total interest-earning assets	3,900,546	39,355	4.01	3,668,614	34,172	3.71
Less: Allowance for loan losses	(34,833)			(33,740)		
Other noninterest-earning assets	321,825			316,128		
Total assets	$4,187,538			$3,951,002		
Interest-bearing liabilities:						
Deposits:						
Interest-bearing demand	$642,234	302	0.19 %	$612,401	224	0.14 %
Savings and money market	978,578	819	0.33	998,769	386	0.15
Time deposits	946,499	4,042	1.69	855,371	2,479	1.15
Total interest-bearing deposits	2,567,311	5,163	0.80	2,466,541	3,089	0.50
Short-term borrowings	430,697	2,434	2.24	385,512	1,251	1.29
Long-term borrowings	39,174	617	6.31	39,103	618	6.32
Total borrowings	469,871	3,051	2.58	424,615	1,869	1.75
Total interest-bearing liabilities	3,037,182	8,214	1.07	2,891,156	4,958	0.68
Noninterest-bearing demand deposits	730,960			679,303		
Other noninterest-bearing liabilities	27,585			22,226		
Shareholders' equity	391,811			358,317		
Total liabilities and shareholders' equity	$4,187,538			$3,951,002		
Net interest income (tax-equivalent)		$31,141			$29,214	

Interest rate spread		2.94	%		3.03	%
Net earning assets	$863,364			$777,458		
Net interest margin (tax-equivalent)		3.18	%		3.17	%
Ratio of average interest-earning assets to average interest-bearing liabilities		128.43	%		126.89	%

(1) Investment securities are shown at amortized cost.
(2) The interest on tax-exempt securities is calculated on a tax equivalent basis assuming a Federal tax rate of 21% and 35% for the three-month periods ended September 30, 2018 and 2017, respectively.

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MANAGEMENT'S DISCUSSION AND ANALYSIS

	Nine months ended September 30, 2018 Average Balance	Interest	Average Rate		2017 Average Balance	Interest	Average Rate	
Interest-earning assets:								
Federal funds sold and interest-earning deposits	$220	$6	3.56	%	$8,869	$67	1.02	%
Investment securities (1):								
Taxable	733,232	12,518	2.28		790,407	13,287	2.24	
Tax-exempt (2)	267,040	4,976	2.48		300,318	6,844	3.04	
Total investment securities	1,000,272	17,494	2.33		1,090,725	20,131	2.46	
Loans:								
Commercial business	484,711	17,657	4.87		385,025	12,522	4.35	
Commercial mortgage	853,571	31,443	4.93		710,690	24,761	4.66	
Residential real estate loans	484,288	13,705	3.77		432,838	12,157	3.74	
Residential real estate lines	113,761	3,920	4.61		119,493	3,611	4.04	
Consumer indirect	896,493	26,590	3.97		804,051	22,962	3.82	
Other consumer	16,685	1,536	12.31		16,941	1,527	12.05	
Total loans	2,849,509	94,851	4.45		2,469,038	77,540	4.20	
Total interest-earning assets	3,850,001	112,351	3.90		3,568,632	97,738	3.66	
Less: Allowance for loan losses	(35,630)				(32,325)			
Other noninterest-earning assets	324,967				315,283			
Total assets	$4,139,338				$3,851,590			
Interest-bearing liabilities:								
Deposits:								
Interest-bearing demand	$663,827	$732	0.15	%	$632,596	$667	0.14	%
Savings and money market	1,007,734	1,930	0.26		1,027,927	1,073	0.14	
Time deposits	903,645	10,210	1.51		780,374	6,080	1.04	
Total interest-bearing deposits	2,575,206	12,872	0.67		2,440,897	7,820	0.43	
Short-term borrowings	407,903	6,047	1.98		345,637	2,815	1.09	
Long-term borrowings	39,156	1,853	6.31		39,085	1,853	6.32	
Total borrowings	447,059	7,900	2.36		384,722	4,668	1.62	
Total interest-bearing liabilities	3,022,265	20,772	0.92		2,825,619	12,488	0.59	
Noninterest-bearing demand deposits	706,222				665,221			
Other noninterest-bearing liabilities	25,167				20,954			
Shareholders' equity	385,684				339,796			
Total liabilities and shareholders' equity	$4,139,338				$3,851,590			
Net interest income (tax-equivalent)		$91,579				$85,250		
Interest rate spread			2.98	%			3.07	%
Net earning assets	$827,736				$743,013			

Net interest margin (tax-equivalent)	3.18 %	3.19 %
Ratio of average interest-earning assets to average interest-bearing liabilities	127.39 %	126.30 %

(1) Investment securities are shown at amortized cost.
(2) The interest on tax-exempt securities is calculated on a tax equivalent basis assuming a Federal tax rate of 21% and 35% for the nine-month periods ended September 30, 2018 and 2017, respectively.

MANAGEMENT'S DISCUSSION AND 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 income 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):

	Three months ended September 30, 2018 vs. 2017			Nine months ended September 30, 2018 vs. 2017		
Increase (decrease) in:	Volume	Rate	Total	Volume	Rate	Total
Interest income:						
Federal funds sold and interest-earning deposits	$2	$—	$2	$(111)	$50	$(61)
Investment securities:						
Taxable	(549)	128	(421)	(973)	204	(769)
Tax-exempt	(323)	(370)	(693)	(706)	(1,162)	(1,868)
Total investment securities	(872)	(242)	(1,114)	(1,679)	(958)	(2,637)
Loans:						
Commercial business	1,397	607	2,004	3,508	1,627	5,135
Commercial mortgage	1,777	622	2,399	5,200	1,482	6,682
Residential real estate loans	571	118	689	1,455	93	1,548
Residential real estate lines	(64)	181	117	(179)	488	309
Consumer indirect	634	460	1,094	2,716	912	3,628
Other consumer	(17)	9	(8)	(23)	32	9
Total loans	4,298	1,997	6,295	12,677	4,634	17,311
Total interest income	3,428	1,755	5,183	10,887	3,726	14,613
Interest expense:						
Deposits:						
Interest-bearing demand	11	67	78	34	31	65
Savings and money market	(8)	441	433	(21)	878	857
Time deposits	287	1,276	1,563	1,072	3,058	4,130
Total interest-bearing deposits	290	1,784	2,074	1,085	3,967	5,052
Short-term borrowings	162	1,021	1,183	582	2,650	3,232
Long-term borrowings	1	(2)	(1)	3	(3)	—
Total borrowings	163	1,019	1,182	585	2,647	3,232
Total interest expense	453	2,803	3,256	1,670	6,614	8,284
Net interest income	$2,975	$(1,048)	$1,927	$9,217	$(2,888)	$6,329

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 for the three and nine months ended September 30, 2018 was $2.1 million and $5.1 million, respectively, compared to $2.8

million and $9.4 million for the corresponding periods in 2017. The decrease in provision is the result of a combination of factors which include lower historical net charge-off experience, an increase in the collateral values supporting impaired loans, and improved qualitative factors which include but are not limited to: national and local economic trends and conditions, the regulatory environment and levels and trends in delinquent and non-accruing loans.

See the “Allowance for Loan Losses” and “Non-Performing Assets and Potential Problem Loans” sections of this Management’s Discussion and Analysis for further discussion.

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Noninterest Income

The following table details the major categories of noninterest income for the periods presented (in thousands):

	Three months ended September 30,		Nine months ended September 30,	
	2018	2017	2018	2017
Service charges on deposits	$ 1,813	$ 1,901	$ 5,254	$ 5,486
Insurance income	1,501	1,488	3,918	4,052
ATM and debit card	1,557	1,445	4,509	4,230
Investment advisory	2,245	1,497	5,934	4,357
Company owned life insurance	440	449	1,333	1,367
Investments in limited partnerships	328	(14)	1,019	91
Loan servicing	78	105	396	348
Net gain on sale of loans held for sale	303	150	530	270
Net (loss) gain on investment securities	(95)	184	(88)	600
Net gain on derivative instruments	354	127	606	127
Net gain on other assets	37	21	49	25
Contingent consideration liability adjustment	—	—	—	1,200
Other	1,337	1,221	3,971	3,590
Total noninterest income	$ 9,898	$ 8,574	$ 27,431	$ 25,743

Insurance income for the nine months ended September 30, 2018 decreased $134 thousand to $3.9 million compared to $4.1 million during the nine months ended September 30, 2017. The decrease was primarily the result of non-renewals in one of the agency's specialty lines of business during the second quarter of 2018. This negative impact was partially offset by new commercial business generated as a result of successful business development efforts and integration with the Bank.

Investment advisory income for the nine months ended September 30, 2018 increased $1.6 million to $5.9 million compared to $4.4 million during the nine months ended September 30, 2017, reflecting higher assets under management driven by the acquisition of the assets of Robshaw & Julian in the third quarter of 2017, the acquisition of HNP Capital in the second quarter of 2018 and growth in assets under management at Courier Capital.

We have investments in limited partnerships, primarily small business investment companies, and account for these investments under the equity method. The income (loss) from these equity method investments fluctuates based on the maturity and performance of the underlying investments.

During the first nine months of 2018, we recognized net losses on investment securities totaling $88 thousand from the sale of five agency securities and 21 mortgage-backed securities. During the first nine months of 2017, we recognized net gains on investment securities totaling $600 thousand from the sale of eleven agency securities and six mortgage-backed securities. The amount and timing of our sale of investment securities is dependent on several factors, including our prudent efforts to realize gains while managing duration, premium and credit risk.

Net gain on derivative instruments primarily consists of income associated with interest rate swap products offered to commercial loan customers. The program was implemented in the third quarter of 2017. The net gain for the nine months ended September 30, 2018 increased $479 thousand to $606 thousand compared to $127 thousand during the nine months ended September 30, 2017, as a result of an increase in the number and value of transactions executed in 2018.

In the second quarter of 2017, we recognized a $1.2 million non-cash fair value adjustment of the contingent consideration liability related to the 2014 acquisition of SDN.

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Noninterest Expense

The following table details the major categories of noninterest expense for the periods presented (in thousands):

	Three months ended		Nine months ended	
	September 30,		September 30,	
	2018	2017	2018	2017
Salaries and employee benefits	$ 13,970	$ 12,348	$ 40,270	$ 35,703
Occupancy and equipment	4,337	4,087	12,911	12,235
Professional services	1,353	1,157	3,132	3,229
Computer and data processing	1,291	1,208	3,884	3,691
Supplies and postage	485	492	1,545	1,496
FDIC assessments	498	440	1,486	1,366
Advertising and promotions	949	344	2,647	1,451
Amortization of intangibles	334	288	927	876
Goodwill impairment	—	—	—	1,575
Other	2,304	2,103	6,271	5,728
Total noninterest expense	$ 25,521	$ 22,467	$ 73,073	$ 67,350

Salaries and employee benefits expense increased by $4.6 million to $40.3 million in the first nine months of 2018 compared to $35.7 million during the same period in 2017, primarily due to investments in Bank personnel, the acquisition of the assets of Robshaw & Julian in the third quarter of 2017 and the acquisition of HNP Capital in the second quarter of 2018.

Occupancy and equipment expense increased $676 thousand to $12.9 million in the first nine months of 2018 compared to $12.2 million during the same period in 2017, primarily as a result of investments in software and facilities.

Advertising and promotions expense increased $1.2 million to $2.6 million when comparing the first nine months of 2018 to the same period in 2017, as a result of the new Five Star Bank brand campaign launched in February 2018.

In the second quarter of 2017, we recognized a $1.6 million non-cash goodwill impairment charge related to the 2014 SDN acquisition.

Our efficiency ratio for the first nine months of 2018 was 61.36% compared with 61.01% for the first nine months of 2017. The higher efficiency ratio is a result of the higher noninterest expenses associated with our organic growth initiatives. The efficiency ratio is calculated by dividing total noninterest expense by net revenue, defined as the sum of tax-equivalent net interest income and noninterest income before net gains on investment securities. An increase in the efficiency ratio indicates that more resources are being utilized to generate the same volume of income, while a decrease indicates a more efficient allocation of resources. The efficiency ratio, a banking industry financial measure, is not required by GAAP. However, the efficiency ratio is used by management in its assessment of financial performance specifically as it relates to noninterest expense control. Management also believes such information is useful to investors in evaluating Company performance.

Income Taxes

For the nine months ended September 30, 2018, we recorded income tax expense of $7.8 million, versus $9.4 million a year ago. The effective tax rates for the first nine months of 2018 and 2017 were 19.6% and 29.4%, respectively. The decrease in income tax expense and effective tax rate was primarily due to the lower federal corporate tax rate as a result of the TCJ Act. 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, our effective tax rate for 2018 and 2017 reflects the New York State tax benefit generated by our real estate investment trust.

ANALYSIS OF FINANCIAL CONDITION

INVESTING ACTIVITIES

Investment Securities

The following table summarizes the composition of our investment securities portfolio as of the dates indicated (in thousands):

	Investment Securities Portfolio Composition			
	September 30, 2018		December 31, 2017	
	Amortized Cost	Fair Value	Amortized Cost	Fair Value
Securities available for sale:				
U.S. Government agency and government-sponsored enterprise securities	$157,786	$151,809	$163,025	$161,889
Mortgage-backed securities:				
Agency mortgage-backed securities	318,332	305,651	365,433	362,108
Non-Agency mortgage-backed securities	—	850	—	976
Total available for sale securities	476,118	458,310	528,458	524,973
Securities held to maturity:				
State and political subdivisions	241,637	239,964	283,557	285,212
Mortgage-backed securities	217,986	207,754	232,909	227,771
Total held to maturity securities	459,623	447,718	516,466	512,983
Total investment securities	$935,741	$906,028	$1,044,924	$1,037,956

The available for sale ("AFS") investment securities portfolio decreased $66.7 million from $525.0 million at December 31, 2017 to $458.3 million at September 30, 2018. The AFS portfolio had net unrealized losses totaling $17.8 million and $3.5 million at September 30, 2018 and December 31, 2017, respectively. The unrealized losses in the AFS portfolio were predominantly caused by changes in market interest rates. The fair value of most of the investment securities in the AFS portfolio fluctuates as market interest rates change.

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 September 30, 2018. 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 Cost	Yield	Due from one to five years Cost	Yield	Due after five years through ten years Cost	Yield	Due after ten years Cost	Yield	Total Cost	Yield
Available for sale debt securities:										
U.S. Government agencies and government-sponsored enterprises	$10,087	1.70%	$62,220	2.22%	$85,479	2.40%	$—	0.00%	$157,786	2.29%
Mortgage-backed securities	25,589	1.98	77,003	1.97	129,161	2.52	86,579	2.32	318,332	2.29
	35,676	1.90	139,223	2.08	214,640	2.47	86,579	2.32	476,118	2.29
Held to maturity debt securities:										
State and political subdivisions	49,829	2.21	148,276	2.15	43,532	1.80	—	—	241,637	2.10
Mortgage-backed securities	—	—	2,473	2.30	39,745	1.77	175,768	2.35	217,986	2.25
	49,829	2.21	150,749	2.15	83,277	1.79	175,768	2.35	459,623	2.17
Total investment securities	$85,505	2.08%	$289,972	2.12%	$297,917	2.28%	$262,347	2.34%	$935,741	2.23%

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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 for available for sale securities 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. The assessment of whether OTTI exists involves a high degree of subjectivity and judgment and is based on the information available to management at a point in time. There were no securities deemed to be OTTI during the nine months ended September 30, 2018 and 2017.

LENDING ACTIVITIES

The following table summarizes the composition of our loan portfolio, excluding loans held for sale and including net unearned income and net deferred fees and costs, as of the dates indicated (in thousands).

	Loan Portfolio Composition			
	September 30, 2018		December 31, 2017	
	Amount	% of Total	Amount	% of Total
Commercial business	$537,942	18.0 %	$450,326	16.5 %
Commercial mortgage	905,011	30.3	808,908	29.6
Total commercial	1,442,953	48.3	1,259,234	46.1
Residential real estate loans	507,598	17.0	465,283	17.0
Residential real estate lines	111,204	3.7	116,309	4.3
Consumer indirect	909,434	30.4	876,570	32.0
Other consumer	17,142	0.6	17,621	0.6
Total consumer	1,545,378	51.7	1,475,783	53.9
Total loans	2,988,331	100.0%	2,735,017	100.0%
Less: Allowance for loan losses	33,955		34,672	
Total loans, net	$2,954,376		$2,700,345	

Total loans increased $253.3 million to $2.99 billion at September 30, 2018 from $2.74 billion at December 31, 2017. The increase in loans was attributable to our organic growth initiatives.

Commercial loans increased $183.7 million during the nine months ended September 30, 2018 and represented 48.3% of total loans as of September 30, 2018 as a result of our continued commercial business development efforts.

The consumer indirect portfolio totaled $909.4 million and represented 30.4% of total loans as of September 30, 2018. During the first nine months of 2018, we originated $297.1 million in indirect auto loans with a mix of approximately 39% new auto and 61% used auto. During the first nine months of 2017, we originated $334.9 million in indirect auto loans with a mix of approximately 42% new auto and 58% used auto. Our origination volumes and mix of new and used vehicles financed fluctuate depending on general market conditions.

Loans Held for Sale and Loan Servicing Rights

Loans held for sale (not included in the loan portfolio composition table) were entirely comprised of residential real estate loans and totaled $3.2 million and $2.7 million as of September 30, 2018 and December 31, 2017, respectively.

We sell certain qualifying newly originated or refinanced residential real estate loans on the secondary market. Residential real estate loans serviced for others, which are not included in the consolidated statements of financial condition, amounted to $167.6 million and $163.3 million as of September 30, 2018 and December 31, 2017, respectively.

Allowance for Loan Losses

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

	Loan Loss Analysis Three months ended September 30,		Nine months ended September 30,	
	2018	2017	2018	2017
Allowance for loan losses, beginning of period	$33,955	$33,159	$34,672	$30,934
Charge-offs:				
Commercial business	672	130	1,113	1,908
Commercial mortgage	113	—	117	10
Residential real estate loans	24	198	53	298
Residential real estate lines	23	21	124	64
Consumer indirect	2,474	2,330	8,089	7,343
Other consumer	301	230	969	620
Total charge-offs	3,607	2,909	10,465	10,243
Recoveries:				
Commercial business	241	86	438	332
Commercial mortgage	3	5	11	257
Residential real estate loans	8	37	140	85
Residential real estate lines	2	2	17	58
Consumer indirect	1,228	1,086	3,862	3,259
Other consumer	64	79	230	250
Total recoveries	1,546	1,295	4,698	4,241
Net charge-offs	2,061	1,614	5,767	6,002
Provision for loan losses	2,061	2,802	5,050	9,415
Allowance for loan losses, end of period	$33,955	$34,347	$33,955	$34,347
Net loan charge-offs to average loans (annualized)	0.28 %	0.25 %	0.27 %	0.33 %
Allowance for loan losses to total loans	1.14 %	1.31 %	1.14 %	1.31 %
Allowance for loan losses to non-performing loans	433 %	273 %	433 %	273 %

The allowance for loan losses represents the estimated amount of probable credit losses inherent in our loan portfolio. We perform periodic, systematic reviews of the loan portfolio to estimate probable losses in the respective loan portfolios. In addition, we regularly evaluate prevailing economic and business conditions, industry concentrations, changes in the size and characteristics of the portfolio and other pertinent factors. The process we use to determine the overall allowance for loan losses is based on this analysis. Based on this analysis, we believe the allowance for loan losses is adequate as of September 30, 2018.

Assessing the adequacy of the allowance for loan losses involves substantial uncertainties and is based upon management's evaluation of the amounts required to meet estimated charge-offs in the loan portfolio after weighing a variety of factors, including the risk-profile of our loan products and customers.

The adequacy of the allowance for loan losses is subject to ongoing management review. 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 increase the allowance based on their judgments about information available to them at the time of their examination.

Net charge-offs of $2.1 million in the third quarter of 2018 represented 0.28% of average loans on an annualized basis compared to $1.6 million or 0.25% in the third quarter of 2017. For the nine months ended September 30, 2018, net charge-offs of $5.8 million represented 0.27% of average loans, compared to $6.0 million or 0.33% of average loans for the same period in 2017. The decrease in net charge-offs in the nine months ended September 30, 2018 is primarily due to improved credit quality of our outstanding loans portfolio. The allowance for loan losses was $34.0 million at September 30, 2018, compared with $34.7 million at December 31, 2017. The ratio of the allowance for loan losses to total loans was 1.14% and 1.27% at September 30, 2018 and December 31, 2017, respectively. The ratio of allowance for loan losses to non-performing loans was 433% at September 30, 2018, compared with 277% at December 31, 2017.

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MANAGEMENT'S DISCUSSION AND ANALYSIS

Non-Performing Assets and Potential Problem Loans

The table below summarizes our non-performing assets at the dates indicated (in thousands).

	Non-Performing Assets			
	September 30, 2018		December 31, 2017	
Nonaccrual loans:				
Commercial business	$2,203		$ 5,344	
Commercial mortgage	1,900		2,623	
Residential real estate loans	2,057		2,252	
Residential real estate lines	297		404	
Consumer indirect	1,385		1,895	
Other consumer	—		2	
Total nonaccrual loans	7,842		12,520	
Accruing loans 90 days or more delinquent	8		11	
Total non-performing loans	7,850		12,531	
Foreclosed assets	290		148	
Total non-performing assets	$8,140		$ 12,679	
Non-performing loans to total loans	0.26	%	0.46	%
Non-performing assets to total assets	0.19	%	0.31	%

Changes in the level of nonaccrual loans typically represent increases for loans that reach a specified past due status, offset by reductions for loans that are charged-off, paid down, sold, transferred to foreclosed real estate, or are no longer classified as nonaccrual because they have returned to accrual status. Activity in nonaccrual loans for the three and nine months ended September 30, 2018 was as follows (in thousands):

	Three months ended September 30, 2018		Nine months ended September 30, 2018	
Nonaccrual loans, beginning of period	$ 9,727		$ 12,520	
Additions	4,673		13,417	
Payments	(2,539	)	(6,382	)
Charge-offs	(3,449	)	(9,833	)
Returned to accruing status	(388	)	(1,284	)
Transferred to other real estate or repossessed assets	(182	)	(596	)
Nonaccrual loans, end of period	$ 7,842		$ 7,842	

Non-performing assets include non-performing loans and foreclosed assets. Non-performing assets at September 30, 2018 were $8.1 million, a decrease of $4.5 million from the $12.7 million balance at December 31, 2017. The primary component of non-performing assets is non-performing loans, which were $7.8 million or 0.26% of total loans at September 30, 2018, compared with $12.5 million or 0.46% of total loans at December 31, 2017.

Approximately $563 thousand, or 7%, of the $7.8 million in non-performing loans as of September 30, 2018 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. Included in nonaccrual loans are troubled debt restructurings ("TDRs") of $581 thousand and $691 thousand at September 30, 2018 and December 31, 2017, respectively. We had one TDR of $598 thousand that was accruing interest as of September 30, 2018 and one TDR of $633 thousand that was accruing interest as of December 31, 2017.

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 $290 thousand at September 30, 2018 and four properties totaling $148 thousand at December 31, 2017.

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MANAGEMENT'S DISCUSSION AND ANALYSIS

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 $13.3 million and $12.5 million in loans that continued to accrue interest which were classified as substandard as of September 30, 2018 and December 31, 2017, respectively.

FUNDING ACTIVITIES

Deposits

The following table summarizes the composition of our deposits at the dates indicated (dollars in thousands):

	Deposit Composition September 30, 2018		December 31, 2017	
	Amount	% of Total	Amount	% of Total
Noninterest-bearing demand	$748,167	21.5 %	$718,498	22.4 %
Interest-bearing demand	711,321	20.4	634,203	19.8
Savings and money market	988,486	28.3	1,005,317	31.3
Time deposits < $250,000	785,204	22.6	698,179	21.7
Time deposits of $250,000 or more	252,551	7.2	153,977	4.8
Total deposits	$3,485,729	100.0%	$3,210,174	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 September 30, 2018, total deposits were $3.49 billion, representing an increase of $275.6 million from December 31, 2017. Time deposits were approximately 30% and 27% of total deposits at September 30, 2018 and December 31, 2017, respectively.

Nonpublic deposits, the largest component of our funding sources, totaled $2.17 billion and $2.07 billion at September 30, 2018 and December 31, 2017, respectively, and represented 62% and 65% of total deposits as of the end of each period, respectively. We have managed this segment of funding through a strategy of competitive pricing that minimizes the number of customer relationships that have only a single service high cost deposit account.

As an additional source of funding, we offer a variety of public (municipal) deposit products to the towns, villages, counties and school districts within our market. Public deposits generally range from 20% to 30% of our total deposits. There is a high degree of seasonality in this component of funding, because the level of deposits varies with the seasonal cash flows for these public customers. We maintain the necessary levels of short-term liquid assets to accommodate the seasonality associated with public deposits. Total public deposits were $971.5 million and $829.5 million at September 30, 2018 and December 31, 2017, respectively, and represented 28% and 26% of total deposits as of the end of each period, respectively. The increase in public deposits during 2018 was due largely to successful business development efforts.

We also participate in CDARS and 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. Prior to the Economic Growth, Regulatory Relief and Consumer Protection Act ("EGRRCPA") enacted on May 14, 2018, all CDARS and ICS deposits were considered brokered deposits for regulatory reporting purposes. With the enactment of EGRRCPA, reciprocal CDARS and ICS deposits, subject to certain restrictions, are no longer required to be reported as brokered deposits. CDARS deposits and ICS deposits, the majority of which were reciprocal, totaled $185.3 million and $162.8 million, respectively, at September 30, 2018, compared to $159.2 million and $147.3 million, respectively, at December 31, 2017, and collectively represented 10% and 9% of total deposits as of the end of each period, respectively.

Borrowings

The Company classifies borrowings as short-term or long-term in accordance with the original terms of the applicable agreement. Outstanding borrowings consisted of the following as of the dates indicated (in thousands):

	September 30, 2018	December 31, 2017
Short-term borrowings - Short-term FHLB borrowings	$ 308,200	$ 446,200
Long-term borrowings - Subordinated notes, net	39,184	39,131
Total borrowings	$ 347,384	$ 485,331

MANAGEMENT’S DISCUSSION AND ANALYSIS

Short-term Borrowings

Short-term Federal Home Loan Bank (“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 September 30, 2018 consisted of $90.7 million in overnight borrowings and $217.5 million in short-term borrowings. The maximum amount of short-term FHLB borrowings outstanding at any month-end during the nine months ended September 30, 2018 was $477.1 million. Short-term FHLB borrowings at December 31, 2017 consisted of $304.7 million in overnight borrowings and $141.5 million in short-term borrowings.

We have credit capacity with the FHLB and can borrow through facilities that include amortizing and term advances or repurchase agreements. We had approximately $77.6 million of immediate credit capacity with the FHLB as of September 30, 2018. We had approximately $663.9 million in secured borrowing capacity at the Federal Reserve Bank (“FRB”) discount window, none of which was outstanding at September 30, 2018. The FHLB and FRB credit capacity are collateralized by securities from our investment portfolio and certain qualifying loans. We had approximately $145.0 million of credit available under unsecured federal funds purchased lines with various banks as of September 30, 2018. Additionally, we had approximately $104.3 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 September 30, 2018, no amounts have been drawn on the line of credit.

Long-term Borrowings

On April 15, 2015, we issued $40.0 million of Subordinated Notes in a registered public offering. The Subordinated Notes bear interest at a fixed rate of 6.0% per year, payable semi-annually, for the first 10 years. From April 15, 2025 to the April 15, 2030 maturity date, the interest rate will reset quarterly to an annual interest rate equal to the then-current three-month London Interbank Offered Rate (LIBOR) plus 3.944%, payable quarterly. The Subordinated Notes are redeemable by us at any quarterly interest payment date beginning on April 15, 2025 to maturity at par, plus accrued and unpaid interest. Proceeds, net of debt issuance costs of $1.1 million, were $38.9 million. The Subordinated Notes qualify as Tier 2 capital for regulatory purposes.

LIQUIDITY AND CAPITAL MANAGEMENT

Liquidity

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 both core customer funds and maturing short-term assets; we also rely on our ability to sell or pledge securities and lines-of-credit and our overall ability to access to the financial and capital markets.

Liquidity for the Bank is managed through the monitoring of anticipated changes in loans, the investment portfolio, 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 source of our non-deposit borrowings is FHLB advances, of which we had $308.2 million outstanding at September 30, 2018. In addition to this amount, we have additional collateralized wholesale borrowing capacity of approximately $886.4 million from various funding sources which include the FHLB, the FRB, and commercial banks that we can use to fund lending activities, liquidity needs, and/or to adjust and manage our asset and liability position.

The Parent’s funding requirements consist primarily of dividends to shareholders, debt service, income taxes, operating expenses, funding of nonbank subsidiaries, repurchases of our stock, and acquisitions. The Parent obtains funding to meet obligations from dividends received from the Bank, net taxes collected from subsidiaries included in the federal consolidated tax return, and the issuance of debt and equity securities. In addition, the Parent maintains a revolving line of credit with a commercial bank for an aggregate amount of up to $20.0 million, all of which was available at September 30, 2018. The line of credit has a one-year term and matures in May 2019. Funds drawn would be used for general corporate purposes and backup liquidity.

Cash and cash equivalents were $117.3 million as of September 30, 2018, up $18.1 million from $99.2 million as of December 31, 2017. Net cash provided by operating activities totaled $50.8 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 $158.2 million, which included outflows of $259.7 million for net loan originations and was partially offset by inflows of $107.5 million from net investment securities transactions. Net cash provided by financing activities of $125.5 million was attributed to a $275.6 million increase in deposits, partially offset by a $138.0 million decrease in short-term borrowings and by $12.2 million in dividend payments.

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Capital Management

We actively manage capital, commensurate with our risk profile, to enhance shareholder value. We also seek to maintain capital levels for the Company and the Bank at amounts in excess of the regulatory "well-capitalized" thresholds. Periodically, we may respond to market conditions by implementing changes to our overall balance sheet positioning to manage our capital position.

Banks and financial holding companies are subject to various regulatory capital requirements administered by state and federal banking agencies. Failure to meet minimum capital requirements can result in certain mandatory and possibly additional discretionary actions by regulators that, if undertaken, could have a direct material impact on our consolidated financial statements. 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.

Shareholders' equity was $392.2 million at September 30, 2018, an increase of $11.0 million from $381.2 million at December 31, 2017. Net income for the nine months ended September 30, 2018 increased shareholders' equity by $32.0 million, which was partially offset by common and preferred stock dividends declared of $12.6 million. Accumulated other comprehensive loss included in shareholders' equity increased $9.9 million during the first nine months of 2018 due primarily to higher net unrealized losses on securities available for sale.

The FRB and FDIC have adopted a system using risk-based capital guidelines to evaluate the capital adequacy of banks and bank holding companies. 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 September 30, 2018, the Company's capital levels remained characterized as "well-capitalized" under the new rules.

The following table reflects the ratios and their components (dollars in thousands):

	September 30, 2018	December 31, 2017
Common shareholders' equity	$ 374,825	$ 363,848
Less: Goodwill and other intangible assets	75,972	70,413
Net unrealized loss on investment securities (1)	(13,768)	(3,275)
Hedging derivative instruments	208	—
Net periodic pension and postretirement benefits plan adjustments	(8,260)	(8,641)
Other	—	—
Common Equity Tier 1 ("CET1") Capital	320,673	305,351
Plus: Preferred stock	17,329	17,329
Less: Other	—	—
Tier 1 Capital	338,002	322,680
Plus: Qualifying allowance for loan losses	33,955	34,672
Subordinated Notes	39,184	39,131

Total regulatory capital	$ 411,141		$ 396,483	
Adjusted average total assets (for leverage capital purposes)	$ 4,133,239		$ 3,967,749	
Total risk-weighted assets	$ 3,269,366		$ 3,005,655	
Regulatory Capital Ratios				
Tier 1 Leverage (Tier 1 capital to adjusted average assets)	8.18	%	8.13	%
CET1 Capital (CET1 capital to total risk-weighted assets)	9.81		10.16	
Tier 1 Capital (Tier 1 capital to total risk-weighted assets)	10.34		10.74	
Total Risk-Based Capital (Total regulatory capital to total risk-weighted assets)	12.58		13.19	

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

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MANAGEMENT'S DISCUSSION AND ANALYSIS

BCBS Capital Rules

The BCBS Capital Rules include a new Common Equity Tier 1 Capital to risk-weighted assets minimum ratio of 4.5%, increase the minimum Tier 1 capital to risk-weighted assets ratio from 4.0% to 6.0%, require a minimum total capital to risk-weighted assets ratio 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, effectively increasing the minimum required risk-weighted asset ratios. This capital conservation buffer was phased-in as of January 1, 2016 at 0.625% of risk-weighted assets and has increased each subsequent year by an additional 0.625% (currently 1.875% as of June 30, 2018) until reaching its final level of 2.5% on January 1, 2019. Banking institutions with a capital conservation buffer below the minimum level will face constraints on dividends, equity repurchases and compensation based on the amount of the shortfall. The BCBS 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. Strict eligibility criteria for regulatory capital instruments were also implemented under the final rules. The final rules also revised the definition and calculation of Tier 1 capital, total capital, and risk-weighted assets.

The following table presents actual and required capital ratios as of September 30, 2018 and December 31, 2017 for the Company and the Bank under the BCBS Capital Rules. The minimum required capital amounts presented include the minimum required capital levels as of those dates based on the phase-in provisions of the BCBS Capital Rules and the minimum required capital levels as of January 1, 2019 when the BCBS 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 BCBS 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
September 30, 2018								
Tier 1 leverage:								
Company	$338,002	8.18 %	$165,330	4.00 %	$165,330	4.00 %	$206,662	5.00 %
Bank	367,159	8.90	165,002	4.00	165,002	4.00	206,253	5.00
CET1 capital:								
Company	320,673	9.81	208,422	6.38	228,856	7.00	212,509	6.50
Bank	367,159	11.26	207,856	6.38	228,234	7.00	211,931	6.50
Tier 1 capital:								
Company	338,002	10.34	257,463	7.88	277,896	8.50	261,549	8.00
Bank	367,159	11.26	256,763	7.88	277,141	8.50	260,839	8.00
Total capital:								
Company	411,141	12.58	322,850	9.88	343,283	10.50	326,937	10.00
Bank	401,115	12.30	321,973	9.88	342,351	10.50	326,048	10.00
December 31, 2017								

Tier 1 leverage:								
Company	$322,680	8.13 %	$158,710	4.00 %	$158,710	4.00 %	$198,387	5.00 %
Bank	346,532	8.75	158,372	4.00	158,372	4.00	197,965	5.00
CET1 capital:								
Company	305,351	10.16	172,825	5.75	210,396	7.00	195,368	6.50
Bank	346,532	11.57	172,224	5.75	209,664	7.00	194,688	6.50
Tier 1 capital:								
Company	322,680	10.74	217,910	7.25	255,481	8.50	240,452	8.00
Bank	346,532	11.57	217,152	7.25	254,592	8.50	239,616	8.00
Total capital:								
Company	396,483	13.19	278,023	9.25	315,594	10.50	300,565	10.00
Bank	381,204	12.73	277,056	9.25	314,496	10.50	299,520	10.00

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.

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ITEM 3. Quantitative and Qualitative Disclosures About Market Risk

Quantitative and qualitative disclosures about market risk were presented at December 31, 2017 in Item 7A of the Company's Annual Report on Form 10-K for the year ended December 31, 2017, as filed with the Securities and Exchange Commission on March 14, 2018. The following is an update of the discussion provided therein.

Portfolio Composition

There was no material change in the composition of assets, deposit liabilities or borrowings from December 31, 2017 to September 30, 2018. See the section titled "Analysis of Financial Condition" in Part I, Item 2, "Management's Discussion and Analysis of Financial Condition and Results of Operations" for a discussion of asset, deposit and borrowing activity during the period.

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 September 30, 2018, the Company's sensitivity was relatively neutral, meaning that net interest income is modestly impacted as interest rates change.

Net interest income at risk is measured by estimating the changes in net interest income resulting from instantaneous and sustained parallel shifts in interest rates of different magnitudes over a period of 12 months. The following table sets forth the estimated changes to net interest income over the 12-month period ending September 30, 2019 assuming instantaneous changes in interest rates for the given rate shock scenarios (dollars in thousands):

	Changes in Interest Rate			
	-100 bp	+100 bp	+200 bp	+300 bp
Estimated change in net interest income	$(4,443)	$1,127	$2,277	$3,463
% Change	(3.30)%	0.84 %	1.69 %	2.57 %

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 future results, does not measure the effect of changing interest rates on noninterest income and is based on many assumptions that, if changed, could cause a different outcome.

Economic Value of Equity At Risk

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

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

The analysis that follows presents the estimated EVE resulting from market interest rates prevailing at a given quarter-end ("Pre-Shock Scenario"), and under other interest rate scenarios (each a "Rate Shock Scenario") represented by immediate, permanent, parallel shifts in interest rates from those observed at September 30, 2018 and December 31, 2017 (dollars in thousands). The analysis additionally presents a measurement of the interest rate sensitivity at September 30, 2018 and December 31, 2017. 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.

	September 30, 2018			December 31, 2017		
			Percentage			Percentage
Rate Shock Scenario:	EVE	Change	Change	EVE	Change	Change
Pre-Shock Scenario	$627,171			$578,550		
- 100 Basis Points	636,995	$9,824	1.57 %	592,527	$13,977	2.42 %
+ 100 Basis Points	598,310	(28,861)	(4.60)	544,507	(34,043)	(5.88)
+ 200 Basis Points	567,334	(59,837)	(9.54)	507,137	(71,413)	(12.34)
+ 300 Basis Points	536,596	(90,575)	(14.44)	468,787	(109,763)	(18.97)

The Pre-Shock Scenario EVE was $627.2 million at September 30, 2018, compared to $578.6 million at December 31, 2017. The increase in the Pre-Shock Scenario EVE at September 30, 2018 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 $507.1 million at December 31, 2017 to $567.3 million at September 30, 2018, 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 changed from (12.34)% at December 31, 2017 to (9.54)% at September 30, 2018. The decrease in sensitivity resulted from the addition of the interest rate cap and a change in the valuation of certain fixed rate assets in the +200 basis point Rate Shock Scenario EVE as of September 30, 2018, compared to December 31, 2017.

ITEM 4. Controls and Procedures

Evaluation of Disclosure Controls and Procedures

As of September 30, 2018, 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 and Chief Financial 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 SEC under the Securities Exchange Act of 1934, as amended ("Exchange Act"). Based upon that evaluation, the Company's 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 report.

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 Company's Chief Executive Officer and Chief Financial Officer, as appropriate, to allow timely decisions regarding required disclosure.

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 September 30, 2018 that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

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PART II. OTHER INFORMATION

ITEM 1. Legal Proceedings

The Company has experienced no material developments in its legal proceedings from the disclosure included in the Company's Annual Report on Form 10-K for the year ended December 31, 2017, dated March 14, 2018, as filed with the SEC.

ITEM 6. Exhibits

(a)The following is a list of all exhibits filed or incorporated by reference as part of this Report:

Exhibit Number	Description	Location
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	

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SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

FINANCIAL INSTITUTIONS, INC.

/s/ Martin K. Birmingham , November 7, 2018
Martin K. Birmingham
President and Chief Executive Officer
(Principal Executive Officer)

/s/ Kevin B. Klotzbach , November 7, 2018
Kevin B. Klotzbach
Executive Vice President, Chief Financial Officer and Treasurer
(Principal Financial Officer)

/s/ Michael D. Grover , November 7, 2018
Michael D. Grover
Senior Vice President and Chief Accounting Officer
(Principal Accounting Officer)