FINANCIAL INSTITUTIONS INC
Form 10-K
March 12, 2009

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

Form 10-K

þ **ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
For the fiscal year ended December 31, 2008
OR

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

FINANCIAL INSTITUTIONS, INC.
(Exact name of registrant as specified in its charter)

NEW YORK	**16-0816610**
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)
220 LIBERTY STREET, WARSAW, NEW YORK	**14569**
(Address of principal executive offices)	(ZIP Code)

Registrant s telephone number, including area code: **(585) 786-1100**
Securities registered under Section 12(b) of the Exchange Act:

Title of each class	Name of exchange on which registered
Common stock, par value $.01 per share	**NASDAQ Global Select Market**

Securities registered under Section 12(g) of the Exchange Act: **NONE**

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

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

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

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K (§ 229.405 of this chapter) is not contained herein, and will not be contained, to the best of the registrant s knowledge, in definitive proxy or information statements incorporated by reference in Part III of this form 10-K or any amendment to this Form 10-K. o

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

Large accelerated filer o Accelerated filer þ Non-accelerated filer o Smaller reporting company o

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

The aggregate market value of common stock held by non-affiliates of the registrant, as computed by reference to the June 30, 2008 closing price reported by NASDAQ, was $160,362,000.

As of February 28, 2009, there were issued and outstanding, exclusive of treasury shares, 10,846,519 shares of the registrant s common stock.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the Proxy Statement for the 2009 Annual Meeting of Shareholders are incorporated by reference in Part III.

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PART I

FORWARD LOOKING INFORMATION

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

- statements with respect to the beliefs, plans, objectives, goals, guidelines, expectations, anticipations, and future financial condition, results of operations and performance of Financial Institutions, Inc. (the parent or FII) and its subsidiaries (collectively the Company, we, our, us);
- statements preceded by, followed by or that include the words may, could, should, would, believe, an estimate, expect, intend, plan, projects, or similar expressions.

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

- the Company s ability to successfully execute its business plans, manage its risks, and achieve its objectives;
- changes in political and economic conditions, including the political and economic effects of the current economic crisis and other major developments, including wars, military actions and terrorist attacks;
- changes in financial market conditions, either internationally, nationally or locally in areas in which the Company conducts its operations, including without limitation, reduced rates of business formation and growth, commercial and residential real estate development and real estate prices;
- fluctuations in markets for equity, fixed-income, commercial paper and other securities, including availability, market liquidity levels, and pricing;
- changes in interest rates, the quality and composition of the loan and securities portfolios, demand for loan products, deposit flows and competition;
- acquisitions and integration of acquired businesses;
- increases in the levels of losses, customer bankruptcies, claims and assessments;
- changes in fiscal, monetary, regulatory, trade and tax policies and laws, including policies of the U.S. Department of Treasury and the Federal Reserve Board (FRB);
- the Company s participation or lack of participation in governmental programs implemented under the Emergency Economic Stabilization Act (EESA) and the American Recovery and Reinvestment Act (ARRA), including without limitation the Troubled Asset Relief Program (TARP), the Capital Purchase Program (CPP), and the Temporary Liquidity Guarantee Program (TLGP) and the impact of such programs and related regulations on the Company and on international, national, and local economic and financial markets and conditions;
- the impact of the EESA and the ARRA and related rules and regulations on the business operations and competitiveness of the Company and other participating American financial institutions, including the impact of the executive compensation limits of these acts, which may impact the ability of the Company and other American financial institutions to retain and recruit executives and other personnel necessary for their businesses and competitiveness;
- the impact of certain provisions of the EESA and ARRA and related rules and regulations on the attractiveness of governmental programs to mitigate the effects of the current economic crisis, including the risks that certain financial institutions may elect not to participate in such programs, thereby decreasing the effectiveness of such programs;
- continuing consolidation in the financial services industry;
- new litigation or changes in existing litigation;
- success in gaining regulatory approvals, when required;
- changes in consumer spending and savings habits;
- increased competitive challenges and expanding product and pricing pressures among financial institutions;

demand for financial services in the Company s market areas;
inflation and deflation;
technological changes and the Company s implementation of new technologies;
the Company s ability to develop and maintain secure and reliable information technology systems;
legislation or regulatory changes which adversely affect the Company s operations or business;

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- the Company s ability to comply with applicable laws and regulations;
- changes in accounting policies or procedures as may be required by the Financial Accounting Standards Board or regulatory agencies;
- increased costs of deposit insurance and changes with respect to Federal Deposit Insurance Corporation (FDIC) insurance coverage levels; and
- further declines in the market value of the Company s publicly traded stock price or declines in the Company s ability to generate future cash flows may increase the potential that goodwill recorded on the Company s consolidated statement of financial position be designated as impaired and that the Company may incur a goodwill write-down in the future.

The Company cautions readers not to place undue reliance on any forward-looking statements, which speak only as of the date made, and advises readers that various factors, including those described above, could affect the Company s financial performance and could cause the Company s actual results or circumstances for future periods to differ materially from those anticipated or projected. See also Item 1A, Risk Factors, in this Form 10-K.

Except as required by law, the Company does not undertake, and specifically disclaims any obligation to publicly release any revisions to any forward-looking statements to reflect the occurrence of anticipated or unanticipated events or circumstances after the date of such statements.

GLOSSARY OF ACRONYMS

ABS	Asset-Backed Security
AFS	Available-for-Sale
ALCO	Asset/Liability Committee
ALM	Asset-Liability Management
AML	Anti-Money Laundering
ARM	Adjustable Rate Mortgage
ARRA	American Recovery and Reinvestment Act
ATM	Automated Teller Machine
BCBS	Basel Committee on Banking Supervision
BSA	Bank Secrecy Act
CDO	Collateralized Debt Obligation
CMC	Capital Management Committee
COSO	Committee of Sponsoring Organizations of the Treadway Commission
CPP	Capital Purchase Program
CRA	Community Reinvestment Act
CRE	Commercial Real Estate
EESA	Emergency Economic Stabilization Act
EITF	Emerging Issues Task Force
FAMC	Federal Agricultural Mortgage Corporation
FASB	Financial Accounting Standards Board
FDIC	Federal Deposit Insurance Corporation
FHLB	Federal Home Loan Bank
FHLMC	Federal Home Loan Mortgage Corporation
FIN	FASB Interpretation
FNMA	Federal National Mortgage Association
FRB	Federal Reserve Board
FSP	FASB Staff Position
FTE	Full-Time Equivalent
GNMA	Government National Mortgage Association
HTM	Held-to-Maturity
MD&A	Management s Discussion and Analysis
OCI	Other Comprehensive Income

OREO	Other Real Estate Owned
OTC	Over-the-Counter
OTTI	Other-Than-Temporary-Impairment
PCAOB	Public Company Accounting Oversight Board
SBA	Small Business Administration
SEC	Securities and Exchange Commission
SFAS	Statement of Financial Accounting Standards
TARP	Troubled Asset Relief Program
TLGP	Temporary Liquidity Guarantee Program
VIE	Variable Interest Entity

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ITEM 1. BUSINESS

GENERAL

Financial Institutions, Inc. is a financial holding company organized in 1931 under the laws of New York State. Through its subsidiaries, including its wholly-owned, New York State chartered banking subsidiary, Five Star Bank, Financial Institutions, Inc. provides deposit, lending and other financial services to individuals and businesses in Central and Western New York State. All references in this Form 10-K to the parent company are to Financial Institutions, Inc. (FII). Unless otherwise indicated or unless the context requires otherwise, all references in this Form 10-K to the Company means Financial Institutions, Inc. and its subsidiaries on a consolidated basis. Five Star Bank is referred to as Five Star Bank, FSB or the Bank . The parent company is a legal entity separate and distinct from its subsidiaries, assisting those subsidiaries by providing financial resources and management. The Company s executive offices are located at 220 Liberty Street, Warsaw, New York.

We conduct our business primarily through our banking subsidiary, Five Star Bank, which adopted its current name in 2005 when the Company merged three of its bank subsidiaries, Wyoming County Bank, National Bank of Geneva and Bath National Bank into its New York State chartered bank subsidiary, First Tier Bank & Trust, which was then renamed Five Star Bank. In addition, our business operations include a broker-dealer subsidiary, Five Star Investment Services, Inc. (100% owned) (FSIS).

In February 2001, the FISI Statutory Trust I (the Trust) was formed to facilitate the private placement of $16.2 million in capital securities (trust preferred securities). FII capitalized the Trust with a $502 thousand investment in the Trust s common securities. The Trust is a variable interest entity as defined by Financial Accounting Standards Board (FASB) Interpretation No. 46, Consolidation of Variable Interest Entities, and, as such, the Trust is accounted for as an unconsolidated subsidiary. Therefore, the Company s consolidated statements of financial position reflect the $16.7 million in junior subordinated debentures as a liability and the $502 thousand investment in the Trust s common securities is included in other assets.

During the second quarter of 2008, the Company received Federal Reserve approval for an election to reinstate its status as a financial holding company under the Gramm-Leach-Bliley Act, which permits the Company to engage in business activities that are financial in nature or incidental to financial activity.

OTHER INFORMATION

This annual report, including the exhibits and schedules filed as part of the annual report, may be inspected at the public reference facility maintained by the SEC at its public reference room at 100 F. Street, N.E., Room 1580, Washington, DC 20549 and copies of all or any part thereof may be obtained from that office upon payment of the prescribed fees. You may call the SEC at 1-800-SEC-0330 for further information on the operation of the public reference room and you can request copies of the documents upon payment of a duplicating fee, by writing to the SEC. In addition, the SEC maintains a website that contains reports, proxy and information statements and other information regarding registrants, including us, that file electronically with the SEC which can be accessed at www.sec.gov.

The Company also makes available, free of charge through its website at www.fiiwarsaw.com, all reports filed with the SEC, including our Annual Report on Form 10-K, Quarterly Reports on Form 10-Q and Current Reports on Form 8-K, as well as any amendments to those reports, as soon as reasonably practicable after those documents are filed with, or furnished to, the SEC. Information available on our website is not a part of, and is not incorporated into, this annual report on Form 10-K.

MARKET AREAS AND COMPETITION

The Company provides a wide range of consumer and commercial banking and financial services to individuals, municipalities and businesses through a network of 52 offices and over 70 ATMs in fourteen contiguous counties of Western and Central New York State: Allegany, Cattaraugus, Cayuga, Chautauqua, Chemung, Erie, Genesee, Livingston, Monroe, Ontario, Seneca, Steuben, Wyoming and Yates Counties.

The Company s market area is geographically and economically diversified in that it serves both rural markets and the larger more affluent markets of suburban Rochester and suburban Buffalo. Rochester and Buffalo are the two largest cities in New York State outside of New York City, with combined metropolitan area populations of over two million people. The Company anticipates increasing its presence in the markets around these two cities and opened two

branches in the Rochester suburbs during 2008.

The Company faces significant competition in both making loans and attracting deposits, as Western and Central New York have a high density of financial institutions. The Company s competition for loans comes principally from commercial banks, savings banks, savings and loan associations, mortgage banking companies, credit unions, insurance companies and other financial service companies. Its most direct competition for deposits has historically come from commercial banks, savings banks and credit unions. The Company faces additional competition for deposits from non-depository competitors such as the mutual fund industry, securities and brokerage firms and insurance companies.

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LENDING ACTIVITIES

General

The Company offers a broad range of loans including commercial and agricultural working capital and revolving lines of credit, commercial and agricultural mortgages, equipment loans, crop and livestock loans, residential mortgage loans and home equity loans and lines of credit, home improvement loans, automobile loans and personal loans. Newly originated and refinanced fixed rate residential mortgage loans are either retained in the Company s portfolio or sold to the secondary market and servicing rights are retained.

The Company has thoroughly evaluated and updated its lending policy in recent years. The revisions to the loan policy include a renewed focus on lending philosophy and credit objectives.

The key elements of the Company s lending philosophy include the following:

- To ensure consistent underwriting, all employees must share a common view of the risks inherent in lending activities as well as the standards to be applied in underwriting and managing credit risk;
- Pricing of credit products should be risk-based;
- The loan portfolio must be diversified to limit the potential impact of negative events; and
- Careful, timely exposure monitoring through dynamic use of our risk rating system is required to provide early warning and assure proactive management of potential problems.

Commercial and Agricultural Lending

The Company originates commercial loans in its primary market areas and underwrites them based on the borrower s ability to service the loan from operating income. The Company offers a broad range of commercial lending products, including term loans and lines of credit. Short and medium-term commercial loans, primarily collateralized, are made available to businesses for working capital (including inventory and receivables), business expansion (including acquisition of real estate, expansion and improvements) and the purchase of equipment. As a general practice, where possible, a collateral lien is placed on any available real estate, equipment or other assets owned by the borrower and a personal guarantee of the owner is obtained. As of December 31, 2008, $46.6 million, or 29.4%, of the aggregate commercial loan portfolio were at fixed rates, while $111.9 million, or 70.6%, were at variable rates. The Company utilizes government loan guarantee programs where available and appropriate. See Government Guarantee Programs below.

Agricultural loans are offered for short-term crop production, farm equipment and livestock financing and agricultural real estate financing, including term loans and lines of credit. Short and medium-term agricultural loans, primarily collateralized, are made available for working capital (crops and livestock), business expansion (including acquisition of real estate, expansion and improvement) and the purchase of equipment. As of December 31, 2008, $12.6 million, or 28.3%, of the agricultural loan portfolio were at fixed rates, while $32.1 million, or 71.7%, were at variable rates. The Company utilizes government loan guarantee programs where available and appropriate. See Government Guarantee Programs below.

Commercial Real Estate Lending

In addition to commercial loans secured by real estate, the Company makes commercial real estate loans to finance the purchase of real property, which generally consists of real estate with completed structures. Commercial real estate loans are secured by first liens on the real estate and are typically amortized over a 10 to 20 year period. The underwriting analysis includes credit verification, appraisals and a review of the borrower s financial condition and repayment capacity. As of December 31, 2008, $58.0 million, or 22.1%, of the aggregate commercial real estate loan portfolio were at fixed rates, while $204.2 million, or 77.9%, were at variable rates.

Government Guarantee Programs

The Company participates in government loan guarantee programs offered by the SBA, United States Department of Agriculture, Rural Economic and Community Development and Farm Service Agency, among others. As of December 31, 2008, the Company had loans with an aggregate principal balance of $37.6 million that were covered by guarantees under these programs. The guarantees only cover a certain percentage of these loans. By participating in these programs, the Company is able to broaden its base of borrowers while minimizing credit risk.

Consumer Lending

The Company offers a variety of loan products to its consumer customers located in Western and Central New York, including home equity loans and lines of credit, automobile loans, secured installment loans and various other types of secured and unsecured personal loans. At December 31, 2008, outstanding consumer loan balances were concentrated in indirect automobile loans and home equity products.

The Company indirectly originates, through dealers, consumer indirect automobile loans. The consumer indirect loan portfolio is primarily comprised of new and used automobile loans with terms that typically range from 36 to 72 months. The Company has expanded its relationships with franchised new car dealers in our general market area and has selectively originated a mix of new and used automobile loans from those dealers. As of December 31, 2008, the consumer indirect portfolio totaled $255.1 million, nearly all of which were fixed rate automobile loans.

The Company also originates, independently of the indirect loans described above, consumer automobile loans, recreational vehicle loans, boat loans, home improvement loans, closed-end home equity loans, home equity lines of credit, personal loans (collateralized and uncollateralized) and deposit account collateralized loans. The terms of these loans typically range from 12 to 180 months and vary based upon the nature of the collateral and the size of loan. The majority of the consumer lending program is underwritten on a secured basis using the customer s home or the financed automobile, mobile home, boat or recreational vehicle as collateral. As of December 31, 2008, $134.0 million, or 60.1%, of consumer and home equity loans were at fixed rates, while $88.9 million, or 39.9%, were at variable rates.

Residential Mortgage Lending

The Company originates fixed and variable rate one-to-four family residential mortgages collateralized by owner-occupied properties located in its market areas. The Company offers a variety of real estate loan products, which are generally amortized for periods up to 30 years. Loans collateralized by one-to-four family residential real estate generally have been originated in amounts of no more than 80% of appraised value or have mortgage insurance. Mortgage title insurance and hazard insurance are normally required. The Company sells certain one-to-four family residential mortgages to the secondary mortgage market and typically retains the right to service the mortgages. To assure maximum salability of the residential loan products for possible resale, the Company has formally adopted the underwriting, appraisal, and servicing guidelines of the FHLMC as part of its standard loan policy. As of December 31, 2008, the residential mortgage servicing portfolio totaled $315.7 million, the majority of which have been sold to FHLMC. As of December 31, 2008, $138.8 million, or 78.1%, of residential real estate loans retained in portfolio were at fixed rates, while $38.9 million, or 21.9%, were at variable rates. The Company does not engage in sub-prime or other high-risk residential mortgage lending as a line-of-business.

Credit Administration

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

The Company s credit objectives are as follows:

- Compete effectively and service the legitimate credit needs of our target market;
- Enhance our reputation for superior quality and timely delivery of products and services;
- Provide pricing that reflects the entire relationship and is commensurate with the risk profiles of our borrowers;
- Retain, develop and acquire profitable, multi-product, value added relationships with high quality borrowers;
- Focus on government guaranteed lending and establish a specialization in this area to meet the needs of the small businesses in our communities; and
- Comply with the relevant laws and regulations.

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

Risk ratings are assigned to loans in the commercial, commercial real estate and agricultural portfolios. The risk ratings are specifically used as follows:

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

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

The Company has several procedures in place to assist in maintaining the overall quality of its loan portfolio. Delinquent loan reports are monitored by credit administration to identify adverse levels and trends. Loans are generally placed on nonaccruing status and cease accruing interest when the payment of principal or interest is delinquent for 90 days, or earlier in some cases, unless the loan is in the process of collection and the underlying collateral further supports the carrying value of the loan.

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Allowance for Loan Losses

The allowance for loan losses is established through charges or credits to earnings in the form of a provision (credit) for loan losses. The allowance reflects management s estimate of the amount of probable loan losses in the portfolio, based on factors such as:

- Specific allocations for individually analyzed credits;
- Risk assessment process;
- Historical net charge-off experience;
- Evaluation of the loan portfolio with loan reviews;
- Levels and trends in delinquent and nonaccruing loans;
- Trends in volume and terms;
- Collateral values;
- Effects of changes in lending policy;
- Experience, ability and depth of management;
- National and local economic trends and conditions; and
- Concentrations of credit.

The Company s methodology in the estimation of the allowance for loan losses includes the following broad areas:

1. Impaired commercial, commercial real estate and agricultural loans, in excess of $50 thousand are reviewed individually and assigned a specific loss allowance, if considered necessary, in accordance with SFAS No. 114, Accounting by Creditors for Impairment of a Loan an amendment of FASB Statements No. 5 and 15.
2. The remaining portfolios of commercial, commercial real estate and agricultural loans are segmented by risk rating into the following loan classification categories: uncriticized or pass, special mention and substandard. Uncriticized loans, special mention loans and all substandard loans not assigned a specific loss allowance are assigned allowance allocations based on historical net loan charge-off experience for each of the respective loan categories, supplemented with additional reserve amounts, if considered necessary, based upon qualitative factors. These qualitative factors include the levels and trends in delinquencies, nonaccruing loans, and risk ratings; trends in volume and terms of loans; effects of changes in lending policy; experience, ability, and depth of management; national and local economic conditions; and concentrations of credit, among others.
3. The consumer loan portfolio is segmented into six types of loans: residential real estate, home equity loans, home equity lines of credit, consumer direct, consumer indirect, and overdrafts. Each of those categories is subdivided into categories based on delinquency status, either 90 days and over past due or under 90 days. Allowance allocations on these types of loans are based on the average loss experience over the last three years for each subdivision of delinquency status supplemented with qualitative factors containing the same elements as described above.

Management presents a quarterly review of the adequacy of the allowance for loan losses to the Company s Board of Directors based on the methodology described above. See also the sections titled Analysis of Allowance for Loan Losses and Allocation of Allowance for Loan Losses in Part II, Item 7, Management s Discussion and Analysis of Financial Condition and Results of Operations.

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INVESTMENT ACTIVITIES

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

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

U.S. treasury securities;

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

Mortgage-backed securities (MBS) include mortgage-backed pass-through securities (pass-throughs) and collateralized mortgage obligations (CMO) issued by GNMA, FNMA and FHLMC and privately issued whole loan CMOs that contain some exposure to sub-prime loans. See also the section titled Investing Activities in Part II, Item 7, Management s Discussion and Analysis of Financial Condition and Results of Operations;

Other asset-backed securities (ABS) and other privately issued investment grade quality securities;

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

Certain creditworthy un-rated securities issued by municipalities;

Investment grade corporate debt, certificates of deposit and qualified preferred equity securities issued by U.S. government-sponsored enterprises (such as FNMA or FHLMC) rated A+ or better;

Equity securities at the holding company level; and

Limited partnership investments in Small Business Investment Companies (SBIC).

SOURCES OF FUNDS

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

The Company offers a variety of deposit account products with a range of interest rates and terms. The deposit accounts consist of noninterest-bearing demand, interest-bearing demand, savings, money market, club accounts and certificates of deposit. The Company also offers certificates of deposit with balances in excess of $100,000 to local municipalities, businesses, and individuals as well as Individual Retirement Accounts and other qualified plan accounts. The flow of deposits is influenced significantly by general economic conditions, changes in money market rates, prevailing interest rates and competition. The Company s deposits are obtained predominantly from the areas in which its branch offices are located. The Company relies primarily on competitive pricing of its deposit products, customer service and long-standing relationships with customers to attract and retain these deposits. In the past, the Company has also utilized certificate of deposit sales in the national brokered market (brokered deposits) as a wholesale funding source. The Company had no brokered deposits at December 31, 2008. The Company s borrowings consist mainly of advances entered into with the FHLB, federal funds purchased and securities sold under repurchase agreements.

OPERATING SEGMENTS

The Company s primary operating segment is its subsidiary bank, FSB. The Company s brokerage subsidiary, FSIS, is also deemed an operating segment; however it does not meet the thresholds included in SFAS No. 131 for separation.

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SUPERVISION AND REGULATION

General

FII and FSB are subject to extensive federal and state laws and regulations that impose restrictions on, and provide for regulatory oversight of, FII s and FSB s operations. These laws and regulations are generally intended to protect depositors and not shareholders. Any change in any applicable statute or regulation could have a material effect on FII s and FSB s business.

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

The Company is also affected by various governmental requirements and regulations, general economic conditions, and the fiscal and monetary policies of the federal government and the FRB. The monetary policies of the FRB influence to a significant extent the overall growth of loans, investments, deposits, interest rates charged on loans, and interest rates paid on deposits. The nature and impact of future changes in monetary policies are often not predictable.

The following description summarizes some of the laws to which the Company is subject. References to applicable statutes and regulations are brief summaries and do not claim to be complete. They are qualified in their entirety by reference to such statutes and regulations. Management believes the Company is in compliance in all material respects with these laws and regulations. Changes in the laws, regulations or policies that impact the Company cannot necessarily be predicted, but they may have a material effect on the Company s consolidated financial position, consolidated results of operations, or liquidity.

Regulation of FII

FII is a financial holding company registered under the Bank Holding Company Act of 1956, as amended, and is subject to supervision, regulation and examination by the FRB. The Bank Holding Company Act and other federal laws subject bank holding companies to particular restrictions on the types of activities in which they may engage, and to a range of supervisory requirements and activities, including regulatory enforcement actions for violations of laws and regulations.

Regulatory Restrictions on Dividends; Source of Strength. It is the policy of the FRB that bank holding companies should pay cash dividends on common stock only out of income available over the past year, and only if prospective earnings retention is consistent with the holding company s expected future needs and financial condition. The policy provides that bank holding companies should not maintain a level of cash dividends that undermines the bank holding company s ability to serve as a source of strength to its subsidiaries.

Under FRB policy, a bank holding company is expected to act as a source of financial strength to each of its subsidiaries and commit resources to their support. Such support may be required at times when, absent this FRB policy, a holding company may not be inclined to provide it. As discussed below, a bank holding company in certain circumstances could be required to guarantee the capital plan of an undercapitalized banking subsidiary.

Safe and Sound Banking Practices. Bank holding companies are not permitted to engage in unsafe and unsound banking practices. The FRB s Regulation Y, for example, generally requires a holding company to give the FRB prior notice of any redemption or repurchase of its own equity securities, if the consideration to be paid, together with the consideration paid for any repurchases or redemptions in the preceding year, is equal to 10% or more of the company s consolidated net worth. The FRB may oppose the transaction if it believes that the transaction would constitute an unsafe or unsound practice or would violate any law or regulation. Depending upon the circumstances, the FRB could take the position that paying a dividend would constitute an unsafe or unsound banking practice.

The FRB has broad authority to prohibit activities of bank holding companies and their non-banking subsidiaries which represent unsafe and unsound banking practices or which constitute violations of laws or regulations, and can assess civil money penalties for certain activities conducted on a knowing and reckless basis, if those activities caused a substantial loss to a depository institution. The penalties can be as high as $1,000,000 for each day the activity continues.

Anti-Tying Restrictions. Bank holding companies and their affiliates are prohibited from tying the provision of certain services, such as extensions of credit, to other services offered by a holding company or its affiliates. In 2002, the FRB adopted Regulation W, a comprehensive synthesis of prior opinions and interpretations under Sections 23A and 23B of the Federal Reserve Act. Regulation W contains an extensive discussion of tying arrangements, which could impact the way banks and bank holding companies transact business with affiliates.

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Capital Adequacy Requirements. The FRB has adopted a system using risk-based capital guidelines to evaluate the capital adequacy of bank holding companies. Under the guidelines, specific categories of assets are assigned different risk weights, based generally on the perceived credit risk of the asset. These risk weights are multiplied by corresponding asset balances to determine a risk-weighted asset base. The guidelines require a minimum total risk-based capital ratio of 8.0% (of which at least 4.0% is required to consist of Tier 1 capital elements). Total capital is the sum of Tier 1 and Tier 2 capital. As of December 31, 2008, the Company s ratio of Tier 1 capital to total risk-weighted assets was 11.83% and the ratio of total capital to total risk-weighted assets was 13.08%. See also the section titled Capital Resources in Part II, Item 7, Management s Discussion and Analysis of Financial Condition and Results of Operations and Note 10, Regulatory Matters, of the notes to consolidated financial statements.

In addition to the risk-based capital guidelines, the FRB uses a leverage ratio as an additional tool to evaluate the capital adequacy of bank holding companies. The leverage ratio is a company s Tier 1 capital divided by quarterly average consolidated assets. Certain highly rated bank holding companies may maintain a minimum leverage ratio of 3.0%, but other bank holding companies may be required to maintain a leverage ratio of up to 200 basis points above the regulatory minimum. As of December 31, 2008, the Company s leverage ratio was 8.05%.

The federal banking agencies risk-based and leverage ratios are minimum supervisory ratios generally applicable to banking organizations that meet certain specified criteria, assuming that they have the highest regulatory rating. Banking organizations not meeting these criteria are expected to operate with capital positions well above the minimum ratios. The federal bank regulatory agencies may set capital requirements for a particular banking organization that are higher than the minimum ratios when circumstances warrant. FRB guidelines also provide that banking organizations experiencing internal growth or making acquisitions will be expected to maintain strong capital positions substantially above the minimum supervisory levels, without significant reliance on intangible assets.

Imposition of Liability for Undercapitalized Subsidiaries. Bank regulators are required to take prompt corrective action to resolve problems associated with insured depository institutions whose capital declines below certain levels. In the event an institution becomes undercapitalized, it must submit a capital restoration plan. The capital restoration plan will not be accepted by the regulators unless each company having control of the undercapitalized institution guarantees the subsidiary s compliance with the capital restoration plan up to a certain specified amount. Any such guarantee from a depository institution holding company is entitled to a priority of payment in bankruptcy.

The aggregate liability of the holding company of an undercapitalized bank is limited to the lesser of 5% of the institution s assets at the time it became undercapitalized or the amount necessary to cause the institution to be adequately capitalized. The bank regulators have greater power in situations where an institution becomes significantly or critically undercapitalized or fails to submit a capital restoration plan. For example, a bank holding company controlling such an institution can be required to obtain prior FRB approval of proposed dividends, or might be required to consent to a consolidation or to divest the troubled institution or other affiliates.

Acquisitions by Bank Holding Companies. The Bank Holding Company Act requires every bank holding company to obtain the prior approval of the FRB before it may acquire all or substantially all of the assets of any bank, or ownership or control of any voting shares of any bank, if after such acquisition it would own or control, directly or indirectly, more than 5% of the voting shares of such bank. In approving bank acquisitions by bank holding companies, the FRB is required to consider the financial and managerial resources and future prospects of the bank holding company and the banks involved, the convenience and needs of the communities to be served, and various competitive factors.

Control Acquisitions. The Change in Bank Control Act prohibits a person or group of persons from acquiring control of a bank holding company unless the FRB has been notified and has not objected to the transaction. Under a rebuttable presumption established by the FRB, the acquisition of 10% or more of a class of voting stock of a bank holding company with a class of securities registered under Section 12 of the Exchange Act, would, under the circumstances set forth in the presumption, constitute acquisition of control of the Company.

In addition, any entity is required to obtain the approval of the FRB under the Bank Holding Company Act before acquiring 25% (5% in the case of an acquirer that is a bank holding company) or more of the Company s outstanding common stock, or otherwise obtaining control or a controlling influence over the Company.

Regulation of FSB

Five Star Bank (FSB or the Bank) is a New York State-chartered bank and a member of the Federal Reserve System. The FDIC, through the Bank Insurance Fund, insures deposits of the Bank. The supervision and regulation of FSB subjects the Bank to special restrictions, requirements, potential enforcement actions and periodic examination by the FDIC, the FRB and the New York State Banking Department. Because the FRB regulates the holding company parent, the FRB also has supervisory authority that directly affects FSB.

Restrictions on Transactions with Affiliates and Insiders. Transactions between the holding company and its subsidiaries, including the Bank, are subject to Section 23A of the Federal Reserve Act, and to the requirements of Regulation W. In general, Section 23A imposes limits on the amount of such transactions, and also requires certain levels of collateral for loans to affiliated parties. It also limits the amount of advances to third parties, which are collateralized by the securities, or obligations of FII or its subsidiaries.

Affiliate transactions are also subject to Section 23B of the Federal Reserve Act, and to the requirements of Regulation W which generally requires that certain transactions between the holding company and its affiliates be on terms substantially the same, or at least as favorable to the Bank, as those prevailing at the time for comparable transactions with or involving other nonaffiliated persons.

The restrictions on loans to directors, executive officers, principal shareholders and their related interests (collectively referred to herein as insiders) contained in the Federal Reserve Act and Regulation O apply to all insured institutions and their subsidiaries and holding companies. These restrictions include limits on loans to one borrower and conditions that must be met before such a loan can be made. There is also an aggregate limitation on all loans to insiders and their related interests. These loans cannot exceed the institution s total unimpaired capital and surplus, and the FDIC may determine that a lesser amount is appropriate. Insiders are subject to enforcement actions for knowingly accepting loans in violation of applicable restrictions.

Restrictions on Distribution of Subsidiary Bank Dividends and Assets. Dividends paid by the Bank provide a substantial part of FII s operating funds and, for the foreseeable future, it is anticipated that dividends paid by the Bank will continue to be its principal source of operating funds. Capital adequacy requirements serve to limit the amount of dividends that may be paid by the subsidiaries. Under federal law, the subsidiaries cannot pay a dividend if, after paying the dividend, a particular subsidiary will be undercapitalized. The FDIC may declare a dividend payment to be unsafe and unsound even though the bank would continue to meet its capital requirements after the dividend.

Because FII is a legal entity separate and distinct from its subsidiaries, FII s right to participate in the distribution of assets of any subsidiary upon the subsidiary s liquidation or reorganization will be subject to the prior claims of the subsidiary s creditors. In the event of a liquidation or other resolution of an insured depository institution, the claims of depositors and other general or subordinated creditors are entitled to a priority of payment over the claims of holders of any obligation of the institution to its shareholders, including any depository bank holding company (such as FII) or any shareholder or creditor thereof.

Examinations. The New York State Banking Department, the FRB and the FDIC periodically examine and evaluate the Bank. Based upon such examinations, the appropriate regulator may revalue the assets of the institution and require that it establish specific reserves to compensate for the difference between what the regulator determines the value to be and the book value of such assets.

Audit Reports. Insured institutions with total assets of $500 million or more at the beginning of a fiscal year must submit annual audit reports prepared by independent auditors to federal and state regulators. In some instances, the audit report of the institution s holding company can be used to satisfy this requirement. Auditors must receive examination reports, supervisory agreements and reports of enforcement actions. In addition, financial statements prepared in accordance with U.S. generally accepted accounting principles, management s certifications concerning responsibility for the financial statements, internal controls and compliance with legal requirements designated by the FDIC, and if total assets exceed $1.0 billion, an attestation by the auditor regarding the statements of management relating to the internal controls must be submitted. The FDIC Improvement Act of 1991 requires that independent audit committees be formed, consisting of outside directors only. The committees of institutions with assets of more than $3.0 billion must include members with experience in banking or financial management must have access to outside counsel and must not include representatives of large customers.

Capital Adequacy Requirements. The FDIC has adopted regulations establishing minimum requirements for the capital adequacy of insured institutions. The FDIC may establish higher minimum requirements if, for example, a bank has previously received special attention or has a high susceptibility to interest rate risk. The most recent notification from the FDIC categorized the Bank as well capitalized under the regulatory framework for prompt corrective action.

The FDIC s risk-based capital guidelines generally require banks to have a minimum ratio of Tier 1 capital to total risk-weighted assets of 4.0% and a ratio of total capital to total risk-weighted assets of 8.0%. The capital categories have the same definitions for the Company. As of December 31, 2008, the ratio of Tier 1 capital to total risk-weighted assets for the Bank was 9.52% and the ratio of total capital to total risk-weighted assets was 10.77%. The FDIC s leverage guidelines require banks to maintain Tier 1 capital of no less than 4.0% of average total assets, except in the case of certain highly rated banks for which the requirement is 3.0% of average total assets. As of December 31, 2008, the ratio of Tier 1 capital to quarterly average total assets (leverage ratio) was 6.46% for FSB. See the section captioned Liquidity and Capital Resources included in Part II, Item 7, Management s Discussion and Analysis of Financial Condition and Results of Operations and Note 10, Regulatory Matters, of the notes to consolidated financial statements.

Corrective Measures for Capital Deficiencies. The federal banking regulators are required to take prompt corrective action with respect to capital-deficient institutions. Agency regulations define, for each capital category, the levels at which institutions are well-capitalized, adequately capitalized, undercapitalized, significantly undercapitalized critically undercapitalized. A well-capitalized bank has a total risk-based capital ratio of 10.0% or higher; a Tier 1 risk-based capital ratio of 6.0% or higher; a leverage ratio of 5.0% or higher; and is not subject to any written agreement, order or directive requiring it to maintain a specific capital level for any capital measure. An adequately capitalized bank has a total risk-based capital ratio of 8.0% or higher; a Tier 1 risk-based capital ratio of 4.0% or higher; a leverage ratio of 4.0% or higher (3.0% or higher if the bank was rated a composite 1 in its most recent examination report and is not experiencing significant growth); and does not meet the criteria for a well-capitalized bank. A bank is undercapitalized if it fails to meet any one of the adequately capitalized ratios.

In addition to requiring undercapitalized institutions to submit a capital restoration plan, agency regulations contain broad restrictions on certain activities of undercapitalized institutions including asset growth, acquisitions, branch establishment and expansion into new lines of business. With certain exceptions, an insured depository institution is prohibited from making capital distributions, including dividends, and is prohibited from paying management fees to control persons if the institution would be undercapitalized after any such distribution or payment.

As an institution s capital decreases, the FDIC s enforcement powers become more severe. A significantly undercapitalized institution is subject to mandated capital raising activities, restrictions on interest rates paid and transactions with affiliates, removal of management and other restrictions. The FDIC has only very limited discretion in dealing with a critically undercapitalized institution and is virtually required to appoint a receiver or conservator.

Banks with risk-based capital and leverage ratios below the required minimums may also be subject to certain administrative actions, including the termination of deposit insurance upon notice and hearing, or a temporary suspension of insurance without a hearing in the event the institution has no tangible capital.

Deposit Insurance Assessments. The Bank must pay assessments to the FDIC for federal deposit insurance protection that was impacted by legislation enacted during 2006. The Federal Deposit Insurance Reform Act of 2005 and the Federal Deposit Insurance Reform Conforming Amendment Act of 2005 were signed into law in 2006 (collectively the Reform Act) providing the following changes:

- Merged the Bank Insurance Fund (BIF) and the Savings Association Insurance Fund (SAIF) into a new fund, the Deposit Insurance Fund (DIF).
- Increased the coverage limit for retirement accounts to $250,000.
- Indexed the coverage limit for deposit insurance for inflation.
- Establishing a range of 1.15 percent to 1.50 percent within which the FDIC may set the Designated Reserve Ratio (DRR).
- Eliminating the restrictions on premium rates based on the DRR and granting the FDIC the discretion to price deposit insurance according to risk for all insured institutions regardless of the level of the reserve ratio.
- Granting a one-time initial assessment credit to recognize institutions past contributions to the fund.

The Deposit Insurance Fund Act of 1996 contained a comprehensive approach to recapitalizing the Savings Association Insurance Fund and to assuring the payment of the Financing Corporation s (FICO) bond obligations. Under this law, banks insured under the Bank Insurance Fund are required to pay a portion of the interest due on bonds that were issued by FICO in 1987 to help shore up the ailing Federal Savings and Loan Insurance Corporation. The FDIC bills and collects this assessment on behalf of FICO.

As a result of the Reform Act previously described, effective for the FDIC billing period that commenced January 1, 2007, the Company had a $1.3 million assessment credit available to offset future FDIC premium assessments, but not the FICO assessment. The $442 thousand in assessment credits that remained as of December 31, 2007 were fully utilized in 2008, contributing to a $385 increase in the FDIC expense over 2007.

The Reform Act also requires that the FDIC Board of Directors adopt a restoration plan when the DIF reserve ratio falls or is expected to fall below certain minimum levels. The bank failures that occurred in 2008 adversely impacted the deposit insurance fund s loss provisions, resulting in a decline in the reserve ratio. As part of the restoration plan, the FDIC has increased the insurance assessment rates by seven basis points uniformly for the quarter beginning

January 1, 2009. In addition, on February 27, 2009 the FDIC Board adopted an interim rule imposing a 20 basis point emergency special assessment on the industry on June 30, 2009. The assessment is to be collected on September 30, 2009. The interim rule would also permit the Board to impose an emergency special assessment after June 30, 2009, of up to 10 basis points if necessary to maintain public confidence in federal deposit insurance. The Company estimates the combined impact of the seven basis point increase and 20 basis point emergency special assessment to be an approximate increase of $4.6 million in its FDIC deposit insurance assessments for 2009. Subsequently, on March 5, 2009 the Chairman of the FDIC announced that it may cut the 20 basis point emergency special assessment to 10 basis points if legislation passes to expand the FDIC s existing line of credit with the U.S. Treasury Department.

Enforcement Powers. The FDIC, the New York State Banking Department and the FRB have broad enforcement powers, including the power to terminate deposit insurance, impose substantial fines and other civil and criminal penalties and appoint a conservator or receiver. Failure to comply with applicable laws, regulations and supervisory agreements could subject the Company or the Bank, as well as the officers, directors and other institution-affiliated parties of these organizations, to administrative sanctions and potentially substantial civil money penalties.

Federal Home Loan Bank System. FSB is a member of the FHLB System, which consists of 12 regional Federal Home Loan Banks. The FHLB System provides a central credit facility primarily for member institutions. As members of the FHLB of New York, the Bank is required to acquire and hold shares of capital stock in the FHLB. The minimum investment requirement is determined by a membership investment component and an activity-based investment component. Under the membership component, a certain minimum investment in capital stock is required to be maintained as long as the institution remains a member of the FHLB. Under the activity-based component, members are required to purchase capital stock in proportion to the volume of certain transactions with the FLHB. As of December 31, 2008, FSB complied with these requirements.

Brokered Deposit Restrictions. Adequately capitalized institutions cannot accept, renew or roll over brokered deposits except with a waiver from the FDIC, and are subject to restrictions on the interest rates that can be paid on such deposits. Undercapitalized institutions may not accept, renew or roll over brokered deposits. As of December 31, 2008, FSB was considered well-capitalized and subject to the brokered deposit restrictions.

Cross-Guarantee Provisions. The Financial Institutions Reform, Recovery and Enforcement Act of 1989 (FIRREA) contains a cross-guarantee provision which generally makes commonly controlled insured depository institutions liable to the FDIC for any losses incurred in connection with the failure of a commonly controlled depository institution.

Community Reinvestment Act. The Community Reinvestment Act of 1977 (CRA) and the regulations issued hereunder are intended to encourage banks to help meet the credit needs of their service area, including low and moderate income neighborhoods, consistent with the safe and sound operations of the banks. These regulations also provide for regulatory assessment of a bank s record in meeting the needs of its service area when considering applications regarding establishing branches, mergers or other bank or branch acquisitions. FIRREA requires federal banking agencies to make public a rating of a bank s performance under the CRA. In the case of a bank holding company, the CRA performance record of the banks involved in the transaction are reviewed in connection with the filing of an application to acquire ownership or control of shares or assets of a bank or to merge with any other bank holding company. An unsatisfactory record can substantially delay or block the transaction. Five Star Bank received a rating of outstanding as of its most recent CRA performance evaluation.

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

Gramm-Leach-Bliley Act

The Gramm-Leach-Bliley Act (Gramm-Leach) was signed into law on November 12, 1999. Gramm-Leach permits, subject to certain conditions, combinations among banks, securities firms and insurance companies. Under Gramm-Leach, bank holding companies are permitted to offer their customers virtually any type of financial service including banking, securities underwriting, insurance (both underwriting and agency), and merchant banking. In order

to engage in these additional financial activities, a bank holding company must qualify and register with the Board of Governors of the Federal Reserve System as a financial holding company by demonstrating that each of its subsidiaries is well capitalized, well managed, and has at least a satisfactory rating under the CRA. During the second quarter of 2008, FII received FRB approval for an election to re-instate its status as a financial holding company, which the Company terminated during 2003. The change in status did not affect the activities being conducted by the Company or its subsidiaries. Gramm-Leach establishes that the federal banking agencies will regulate the banking activities of financial holding companies and banks financial subsidiaries, the SEC will regulate their securities activities and state insurance regulators will regulate their insurance activities. Gramm-Leach also provides new protections against the transfer and use by financial institutions of consumers nonpublic, personal information.

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The major provisions of Gramm-Leach include:

Financial Holding Companies and Financial Activities. Title I establishes a comprehensive framework to permit affiliations among commercial banks, insurance companies, securities firms, and other financial service providers by revising and expanding the Bank Holding Company Act framework to permit a holding company system to engage in a full range of financial activities through qualification as a new entity known as a financial holding company. A bank holding company that qualifies as a financial holding company can expand into a wide variety of services that are financial in nature, if its subsidiary depository institutions are well-managed , well-capitalized and have received at least a satisfactory rating on their last CRA examination. Services that have been deemed to be financial in nature include securities underwriting, dealing and market making, sponsoring mutual funds and investment companies, insurance underwriting and agency activities and merchant banking.

Securities Activities. Title II narrows the exemptions from the securities laws previously enjoyed by banks, requires the FRB and the SEC to work together to draft rules governing certain securities activities of banks and creates a new, voluntary investment bank holding company.

Insurance Activities. Title III restates the proposition that the states are the functional regulators for all insurance activities, including the insurance activities of federally chartered banks, and bars the states from prohibiting insurance activities by depository institutions. The law encourages the states to develop uniform or reciprocal rules for the licensing of insurance agents.

Privacy. Under Title V, federal banking regulators were required to adopt rules that have limited the ability of banks and other financial institutions to disclose non-public information about consumers to nonaffiliated third parties. These limitations require disclosure of privacy policies to consumers and, in some circumstances, allow consumers to prevent disclosure of certain personal information to a nonaffiliated third party. Federal banking regulators issued final rules on May 10, 2000 to implement the privacy provisions of Title V. Under the rules, financial institutions must provide:

- Initial notices to customers about their privacy policies, describing the conditions under which they may disclose nonpublic personal information to nonaffiliated third parties and affiliates;
- Annual notices of their privacy policies to current customers; and
- A reasonable method for customers to opt out of disclosures to nonaffiliated third parties.

The Bank is in full compliance with the rules.

Safeguarding Confidential Customer Information. Under Title V, federal banking regulators are required to adopt rules requiring financial institutions to implement a program to protect confidential customer information. In January 2000, the federal banking agencies adopted guidelines requiring financial institutions to establish an information security program to:

- Identify and assess the risks that may threaten customer information;
- Develop a written plan containing policies and procedures to manage and control these risks;
- Implement and test the plan; and
- Adjust the plan on a continuing basis to account for changes in technology, the sensitivity of customer information and internal or external threats to information security.

The Bank approved security programs appropriate to its size and complexity and the nature and scope of its operations prior to the effective date of the regulatory guidelines. The implementation of the programs is an ongoing process.

Community Reinvestment Act Sunshine Requirements. In February 2001, the federal banking agencies adopted final regulations implementing Section 711 of Title VII, the CRA Sunshine Requirements. The regulations require nongovernmental entities or persons and insured depository institutions and affiliates that are parties to written agreements made in connection with the fulfillment of the institution s CRA obligations to make available to the public and the federal banking agencies a copy of each agreement. The regulations impose annual reporting requirements concerning the disbursement, receipt and use of funds or other resources under these agreements. The effective date of the regulations was April 1, 2001. Neither FII nor the Bank is a party to any agreement that would be the subject of reporting pursuant to the CRA Sunshine Requirements.

USA Patriot Act

As part of the Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism Act of 2001 (USA Patriot Act), signed into law on October 26, 2001, Congress adopted the International Money Laundering Abatement and Financial Anti-Terrorism Act of 2001 (AML). AML authorizes the Secretary of the Treasury, in consultation with the heads of other government agencies, to adopt special measures applicable to banks, bank holding companies or other financial institutions. During 2002, the Department of Treasury issued a number of regulations relating to enhanced recordkeeping and reporting requirements for certain financial transactions that are of primary money laundering concern, due diligence requirements concerning the beneficial ownership of certain types of accounts, and restrictions or prohibitions on certain types of accounts with foreign financial institutions. Covered financial institutions also are barred from dealing with foreign shell banks. In addition, AML expands the circumstances under which funds in a bank account may be forfeited and requires covered financial institutions to respond under certain circumstances to requests for information from federal banking agencies within 120 hours.

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Regulations were also adopted during 2002 to implement minimum standards to verify customer identity, to encourage cooperation among financial institutions, federal banking agencies, and law enforcement authorities regarding possible money laundering or terrorist activities, to prohibit the anonymous use of concentration accounts, and to require all covered financial institutions to have in place a Bank Secrecy Act compliance program. AML also amends the Bank Holding Company Act and the Bank Merger Act to require the federal banking agencies to consider the effectiveness of a financial institution s anti-money laundering activities when reviewing an application under these acts.

The Bank has in place a Bank Secrecy Act compliance program, and it engages in very few transactions of any kind with foreign financial institutions or foreign persons.

Sarbanes-Oxley Act

On July 30, 2002, the President signed into law the Sarbanes-Oxley Act of 2002 (the Act) implementing legislative reforms intended to address corporate and accounting fraud. In addition to the establishment of a new accounting oversight board that enforces auditing, quality control and independence standards and is funded by fees from all publicly traded companies, the law restricts accounting firms from providing both auditing and consulting services to the same client. To ensure auditor independence, any non-audit services being provided to an audit client requires pre-approval by the issuer s audit committee members. In addition, the audit partners must be rotated. The Act requires chief executive officers and chief financial officers, or their equivalent, to certify to the accuracy of periodic reports filed with the SEC, subject to civil and criminal penalties if they knowingly or willfully violate this certification requirement. In addition, under the Act, legal counsel is required to report evidence of a material violation of the securities laws or a breach of fiduciary duty by a company to its chief executive officer or its chief legal officer, and, if such officer does not appropriately respond, to report such evidence to the audit committee or other similar committee of the board of directors or the board itself.

Longer prison terms and increased penalties are also applied to corporate executives who violate federal securities laws, the period during which certain types of suits can be brought against a company or its officers has been extended, and bonuses issued to top executives prior to restatement of a company s financial statements are subject to disgorgement if such restatement was due to corporate misconduct. Executives are also prohibited from insider trading during retirement plan blackout periods, and loans to company executives are restricted. The Act accelerates the time frame for disclosures by public companies, as they must immediately disclose any material changes in their financial condition or operations. Directors and executive officers must also provide information for most changes in ownership in a company s securities within two business days of the change.

The Act also prohibits any officer or director of a company or any other person acting under their direction from taking any action to fraudulently influence, coerce, manipulate or mislead any independent public or certified accountant engaged in the audit of the company s financial statements for the purpose of rendering the financial statement s materially misleading. The Act also requires the SEC to prescribe rules requiring inclusion of an internal control report and assessment by management in the annual report to stockholders. In addition, the Act requires that each financial report required to be prepared in accordance with (or reconciled to) accounting principles generally accepted in the United States of America and filed with the SEC reflect all material correcting adjustments that are identified by a registered public accounting firm in accordance with accounting principles generally accepted in the United States of America and the rules and regulations of the SEC.

As directed by Section 302(a) of the Act, the Company s chief executive officer and chief financial officer are each required to certify that the Company s quarterly and annual reports do not contain any untrue statement of a material fact. The Act imposes several requirements, including having these officers certify that: they are responsible for establishing, maintaining and regularly evaluating the effectiveness of the Company s internal controls; they have made certain disclosures to the Company s auditors and the Audit Committee of the Board of Directors about the Company s internal controls; and they have included information in the Company s quarterly and annual reports about their evaluation and whether there have been significant changes in the Company s internal controls or in other factors that could significantly affect internal controls during the last quarter.

Fair Credit Reporting Act and Fair and Accurate Transactions Act

In 1970, the U. S. Congress enacted the Fair Credit Reporting Act (the FCRA) in order to ensure the confidentiality, accuracy, relevancy and proper utilization of consumer credit report information. Under the framework of the FCRA, the United States has developed a highly advanced and efficient credit reporting system. The information contained in that broad system is used by financial institutions, retailers and other creditors of every size in making a wide variety of decisions regarding financial transactions. Employers and law enforcement agencies have also made wide use of the information collected and maintained in databases made possible by the FCRA. The FCRA affirmatively preempts state law in a number of areas, including the ability of entities affiliated by common ownership to share and exchange information freely, the requirements on credit bureaus to reinvestigate the contents of reports in response to consumer complaints, among others. By its terms, the preemption provisions of the FCRA were to terminate as of December 31, 2003. With the enactment of the Fair and Accurate Transactions Act (the FACT Act) in late 2003, the preemption provisions of FCRA were extended, although the FACT Act imposes additional requirements on entities that gather and share consumer credit information. The FACT Act required the FRB and the Federal Trade Commission (FTC) to issue final regulations within nine months of the effective date of the Act. A series of regulations and announcements have been promulgated, including a joint FTC/FRB announcement of effective dates for FCRA amendments, the FTC s Free Credit Report rule, revisions to the FTC s FACT Act Rules, the FTC s final rules on identity theft and proof of identity, the FTC s final regulation on consumer information and records disposal, the FTC s final summaries and the final rule on prescreen notices.

Emergency Economic Stabilization Act of 2008

On October 3, 2008, EESA was signed into law as part of a broad initiative to stabilize U.S. financial markets and provide liquidity. EESA enables the federal government, under terms and conditions to be developed by the Secretary of the Treasury, to insure troubled assets, including mortgage-backed securities, and collect premiums from participating financial institutions. EESA includes, among other provisions: (a) the $700 billion TARP, under which the Secretary of the Treasury is authorized to purchase, insure, hold, and sell a wide variety of financial instruments, particularly those that are based on or related to residential or commercial mortgages originated or issued on or before March 14, 2008; and (b) an increase in the amount of deposit insurance provided by the FDIC.

Troubled Assets Relief Program

Under the TARP, the Department of Treasury authorized a voluntary capital purchase program (CPP) to purchase up to $250 billion of senior preferred shares of qualifying financial institutions that elected to participate by November 14, 2008. Participating companies must adopt certain standards for executive compensation, including (a) prohibiting golden parachute payments as defined in EESA to senior Executive Officers; (b) requiring recovery of any compensation paid to senior Executive Officers based on criteria that is later proven to be materially inaccurate; and (c) prohibiting incentive compensation that encourages unnecessary and excessive risks that threaten the value of the financial institution. The terms of the CPP also limit certain uses of capital by the issuer, including repurchases of company stock, and increases in dividends.

Federal Deposit Insurance Corporation Insurance Limit Increases

EESA temporarily raised the limit on federal deposit insurance coverage from $100,000 to $250,000 per depositor. Separate from EESA, in October 2008, the FDIC also announced the TLGP. Under one component of this program, the FDIC temporarily provides unlimited coverage for noninterest bearing transaction deposit accounts through December 31, 2009. The limits are scheduled to return to $100,000 on January 1, 2010.

Change in Tax Treatment of Fannie Mae and Freddie Mac Preferred Stock

Section 301 of the EESA changes the tax treatment of gains or losses from the sale or exchange of FNMA or FHLMC preferred stock by an applicable financial institution, such as FSB, by stating that a gain or loss on Fannie Mae or Freddie Mac preferred stock shall be treated as ordinary gain or loss instead of capital gain or loss, as was previously the case. This change, which was enacted in the 2008 fourth quarter, provides tax relief to banking organizations that have suffered losses on certain direct and indirect investments in Fannie Mae and Freddie Mac preferred stock. As a

result, the Company was able to recognize the tax effects of the other-than-temporary-impairment (OTTI) charge on its investment in auction rate preferred equity securities, which are collateralized by FNMA and FHLMC preferred stock, as an ordinary loss in the consolidated financial statements for the year ended December 31, 2008.

Financial Stability Plan

On February 10, 2009, the Financial Stability Plan was announced by the U.S. Treasury Department. The Financial Stability Plan is a comprehensive set of measures intended to shore up the financial system. The core elements of the plan include making bank capital injections, creating a public-private investment fund to buy troubled assets, establishing guidelines for loan modification programs and expanding the Federal Reserve lending program. The U.S. Treasury Department has indicated more details regarding the Financial Stability Plan are to be announced on a newly created government website, www.FinancialStability.gov, in the next several weeks.

American Recovery and Reinvestment Act of 2009

On February 17, 2009, the ARRA was enacted. ARRA is intended to provide a stimulus to the U.S. economy in the wake of the economic downturn brought about by the subprime mortgage crisis and the resulting credit crunch. The bill includes federal tax cuts, expansion of unemployment benefits and other social welfare provisions, and domestic spending in education, healthcare, and infrastructure. The new law also includes numerous non-economic recovery related items, including a limitation on executive compensation in federally-aided banks.

Under ARRA, an institution will be subject to the following restrictions and standards throughout the period in which any obligation arising from financial assistance provided under TARP remains outstanding:

- Limits on compensation incentives for risk-taking by senior executive officers.
- Requirement of recovery of any compensation paid based on inaccurate financial information.
- Prohibition on Golden Parachute Payments .
- Prohibition on compensation plans that would encourage manipulation of reported earnings to enhance the compensation of employees.
- Publicly registered TARP recipients must establish a board compensation committee comprised entirely of independent directors, for the purpose of reviewing employee compensation plans.
- Prohibition on bonus, retention award, or incentive compensation, except for payments of long term restricted stock.
- Limitation on luxury expenditures.
- TARP recipients are required to permit a separate non-binding shareholder vote to approve the compensation of executives, as disclosed pursuant to the SEC s compensation disclosure rules.
- The chief executive officer and chief financial officer of each TARP recipient will be required to provide a written certification of compliance with these standards to the SEC.

Notwithstanding the foregoing, the ARRA provides that the Secretary of the Treasury shall permit a TARP recipient, subject to consultation with the recipient s appropriate Federal banking agency, to repay such assistance without regard to whether the recipient has replaced such funds from any other source or to any waiting period. ARRA further provides that when the recipient repays such assistance, the Secretary of the Treasury shall liquidate the warrants associated with the assistance at the current market price. While Treasury has not yet issued implementing regulations, it appears that ARRA will permit the Company, if it so elects and following consultation with the FRB, to redeem the Series A Preferred Stock at any time without restriction.

Homeowner Affordability and Stability Plan

On February 18, 2009, the Homeowner Affordability and Stability Plan (HASP) was announced by the President of the United States. HASP is intended to support a recovery in the housing market and ensure that workers can continue to pay off their mortgages through the following elements:

- Provide access to low-cost refinancing for responsible homeowners suffering from falling home prices.
- A $75 billion homeowner stability initiative to prevent foreclosure and help responsible families stay in their homes.
- Support low mortgage rates by strengthening confidence in Fannie Mae and Freddie Mac.

Impact of Inflation and Changing Prices

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

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Regulatory and Economic Policies

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

EMPLOYEES

At December 31, 2008, the Company had 532 full-time and 133 part-time employees.

EXECUTIVE OFFICERS OF REGISTRANT

The following table sets forth current information regarding executive officers and other significant employees (ages are as of the 2009 Annual Meeting).

Name	Age	Starting In	Positions/Offices
Peter G. Humphrey	54	1977	President and Chief Executive Officer of FII and Five Star Bank.
Ronald A. Miller	60	1996	Executive Vice President, Chief Financial Officer and Corporate Secretary of FII and Five Star Bank.
James T. Rudgers	59	2004	Executive Vice President and Chief of Community Banking Officer of FII and Five Star Bank. Executive Vice President of Retail Banking at Hudson United Bank Corporation from 2002 to 2004.
John J. Witkowski	46	2005	Senior Vice President and Regional President / Retail Banking Executive Officer of Five Star Bank. Senior Vice President and Director of Sales for Business Banking / Client Development Group at Bank of America from 1993 to 2005.
Martin K. Birmingham	42	2005	Senior Vice President and Regional President / Commercial Banking Executive Officer of Five Star Bank. Senior Team Leader and Regional President of the Rochester Market at Bank of America (formally Fleet Boston Financial) from 2000 to 2005.
George D. Hagi	56	2006	Executive Vice President and Chief Risk Officer of FII and Five Star Bank. Senior Vice President and Director of Risk Management at First National Bankshares of Florida and FNB Corp from 1997 to 2005.
Kevin B. Klotzbach	56	2001	Senior Vice President and Treasurer of Five Star Bank.

Bruce H. Nagle	60	2006	Senior Vice President and Director of Human Resources of FII and Five Star Bank. Vice President of Human Resources at University of Pittsburgh Medical Center from 2000 to 2006.
Richard J. Harrison	63	2003	Senior Vice President and Senior Retail Lending Administrator of Five Star Bank. Executive Vice President and Chief Credit Officer at Savings Bank of the Fingerlakes from 2000 to 2003.

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ITEM 1A. RISK FACTORS

Making or continuing an investment in securities issued by the Company, including its common stock, involves certain risks that you should carefully consider. The risks and uncertainties described below are not the only risks that may have a material adverse effect on the Company. Additional risks and uncertainties also could adversely affect the Company s business, financial condition and results of operations. If any of the following risks actually occur, the Company s business, financial condition or results of operations could be negatively affected, the market price for your securities could decline, and you could lose all or a part of your investment. Further, to the extent that any of the information contained in this Annual Report on Form 10-K constitutes forward-looking statements, the risk factors set forth below also are cautionary statements identifying important factors that could cause the Company s actual results to differ materially from those expressed in any forward-looking statements made by or on behalf of the Company.

The Company s business may be adversely impacted by adverse conditions in the financial markets and economic conditions generally.

The capital and credit markets have been experiencing unprecedented levels of volatility and disruption for more than a year. In some cases, the markets have produced downward pressure on stock prices and credit availability for certain issuers without regard to those issuers underlying financial strength. As a consequence of the recession that the United States now finds itself in, business activity across a wide range of industries face serious difficulties due to the lack of consumer spending and the extreme lack of liquidity in the global credit markets. Unemployment has also increased significantly.

A sustained weakness or weakening in business and economic conditions generally or specifically in the principal markets in which the Company does business could have one or more of the following material adverse impacts on the Company s business, financial condition and results of operations:

- A decrease in the demand for loans and other products and services offered by the Company;
- A decrease in the value of our loans held for sale or other assets secured by consumer or commercial real estate;
- An impairment of certain intangible assets, such as goodwill;
- An increase in the number of clients and counterparties who become delinquent, file for protection under bankruptcy laws or default on their loans or other obligations to the Company. An increase in the number of delinquencies, bankruptcies or defaults could result in a higher level of non-performing assets, net charge-offs, provision for loan losses, and valuation adjustments on loans held for sale.

Current market developments may adversely impact the Company s industry and business.

Dramatic declines in the housing market during the prior year, with falling home prices and increasing foreclosures and unemployment, have resulted in, and may continue to result in, significant write-downs of asset values by the Company and other financial institutions, including government-sponsored entities and major commercial and investment banks. These write-downs, initially of mortgage-backed securities but spreading to credit default swaps and other derivative securities, have caused many financial institutions to seek additional capital, to merge with larger and stronger institutions and, in some cases, to fail. Reflecting concern about the stability of the financial markets generally and the strength of counterparties, many lenders and institutional investors have reduced, and in some cases, ceased to provide funding to borrowers including financial institutions.

This market turmoil and tightening of credit have led to an increased level of commercial and consumer delinquencies, lack of consumer confidence, increased market volatility and widespread reduction of business activity generally. The resulting lack of available credit, lack of confidence in the financial sector, increased volatility in the financial markets and reduced business activity could have a material adverse impact on the Company s business, financial condition or results of operations.

Further negative market developments may affect consumer confidence levels and may cause adverse changes in payment patterns, causing increases in delinquencies and default rates, which may impact our charge-offs and provisions for credit losses. A worsening of these conditions would likely exacerbate the adverse effects of these difficult market conditions on the financial services industry and could have a material adverse impact on the Company s business, financial condition or results of operations.

The Company is subject to liquidity risks.

The Company maintains liquidity primarily through customer deposits and other funding sources. If economic influences change so that we do not have access to short-term credit, or our depositors withdraw a substantial amount of their funds for other uses, Five Star Bank might experience liquidity issues. Our efforts to monitor and manage liquidity risk may not be successful or sufficient to deal with dramatic or unanticipated reductions in our liquidity. In such events, our cost of funds may increase, thereby reducing our net interest revenue, or we may need to sell a portion of our investment portfolio, which, depending upon market conditions, could result in our realizing a loss.

The soundness of other financial institutions, including Federal Home Loan Bank, could adversely impact the Company.

The Company s ability to engage in routine funding transactions could be adversely affected by the actions and commercial soundness of other financial institutions. Financial services institutions are interrelated as a result of counterparty relationships. The Company has exposure to many different industries and counterparties, and routinely executes transactions with counterparties in the financial services industry. The most important counterparty for the Company, in terms of liquidity, is the Federal Home Loan Bank of New York (FHLBNY). The Company uses FHLBNY as its primary source of long-term wholesale funding. At December 31, 2008, the Company had a total of $30.7 million in borrowed funds with FHLBNY.

There are twelve branches of the Federal Home Loan Bank (FHLB), including New York. Several members have warned that they have either breached risk-based capital requirements or that they are close to breaching those requirements. To conserve capital, some FHLB branches are suspending dividends, cutting dividend payments, and not buying back excess FHLB stock that members hold. FHLBNY has stated that they expect to be able to continue to pay dividends, redeem excess capital stock, and provide competitively priced advances in the future. The most severe problems in the FHLB system have been at some of the other FHLB branches. Nonetheless, the twelve FHLB branches are jointly liable for the consolidated obligations of the FHLB system. To the extent that one FHLB branch cannot meet its obligations to pay its share of debt, other FHLB branches may be called upon to make the payment.

As a member of the FHLB System, the Company is required to hold stock in FHLBNY. The carrying value and fair value of the Company s FHLBNY common stock as of December 31, 2008 was $3.2 million based on its par value. In an extreme situation, it is possible that the capitalization of an FHLB, including FHLBNY, could be substantially diminished or reduced to zero. Consequently, given that there is no market for the Company s FHLBNY common stock, there is a risk that the investment could be determined to be impaired in the future.

Deterioration in the soundness of FHLBNY or the FHLB System could have a material adverse impact on the Company s business, financial condition, results of operations or liquidity.

The value of certain securities in the Company s investment securities portfolio may be negatively affected by disruptions in the market for these securities.

In addition to interest rate risk typically associated with an investment portfolio, the market for certain investment securities held within the Company s investment portfolio has, over the past year, become much less liquid. This coupled with uncertainly surrounding the credit risk associated with the underlying collateral has caused material discrepancies in valuation estimates obtained from third parties. The Company values some of its investments using internally developed cash flow and valuation models, which include certain subjective estimates which are believed to reflect the estimates a purchaser of such securities would use if such a transaction were to occur. The volatile market may affect the value of these securities, such as through reduced valuations due to the perception of heightened credit and liquidity risks, in addition to interest rate risk typically associated with these securities. There can be no assurance that the declines in market value associated with these disruptions will not result in impairments of these assets, which could have a material adverse impact on the Company s business, financial condition, results of operations or liquidity.

FDIC insurance premiums may increase materially.

The FDIC insures deposits at FDIC insured financial institutions, including FSB. The FDIC charges the insured financial institutions premiums to maintain the Deposit Insurance Fund at a certain level. Current economic conditions have increased bank failures and expectations for further failures, in which case the FDIC ensures payments of deposits up to insured limits from the Deposit Insurance Fund. In December 2008 and again in February 2009, the FDIC adopted rules that will increase premiums paid by insured institutions and make other changes to the assessment system. Significant increases in deposit insurance premiums could have a material adverse impact on the Company s business, financial condition, results of operations or liquidity.

There can be no assurance that the EESA and other recently enacted government programs will help stabilize the U.S. financial system.

On October 3, 2008, the EESA was signed into law by the President. The legislation was the result of a proposal by the Secretary of the Treasury on September 20, 2008 in response to the financial crises affecting the banking system and financial markets and going concern threats to investment banks and other financial institutions. The U.S.

Treasury and federal banking regulators are implementing a number of programs under this legislation and otherwise to address capital and liquidity issues in the banking system, including the CPP, in which the Company participates. In addition, other regulators have taken steps to attempt to stabilize and add liquidity to the financial markets, such as the FDIC s TLGP.

On February 10, 2009, the Secretary of the Treasury announced the Financial Stability Plan, which earmarks the second $350 billion originally authorized under the EESA. The Financial Stability Plan is intended to, among other things, make capital available to financial institutions, purchase certain legacy loans and assets from financial institutions, restart securitization markets for loans to consumers and businesses and relieve certain pressures on the housing market, including the reduction of mortgage payments and interest rates.

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In addition, the ARRA, which was signed into law on February 17, 2009, includes, among other things, extensive new restrictions on the compensation arrangements of financial institutions participating in TARP.

There can be no assurance, however, as to the actual impact that the EESA, as supplemented by the Financial Stability Plan, the ARRA and other programs will have on the financial markets, including the extreme levels of volatility and limited credit availability currently being experienced. The failure of the EESA, the ARRA, the Financial Stability Plan and other programs to stabilize the financial markets and a continuation or worsening of current financial market conditions could materially and adversely affect the Company s business, financial condition, results of operations, access to credit or the trading price of the Company s common stock.

The EESA, ARRA and the Financial Stability Plan are relatively new initiatives and, as such, are subject to change and evolving interpretation. There can be no assurances as to the effects that any further changes will have on the effectiveness of the government s efforts to stabilize the credit markets and economy or on the Company s business, financial condition, results of operations or liquidity.

The limitations on incentive compensation contained in the ARRA may adversely affect the Company s ability to retain its highest performing employees.

The Company received CPP funds and the ARRA contains restrictions on bonus and other incentive compensation payable to the five executives named in the Company s proxy statement. Depending upon the limitations placed on incentive compensation by the final regulations issued under the ARRA, it is possible that the Company may be unable to create a compensation structure that permits it to retain its highest performing employees. If this were to occur, it could have a material adverse impact on the Company s business, financial condition, results of operations or liquidity.

Participants in the CPP are subject to certain restrictions on dividends, repurchases of common stock and executive compensation.

The Company is subject to restrictions on dividends, repurchases of common stock, and executive compensation. Compliance with these restrictions and other restrictions may increase the Company s costs and limit its ability to pursue business opportunities. Additionally, any reduction of, or the elimination of, the Company s common stock dividend in the future could adversely affect the market price of the Company s common stock. The current restrictions, as well as any possible future restrictions, associated with participation in the CPP could have a material adverse impact on the Company s business, financial condition, results of operations.

The Company may need to raise additional capital in the future and such capital may not be available when needed or at all.

The Company may need to raise additional capital in the future to provide sufficient capital resources and liquidity to meet the Company s commitments and business needs. The Company s ability to raise additional capital, if needed, will depend on, among other things, conditions in the capital markets at that time, which are outside of the Company s control, and its financial performance. The ongoing liquidity crisis and the loss of confidence in financial institutions may increase the Company s cost of funding and limit its access to some of its customary sources of capital.

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

FII is a holding company and is dependent on its banking subsidiary for dividends, distributions and other payments.

The parent company, FII, is a legal entity separate and distinct from its banking and other subsidiaries. FII s principal source of cash flow, including cash flow to pay dividends to its shareholders and principal and interest on its outstanding debt, is dividends from Five Star Bank. There are statutory and regulatory limitations on the payment of dividends by FSB to the parent company, as well as by FII to its shareholders. Regulations of both the Federal Reserve and the State of New York affect the ability of FSB to pay dividends and other distributions, as well as make loans to FII. Given the loss recorded at FSB during the year ended December 31, 2008, under New York State

Banking Department rules, FSB does not expect to be able to pay dividends to FII in the near term without first obtaining regulatory approval. If FSB is unable to make dividend payments to FII and sufficient capital is not otherwise available, FII may not be able to make dividend payments to its common shareholders or principal and interest payments on its outstanding debt. See also the section titled Supervision and Regulation Restrictions on Distribution of Subsidiary Bank Dividends and Assets of this Annual Report on Form 10-K.

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The Company may not pay dividends on its common stock.

Shareholders of the Company s common stock are only entitled to receive such dividends as the Company s Board of Directors may declare out of funds legally available for such payments. Although the Company has historically declared cash dividends on its common stock, it is not required to do so and may reduce or eliminate its common stock dividend in the future. This could adversely affect the market price of the Company s common stock. Also, participation in the CPP limits our ability to increase our dividend or to repurchase our common stock, for so long as any securities issued under such program remain outstanding, as discussed in greater detail below.

If the Company experiences greater credit losses than anticipated, earnings may be adversely impacted.

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

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

Geographic concentration in one market may unfavorably impact the Company s operations.

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

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

Generally, the Company makes loans to small to mid-sized businesses whose success depends on the regional economy. These businesses generally have fewer financial resources in terms of capital or borrowing capacity than larger entities. Adverse economic and business conditions in these market areas could reduce the Company s growth rate, affect our borrowers ability to repay their loans and, consequently, adversely affect the Company s business, financial condition and performance. For example, the Company places substantial reliance on real estate as collateral for its loan portfolio. A sharp downturn in real estate values in our market area could leave many of these loans inadequately collateralized. If the Company is required to liquidate the collateral securing a loan to satisfy the debt during a period of reduced real estate values, the impact on the Company s results of operations could be materially adverse. See also the section titled Market Area and Competition of this Annual Report on Form 10-K.

The market price of shares of the Company s common stock may fluctuate.

The market price of the Company s common stock could be subject to significant fluctuations due to a change in sentiment in the market regarding the Company s operations or business prospects. Such risks may be affected by:

- Operating results that vary from the expectations of management, securities analysts and investors;
- Developments in the Company s business or in the financial sector generally;
- Regulatory changes affecting the financial services industry generally or the Company s business and operations;
- The operating and securities price performance of companies that investors consider to be comparable to the Company;

Announcements of strategic developments, acquisitions and other material events by the Company or its competitors;
Changes in the credit, mortgage and real estate markets, including the markets for mortgage-related securities; and
Changes in global financial markets and global economies and general market conditions, such as interest or foreign exchange rates, stock, commodity, credit or asset valuations or volatility.

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Stock markets in general and the Company s common stock in particular have, over the past year, and continue to be experiencing significant price and volume volatility. As a result, the market price of the Company s common stock may continue to be subject to similar market fluctuations that may be unrelated to its operating performance or prospects. Increased volatility could result in a decline in the market price of the Company s common stock and may make it more difficult for shareholders to liquidate the common stock.

Future issuances of additional securities could result in dilution of your ownership.

The Company may determine from time to time to issue additional securities to raise additional capital, support growth, or to make acquisitions. Further, the Company may issue stock options or other stock grants to retain and motivate its employees. These issuances of the Company s securities may dilute the ownership interests of existing shareholders.

The Company s market value could result in an impairment of goodwill.

The Company s goodwill is evaluated for impairment on an annual basis at September 30, or when triggering events or circumstances indicate impairment may exist. During the fourth quarter of 2008, the Company experienced a decline in its market capitalization, therefore the Company evaluated its goodwill as of December 31, 2008 and concluded that there was no impairment. In the first quarter of 2009, the Company has experienced further declines in its market capitalization as its common stock has been trading at a price significantly below its book value. Significant and sustained declines in the Company s stock price and market capitalization, significant declines in the Company s expected future cash flows, significant adverse changes in the business climate or slower growth rates could result in impairment of goodwill. If impairment of goodwill was determined to exist, the Company would be required to write down its goodwill as a charge to earnings, which could have a material adverse impact on the Company s results of operations or financial condition. For further discussion, see Note 1, Summary of Significant Accounting Policies, and Note 6, Goodwill and Other Intangible Assets, to the Consolidated Financial Statements included in Item 8 of this Annual Report on Form 10-K.

Changes in interest rates could adversely impact the Company s results of operations and financial condition.

The banking industry s earnings depend largely on the relationship between the yield on earning assets, primarily loans and investments, and the cost of funds, primarily deposits and borrowings. This relationship, known as the interest rate spread, is subject to fluctuation and is affected by economic and competitive factors which influence interest rates, the volume and mix of interest-earning assets and interest-bearing liabilities and the level of non-performing assets. Fluctuations in interest rates affect the demand of customers for the Company s products and services. The Bank is subject to interest rate risk to the degree that interest-bearing liabilities re-price or mature more slowly or more rapidly or on a different basis than interest-earning assets. Significant fluctuations in interest rates could have a material adverse impact on the Company s business, financial condition, results of operations or liquidity. For additional information regarding interest rate risk, see Part II, Item 7A, Quantitative and Qualitative Disclosures About Market Risk of this Annual Report on Form 10-K.

Industry competition may have an adverse impact on the Company s success.

The Company s profitability depends on its ability to compete successfully. The Company operates in a highly competitive environment where certain of its competitors are larger and have more resources. In the Company s market areas, it faces competition from commercial banks, savings and loan associations, credit unions, internet banks, finance companies, insurance companies, brokerage and investment banking firms, and other financial intermediaries that offer similar services. Some of the Company s non-bank competitors are not subject to the same extensive regulations that govern FII or FSB and may have greater flexibility in competing for business. The Company expects competition to intensify among financial services companies due to the recent consolidation of certain competing financial institutions and the conversion of certain investment banks to bank holding companies. Should competition in the financial services industry intensify, the Company s ability to market its products and services may be adversely impacted.

The Company s deferred tax assets may not ultimately be realized or its tax positions may be subject to challenge by the IRS.

The Company s deferred tax assets may provide significant future tax savings to the Company. The Company s use of these deferred tax benefits may depend on a number of factors including the ability of the Company to generate significant taxable income; the absence of a future ownership change of the Company that could limit or eliminate the

tax benefits; the acceptance by the taxing authorities of the positions taken on the Company s tax returns as to the amount and timing of its income and expenses; and future changes in laws or regulations relating to tax deductions and net operating losses.

The Company assesses the likelihood that deferred tax assets will be realizable based on future taxable income and, if necessary, establishes a valuation allowance for those deferred tax assets determined to not likely be realizable. Management judgment is required in determining the appropriate recognition of deferred tax assets and liabilities, including projections of future taxable income. There can be no absolute assurance, however, that the net deferred assets will ultimately be realized.

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The Company s information systems may experience an interruption or breach in security.

The Company depends upon data processing, software, communication and information exchange on a variety of computing platforms and networks and over the internet. Despite instituted safeguards, the Company cannot be certain that all of its systems are entirely free from vulnerability to attack or other technological difficulties or failures. The Company relies on the services of a variety of vendors to meet its data processing and communication needs. If information security is breached or other technology difficulties or failures occur, information may be lost or misappropriated, services and operations may be interrupted and the Company could be exposed to claims from customers. Any of these results could have a material adverse impact on the Company s business, financial condition, results of operations or liquidity.

ITEM 1B. UNRESOLVED STAFF COMMENTS

Not applicable.

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ITEM 2. PROPERTIES

The Company believes that its properties have been adequately maintained, are in good operating condition and are suitable for its business as presently conducted. The Company conducts banking operations at the following locations.

Location	Type	Owned or Leased	Lease Expiration
Allegany	Branch	Owned	
Amherst	Branch	Leased	February 2020
Attica	Branch	Owned	
Auburn	Branch	Owned	
Avoca	Branch	Owned	
Batavia	Branch	Leased	December 2016
Batavia (In-Store)	Branch	Leased	July 2009
Bath	Branch	Owned	
Bath	Drive-up Branch	Owned	
Caledonia	Branch	Leased	July 2012
Canandaigua	Branch	Owned	
Cuba	Branch	Owned	
Dansville	Branch	Ground Leased	March 2014
Dundee	Branch	Owned	
East Aurora	Branch	Leased	January 2013
Ellicottville	Branch	Owned	
Elmira	Branch	Owned	
Elmira Heights	Branch	Leased	August 2009
Erwin	Branch	Leased	October 2010
Geneseo	Branch	Owned	
Geneva	Branch	Owned	
Geneva	Drive-up Branch	Owned	
Greece	Branch	Leased	June 2023
Geneva (Plaza)	Branch	Ground Leased	January 2016
Hammondsport	Branch	Owned	
Henrietta	Branch	Leased	June 2023
Honeoye Falls	Branch	Leased	September 2017
Hornell	Branch	Owned	
Horseheads	Branch	Leased	September 2012
Lakeville	Branch	Owned	
Lakewood	Branch	Owned	
Leroy	Branch	Owned	
Mount Morris	Branch	Owned	
Naples	Branch	Owned	
North Chili	Branch	Owned	
North Java	Branch	Owned	
North Warsaw	Branch	Owned	
Olean	Branch	Owned	
Olean	Drive-up Branch	Owned	
Orchard Park	Branch	Ground Leased	January 2019
Ovid	Branch	Owned	
Pavilion	Branch	Owned	
Penn Yan	Branch	Owned	
Pittsford	Administrative Offices	Leased	April 2017

Salamanca	Branch	Owned	
Strykersville	Branch	Owned	
Victor	Branch	Owned	
Warsaw (220 Liberty Street)	Headquarters	Owned	
Warsaw (29 North Main Street)	Administrative Offices	Owned	
Warsaw (55 North Main Street)	Main Branch	Owned	
Waterloo	Branch	Owned	
Wayland	Branch	Owned	
Williamsville	Branch	Leased	August 2009
Wyoming	Branch	Leased	March 2009
Yorkshire	Branch	Ground Leased	November 2012

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ITEM 3. LEGAL PROCEEDINGS

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

ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

Not applicable.

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PART II

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

The Company s common stock is traded on the NASDAQ Global Select Market under the ticker symbol FISI. At December 31, 2008, 10,798,019 shares of the Company s stock were outstanding by approximately 1,100 shareholders of record. During 2008, the high sales price of our common stock was $22.50 and the low sales price was $10.06. The closing price per share of common stock on December 31, 2008, the last trading day of the Company s fiscal year, was $14.35. The Company declared dividends of $0.54 per common share during the year ended December 31, 2008. See additional information regarding the market price and dividends paid filed herewith in Part II, Item 6, Selected Financial Data.

Equity Compensation Plan Information

The following table sets forth, as of December 31, 2008, information about our equity compensation plans that have been approved by our shareholders, including the number of shares of our common stock exercisable under all outstanding options, warrants and rights, the weighted average exercise price of all outstanding options, warrants and rights and the number of shares available for future issuance under our equity compensation plans. We have no equity compensation plans that have not been approved by our shareholders.

Plan Category	Number of securities to be issued upon exercise of outstanding options, warrants and rights	Weighted average exercise price of outstanding options, warrants and rights	Number of securities remaining for future issuance under equity compensation plans (excluding securities reflected in column (a))
Equity compensation plans approved by shareholders	582,885	$ 19.14	763,378
Equity compensation plans not approved by shareholders		$	

The Company has paid regular quarterly cash dividends on its common stock and its Board of Directors presently intends to continue this practice, subject to the need for those funds for debt service and other purposes. However, the payment of dividends by the Company is subject to continued compliance with minimum regulatory capital requirements and CPP restrictions. See the discussions in the section captioned Supervision and Regulation included in Part I, Item 1, Business , in the section captioned Liquidity and Capital Resources included in Part II, Item 7, in Management s Discussion and Analysis of Financial Condition and Results of Operations and in Note 10, Regulatory Matters, in the accompanying financial statements included in Part II, Item 8, Financial Statements and Supplementary Data , all of which are included elsewhere in this report and incorporated herein by reference thereto.

The table below sets forth the information with respect to purchases made by the Company (as defined in Rule 10b-18(a)(3) under the Securities Exchange Act of 1934), of our common stock during the three months ended December 31, 2008:

	Total number of shares	Approximate dollar value

Period	Total number of shares purchased	Average price paid per share	Total number of shares purchased as part of publicly announced repurchase plans	Approximate dollar value of shares that may yet be purchased under the plans
10/01/08 10/31/08	8,444	$ 14.60	8,444	$ 2,661,113
11/01/08 11/30/08				2,661,113
12/01/08 12/31/08				[(1)]
Total	8,444	$ 14.60	8,444	$

(1) The $5 million stock repurchase plan approved by the Company s Board of Directors during the second quarter of 2008 was terminated in December 2008 and future stock repurchase plans are limited as a result of the Company s participation in the CPP.

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Stock Performance Graph

The stock performance graph below compares (a) the cumulative total return on the Company s common stock for the period beginning December 31, 2003 as reported by the NASDAQ Global Market, through December 31, 2008, (b) the cumulative total return on stocks included in the NASDAQ Composite Index over the same period, and (c) the cumulative total return, as compiled by SNL Financial L.C., of Major Exchange (NYSE, AMEX and NASDAQ) Banks with $1 billion to $5 billion in assets over the same period. Cumulative return assumes the reinvestment of dividends. The graph was prepared by SNL Financial, L.C. and is expressed in dollars based on an assumed investment of $100.

	Period Ending					
Index	**12/31/03**	**12/31/04**	**12/31/05**	**12/31/06**	**12/31/07**	**12/31/08**
Financial Institutions, Inc.	100.00	84.68	72.97	87.10	68.96	57.35
NASDAQ Composite	100.00	108.59	110.08	120.56	132.39	78.72
SNL Bank $1B-$5B	100.00	123.42	121.31	140.38	102.26	84.81

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ITEM 6. SELECTED FINANCIAL DATA

(Dollars in thousands, except per share data)	At or for the year ended December 31, 2008	2007	2006	2005	2004
Selected financial condition data:					
Total assets	$ 1,916,919	$ 1,857,876	$ 1,907,552	$ 2,022,392	$ 2,156,329
Loans, net	1,102,330	948,652	909,434	972,090	1,213,219
Investment securities	606,038	754,720	775,536	833,448	766,515
Deposits	1,633,263	1,575,971	1,617,695	1,717,261	1,818,949
Borrowings	70,820	68,210	87,199	115,199	132,614
Shareholders equity	190,300	195,322	182,388	171,757	184,287
Common shareholders equity[(1)]	137,226	177,741	164,765	154,123	166,565
Tangible common shareholders equity[(2)]	99,577	139,786	126,502	115,440	127,452
Selected operations data:					
Interest income	$ 98,948	$ 105,212	$ 103,070	$ 103,887	$ 106,175
Interest expense	33,617	47,139	43,604	36,395	30,768
Net interest income	65,331	58,073	59,466	67,492	75,407
Provision (credit) for loan losses	6,551	116	(1,842)	28,532	19,676
Net interest income after provision (credit) for loan losses	58,780	57,957	61,308	38,960	55,731
Noninterest (loss) income [(3)]	(48,778)	20,680	21,911	29,384	22,149
Noninterest expense	57,461	57,428	59,612	65,492	61,767
(Loss) income from continuing operations before income taxes	(47,459)	21,209	23,607	2,852	16,113
Income tax (benefit) expense from continuing operations	(21,301)	4,800	6,245	(1,766)	3,170
(Loss) Income from continuing operations	(26,158)	16,409	17,362	4,618	12,943
Loss on discontinued operations, net of tax				2,452	450
Net (loss) income	$ (26,158)	$ 16,409	$ 17,362	$ 2,166	$ 12,493
Preferred stock dividends and accretion	1,538	1,483	1,486	1,488	1,495
Net (loss) income applicable to common shareholders	$ (27,696)	$ 14,926	$ 15,876	$ 678	$ 10,998
Stock and related per share data:					
(Loss) earnings from continuing operations per common share:					
Basic	$ (2.56)	$ 1.34	$ 1.40	$ 0.28	$ 1.02
Diluted	(2.56)	1.33	1.40	0.28	1.02
(Loss) earnings per common share:					

Basic	(2.56)	1.34	1.40	0.06	0.98
Diluted	(2.56)	1.33	1.40	0.06	0.98
Cash dividends declared on common stock	0.54	0.46	0.34	0.40	0.64
Common book value per share [1]	12.71	16.14	14.53	13.60	14.81
Tangible common book value per share [2]	9.22	12.69	11.15	10.19	11.31
Market price (NASDAQ: FISI):					
High	22.50	23.71	25.38	24.93	29.03
Low	10.06	16.18	17.43	15.52	20.52
Close	14.35	17.82	23.05	19.62	23.25

(1) Excludes preferred shareholders equity.

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

(3) The 2008 figure includes OTTI charges of $68.2 million. There were no OTTI charges in the other years presented.

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(Dollars in thousands, except per share data)	At or for the year ended December 31, 2008	2007	2006	2005	2004
Selected financial ratios and other data:					
Performance ratios:					
Net (loss) income (returns on):					
Average assets	-1.37%	0.86%	0.90%	0.10%	0.57%
Average equity	-14.30	8.84	9.86	1.22	6.73
Average common equity [1]	-16.84	8.89	10.02	0.43	6.55
Average tangible common equity [2]	-21.87	11.50	13.23	0.56	8.57
Common dividend payout ratio [3]	NA	34.33	24.29	666.67	65.31
Net interest margin (fully tax-equivalent)	3.93	3.53	3.55	3.65	3.90
Efficiency ratio [4]	64.07%	68.77%	69.78%	70.18%	60.41%
Capital ratios:					
Leverage ratio	8.05%	9.35%	8.91%	7.60%	7.13%
Tier 1 risk-based capital	11.83	15.74	15.85	13.75	11.27
Total risk-based capital	13.08	16.99	17.10	15.01	12.54
Equity to assets [5]	9.60	9.73	9.08	8.37	8.48
Common equity to assets [1] [5]	8.63	8.81	8.17	7.54	7.67
Tangible common equity to tangible assets [2] [5]	6.78%	6.95%	6.32%	5.80%	5.97%
Asset quality [6]:					
Non-accruing loans	$ 8,189	$ 8,075	$ 15,837	$ 17,761	$ 51,946
Other non-performing assets	56	2	3	276	2,018
Allowance for loan losses	18,749	15,521	17,048	20,231	39,186
Net loan charge-offs	$ 3,323	$ 1,643	$ 1,341	$ 47,487	$ 9,554
Total non-performing loans to total loans	0.73%	0.84%	1.71%	1.82%	4.31%
Total non-performing assets to total assets	0.48	0.51	0.89	0.97	2.56
Net charge-offs to average loans	0.32	0.18	0.14	4.27	0.74
Allowance for loan losses to total loans	1.67	1.61	1.84	2.04	3.13
Allowance for loan losses to non-performing loans	229%	192%	108%	112%	73%
Other data:					
Number of branches	52	50	50	50	50
Full time equivalent employees	600	621	640	700	765

[1] Excludes preferred shareholders equity.

[2] Excludes preferred shareholders equity, goodwill and other intangible assets.

[3] Common dividend payout ratio equals

dividends declared during the year divided by earnings per share for the year. There is no ratio shown for years where the Company both declared a dividend and incurred a loss because the ratio would result in a negative payout since the dividend declared (paid out) will always be greater than 100% of earnings.

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

(5) Ratios calculated using average balances for the

periods shown.

(6) Ratios exclude non-accruing commercial-related loans held for sale ($577 thousand for 2005 and zero for all other years presented) from non-performing loans and exclude loans held for sale from total loans.

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SELECTED QUARTERLY DATA

	2008			
(Dollars in thousands, except per share data)	**Fourth Quarter**	**Third Quarter**	**Second Quarter**	**First Quarter**
Interest income	$ 24,582	$ 24,558	$ 24,536	$ 25,272
Interest expense	7,269	7,812	8,349	10,187
Net interest income	17,313	16,746	16,187	15,085
Provision for loan losses	2,586	1,891	1,358	716
Net interest income, after provision for loan losses	14,727	14,855	14,829	14,369
Noninterest (loss) income	(25,106)	(29,348)	932	4,744
Noninterest expense	15,394	13,409	14,385	14,273
(Loss) income before income taxes	(25,773)	(27,902)	1,376	4,840
Income tax (benefit) expense	(22,631)	524	(255)	1,061
Net (loss) income	$ (3,142)	$ (28,426)	$ 1,631	$ 3,779
Preferred stock dividends	426	371	370	371
Net (loss) income applicable to common shareholders	$ (3,568)	$ (28,797)	$ 1,261	$ 3,408
(loss) earnings per common share [1]:				
Basic	$ (0.33)	$ (2.68)	$ 0.12	$ 0.31
Diluted	(0.33)	(2.68)	0.12	0.31
Market price (NASDAQ: FISI):				
High	$ 20.27	$ 22.50	$ 20.00	$ 20.78
Low	10.06	14.82	15.25	15.10
Close	14.35	20.01	16.06	18.95
Dividends declared	$ 0.10	$ 0.15	$ 0.15	$ 0.14

	2007			
(Dollars in thousands, except per share data)	**Fourth Quarter**	**Third Quarter**	**Second Quarter**	**First Quarter**
Interest income	$ 26,397	$ 26,553	$ 26,458	$ 25,806
Interest expense	11,192	11,692	12,406	11,850
Net interest income	15,205	14,861	14,052	13,956
Provision (credit) for loan losses	351	(82)	(153)	
Net interest income, after provision (credit) for loan losses	14,854	14,943	14,205	13,956
Noninterest income	5,002	6,334	4,606	4,738
Noninterest expense	14,543	14,609	14,348	13,928

Income before income taxes	5,313	6,668	4,463	4,766
Income tax expense	1,215	1,414	1,020	1,151
Net income	$ 4,098	$ 5,254	$ 3,443	$ 3,615
Preferred stock dividends	370	371	371	371
Net income applicable to common shareholders	$ 3,728	$ 4,883	$ 3,072	$ 3,244
Earnings per common share [(1)]:				
Basic	$ 0.34	$ 0.44	$ 0.27	$ 0.29
Diluted	0.34	0.44	0.27	0.29
Market price (NASDAQ: FISI):				
High	$ 19.80	$ 20.46	$ 20.62	$ 23.71
Low	16.42	16.18	18.62	19.30
Close	17.82	17.94	20.19	20.07
Dividends declared	$ 0.13	$ 0.12	$ 0.11	$ 0.10

(1) (Loss) earnings per share data is computed independently for each of the quarters presented. Therefore, the sum of the quarterly earnings or loss per common share amounts may not equal the total for the year.

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

GENERAL

The principal objective of this discussion is to provide an overview of the financial condition and results of operations of the Company during the year ended December 31, 2008 and the preceding two years. The following analysis of financial condition and results of operations should be read in conjunction with the consolidated financial statements and related notes filed herewith in Part II, Item 8, Financial Statements and Supplementary Data and the description of the business filed herewith in Part I, Item 1, Business.

Income. The Company s results of operations are dependent primarily on net interest income, which is the difference between the income earned on loans and securities and the interest paid on deposits and borrowings. Results of operations are also affected by the (credit) provision for loan losses, service charges on deposits, financial services group fees and commissions, mortgage banking revenues, gain or loss on the sale of securities, gain or loss on sale of loans and other miscellaneous income.

Expenses. The Company s expenses primarily consist of salaries and employee benefits, occupancy and equipment, supplies and postage, amortization of other intangible assets, computer and data processing, professional fees and services, advertising and promotions and other miscellaneous expense and income tax expense (benefit). Results of operations are also significantly affected by general economic and competitive conditions, particularly changes in consumer and business spending, interest rates, government policies and the actions of regulatory authorities.

RECENT MARKET DEVELOPMENTS

The global and U.S. economies are experiencing significantly reduced business activity as a result of, among other factors, disruptions in the financial system during the past year. Dramatic declines in the housing market during the past year, with falling home prices and increasing foreclosures and unemployment, have resulted in significant write-downs of asset values by financial institutions, including government-sponsored entities and major commercial and investment banks. These write-downs, initially of residential-related loans and mortgage-backed securities, but spreading to credit default swaps and other derivative securities, have caused many financial institutions to seek additional capital, to merge with larger and stronger institutions and, in some cases, to fail.

Reflecting concern about the stability of the financial markets generally and the strength of counterparties, many lenders and institutional investors have reduced, and in some cases, ceased to provide funding to borrowers, including other financial institutions. The availability of credit, confidence in the financial sector, and level of volatility in the financial markets have been significantly adversely affected as a result. In recent months, volatility and disruption in the capital and credit markets have reached unprecedented levels. In some cases, the markets have produced downward pressure on stock prices and credit capacity for certain issuers without regard to those issuers underlying financial strength.

In response to the financial crises affecting the banking system and financial markets and going concern threats to investment banks and other financial institutions, EESA was signed into law on October 3, 2008. The EESA authorizes the Treasury to, among other things, purchase up to $700 billion of mortgages, mortgage-backed securities and certain other financial instruments from financial institutions for the purpose of stabilizing and providing liquidity to the U.S. financial markets. The EESA also provided a temporary increase in deposit insurance coverage from $100,000 to $250,000 per insured account until December 31, 2009.

On October 14, 2008, the Secretary of the Treasury, after consulting with the Federal Reserve and the FDIC, announced that the Treasury will purchase equity stakes in certain banks and thrifts. Under this program, known as the CPP, the Treasury will make $250 billion of capital available to U.S. financial institutions in the form of preferred stock (from the $700 billion authorized by the EESA). In conjunction with the purchase of preferred stock, the Treasury will receive warrants to purchase common stock with an aggregate market price equal to 15% of the preferred investment. Participating financial institutions will be required to adopt the Treasury s standards for executive compensation and corporate governance for the period during which the Treasury holds equity issued under the CPP.

Also on October 14, 2008, after receiving a recommendation from the boards of the FDIC and the Federal Reserve, and consulting with the President, the Secretary of the Treasury signed the systemic risk exception to the FDIC Act,

enabling the FDIC to temporarily provide a 100% guarantee of the senior unsecured debt of all FDIC-insured institutions and their holding companies, as well as deposits in noninterest-bearing transaction deposit accounts under the TLGP through December 31, 2009. All insured depository institutions automatically participated in the TLGP for 30 days following the announcement of the program without charge (subsequently extended to December 5, 2008) and thereafter, unless an institution opted out, at a cost of 75 basis points per annum for senior unsecured debt and 10 basis points per annum for noninterest-bearing transaction deposits.

The Company elected to participate in the CPP, and on December 23, 2008 received $37.5 million in additional capital through the program. In exchange, the Treasury received a like amount of the FII preferred stock that pays an annual dividend of 5% for the first five years, and an annual dividend of 9% in any years thereafter. The Company may redeem the preferred shares issued to Treasury in full during the first three years following issuance only with the proceeds of a qualifying equity offering. Thereafter, the preferred shares may be redeemed in full or in part at any time. The Company also issued a warrant to the Treasury to purchase 378,175 shares of FII common stock, which, upon issuance, would represent approximately 3.4% of our outstanding common shares, based upon current information. The warrant is exercisable at any time during the ten-year period following issuance at an exercise price of $14.88.

Notwithstanding the foregoing, the ARRA, which was signed into law by President Obama on February 17, 2009, provides that the Secretary of the Treasury shall permit a recipient of funds under the TARP, subject to consultation with the recipient s appropriate Federal banking agency, to repay such assistance without regard to whether the recipient has replaced such funds from any other source or to any waiting period. ARRA further provides that when the recipient repays such assistance, the Secretary of the Treasury shall liquidate the warrants associated with the assistance at the current market price. While Treasury has not yet issued implementing regulations, it appears that ARRA will permit the Company, if it so elects and following consultation with the FRB, to redeem the Series A Preferred Stock at any time without restriction.

The FDIC Act also requires that the FDIC Board of Directors adopt a restoration plan when the Deposit Insurance Fund reserve ratio falls or is expected to fall below certain minimum levels. The bank failures that resulted in 2008 adversely impacted the deposit insurance funds loss provisions, resulting in a decline in the reserve ratio. As part of the restoration plan, the FDIC has increased the insurance assessment rates by seven basis points uniformly for the quarter beginning January 1, 2009. In addition, on February 27, 2009 the FDIC Board adopted an interim rule imposing a 20 basis point emergency special assessment on the industry on June 30, 2009. The assessment is to be collected on September 30, 2009. The interim rule would also permit the Board to impose an emergency special assessment after June 30, 2009, of up to 10 basis points if necessary to maintain public confidence in federal deposit insurance. The Company estimates the combined impact of the seven basis point increase and 20 basis point emergency special assessment to be an approximate increase of $4.6 million in its FDIC deposit insurance assessments for 2009. Subsequently, on March 5, 2009 the Chairman of the FDIC announced that it may cut the 20 basis point emergency special assessment to 10 basis points if legislation passes to expand the FDIC s existing line of credit with the U.S. Treasury Department.

Additionally, the Company opted to continue to participate in the Transaction Account Guarantee portion of the TLGP following the expiration of the initial opt-out period. Participation includes the full guarantee of noninterest bearing deposit transaction accounts and eligible, low interest-earning demand accounts (interest rate equal to or less than 0.50%) regardless of dollar amount.

It is not clear at this time what impact the EESA, the CPP, the TLGP, or other liquidity and funding initiatives will have on the financial markets and the other difficulties described above, including the high levels of volatility and limited credit availability currently being experienced, or on the U.S. banking and financial industries and the broader U.S. global economies. Further adverse effects could have an adverse effect on our business.

OVERVIEW

For the year ended December 31, 2008, the Company s net loss totaled $26.2 million (or $2.56 loss per share), which included a pre-tax non-cash charge of $68.2 million for OTTI on certain investment securities. The Company reported net income of $16.4 million ($1.33 per diluted share) and $17.4 million ($1.40 per diluted share) for the years ended December 31, 2007 and 2006, respectively.

Net interest income, the principal source of the Company s earnings, was $65.3 million in 2008, up from $58.1 million in 2007 and $59.5 million in 2006. Net interest margin improved substantially to 3.93% for the year ended December 31, 2008, compared with 3.53% and 3.55% for the two prior years. The improved net interest margin resulted principally from lower funding costs and the benefits associated with a higher percentage of earning assets being deployed in higher yielding loan assets. Total loans increased $156.9 million, or 16%, to $1.121 billion for the one year period ended December 31, 2008. Indirect auto loans increased $120.1 million or 89%, and

commercial-related increased $35.5 million or 8% during that same one year period.

The Company recorded a provision for loan losses of $6.6 million for the year ended December 31, 2008, compared with $116 thousand in 2007. The increase in the provision for loan losses is primarily due to growth in the loan portfolio and the changing mix of the loan portfolio together with higher net charge offs. For the year ended December 31, 2008, net charge-offs were $3.3 million, or 32 basis points of average loans, compared with $1.6 million, or 18 basis points of average loans, for the year ended December 31, 2007. The allowance for loan losses was $18.7 million at December 31, 2008, compared with $15.5 million at December 31, 2007. Non-performing loans were $8.2 million at December 31, 2008, compared with $8.1 million at December 31, 2007. The ratio of allowance for loan losses to non-performing loans improved to 229% at December 31, 2008 versus 192% at December 31, 2007.

For the year ended December 31, 2008, noninterest income (loss) was $(48.8) million, compared with $20.7 million for the same period in 2007. The loss reflects OTTI charges on investment securities totaling $68.2 million for the year ended December 31, 2008. Exclusive of OTTI charges, noninterest income was $19.4 million for the year, compared with $20.7 million in 2007. Aside from the impact of the OTTI charges in 2007, most of the remaining decrease in noninterest income was due to the receipt of $1.1 million in proceeds from company owned life insurance.

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For the year ended December 31, 2008, noninterest expense was $57.5 million compared with $57.4 million for the same period in 2007. Total salaries and benefits cost declined $1.7 million for the year ended December 31, 2008 compared with 2007, and was offset by a $599 thousand increase in occupancy and equipment expense, a $385 thousand increase in FDIC insurance, and a $557 thousand prepayment charge on borrowed funds.

The Company retained its well-capitalized equity position with total equity capital of $190.3 million, which includes $37.5 million in preferred equity issued in December 2008 under the U.S. Treasury Department s CPP. As of December, 31, 2008, the leverage capital ratio was 8.05% and total risk-based capital ratio was 13.08%.

The Company also expanded its branch network in the metro-Rochester area of New York State, adding de novo branches in Henrietta and Greece during the third and fourth quarters of 2008, respectively.

CRITICAL ACCOUNTING ESTIMATES

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

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

Adequacy of the Allowance for Loan Losses

The allowance for loan losses represents management s estimate of probable credit losses inherent in the loan portfolio. Determining the amount of the allowance for loan losses is considered a critical accounting estimate because it requires significant judgment and the use of subjective measurements including management s assessment of the internal risk classifications of loans, changes in the nature of the loan portfolio, industry concentrations and the impact of current local, regional and national economic factors on the quality of the loan portfolio. Changes in these estimates and assumptions are reasonably possible and may have a material impact on the Company s consolidated financial statements, results of operations or liquidity.

A commercial-related loan is considered impaired when, based on current information and events, it is probable that a creditor will be unable to collect all amounts of principal and interest under the original terms of the agreement and all loans restructured in a troubled debt restructuring. Accordingly, the Company evaluates impaired commercial-related loans individually, primarily based on the net realizable value of the collateral, as the majority of the Company s impaired loans are collateral dependent.

Loans, including impaired loans, are generally classified as nonaccruing if they are past due as to maturity or payment of principal or interest for a period of more than 90 days, unless such loans are well-collateralized and in the process of collection. Loans that are on a current payment status or past due less than 90 days may also be classified as nonaccruing if repayment in full of principal and/or interest is uncertain.

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

Valuation of Goodwill

Statement of Financial Accounting Standards (SFAS) No. 142, Goodwill and Other Intangible Assets prescribes the accounting for goodwill and intangible assets subsequent to initial recognition. The provisions of SFAS No. 142 discontinue the amortization of goodwill and intangible assets with indefinite lives. Instead, these assets are subject to at least an annual impairment review and more frequently if certain impairment indicators are in evidence. Goodwill impairment testing is performed at the segment (or reporting unit) level. Currently, the Company s goodwill is evaluated at the entity level as there is only one reporting unit. Goodwill is assigned to reporting units at the date it is initially recorded. Once goodwill has been assigned to reporting units, it no longer retains its association with a particular acquisition, and all of the activities within a reporting unit, whether acquired or organically grown, are available to support the value of the goodwill. Changes in the estimates and assumptions are reasonably possible and may have a material impact on the Company s consolidated financial statements, results of operations or liquidity. For additional discussion related to the Company s accounting policy for goodwill and other intangible assets, see Note 1, Summary of Significant Accounting Policies, of the notes to consolidated financial statements.

Valuation of Deferred Tax Assets

The determination of deferred tax expense or benefit is based on changes in the carrying amounts of assets and liabilities that generate temporary differences. The carrying value of the Company s net deferred tax assets assumes that the Company will be able to generate sufficient future taxable income based on estimates and assumptions (after consideration of historical taxable income as well as tax planning strategies). If these estimates and related assumptions change, the Company may be required to record valuation allowances against its deferred tax assets resulting in additional income tax expense in the consolidated statements of operations. Management evaluates its deferred tax assets on a quarterly basis and assesses the need for a valuation allowance, if any. A valuation allowance is established when management believes that it is more likely than not that some portion of its deferred tax assets will not be realized. Changes in valuation allowance from period to period are included in the Company s tax provision in the period of change. For additional discussion related to the Company s accounting policy for income taxes see Note 14, Income Taxes, of the notes to consolidated financial statements.

Valuation and Other Than Temporary Impairment of Securities

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

Securities are evaluated quarterly to determine whether a decline in their fair value is other than temporary. Management utilizes criteria such as, the magnitude and duration of the decline and, when appropriate, consideration of adverse changes in cash flows, in addition to the reasons underlying the decline, including creditworthiness, capital adequacy and near term prospects of issuers, the level of credit subordination, estimated loss severity, prepayments and future delinquencies, to determine whether the loss in value is other than temporary. The term other than temporary is not intended to indicate that the decline is permanent, but indicates that the prospect for a near-term recovery of value is not necessarily favorable. Once a decline in fair value is determined to be other than temporary the cost basis of the security is reduced through a charge to earnings.

Defined Benefit Pension Plan

Management is required to make various assumptions in valuing its defined benefit pension plan assets and liabilities. These assumptions include, but are not limited to, the expected long-term rate of return on plan assets, the weighted average discount rate used to value certain liabilities and the rate of compensation increase. The Company uses a third-party specialist to assist in making these estimates and assumptions. Changes in these estimates and assumptions

are reasonably possible and may have a material impact on the Company s consolidated financial statements, results of operations or liquidity.

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ANALYSIS OF FINANCIAL CONDITION

Overview

At December 31, 2008, the Company had total assets of $1.917 billion, an increase of 3% from $1.858 billion as of December 31, 2007, primarily a result of growth of its core business of loans and deposits. Loans totaled $1.121 billion as of December 31, 2008, up $156.9 million, or 16%, when compared to $964.2 million as of December 31, 2007. The increase in loans was primarily attributed to the expansion of the indirect lending program and commercial business development efforts. Nonperforming assets totaled $9.3 million as of December 31, 2008, down $246 thousand from a year ago despite the increase the loan portfolio. For the year ended December 31, 2008, net charge-offs were $3.3 million, or 32 basis points of average loans, compared with $1.6 million, or 18 basis points of average loans, for the year ended December 31, 2007. The increase in net charge-offs in 2008 related principally to the commercial mortgage and consumer indirect loan portfolios. Total deposits amounted to $1.633 billion and $1.576 billion as of December 31, 2008 and 2007, respectively. The increase in deposits was due in part to the Company s successfully expansion of its branch network in the metro-Rochester area, where de novo branches were added in Henrietta and Greece during the third and fourth quarters of 2008, respectively. As of December 31, 2008, total borrowed funds were $70.8 million, comparable to $68.2 million as of December 31, 2007. While the outstanding balance of borrowed funds is up slightly, the average cost of the borrowed funds is down considerably as the Company took advantage of the low interest rate environment and prepaid a portion of its higher cost long term debt in the fourth quarter of 2008. Book value per common share was $12.71 and $16.14 as of December 31, 2008 and 2007, respectively. As of December 31, 2008 the Company s total shareholders equity was $190.3 million compared to $195.3 million a year earlier.

Goodwill

At December 31, 2008, the carrying amount of our goodwill totaled $37.4 million. On September 30, 2008, the Company performed the annual goodwill impairment test and determined the estimated fair value of our reporting unit to be in excess of its carrying amount. Accordingly, as of the Company s annual impairment test date, there was no indication of goodwill impairment. The Company tests its goodwill for impairment between annual tests if an event occurs or circumstances change that would more likely than not reduce the fair value of our reporting unit below its carrying amount. Accordingly, an evaluation of the goodwill for impairment was performed as of December 31, 2008 due to the market s continued contraction. The estimated fair value of the Company s reporting unit was in excess of its carrying amount at December 31, 2008. No assurance can be given that the Company will not record an impairment loss on goodwill in 2009. However, the Company s tangible capital ratio and Bank s regulatory capital ratios would not be affected by this potential non-cash expense since goodwill is not included in these calculations.

Subsequent to December 31, 2008, the Company s stock price significantly declined as was the case for the financial services sector as a whole. The Company considers this to be primarily a financial services industry issue and not related specifically to the Company. If this decline does not reverse by March 31, 2009, there may be a triggering event requiring a goodwill impairment analysis under SFAS No. 142 that may result in an impairment charge.

Investing Activities

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

	At December 31,					
	2008		2007		2006	
	Adjusted Amortized Cost	Fair Value	Amortized Cost	Fair Value	Amortized Cost	Fair Value
Securities available for sale:						
U.S. Government agency and government-sponsored enterprise securities	$ 67,871	$ 68,173	$ 158,920	$ 158,940	$ 235,863	$ 231,936
Mortgage-backed securities:	339,574	342,552	297,798	295,872	304,833	296,738

Other asset-backed securities	3,918	3,918	34,115	33,198	7,082	7,077
State and municipal obligations	129,572	131,711	171,294	172,601	198,428	198,310
Equity securities	923	1,152	33,930	34,630	80	1,087
Total available for sale securities	541,858	547,506	696,057	695,241	746,286	735,148
Securities held to maturity:						
State and municipal obligations						
Total held to maturity securities	58,532	59,147	59,479	59,902	40,388	40,421
Total investment securities	$ 600,390	$ 606,653	$ 755,536	$ 755,143	$ 786,674	$ 775,569

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The deteriorating credit quality of assets linked to the sub-prime mortgage market has led to a lack of liquidity and downgrades to certain whole-loan mortgage-backed securities, trust preferred and auction rate securities. This, in turn, has contributed to a broad-based liquidity shortfall in the financial system. The subsequent increase in risk aversion has contributed to a decline in credit availability in the financial and capital markets. The U.S. Government has attempted to stabilize the financial and capital markets through an injection of liquidity and capital, but it is unclear if and how long it may take for those efforts to be successful.

For the year ended December 31, 2008, the Company recorded OTTI non-cash charges on certain equity, mortgage-backed and other asset-backed investment securities totaling $68.2 million. There were no such charges in prior years. Further deterioration in credit quality and/or a continuation of the current imbalances in liquidity that exist in the marketplace may adversely effect the fair values of the Company s investment portfolio and increase the potential that certain unrealized losses may be designated as other than temporary in future periods and that the Company may incur additional write-downs in the future that could be material.

U.S. Government Agency and U.S. Government-Sponsored Enterprise (GSE) Obligations

The U.S. government agency and GSE obligations portfolio, all of which was classified as available for sale, was comprised of debt obligations issued directly by the U.S. government agencies or GSEs and totaled $68.2 million and $158.9 million as of December 31, 2008 and December 31, 2007, respectively. At December 31, 2008, the portfolio consisted of approximately $20.2 million, or 30%, callable securities. As of December 31, 2008, this category of investment securities also included $7.2 million of structured notes, the majority of which were step-callable debt issues that step-up in rate at specified intervals and are periodically callable by the issuer. As of December 31, 2008, the structured notes had a current average coupon rate of 4.21% that adjust on average to 6.00% within five years. However, under current market conditions these notes are likely to be called at the time of the rate adjustment.

Mortgage-Backed Securities (MBS)

The MBS portfolio totaled $342.6 million as of December 31, 2008, which was comprised of $239.5 million of mortgage-backed pass-through securities (pass-through) and $103.1 million of collateralized mortgage obligations (CMO). As of December 31, 2007, the available for sale MBS portfolio totaled $295.9 million, which consisted of $160.0 million of pass-throughs and $135.9 million of CMOs.

The pass-throughs were predominately issued by FNMA, FHLMC or GNMA. The majority of the pass-through portfolio was in fixed rate securities that were most frequently formed with mortgages having an original balloon payment of five or seven years and 15, 20 and 30 year seasoned mortgages. The remainder of the pass-through portfolio was principally adjustable rate securities indexed to the one-year Treasury bill.

The CMO portfolio consisted of two principal groups, with balances as of December 31, 2008 as follows: (1) $63.6 million of fixed and variable rate CMOs issued by FNMA, FHLMC or GNMA that carried a full guaranty by the issuing agency of both principal and interest, and (2) $39.5 million of privately issued whole loan CMOs.

The following table details, by credit rating, the privately issued whole loan CMOs as of December 31, 2008 (dollars in thousands):

Number of Securities	Moody s Rating	S&P Rating	Fitch Rating	Fair Value
Five [1]	Aaa	AAA		$ 11,408
Two	Aaa		AAA	6,240
Four		AAA	AAA	6,261
One			AAA	5,651
Two [2]	Aa1	AAA	AAA	4,698
One	Baa3		AAA	2,467
One		BB	AAA	1,518
Total whole loan CMOs with prime and Alt-A collateral (at least 90% prime collateral)				38,243

One [3]	A3	AAA			426
One		BBB-	AAA		657
One	A3	BB			124
Total whole loan CMOs with a high level of sub-prime collateral (more than 35% sub-prime collateral)					1,207
Total privately issued whole loan CMOs				$	39,450

In February 2009, the Moody s credit ratings on certain securities have been changed as follows:

(1) One $5.6 million security was changed to Baa3 and one $2.0 million security was changed to Caa.

(2) One $1.3 million security was changed to Ba1 and one $ 3.4 million security was changed to Ca.

(3) This security was changed to Ca.

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The securities in the privately issued whole loan CMO portoflio carry varying levels of credit enhancement. These securities were purchased based on the underlying loan characteristics such as loan to value ratio, credit scores, property type and location. Current chacteristics of each security such as delinquency and foreclosures levels, loss severity levels, credit enhancement, and coverage ratios are reviewed regularly by management. When the level of credit loss coverage for an individual security deteriorates below a specified level, analysis of the security is expanded. Projected credit losses are compared to the current level of credit enhancement to estimate whether the security is expected to experience losses in the future. The amount of OTTI recognized during the year ended December 31, 2008 on the privately issued whole loan CMOs totaled $6.5 million, of which, $4.6 million related to three securities with a high level (more than 35%) of sub-prime collateral. As the current market disruption continues, more securities may be downgraded and/or devalued, which may resut in additional impairment charges in future periods.

Other Asset-Backed Securities (ABS)

The ABS portfolio totaled $3.9 million and $33.2 million as of December 31, 2008 and December 31, 2007, respectively. As of December 31, 2008, the ABS portfolio consists principally of positions in 14 different pooled trust preferred securities and one Student Loan Marketing Association (SLMA) security. The following table summarizes changes to amortized cost for the portfolio of ABS in 2008 and the fair value of the portfolio at December 31, 2008 (in thousands).

	Trust Preferred		SLMA		Total ABS	
	Adjusted Amortized Cost	Fair Value	Adjusted Amortized Cost	Fair Value	Adjusted Amortized Cost	Fair Value
Balance December 31, 2007	$ 33,307	$ 32,390	$ 808	$ 808	$ 34,115	$ 33,198
Net change to cost basis before OTTI	(106)		(662)		(768)	
OTTI non-cash charge	(29,429)				(29,429)	
Balance December 31, 2008	$ 3,772	$ 3,772	$ 146	$ 146	$ 3,918	$ 3,918

All of the pooled trust preferred securities are collateralized by preferred debt issued primarily by financial institutions and, to a lesser extent, insurance companies. The financial services industry is experiencing conditions that have, in some individual companies, resulted in lowered earnings and strained capital positions. Each of the pooled trust preferred securities owned by the Company has some individual companies backing that specific security that have either defaulted or are deferring dividend payments. The class level that the Company owns in each security has at least one subordinate class below the class owned by the Company and as a result, to date, the Company has received scheduled dividend payments on all but one of the securities in accordance with the terms of the security. These securities fall under a class of securities referred to as a collateralized debt obligation (CDO). The market for CDOs has very low demand due principally to imbalances in liquidity that exist in the marketplace. The resulting impact from this inactive market, as well as the increased credit risk profile of the banking sector in general and certain of the companies collateralizing the securities has created adverse changes to expected cash flows and to the fair value of the securities. For the year ended December 31, 2008, the Company recorded $29.4 million in OTTI charges of ABS. Further deterioration in credit quality of the companies collateralizing the securities and/or a continuation of the current imbalances in liquidity that exist in the marketplace may further effect the fair value of these securities and increase the potential that certain unrealized losses may be designated as other than temporary in future periods and that the Company may incur additional write downs.

State and Municipal Obligations

At December 31, 2008, the portfolio of state and municipal obligations totaled $190.2 million, of which $131.7 million was classified as available for sale. As of that date, $58.5 million was classified as held to maturity,

with a fair value of $59.1 million. As of December 31, 2007 the portfolio of state and municipal obligations totaled $232.1 million, of which $172.6 million was classified as available for sale. As of that date, $59.5 million was classified as held to maturity, with a fair value of $59.9 million.

Equity Securities

As of December 31, 2008, the Company had $1.2 million in equity securities including $528 thousand of auction rate preferred equity securities collateralized by FNMA and FHLMC preferred stock and $624 thousand of common equity securities. As of December 31, 2007, the Company had $34.6 million in equity securities, including $33.8 million of auction rate preferred equity securities collateralized by FNMA and FHLMC preferred stock and $780 thousand of common equity securities.

The auction rate preferred equity securities consist of positions collateralized by FNMA and FHLMC preferred stock. The auction rate preferred equity securities were structured to be tendered at par, at the option of the investor, at auctions occurring about every 90 days. The auctions were unsuccessful beginning in April 2008, primarily as a result of the financial and capital market crisis. The FNMA and FHLMC preferred stock fair values deteriorated significantly during the third quarter of 2008. On July 30, 2008, the Housing and Economic Recovery Act of 2008 (the Act) was signed into law. The Act established the Federal Housing Finance Agency (FHFA) as the federal regulator of FNMA and FHLMC, and provided the FHFA the power to oversee the operations, activities, corporate governance, safety and soundness, and missions of FNMA and FHLMC. On September 7, 2008, the FHFA announced that FNMA and FHLMC were being placed into conservatorship, which significantly reduced the value of existing equity positions in FNMA and FHLMC. As a result, impairment write-downs on the auction rate preferred equity securities totaling $32.3 million were recorded during the year ended December 31, 2008. The EESA changed the tax treatment of gains or losses from the sale or exchange of FNMA or FHLMC preferred stock by stating that a gain or loss on Fannie Mae or Freddie Mac preferred stock will be treated as ordinary gain or loss instead of capital gain or loss, as was previously the case. As a result, the Company was able to recognize the tax effects of the OTTI charge on its investment in auction rate preferred equity securities as an ordinary loss in the consolidated financial statements for the year ended December 31, 2008.

The dividend income related to both the common and auction rate preferred equity securities qualifies for the Federal income tax dividend received deduction. For the year ended December 31, 2008, dividend income of $1.4 million was earned on these securities. FHFA has suspended the payment of preferred dividends for FNMA and FHLMC and the Company will receive no future dividend income while the suspension is in place. The Company does not expect to receive further dividends on FNMA or FHLMC preferred securities.

Lending Activities

The composition of the Company s loan portfolio, excluding loans held for sale and including net unearned income and net deferred fees and costs, is summarized as follows (in thousands):

Loan Portfolio Composition
At December 31,

	2008		2007		2006		2005		2004	
	Amount	**Percent**	**Amount**	**Percent**	**Amount**	**Percent**	**Amount**	**Percent**	**Amount**	**Percent**
Commercial	$ 158,543	14.1%	$ 136,780	14.2%	$ 105,806	11.4%	$ 116,444	11.7%	$ 203,178	16.2%
Commercial real estate	262,234	23.4	245,797	25.5	243,966	26.4	264,727	26.7	343,532	27.4
Agricultural	44,706	4.0	47,367	4.9	56,808	6.1	75,018	7.5	195,185	15.6
Residential real estate	177,683	15.8	166,863	17.3	163,243	17.6	168,498	17.0	178,282	14.2
Consumer indirect	255,054	22.8	134,977	14.0	106,443	11.5	85,237	8.6	67,993	5.5
Consumer direct and home equity	222,859	19.9	232,389	24.1	250,216	27.0	282,397	28.5	264,235	21.1
Total loans	1,121,079	100.0%	964,173	100.0%	926,482	100.0%	992,321	100.0%	1,252,405	100.0%
	(18,749)		(15,521)		(17,048)		(20,231)		(39,186)	

Allowance for loan losses					
Total loans, net	$ 1,102,330	$ 948,652	$ 909,434	$ 972,090	$ 1,213,219

Total loans increased 16%, or $156.9 million, to $1.121 billion as of December 31, 2008 from $964.2 million as of December 31, 2007, primarily attributed to the expansion of the indirect lending program and commercial business development efforts, offset by a reduction in agricultural loans and the consumer direct and home equity category.
Commercial loans and commercial real estate loans increased $38.2 million to $420.8 million as of December 31, 2008 from $382.6 million as of December 31, 2007, a result of the Company s focused commercial business development programs. Agricultural loans decreased $2.7 million, to $44.7 million as of December 31, 2008 from $47.4 million as of December 31, 2007. Competition and adherence to strict credit standards has led to payments outpacing new loan originations in the agricultural portfolio.
Residential real estate loans increased $10.8 million to $177.7 million as of December 31, 2008 in comparison to $166.9 million as of December 31, 2007. The increase resulted from management s decision to add certain newly originated or refinanced residential mortgages, namely 15 year FHLMC conforming mortgages, to its portfolio rather than selling to the secondary market. The Company does not engage in sub-prime or other high-risk residential mortgage lending as a line-of-business.

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The consumer indirect portfolio increased 89% to $255.1 million as of December 31, 2008 from $135.0 million as of December 31, 2007. The Company increased its indirect portfolio by managing existing and developing new relationships with over 250 franchised auto dealers in Western and Central New York State. During the year ended December 31, 2008 the Company originated $180.9 million in indirect auto loans with a mix of approximately 38% new auto and 62% used auto. This compares with $76.6 million in indirect loan auto originations with a mix of approximately 41% new auto and 59% used auto for the same period in 2007.

The consumer direct and home equity portfolio decreased $9.5 million to $222.9 million as of December 31, 2008 in comparison to $232.4 million as of December 31, 2007. The decline in direct consumer and home equity products is reflective of an overall slowing in the economy, as well as the Company s policy to maintain a firm pricing and underwriting discipline on these products, which has led to slower loan originations in this category.

Parts of the country have experienced a significant decline in real estate values that has led, in some cases, to the debt on the real estate exceeding the value of the real estate. Generally, the Western and Central New York State markets the Company serves have not experienced, to this point, such conditions. Should deterioration in real estate values in the markets we serve occur, the value and liquidity of real estate securing the Company s loans could become impaired. While the Company is not engaged in the business of sub-prime lending, a decline in the value of residential or commercial real estate could have a material adverse effect on the value of property pledged as collateral for our loans. Adverse changes in the economy may have a negative effect on the ability of borrowers to make timely loan payments, which could have a negative impact on earnings.

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

	Delinquent and Non-performing Assets At December 31,				
	2008	**2007**	**2006**	**2005**	**2004**
Non-accruing loans:					
Commercial	$ 510	$ 827	$ 2,205	$ 4,389	$ 20,576
Commercial real estate	2,360	2,825	4,661	6,985	15,954
Agricultural	310	481	4,836	2,786	13,165
Residential real estate	3,365	2,987	3,127	2,615	1,473
Consumer indirect	445	278	166	63	74
Consumer direct and home equity	1,199	677	842	923	704
Total non-accruing loans	8,189	8,075	15,837	17,761	51,946
Restructured loans					
Accruing loans contractually past due over 90 days	7	2	3	276	2,018
Total non-performing loans	8,196	8,077	15,840	18,037	53,964
Foreclosed assets	1,007	1,421	1,203	1,099	1,196
Non-accruing commercial-related loans held for sale				577	
Non-performing investment securities	49				
Total non-performing assets	$ 9,252	$ 9,498	$ 17,043	$ 19,713	$ 55,160
Non-performing loans to total loans	0.73%	0.84%	1.71%	1.82%	4.31%

Non-performing assets to total assets	0.48%	0.51%	0.89%	0.97%	2.56%

Approximately $3.2 million, or 39.3%, of the $8.2 million in nonaccruing loans as of December 31, 2008 were current with respect to payment of principal and interest, but were classified as nonaccruing because reasonable doubt existed with respect to the future collectibility of principal and interest in accordance with the original contractual terms. For nonaccruing loans outstanding as of December 31, 2008, the amount of interest income forgone on nonaccruing loans totaled $546 thousand for the year ended December 31, 2008.

Potential problem loans are loans that are currently performing, but information known about possible credit problems of the borrowers causes management to have concern as to the ability of such borrowers to comply with the present loan payment terms and may result in disclosure of such loans as nonperforming at some time in the future. These loans remain in a performing status due to a variety of factors, including payment history, the value of collateral supporting the credits, and/or personal or government guarantees. Management considers loans classified as substandard, which continue to accrue interest, to be potential problem loans. The Company identified $20.5 million and $16.6 million in loans that continued to accrue interest which were classified as substandard as of December 31, 2008 and 2007, respectively.

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Loans Held for Sale

Loans held for sale (not included in the loan portfolio composition table) totaled $1.0 million and $906 thousand as of December 31, 2008 and 2007, respectively, all of which were residential real estate loans.

The Company sells certain qualifying newly originated and refinanced residential real estate mortgages on the secondary market. The sold and serviced residential real estate loan portfolio decreased to $315.7 million as of December 31, 2008 from $338.1 million as of December 31, 2007. The decrease in the sold and serviced portfolio partially resulted from management s decision to add certain newly originated or refinanced residential mortgages, namely 15 year FHLMC conforming mortgages, to its portfolio rather than selling to the secondary market, leading to payments and run-off outpacing new sold and serviced residential loan volumes.

Allowance for Loan Losses

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

	Loan Loss Analysis Year Ended December 31,				
	2008	2007	2006	2005	2004
Allowance for loan losses, beginning of year	$ 15,521	$ 17,048	$ 20,231	$ 39,186	$ 29,064
Charge-offs [1]:					
Commercial	675	562	1,195	12,980	4,486
Commercial real estate	1,190	439	501	15,397	1,779
Agricultural	47	56	379	18,543	2,519
Residential real estate	320	319	278	56	227
Consumer indirect	2,011	988	532	775	759
Consumer direct and home equity	1,216	1,531	1,314	1,535	1,027
Total charge-offs	5,459	3,895	4,199	49,286	10,797
Recoveries:					
Commercial	664	972	1,417	864	598
Commercial real estate	280	216	132	280	103
Agricultural	55	168	389	57	39
Residential real estate	26	50	71	5	43
Consumer indirect	548	235	224	261	212
Consumer direct and home equity	563	611	625	332	248
Total recoveries	2,136	2,252	2,858	1,799	1,243
Net charge-offs	3,323	1,643	1,341	47,487	9,554
Provision (credit) for loan losses	6,551	116	(1,842)	28,532	19,676
Allowance for loan losses, end of year	$ 18,749	$ 15,521	$ 17,048	$ 20,231	$ 39,186
Net charge-offs to average loans	0.32%	0.18%	0.14%	4.27%	0.74%
Allowance to end of period loans	1.67%	1.61%	1.84%	2.04%	3.13%
Allowance to end of period non-performing loans	229%	192%	108%	112%	73%

(1) During 2005 the Company transferred $169.0 million in commercial-related loans to held for sale, at an estimated fair value less costs to sell of $132.3 million, resulting in $36.7 million in commercial-related charge-offs. In the second half of 2005, the Company realized a net gain of $9.4 million on the ultimate sale or settlement of commercial-related loans held for sale.

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

	Allowance for Loan Losses At December 31,									
	2008		2007		2006		2005		2004	
	Loan Loss Allowance	Percentage of loans by category to total loans	Loan Loss Allowance	Percentage of loans by category to total loans	Loan Loss Allowance	Percentage of loans by category to total loans	Loan Loss Allowance	Percentage of loans by category to total loans	Loan Loss Allowance	Percentage of loans by category to total loans
Commercial	$ 2,871	14.1%	$ 1,878	14.2%	$ 2,443	11.4%	$ 4,098	11.7%	$ 11,420	16.2%
Commercial real estate	4,052	23.4	3,751	25.5	4,458	26.4	6,564	26.7	9,297	27.4
Agricultural	1,012	4.0	1,516	4.9	1,887	6.1	2,187	7.5	8,197	15.6
Residential real estate	2,516	15.8	1,763	17.3	1,748	17.6	1,252	17.0	910	14.2
Consumer indirect	5,152	22.8	2,284	14.0	1,749	11.5	1,032	8.6	666	5.5
Consumer direct and home equity	3,146	19.9	2,667	24.1	2,833	27.0	2,504	28.5	2,014	21.1
Unallocated			1,662		1,930		2,594		6,682	
Total	$ 18,749	100.0%	$ 15,521	100.0%	$ 17,048	100.0%	$ 20,231	100.0%	$ 39,186	100.0%

During the first quarter of 2008, management revised estimation techniques related to allocation of the allowance to specific loan segments. The result was the elimination of the unallocated portion of the allowance for loan losses and allocation of the entire balance to specific loan segments.

Management believes that the allowance for loan losses at December 31, 2008 is adequate to cover probable losses in the loan portfolio at that date. Factors beyond the Company s control, however, such as general national and local economic conditions, can adversely impact the adequacy of the allowance for loan losses. As a result, no assurance can be given that adverse economic conditions or other circumstances will not result in increased losses in the portfolio or that the allowance for loan losses will be sufficient to meet actual loan losses.

Funding Activities

Deposits

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

	At December 31,					
	2008		2007		2006	
	Amount	Percent	Amount	Percent	Amount	Percent
Noninterest-bearing demand	$ 292,586	17.9%	$ 286,362	18.2%	$ 273,783	16.9%
Interest-bearing demand	344,616	21.1	335,314	21.3	352,661	21.8

Savings and money market	348,594	21.3	346,639	22.0	321,563	19.9
Certificates of deposit < $100,000	482,863	29.6	453,140	28.7	474,321	29.3
Certificates of deposit of $100,000 or more	164,604	10.1	154,516	9.8	195,367	12.1
	$ 1,633,263	100.0%	$ 1,575,971	100.0%	$ 1,617,695	100.0%

The Company offers a variety of deposit products designed to attract and retain customers, with the primary focus on building and expanding long-term relationships. At December 31, 2008, total deposits were $1.633 billion, representing an increase of $57.3 million for the year. Certificates of deposit were 39.7% and 38.5% of total deposits at December 31, 2008 and 2007, respectively.

Nonpublic deposits represent the largest component of the Company s funding sources and totaled $1.280 billion and $1.251 billion as of December 31, 2008 and 2007, respectively. The Company has 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. Nonpublic deposit levels were positively impacted by the expansion of the Company s branch network in the metro-Rochester area, where de novo branches were added in Henrietta and Greece during the third and fourth quarters of 2008, respectively.

As an additional source of funding, the Company offers a variety of public deposit products to the many towns, villages, counties and school districts within our market. Public deposits generally range from 20% to 25% of the Company s total deposits. There is a high degree of seasonality in this component of funding, as the level of deposits varies with the seasonal cash flows for these public customers. The Company maintains the necessary levels of short-term liquid assets to accommodate the seasonality associated with public deposits. As of December 31, 2008, total public deposits were $352.8 million compared to $318.1 million as of December 31, 2007. In general, the number of public relationships remained stable in comparison to prior year. The Company continued to place less reliance on brokered certificates of deposit as $6.8 million in brokered deposits outstanding at December 31, 2007 were repaid at their scheduled maturity dates in the second quarter of 2008.

Short-term Borrowings

At December 31, 2008, short-term borrowings consisted of overnight repurchase agreements of $23.5 million. At December 31, 2007, short-term borrowings consisted of overnight borrowings with the Federal Home Loan Bank (FHLB) of $2.8 million and $22.8 million of overnight repurchase agreements.

Short-term borrowings from the FHLB are used to satisfy funding requirements resulting from daily fluctuations in deposit, loan and investment activities. FHLB borrowings are collateralized by certain investment securities, FHLB stock owned by the Company and certain qualifying loans.

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

	At or for the Year Ended December 31,		
	2008	2007	2006
Year-end balance	$ 23,465	$ 25,643	$ 32,310
Year-end weighted average interest rate	0.48%	2.71%	2.15%
Maximum outstanding at any month-end	$ 56,861	$ 44,944	$ 32,353
Average balance during the year:	$ 38,028	$ 29,048	$ 26,157
Average interest rate for the year:	1.90%	2.97%	2.18%

Long-term Borrowings

Long-term borrowings totaled $47.4 million at December 31, 2008 and consisted of $30.0 million in FHLB repurchase agreements entered into during 2008, $653 thousand of FHLB amortizing advances and $16.7 million in junior subordinated debentures. During the fourth quarter of 2008, the Company prepaid a $20.0 million long-term FHLB advance that bore a fixed interest rate of 5.52%.

In February 2001, the Company established FISI Statutory Trust I (the Trust), which issued 16,200 fixed rate pooled trust preferred securities with a liquidation preference of $1,000 per security. The trust preferred securities represent an interest in the related junior subordinated debentures of the Company, which were purchased by the Trust and have substantially the same payment terms as these trust preferred securities. The subordinated debentures mature in 2031 and are the only assets of the Trust and interest payments from the debentures finance the distributions paid on the trust preferred securities. Distributions on the debentures are payable quarterly at a fixed interest rate equal to 10.20%. The Company incurred $487 thousand in costs related to the issuance that are being amortized over 20 years using the straight-line method. The Trust is a variable interest entity as defined by FASB Interpretation No. 46R, Consolidation of Variable Interest Entities, an Interpretation of ARB No. 51, and, as such, the Trust is accounted for as an unconsolidated subsidiary.

Shareholders Equity

Shareholders equity decreased by $5.0 million in 2008 to $190.3 million at December 31, 2008. Additional repurchases of treasury stock totaling $4.8 million, combined with increases in accumulated other comprehensive loss of $4.7 million, common and preferred dividends of $7.4 million and a net operating loss of $26.2 million for the year ended December 31, 2008 offset the $37.5 million in proceeds from the issuance of the TARP preferred stock and related warrant. For detailed information on shareholders equity and details regarding the TARP preferred stock and related warrant, see Note 11, Shareholders Equity, of the notes to consolidated financial statements.

The Bank is subject to various regulatory capital requirements administered by the Federal Deposit Insurance Corporation (FDIC) and the New York State Banking Department (NYSBD). At December 31, 2008, the Bank s equity as a percentage of total assets exceeded all regulatory requirements. For detailed information on regulatory capital, see Note 10, Regulatory Matters, of the notes to consolidated financial statements.

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RESULTS OF OPERATIONS FOR THE YEARS ENDED DECEMBER 31, 2008 AND DECEMBER 31, 2007

Net Interest Income

Net interest income, the principal source of the Company s earnings, was $65.3 million in 2008 compared to $58.1 million in 2007. Net interest margin was 3.93% for the year ended December 31, 2008, an increase of 40 basis points from 3.53% for the same period last year. The 40 basis point increase in net interest margin was partially offset by a decline in average interest-earning assets of $9.3 million to $1.772 billion as of December 31, 2008 compared to $1.781 billion for the same period last year, which resulted in the $7.3 million increase in net interest income. The increase in net interest margin resulted from the average cost of funds decreasing 74 basis points while average earning asset yield decreased only 34 basis points. In 2008, earning asset yield benefited from a higher percentage of earning assets being deployed in higher yielding loan assets.

Average total loans for the year ended December 31, 2008 were $1.023 billion, up $85.4 million when compared with $937.8 million for the same period last year. The higher average consumer indirect and commercial portfolios more than offset the drop in the average consumer and home equity portfolio. Average total investment securities (excluding federal funds sold and other interest-bearing deposits) totaled $721.6 million for the year ended December 31, 2008, down from $811.1 million for the same period last year.

The Company s yield on average earning assets was 5.83% for 2008, down 34 basis points from 6.17% in 2007. The Company s loan portfolio yield was 6.61% for 2008, down 69 basis points from 2007, and the tax-equivalent investment yield was 4.84% for 2008, down 6 basis points from 2007.

Total average interest-bearing deposits were $1.335 billion for the year ended December 31, 2008, down slightly from $1.357 billion for the same period in 2007. Fewer certificates of deposit, including brokered certificates of deposit, contributed to the decline. Average short-term borrowings amounted to $38.0 million for 2008, up from $29.0 million for 2007. Average long-term borrowings totaled $53.7 million for the year ended December 31, 2008, up slightly from $51.6 million for the same period last year.

The rate on interest-bearing liabilities for the year ended December 31, 2008 was 2.36%, a decrease of 92 basis points from 2007. The decrease primarily resulted from lower general market interest rates experienced in 2008 and a favorable shift to lower cost funding sources.

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

	Years ended December 31,								
	2008			2007			2006		
	Average Balance	Interest	Average Rate	Average Balance	Interest	Average Rate	Average Balance	Interest	Average Rate
Interest-earning assets:									
Federal funds sold and other interest-earning deposits	$ 26,568	$ 619	2.33%	$ 31,756	$ 1,662	5.23%	$ 44,857	$ 2,288	5.10%
Investment securities:									
Taxable	487,687	21,882	4.49	557,035	25,414	4.56	559,864	23,859	4.26
Tax-exempt	208,519	11,059	5.30	234,078	12,880	5.50	251,439	13,663	5.43
Tax-preferred	25,345	2,006	7.91	20,005	1,463	7.31	81	52	63.67
Total investment securities	721,551	34,947	4.84	811,118	39,757	4.90	811,384	37,574	4.63
Loans held for sale	821	51	6.23	770	54	6.99	698	42	5.95
Loans:									
Commercial	149,927	9,141	6.10	119,823	9,728	8.12	111,118	8,910	8.02
Commercial real estate	247,475	17,086	6.90	244,357	18,230	7.46	249,899	18,455	7.39
Agricultural	45,035	3,126	6.94	53,356	4,351	8.16	64,658	5,189	8.02
Residential real estate	171,262	10,710	6.25	165,226	10,815	6.55	164,730	10,676	6.48
Consumer indirect	185,197	13,098	7.07	118,152	8,067	6.83	96,260	6,063	6.30
Consumer direct and home equity	224,343	14,462	6.45	236,910	17,315	7.31	265,817	18,669	7.02
Total loans	1,023,239	67,623	6.61	937,824	68,506	7.30	952,482	67,962	7.14
Total interest-earning assets	1,772,179	103,240	5.83	1,781,468	109,979	6.17	1,809,421	107,866	5.96
Less: Allowance for loan losses	16,287			16,587			19,338		
	149,453			142,156			148,937		

Other noninterest-earning assets									
Total assets	$ 1,905,345			$ 1,907,037			$ 1,939,020		
Interest-bearing liabilities:									
Deposits:									
Interest-bearing demand	$ 347,702	3,246	0.93	$ 338,326	5,760	1.70	$ 379,434	6,705	1.77
Savings and money market	369,926	3,773	1.02	346,131	5,863	1.69	333,155	4,320	1.30
Certificates of deposit	617,381	22,330	3.62	672,239	31,091	4.63	664,358	26,420	3.98
Total interest-bearing deposits	1,335,009	29,349	2.20	1,356,696	42,714	3.15	1,376,947	37,445	2.72
Short-term borrowings	38,028	721	1.90	29,048	864	2.97	26,157	571	2.18
Long-term borrowings	53,687	3,547	6.61	51,561	3,561	6.91	83,725	5,588	6.67
Total interest-bearing liabilities	1,426,724	33,617	2.36	1,437,305	47,139	3.28	1,486,829	43,604	2.93
Noninterest-bearing deposits	280,467			266,239			258,416		
Other liabilities	15,249			17,966			17,638		
Shareholders equity	182,905			185,527			176,137		
Total liabilities and shareholders equity	$ 1,905,345			$ 1,907,037			$ 1,939,020		
Net interest income (tax-equivalent)		$ 69,623			$ 62,840			$ 64,262	
Interest rate spread			3.47%			2.89%			3.03%
Net earning assets	$ 345,455			$ 344,163			$ 322,592		
Net interest margin (tax-equivalent)			3.93%			3.53%			3.55%
Ratio of average interest-earning assets To average interest-bearing	124.21%			123.95%			121.70%		

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Rate /Volume Analysis

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

	December 31, 2008 vs. 2007			December 31, 2007 vs. 2006		
	Increase/(Decrease) Due to Change in		Total Net	Increase/(Decrease) Due to Change in		Total Net
	Average Volume	Average Rate	Increase (Decrease)	Average Volume	Average Rate	Increase (Decrease)
Interest-earning assets:						
Federal funds sold and other interest-earning deposits	$ (238)	$ (805)	$ (1,043)	$ (685)	$ 59	$ (626)
Investment securities:						
Taxable	(3,118)	(414)	(3,532)	(122)	1,677	1,555
Tax-exempt	(1,368)	(453)	(1,821)	(953)	170	(783)
Tax-preferred	415	128	543	1,498	(87)	1,411
Total investment securities			(4,810)			2,183
Loans held for sale	4	(7)	(3)	4	8	12
Loans:						
Commercial	2,138	(2,725)	(587)	706	112	818
Commercial real estate	230	(1,374)	(1,144)	(412)	187	(225)
Agricultural	(627)	(598)	(1,225)	(921)	83	(838)
Residential real estate	387	(492)	(105)	32	107	139
Consumer indirect	4,732	299	5,031	1,464	540	2,004
Consumer direct and home equity	(885)	(1,968)	(2,853)	(2,090)	736	(1,354)
Total loans			(883)			544
Total interest-earning assets			(6,739)			2,113
Interest-bearing liabilities:						
Deposits:						
Interest-bearing demand	156	(2,670)	(2,514)	(707)	(238)	(945)
Savings and money market	379	(2,469)	(2,090)	174	1,369	1,543
Certificates of deposit	(2,386)	(6,375)	(8,761)	316	4,355	4,671
Total interest-bearing deposits			(13,365)			5,269
Short-term borrowings	222	(365)	(143)	68	225	293
Long-term borrowings	144	(158)	(14)	(2,215)	188	(2,027)
Total interest-bearing liabilities			(13,522)			3,535
Change in net interest income			6,783			(1,422)

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Provision for Loan Losses

The provision for loan losses totaled $6.5 million for the year ended December 31, 2008, versus $116 thousand for 2007. The increase in the provision for is primarily due to growth in the consumer indirect loan portfolio and a $1.7 million increase in net charge-offs during 2008. See the Analysis on Allowance for Loan Losses and Allocation of Allowance for Loan Losses sections for further discussion.

Noninterest (Loss) Income

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

	2008	2007	2006
Service charges on deposits	$ 10,497	$ 10,932	$ 11,504
ATM and debit card	3,313	2,883	2,233
Broker-dealer fees and commissions	1,458	1,396	1,511
Loan servicing	664	928	892
Company owned life insurance	563	1,255	521
Net gain on sale of loans held for sale	339	779	972
Net gain on sale of other assets	305	89	169
Net gain on investment securities	288	207	30
Net gain on sale of trust relationships		13	1,386
Impairment charges on investment securities	(68,215)		
Other	2,010	2,198	2,693
Total noninterest (loss) income	$ (48,778)	$ 20,680	$ 21,911

Service charges on deposits declined to $10.5 million for the year ended December 31, 2008 compared with $10.9 million for the same period in 2007, a result of fewer customer overdrafts and related service fees.

Automated Teller Machine (ATM) and debit card income, which represents fees for foreign ATM usage and income associated with customer debit card transactions, totaled $3.3 million and $2.9 million for the years ended December 31, 2008 and 2007, respectively. ATM and debit card income has increased as a result of higher ATM usage fees and an increase in customer utilization of debit card point-of-sale transactions.

Broker-dealer fees and commissions increased due to slightly higher sales volumes.

Loan servicing income represents fees earned for servicing mortgage loans sold to third parties, net of amortization expense and impairment losses associated with capitalized mortgage servicing assets. Loan servicing income in 2008 was adversely impacted by a $343 thousand impairment charge on capitalized mortgage servicing assets that resulted from an increase in prepayment assumptions used to value capitalized mortgage servicing assets, a direct result of the decline in mortgage interest rates experienced in 2008. The impairment charge recorded in 2007 totaled $18 thousand.

For the year ended December 31, 2007, company owned life insurance included $1.1 million in income from the receipt of insurance proceeds. The Company invested $20.0 million in company owned life insurance during the third quarter of 2008, which would have resulted in an increase in income compared to prior year absent the death benefit proceeds received in 2007.

Net gain on sale of loans held for sale declined compared to prior year due primarily to lower student loan sale volumes, which resulted from increased competition and changing market conditions for student loans as the Company exited the business in 2008. For the years ended December 31, 2008 and 2007, student loan sale net gains were $104 thousand and $478 thousand, respectively.

The net gain on sale of other assets includes gains and losses on premises, equipment, other real estate (ORE) and repossessed assets and the increase in the net gain for 2008 was favorable in comparison to 2007.

The impairment charges on investment securities totaled $68.2 million in 2008. See the Investing Activities section for further discussion.

Noninterest Expense

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

	2008	2007	2006
Salaries and employee benefits	$ 31,437	$ 33,175	$ 33,563
Occupancy and equipment	10,502	9,903	9,465
Computer and data processing	2,433	2,126	1,903
Professional services	2,141	2,080	2,837
Supplies and postage	1,800	1,662	1,945
Advertising and promotions	1,453	1,402	1,974
Other	7,695	7,080	7,925
Total noninterest expense	$ 57,461	$ 57,428	$ 59,612

For the year ended December 31, 2008, salaries and benefits totaled $31.4 million, down $1.7 million from the prior year. The factors that contributed to the decline were as follows: a reduction in annual incentive compensation as certain senior management incentive targets contingent on 2008 financial results were not achieved; an increase in the amount of salaries and wages allocated to deferred direct loan origination costs due to higher loan origination volumes; and lastly, a reduction in full-time equivalent employees (FTEs) to 600 as of year-end 2008, a decrease of 21 FTEs compared to prior year-end.

The Company experienced a 6% increase in occupancy and equipment expenses in 2008 to $10.5 million, compared to $9.9 million in 2007. The increase was partly a result of the expansion of the branch network in the metro-Rochester area, as de novo branches were added in Henrietta and Greece during the third and fourth quarters of 2008, respectively. Also contributing to the increase in 2008 were technology upgrades and higher service contract related expenses associated with equipment and computer software.

Supplies and postage increased 8% for the year ended December 31, 2008 versus 2007, primarily the result of higher postage costs.

Computer and data processing costs increased 14% in 2008 compared to the prior year, primarily due to higher debit card data transaction processing expense due to increased customer point-of-sale transaction volumes.

Professional fees and services increased 3% for the year ended December 31, 2008 compared to 2007, primarily due to costs incurred in 2008 associated with valuation of the investment securities portfolio.

Other expenses increased 9% or $615 thousand for the year ended December 31, 2008. Factors that contributed to the increase included a $385 thousand increase in FDIC insurance and a $557 thousand prepayment charge on borrowed funds. Partly offsetting those increases were lower levels of commercial-related loan workout expenses and other real estate expense (ORE) expenses in 2008.

The efficiency ratio for the year ended December 31, 2008 was 64.07% compared with 68.77% for 2007. The improved efficiency ratio is reflective of the higher level of net interest income and relatively flat noninterest expense. The efficiency ratio equals noninterest expense less other real estate expense and amortization of intangible assets as a percentage of net revenue, defined as the sum of tax-equivalent net interest income and noninterest income before net gains and impairment charges on investment securities, proceeds from company owned life insurance included in income and net gain on sale of trust relationships.

Income Taxes

The income tax (benefit) expense amounted to $(21.3) million and $4.8 million for the years ended December 31, 2008 and 2007, respectively. The fluctuation in income tax expense corresponded in general with the level of net income before tax. The Company s effective tax rates were (44.9)% in 2008 and 22.6% in 2007. Effective tax rates are affected by income and expense items that are not subject to Federal or state taxation. The Company s income tax provision reflects the impact of such items, including tax-exempt interest income from municipal securities, tax-exempt earnings on bank-owned life insurance and the effect of certain state tax credits. The unusual 2008 effective tax benefit rate results from the relationship between the size of the favorable permanent differences and

pre-tax loss.

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RESULTS OF OPERATIONS FOR THE YEARS ENDED DECEMBER 31, 2007 AND DECEMBER 31, 2006

Net Interest Income

Net interest income on a tax-equivalent basis was $58.1 million in 2007, compared to $59.5 million in 2006. The net interest margin was 3.53% for the year ended December 31, 2007, a drop of 2 basis points from 3.55% for the same period in 2006. A $28.0 million decline in average earning assets for the year ended December 31, 2007, together with the decline in the net interest margin, resulted in the $1.4 million drop in net interest income when comparing 2007 to 2006. The decline in average earning assets was affected by average total borrowings declining $29.3 million due to the repayment and maturity of borrowings. The drop in net interest margin resulted from the average cost of funds increasing 23 basis points while average earning asset yield increased only 21 basis points. Net interest margin improved in the second half of 2007, principally the result of a reduction in funding costs, an improved investment security portfolio yield and the benefits associated with a higher percentage of earning assets being deployed in higher yielding loan assets.

Average total loans for the year ended December 31, 2007 were $937.8 million, down $14.7 million, or 1.5%, when compared with $952.5 million for the same period in 2006. The increased average consumer indirect portfolio was more than offset by a drop in the average consumer and home equity portfolio.

The Company s yield on average earning assets was 6.17% for 2007, up 21 basis points from 5.96% in 2006. The Company s loan portfolio yield was 7.30% for 2007, up 16 basis points from 2006, and the tax-equivalent investment yield was 4.90% for 2007, up 27 basis points from 2006.

Total average interest-bearing deposits were $1.357 billion for the year ended December 31, 2007, down 1.5% from $1.377 billion for the same period in 2006. Fewer certificates of deposit, including brokered certificates of deposit, contributed to the decline. Average borrowings amounted to $80.6 million for 2007, down from $109.9 million for 2006. The Company s favorable liquidity position allowed for a managed reduction in higher cost deposits and borrowings.

The rate on interest-bearing liabilities for the year ended December 31, 2007 was 3.28%, an increase of 35 basis points over 2006. The increase primarily resulted from higher interest-bearing deposit and short-term borrowing costs due to the higher general market interest rates experienced in 2007, partially offset by a decrease in the rate of long-term borrowings, which declined as a result of the maturity and repayment of higher cost long-term borrowings.

Provision for Loan Losses

The provision for loan losses totaled $116 thousand in 2007, versus a credit for loan losses of $1.8 million in 2006. The increase in the provision for 2007 is primarily due to growth in the loan portfolio, partially offset by the reduction in non-performing loans. Net loan charge-offs were $1.6 million, or 0.18% of average loans, for the year ended December 31, 2007, compared with $1.3 million, or 0.14% of average loans for 2006.

Noninterest Income

Noninterest income for the year ended December 31, 2007 was $20.7 million, down from $21.9 million in the prior year.

Service charges on deposits declined for the year ended December 31, 2007 compared with 2006, a direct result of fewer customer overdrafts and related service fees.

Automated Teller Machine (ATM) and debit card income increased as a result of higher ATM usage fees and an increase in customer utilization of debit card point-of-sale transactions.

Broker-dealer fees and commissions declined due to lower sales volumes. Loan servicing increased slightly in 2007 versus 2006 despite the decrease in the sold and serviced residential mortgage portfolio, a result of a decrease in the amortization of capitalized mortgage servicing assets.

For the years ended December 31, 2007 and 2006, company owned life insurance included $1.1 million and $419 thousand in income, respectively, associated with the proceeds from company owned life insurance policies.

Net gain on sale of loans held for sale declined compared to prior year due primarily to lower student loan sale volumes resulting from increased competition and changing market conditions for student loans. For the years ended December 31, 2007 and 2006, net gains from the sale of student loans were $478 thousand and $670 thousand, respectively.

The net gain on sale or call of securities increased in 2007 as the Company experienced an increase in call activity on investment securities with unamortized discount due to changes in the interest rate environment.
There were no trust fees in 2007, as the Company sold its trust relationships in 2006, as reflected by the $1.4 million net gain on sale of trust relationships included in noninterest income in the third quarter of 2006.

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Noninterest Expense

Noninterest expense for the year ended December 31, 2007 decreased $2.2 million or 3.7% to $57.4 million from $59.6 million for the year ended December 31, 2006. This decline was consistent with management s continued focus on reduction of costs.

For the year ended December 31, 2007, salaries and benefits totaled $33.2 million, down $388 thousand from the prior year. The Company managed a reduction in full-time equivalent employees (FTEs) to 621 as of December 31, 2007, a decrease of 19 FTEs versus the prior year-end. Salaries and wage expense also decreased during 2007 due to an increase in the amount of salaries and wages that were allocated to deferred direct loan origination costs, a direct result of the higher loan origination volumes. The reduction in salaries and wages was partially offset by increases in employee benefits, including stock-based compensation expense, health care costs and the Company s 401(k) benefit plan match, which in turn, was offset by a reduction in pension expense from plan changes implemented during 2007.

The Company has experienced a 4.6% increase in occupancy and equipment expenses when 2007 is compared to 2006. The increase primarily resulted from a higher service contract related expenses associated with equipment and computer software.

Supplies and postage declined 14.6% for the year ended December 31, 2007 versus 2006. The decline was associated with cost reduction efforts and higher than normal expense incurred in the first quarter of 2006 due to the purchase of branding-related stationery and supplies.

Computer and data processing costs increased in 2007 compared to the prior year. The Bank experienced higher debit card data transaction processing expense due to increased customer point-of-sale transaction volumes.

Professional services declined 26.7% for the year ended December 31, 2007 compared to 2006, primarily due to lower legal and external loan review costs associated with commercial-related problem loans.

Other noninterest expense decreased 10.7% for the year ended December 31, 2007. The Company experienced a reduction in commercial-related loan expenses during 2007, a direct result of the lower level of nonperforming loans, which was partially offset by increased other real estate expense (ORE), as the Bank experienced higher ORE write-downs in 2007. In addition, the Company experienced declines in other bank charges, donations and severance expense, all consistent with management s focus on overall cost reduction. The expense related to the amortization of other intangible assets, which is included in other noninterest expense, also declined in 2007 versus 2006 due to run-off, as certain intangible assets were fully amortized in 2006.

The efficiency ratio for the year ended December 31, 2007 was 68.77% compared with 69.78% for 2006. The improved efficiency ratio is reflective of the lower levels of noninterest expense, partially offset by lower revenues. The efficiency ratio represents noninterest expense less other real estate expense and amortization of intangibles, divided by net interest income (tax-equivalent) plus other noninterest income less net gain on sale or call of securities, income associated with the proceeds from company owned life insurance, net gain on sale of commercial-related loans held for sale and net gain on sale of trust relationships.

Income Taxes

The income tax expense provided for federal and New York State income taxes amounted to $4.8 million and $6.2 million for the years ended December 31, 2007 and 2006, respectively. The fluctuation in income tax expense corresponded in general with taxable income levels for each year. The effective tax rate for 2007 was 22.6%, compared to 26.5% in 2006. The lower effective tax rates resulted, in part, from the $1.3 million and $521 thousand in non-taxable corporate owned life insurance income recorded in 2007 versus 2006, respectively.

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2008 FOURTH QUARTER RESULTS

Net loss for the fourth quarter of 2008 was $3.1 million, or $0.33 loss per share, compared with a net loss of $28.4 million, or $2.68 loss per share, for the third quarter of 2008 and net income of $4.1 million, or $0.34 earnings per diluted share, in the fourth quarter of the prior year. The net losses in the third and fourth quarters of 2008 were a result of the impact of OTTI charges recorded on certain securities in the Company s AFS securities portfolio.

Net interest income was $17.3 million for the fourth quarter of 2008, up $567 thousand or 3% from the third quarter of 2008 and $2.1 million or 14% compared with the fourth quarter of 2007. Net interest margin improved to 4.07% in the fourth quarter of 2008, compared with 3.98% in the third quarter of 2008 and 3.75% in the fourth quarter of 2007.

The Company recorded a provision for loan losses of $2.6 million for the fourth quarter of 2008, compared with $351 thousand in the fourth quarter of 2007. The increase in the provision for loan losses is primarily due to growth in the loan portfolio and the changing mix of the loan portfolio together with higher net charge offs. Net charge offs of $1.3 million for the fourth quarter of 2008 represented 46 basis points (annualized) of average loans.

Noninterest income (loss) for the fourth quarter of 2008 was $(25.1) million, compared with $(29.3) million and $5.0 million in the third quarter of 2008 and the fourth quarter of 2007, respectively. The 2008 periods reflect OTTI charges on certain securities in the Company s AFS securities portfolio totaling $29.9 million for the fourth quarter and $34.6 million for the third quarter. Absent the OTTI charges in 2008, noninterest income would have been $4.8 million in the fourth quarter versus $5.2 million in the third quarter of 2008 and $5.0 million in the fourth quarter of 2007. The decrease, exclusive of OTTI charges, is primarily the result of lower service charges on deposits and broker-dealer fees and commissions offset by higher income from company owned life insurance due to a $20.0 million purchase of company owned life insurance made during the third quarter of 2008.

Noninterest expense for the fourth quarter of 2008 was $15.4 million, compared with $13.4 million and $14.5 million in the third quarter of 2008 and fourth quarter of 2007, respectively. The fourth quarter of 2008 results include a $557 thousand prepayment charge on the early repayment of borrowed funds and also a $259 thousand increase in FDIC insurance expense compared with the fourth quarter of last year. The third quarter of 2008 included $1.0 million in reversals of accrued incentive compensation in recognition that certain senior management incentive targets contingent on 2008 financial results would not be met.

The Company recorded income tax (benefit) expense of $(22.6) million and $524 thousand in the fourth and third quarters of 2008, respectively, compared to $1.2 million in the fourth quarter of 2007. In the third quarter of 2008, the tax benefit recognized on the OTTI charge was based on the treatment of a substantial portion of the charge being classified as a capital loss for tax purposes, which significantly limited the tax benefit. Subsequently, on October 3, 2008, the Emergency Economic Stabilization Act was enacted, which included a provision permitting banks, under certain circumstances, to recognize losses relating to Fannie Mae and Freddie Mac preferred stock as an ordinary loss, therefore the fourth quarter results reflected the recognition of a $12.0 million tax benefit associated with the third quarter OTTI charge.

Total assets at December 31, 2008 were $1.917 billion, up $59.0 million from $1.858 billion at December 31, 2007. Total loans were $1.121 billion at December 31, 2008, an increase of $156.9 million from $964.2 million at December 31, 2007, principally from a $120.1 million increase in indirect auto loans. Total deposits increased $57.3 million to $1.633 billion at December 31, 2008, versus $1.576 billion at December 31, 2007. Total borrowings, including junior subordinated debentures, increased $2.6 million to $70.8 million at December 31, 2008, up from $68.2 million at December 31, 2007. Total shareholders equity at December 31, 2008 was $190.3 million, compared with $195.3 million at December 31, 2007. The Company s leverage ratio was 8.05% and total risk-based capital ratio was 13.08% at December 31, 2008, which is within the regulatory standard to be deemed a well-capitalized institution.

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LIQUIDITY AND CAPITAL RESOURCES

The objective of maintaining adequate liquidity is to assure the ability of the Company to meet its 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. The Company achieves liquidity by maintaining a strong base of core customer funds, maturing short-term assets, its ability to sell securities, lines-of-credit, and access to the financial and capital markets.

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

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

The Company s cash and cash equivalents were $55.2 million as of December 31, 2008, up from $46.7 million as of December 31, 2007. The Company s net cash provided by operating activities totaled $21.3 million and the principal source of operating activity cash flow was net (loss) income adjusted for noncash income and expense items and changes in other assets and other liabilities. Net cash used in investing activities totaled $97.8 million, which included net loan origination funding of $161.4 million offset by net proceeds of $88.3 million from the net decrease in securities. Net cash provided by financing activities of $85.0 million was attributed to the $57.3 million increase in deposits and the $35.6 million in proceeds from issuance of preferred and common shares.

Contractual Obligations and Other Commitments

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

	At December 31, 2008				
	Within 1 year	**Over 1 to 3 years**	**Over 3 to 5 Years**	**Over 5 years**	**Total**
Certificates of deposit [1]	$ 546,266	$ 86,588	$ 14,102	$ 511	$ 647,467
Long-term borrowings	508	30,145			30,653
Junior subordinated debentures				16,702	16,702
Operating leases	1,237	2,050	1,815	5,215	10,317
Limited partnership investments [2]	1,865	1,865			3,730
Service agreements	720	108			828
Commitments to extend credit [3]	339,454				
Standby letters of credit [3]	7,902				

(1) Includes the maturity of certificates of deposit amounting to $100 thousand or more as follows: $87.5 million in

three months or less; $30.1 million between three months and six months; $33.3 million between six months and one year; and $13.7 million over one year.

(2) The Company has committed to capital investments in several limited partnerships of up to $5.5 million. As of December 31, 2008, the Company has contributed $1.8 million to the partnerships, including $425 thousand during 2008.

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

With the exception of the Company s obligations in connection with its trust preferred securities and in connection with its irrevocable loan commitments, the Company had no other off-balance sheet arrangements that have or are reasonably likely to have a current or future effect on its financial condition, changes in financial condition, revenues or expenses, results of operations, liquidity, capital expenditures or capital resources that is material to investors. For

additional information on off-balance sheet arrangements, see Note 1, Summary of Significant Accounting Policies and Note 9, Commitments and Contingencies, in the notes to the accompanying consolidated financial statements.

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Security Yields and Maturities Schedule

The following table sets forth certain information regarding the amortized cost (Cost), weighted average yields (Yield) and contractual maturities of the Company s debt securities portfolio as of December 31, 2008. 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 (in thousands).

	Due in one year or less		Due from one to five years		Due after five years through ten years		Due after ten years		Total	
	Cost	Yield	Cost	Yield	Cost	Yield	Cost	Yield	Cost	Yield
Available for sale debt securities:										
U.S. Government agency and government-sponsored enterprise	$ 28,899	3.12%	$ 19,414	3.96%	$ 4,994	4.05%	$ 14,563	2.40%	$ 67,871	3.27%
Mortgage-backed securities	7,518	3.82	85,709	4.18	56,121	4.19	190,226	4.89	339,574	4.57
Other asset-backed securities					147	3.66	3,771	5.26	3,918	5.20
State and municipal obligations	42,284	3.42	69,168	3.61	16,640	3.46	1,481	3.44	129,572	3.53
	78,701	3.35	174,291	3.93	77,902	4.02	210,041	4.71	540,935	4.16
Held to maturity debt securities:										
State and municipal obligations	45,124	2.71	10,773	3.84	2,063	4.78	572	5.37	58,532	3.02
	$ 123,825	3.12%	$ 185,064	3.93%	$ 79,965	4.04%	$ 210,613	4.71%	$ 599,467	4.05%

Contractual Loan Maturity Schedule

The following table summarizes the contractual maturities of the Company s loan portfolio at December 31, 2008. Loans, net of deferred loan origination costs, include principal amortization and non-accrual loans. Demand loans having no stated schedule of repayment or maturity and overdrafts are reported as due in one year or less (in thousands).

	Due in less than one year	Due from one to five years	Due after five years	Total
Commercial	$ 87,175	$ 62,227	$ 9,141	$ 158,543
Commercial real estate	70,694	132,735	58,805	262,234
Agricultural	16,817	16,649	11,240	44,706
Residential real estate	48,682	87,407	41,594	177,683
Consumer indirect	96,718	151,771	6,565	255,054
Consumer direct and home equity	53,735	102,707	66,417	222,859

Total loans	$	373,821	$	553,496	$	193,762	$	1,121,079
Loans maturing after one year:								
With a predetermined interest rate			$	192,464	$	126,903	$	319,367
With a floating or adjustable rate				361,032		66,859		427,891
Total loans maturing after one year			$	553,496	$	193,762	$	747,258

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Capital Resources

The FRB has adopted a system using risk-based capital guidelines to evaluate the capital adequacy of bank holding companies on a consolidated basis. The guidelines require a minimum Tier 1 leverage ratio of 4.00%, a minimum Tier 1 capital ratio of 4.00% and a minimum total risk-based capital ratio of 8.00%. The following table reflects the ratios and their components (in thousands):

	2008	2007
Total shareholders equity	$ 190,300	$ 195,322
Less: Unrealized gain (loss) on securities available for sale, net of tax	3,463	(500)
Unrecognized net periodic pension & postretirement benefits (costs), net of tax	(7,476)	1,167
Disallowed goodwill and other intangible assets	37,650	37,956
Disallowed deferred tax assets	22,437	
Plus: Qualifying trust preferred securities	16,200	16,200
Tier 1 capital	$ 150,426	$ 172,899
Adjusted average total assets (for leverage capital purposes)	$ 1,869,111	$ 1,848,584
Tier 1 leverage ratio (Tier 1 capital to adjusted average total assets)	8.05%	9.35%
Total Tier 1 capital	$ 150,426	$ 172,899
Plus: Qualifying allowance for loan losses	15,936	13,753
Total risk-based capital	$ 166,362	$ 186,652
Net risk-weighted assets	$ 1,272,028	$ 1,098,476
Tier 1 capital ratio (Tier 1 capital to net risk-weighted assets)	11.83%	15.74%
Total risk-based capital ratio (Total risk-based capital to net risk-weighted assets)	13.08%	16.99%

RECENT ACCOUNTING PRONOUNCEMENTS

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

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ITEM 7A. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

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

Net Interest Income at Risk Analysis

The primary tool the Company uses to manage interest rate risk is a rate shock simulation to measure the rate sensitivity of the statement of financial condition. Rate shock simulation is a modeling technique used to estimate the impact of changes in rates on net interest income and economic value of equity. The following table sets forth the results of the modeling analysis as of December 31, 2008 (dollars in thousands):

Changes in interest rate	Net Interest Income Amount	Net Interest Income Change		Economic Value of Equity Amount	Economic Value of Equity Change	
+ 200 basis points	$ 71,287	$ 1,379	1.97%	$ 381,831	$ 7,211	1.92%
+ 100 basis points	70,655	747	1.07	380,915	6,295	1.68
- 100 basis points	69,087	(821)	(1.17)	379,048	4,427	1.18
- 200 basis points	67,671	(2,237)	(3.20)	384,737	10,117	2.70

The Company measures net interest income at risk 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. As of December 31, 2008, a 200 basis point increase in rates would increase net interest income by $1.4 million, or 1.97%, over the next twelve-month period. A 200 basis point decrease in rates would decrease net interest income by $2.2 million, or 3.20%, over a twelve-month period. As of December 31, 2008, a 200 basis point increase in rates would increase the economic value of equity by $7.2 million, or 1.92%, over the next twelve-month period. A 200 basis point decrease in rates would increase the economic value of equity by $10.1 million, or 2.70%, over a twelve-month period. This simulation is based on management s assumption as to the effect of interest rate changes on assets and liabilities and assumes a parallel shift of the yield curve. It also includes certain assumptions about the future pricing of loans and deposits in response to changes in interest rates. Further, it assumes that delinquency rates would not change as a result of changes in interest rates, although there can be no assurance that this will be the case. While this simulation is a useful measure as to net interest income at risk due to a change in interest rates, it is not a forecast of the future results and is based on many assumptions that, if changed, could cause a different outcome.
In addition to the changes in interest rate scenarios listed above, the Company typically runs other scenarios to measure interest rate risk, which vary depending on the economic and interest rate environments.

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The following table presents an analysis of the Company s interest rate sensitivity gap position at December 31, 2008. All interest-earning assets and interest-bearing liabilities are shown based on the earlier of their contractual maturity or repricing date. The expected maturities are presented on a contractual basis or, if more relevant, based on projected call dates. Investment securities are at amortized cost for both securities available for sale and securities held to maturity. Loans, net of deferred loan origination costs, include principal amortization adjusted for estimated prepayments (principal payments in excess of contractual amounts) and non-accrual loans. Borrowings include junior subordinated debentures. Because the interest rate sensitivity levels shown in the table could be changed by external factors such as loan prepayments and liability decay rates or by factors controllable by the Company such as asset sales, it is not an absolute reflection of our potential interest rate risk profile (in thousands).

	At December 31, 2008				
	Three Months or Less	Over Three Months Through One Year	Over One Year Through Five Years	Over Five Years	Total
INTEREST-EARNING ASSETS:					
Federal funds sold and interest-earning deposits in other banks	$ 20,574	$	$ 85	$	$ 20,659
Investment securities	86,574	201,816	277,543	34,457	600,390
Loans held for sale	1,013				1,013
Loans	346,857	208,972	486,835	78,415	1,121,079
Total interest-earning assets	$ 455,018	$ 410,788	$ 764,463	$ 112,872	1,743,141
Cash and due from banks					34,528
Other assets (1)					139,250
Total assets					$ 1,916,919
INTEREST-BEARING LIABILITIES:					
Interest-bearing demand, savings and money market	$ 693,210	$	$	$	$ 693,210
Certificates of deposit	208,856	337,410	100,690	511	647,467
Borrowings	23,943	30	30,145	16,702	70,820
Total interest-bearing liabilities	$ 926,009	$ 337,440	$ 130,835	$ 17,213	1,411,497
Noninterest-bearing deposits					292,586
Other liabilities					22,536
Total liabilities					1,726,619
Shareholders equity					190,300
Total liabilities and shareholders equity					$ 1,916,919

Interest sensitivity gap	$ (470,991)	$ 73,348	$ 633,628	$ 95,659	$ 331,644
Cumulative gap	$ (470,991)	$ (397,643)	$ 235,985	$ 331,644	$
Cumulative gap ratio [2]	49.1%	68.5%	116.9%	123.5%	
Cumulative gap as a percentage of total assets	(24.6)%	(20.7)%	12.3%	17.3%	

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

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

For purposes of interest rate risk management, the Company directs more attention on simulation modeling, such as net interest income at risk as previously discussed, rather than gap analysis. The net interest income at risk simulation modeling is considered by management to be more informative in forecasting future income at risk.

ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES

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Management s Report on Internal Control over Financial Reporting

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

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

The Company s management has assessed the effectiveness of the Company s internal control over financial reporting as of December 31, 2008. To make this assessment, we used the criteria for effective internal control over financial reporting described in *Internal Control Integrated Framework*, issued by the Committee of Sponsoring Organizations of the Treadway Commission. Based on our assessment and based on such criteria, we believe that, as of December 31, 2008, the Company s internal control over financial reporting was effective.

The Company s independent registered public accounting firm that audited the Company s consolidated financial statements has issued an attestation report on internal control over financial reporting as of December 31, 2008. That report appears herein.

/s/ Peter G. Humphrey
President and Chief Executive Officer
March 12, 2009

/s/ Ronald A. Miller
Executive Vice President and Chief Financial Officer
March 12, 2009

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Report of Independent Registered Public Accounting Firm

The Board of Directors and Shareholders
Financial Institutions, Inc.:

We have audited Financial Institutions, Inc. and subsidiaries (the Company) internal control over financial reporting as of December 31, 2008, based on criteria established in *Internal Control Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). The Company s management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting, included in the accompanying Management Report. Our responsibility is to express an opinion on the Company s internal control over financial reporting based on our audit.

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

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

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

In our opinion, the Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 2008, based on criteria established in *Internal Control Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO).

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated statements of financial condition of the Company as of December 31, 2008 and 2007, and the related consolidated statements of operations, changes in shareholders equity, and cash flows for each of the years in the three-year period ended December 31, 2008, and our report dated March 12, 2009 expressed an unqualified opinion on those consolidated financial statements.

/s/ KPMG LLP
Buffalo, New York
March 12, 2009

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Report of Independent Registered Public Accounting Firm

The Board of Directors and Shareholders
Financial Institutions, Inc.:

We have audited the accompanying consolidated statements of financial condition of Financial Institutions, Inc. and subsidiaries (the Company) as of December 31, 2008 and 2007, and the related consolidated statements of operations, changes in shareholders equity, and cash flows for each of the years in the three-year period ended December 31, 2008. These consolidated financial statements are the responsibility of the Company s management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

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

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the consolidated financial position of the Company as of December 31, 2008 and 2007, and the results of their operations and their cash flows for each of the years in the three-year period ended December 31, 2008, in conformity with U.S. generally accepted accounting principles.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the Company s internal control over financial reporting as of December 31, 2008, based on criteria established in *Internal Control Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO), and our report dated March 12, 2009 expressed an unqualified opinion on the effectiveness of the Company s internal control over financial reporting.

/s/ KPMG LLP
Buffalo, New York
March 12, 2009

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

(Dollars in thousands, except share and per share data)	December 31, 2008	2007
ASSETS		
Cash and cash equivalents:		
Cash and due from banks	$ 34,528	$ 45,165
Federal funds sold and interest-bearing deposits in other banks	20,659	1,508
Total cash and cash equivalents	55,187	46,673
Securities available for sale, at fair value	547,506	695,241
Securities held to maturity, at amortized cost (fair value of $59,147 and $59,902, respectively)	58,532	59,479
Loans held for sale	1,013	906
Loans	1,121,079	964,173
Less: Allowance for loan losses	18,749	15,521
Loans, net	1,102,330	948,652
Company owned life insurance	23,692	3,017
Premises and equipment, net	36,712	34,157
Goodwill	37,369	37,369
Other assets	54,578	32,382
Total assets	$ 1,916,919	$ 1,857,876
LIABILITIES AND SHAREHOLDERS EQUITY		
Deposits:		
Noninterest-bearing demand	$ 292,586	$ 286,362
Interest-bearing demand	344,616	335,314
Savings and money market	348,594	346,639
Certificates of deposit	647,467	607,656
Total deposits	1,633,263	1,575,971
Short-term borrowings	23,465	25,643
Long-term borrowings	47,355	42,567
Other liabilities	22,536	18,373
Total liabilities	1,726,619	1,662,554
Commitments and contingencies (Note 9)		
Shareholders equity:		
Series A 3% Preferred Stock, $100 par value; 1,533 shares authorized and issued at December 31, 2008; 10,000 shares authorized, 1,586 shares issued at December 31, 2007	153	159
	35,499	

Series A Preferred Stock, $100 par value; 7,503 shares authorized and issued at December 31, 2008, aggregate liquidation preference $37,515; net of $2,016 discount		
Series B-1 8.48% Preferred Stock, $100 par value, 200,000 shares authorized, 174,223 shares issued	17,422	17,422
Total preferred equity	53,074	17,581
Common stock, $0.01 par value, 50,000,000 shares authorized, 11,348,122 shares issued	113	113
Additional paid-in capital	26,397	24,778
Retained earnings	124,952	158,744
Accumulated other comprehensive (loss) income	(4,013)	667
Treasury stock, at cost 550,103 and 336,971 shares, respectively	(10,223)	(6,561)
Total shareholders equity	190,300	195,322
Total liabilities and shareholders equity	$ 1,916,919	$ 1,857,876

See accompanying notes to the consolidated financial statements.

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FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES
Consolidated Statements of Operations

(Dollars in thousands, except per share amounts)	Years ended December 31, 2008	2007	2006
Interest income:			
Interest and fees on loans	$ 67,674	$ 68,560	$ 68,004
Interest and dividends on investment securities	30,655	34,990	32,778
Other interest income	619	1,662	2,288
Total interest income	98,948	105,212	103,070
Interest expense:			
Deposits	29,349	42,714	37,445
Short-term borrowings	721	864	571
Long-term borrowings	3,547	3,561	5,588
Total interest expense	33,617	47,139	43,604
Net interest income	65,331	58,073	59,466
Provision (credit) for loan losses	6,551	116	(1,842)
Net interest income after provision (credit) for loan losses	58,780	57,957	61,308
Noninterest (loss) income:			
Service charges on deposits	10,497	10,932	11,504
ATM and debit card	3,313	2,883	2,233
Broker-dealer fees and commissions	1,458	1,396	1,511
Loan servicing	664	928	892
Company owned life insurance	563	1,255	521
Net gain on sale of loans held for sale	339	779	972
Net gain on sale of other assets	305	89	169
Net gain on investment securities	288	207	30
Net gain on sale of trust relationships		13	1,386
Impairment charges on investment securities	(68,215)		
Other	2,010	2,198	2,693
Total noninterest (loss) income	(48,778)	20,680	21,911
Noninterest expense:			
Salaries and employee benefits	31,437	33,175	33,563
Occupancy and equipment	10,502	9,903	9,465
Computer and data processing	2,433	2,126	1,903
Professional services	2,141	2,080	2,837
Supplies and postage	1,800	1,662	1,945
Advertising and promotions	1,453	1,402	1,974
Other	7,695	7,080	7,925

Total noninterest expense		57,461		57,428		59,612
(Loss) income before income taxes		(47,459)		21,209		23,607
Income tax (benefit) expense		(21,301)		4,800		6,245
Net (loss) income	$	(26,158)	$	16,409	$	17,362
Preferred stock dividends, net of accretion		1,538		1,483		1,486
Net (loss) income applicable to common shareholders	$	(27,696)	$	14,926	$	15,876
(Loss) earnings per common share (Note 15):						
Basic	$	(2.56)	$	1.34	$	1.40
Diluted	$	(2.56)	$	1.33	$	1.40

See accompanying notes to the consolidated financial statements.

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FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES
Consolidated Statements of Changes in Shareholders Equity
Years ended December 31, 2008, 2007 and 2006

(Dollars in thousands, except per share data)	**Preferred Equity**	**Common Stock**	**Additional Paid-in Capital**	**Retained Earnings**	**Accumulated Other Comprehensive Income (Loss)**	**Treasury Stock**	**Total Shareholders Equity**
Balance at January 1, 2006	**$ 17,634**	**$ 113**	**$ 23,278**	**$ 136,925**	**$ (6,178)**	**$ (15)**	**$ 171,757**
Comprehensive income:							
Net income				17,362			17,362
Other comprehensive loss, net of tax					(622)		(622)
Total comprehensive income							16,740
Adjustment to initially apply SFAS 158					(1,604)		(1,604)
Repurchase of 20,351 common shares						(335)	(335)
Repurchase of Series B-1 8.48% Preferred Stock	(11)						(11)
Share-based compensation plans:							
Share-based compensation			865				865
Stock options exercised			181			23	204
Restricted stock awards issued			(130)			130	
Directors retainer			28			84	112
Cash dividends declared:							
Series A 3% Preferred-$3.00 per share				(5)			(5)
Series B-1 8.48% Preferred-$8.48 per share				(1,481)			(1,481)
Common-$0.34 per share				(3,854)			(3,854)
Balance at December 31, 2006	**$ 17,623**	**$ 113**	**$ 24,222**	**$ 148,947**	**$ (8,404)**	**$ (113)**	**$ 182,388**
Comprehensive income:							
Net income				16,409			16,409
Other comprehensive income, net of tax					9,071		9,071
Total comprehensive income							25,480
Repurchase of 368,815 common shares						(7,203)	(7,203)
Repurchase of Series B-1 8.48% Preferred Stock	(42)						(42)
Share-based compensation plans:							
Share-based compensation			955				955
Stock options exercised			(53)			304	251
Restricted stock awards issued			(344)			344	
Directors retainer			(2)			107	105
Cash dividends declared:							
Series A 3% Preferred-$3.00 per share				(5)			(5)
Series B-1 8.48% Preferred-$8.48 per share				(1,478)			(1,478)
Common-$0.46 per share				(5,129)			(5,129)
Balance at December 31, 2007	**$ 17,581**	**$ 113**	**$ 24,778**	**$ 158,744**	**$ 667**	**$ (6,561)**	**$ 195,322**

Continued on next page

See accompanying notes to the consolidated financial statements.

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FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES
Consolidated Statements of Changes in Shareholders Equity (Continued)
Years ended December 31, 2008, 2007 and 2006

(Dollars in thousands, except per share data)	**Preferred Equity**	**Common Stock**	**Additional Paid-in Capital**	**Retained Earnings**	**Accumulated Other Comprehensive Income (Loss)**	**Treasury Stock**	**Total Shareholders Equity**
Balance at December 31, 2007	**$ 17,581**	**$ 113**	**$ 24,778**	**$ 158,744**	**$ 667**	**$ (6,561)**	**$ 195,322**
Balance carried forward							
Comprehensive income:							
Net loss				(26,158)			(26,158)
Other comprehensive loss, net of tax					(4,680)		(4,680)
Total comprehensive loss							(30,838)
Cumulative effect of adoption of EITF 06-4 and SFAS 158 transition adjustment				(241)			(241)
Repurchase of 272,861 common shares						(4,818)	(4,818)
Repurchase of Series A 3% Preferred Stock	(6)		3				(3)
Warrant issued in connection with Series A Preferred Stock			2,025				2,025
Issue shares of Series A Preferred Stock	37,515						37,515
Discount on Series A Preferred Stock	(2,025)						(2,025)
Accretion of preferred stock discount	9			(9)			
Share-based compensation plans:							
Share-based compensation			603	30			633
Stock options exercised			(12)			44	32
Restricted stock awards issued			(998)			998	
Directors retainer			(2)			114	112
Accrued undeclared cumulative dividend on Series A Preferred Stock				(47)			(47)
Cash dividends declared:							
Series A 3% Preferred-$3.00 per share				(5)			(5)
Series B-1 8.48% Preferred-$8.48 per share				(1,477)			(1,477)
Common-$0.54 per share				(5,885)			(5,885)
Balance at December 31, 2008	**$ 53,074**	**$ 113**	**$ 26,397**	**$ 124,952**	**$ (4,013)**	**$ (10,223)**	**$ 190,300**

See accompanying notes to the consolidated financial statements.

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FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES
Consolidated Statements of Cash Flows

	Years ended December 31,		
(Dollars in thousands)	**2008**	**2007**	**2006**
Cash flows from operating activities:			
Net (loss) income	$ (26,158)	$ 16,409	$ 17,362
Adjustments to reconcile net (loss) income to net cash provided by operating activities:			
Depreciation and amortization	3,959	3,991	4,125
Net amortization (accretion) of premiums and discounts on securities	390	(185)	644
Provision (credit) for loan losses	6,551	116	(1,842)
Share-based compensation	633	955	865
Deferred income tax (benefit) expense	(23,848)	715	63
Proceeds from sale of loans held for sale	28,685	48,048	69,451
Originations of loans held for sale	(28,453)	(47,183)	(68,793)
Increase in company owned life insurance	(563)	(111)	(102)
Net gain on sale of loans held for sale	(339)	(779)	(972)
Net gain on sale and disposal of other assets	(305)	(89)	(169)
Net gain on investment securities	(288)	(207)	(30)
Net gain on sale of trust relationships		(13)	(1,386)
Impairment charge on investment securities	68,215		
(Increase) decrease in other assets	(1,322)	3,510	8,774
(Decrease) increase in other liabilities	(5,866)	(2,406)	2,324
Net cash provided by operating activities	21,291	22,771	30,314
Cash flows from investing activities:			
Purchase of investment securities:			
Available for sale	(310,191)	(307,049)	(66,769)
Held to maturity	(54,925)	(54,926)	(32,524)
Proceeds from principal payments, maturities and calls on investment securities:			
Available for sale	337,704	308,323	119,305
Held to maturity	57,325	36,169	34,724
Proceeds from sale of securities available for sale	58,368	49,350	1,699
Net loan originations	(161,414)	(41,778)	61,996
Purchase of company owned life insurance	(20,112)	(58)	(112)
Proceeds from sales of other assets	1,783	1,294	2,506
Proceeds from sale of trust relationships		13	1,386
Purchase of premises and equipment	(6,333)	(3,407)	(1,871)
Net cash (used in) provided by investing activities	(97,795)	(12,069)	120,340
Cash flows from financing activities:			
Net increase (decrease) in deposits	57,292	(41,724)	(99,566)
Net (decrease) increase in short-term borrowings	(2,178)	(6,668)	12,204
Proceeds from long-term borrowings	30,000		

Repayment of long-term borrowings	(25,212)	(12,321)	(40,204)
Purchase of preferred and common shares	(4,821)	(7,245)	(346)
Proceeds from issuance of preferred and common shares	35,602	105	112
Proceeds from issuance of common stock warrant	2,025		
Proceed from stock options exercised	32	251	204
Cash dividends paid to preferred shareholders	(1,482)	(1,483)	(1,486)
Cash dividends paid to common shareholders	(6,240)	(4,716)	(3,740)
Net cash provided by (used in) financing activities	85,018	(73,801)	(132,822)
Net increase (decrease) in cash and cash equivalents	8,514	(63,099)	17,832
Cash and cash equivalents, beginning of period	46,673	109,772	91,940
Cash and cash equivalents, end of period	$ 55,187	$ 46,673	109,772

See accompanying notes to the consolidated financial statements.

FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
December 31, 2008, 2007 and 2006

(1.) SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

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

The accounting and reporting policies conform to general practices within the banking industry and to U.S. generally accepted accounting principles. Prior years consolidated financial statements are re-classified whenever necessary to conform to the current year s presentation. The following is a description of the significant accounting policies.

(a.) Principles of Consolidation

The consolidated financial statements include the accounts of the Company and its subsidiaries. The Trust is not included in the consolidated financial statements of the Company. All significant intercompany accounts and transactions have been eliminated in consolidation.

(b.) Use of Estimates

In preparing the consolidated financial statements in conformity with U.S. generally accepted accounting principles, management is required to make estimates and assumptions that affect the reported amount of assets and liabilities as of the date of the statement of financial condition and reported amounts of revenue and expenses during the reporting period. Material estimates relate to the determination of the allowance for loan losses, assumptions used in the defined benefit pension plan accounting, the carrying value of goodwill and deferred tax assets, and the valuation and other than temporary impairment considerations related to the securities portfolio. These estimates and assumptions are based on management s best estimates and judgment and are evaluated on an ongoing basis using historical experience and other factors, including the current economic environment. The Company adjusts these estimates and assumptions when facts and circumstances dictate. Illiquid credit markets and volatile equity have combined with declines in consumer spending to increase the uncertainty inherent in these estimates and assumptions. As future events cannot be determined with precision, actual results could differ significantly from the Company s estimates.

(c.) Cash Flow Reporting

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

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

	2008	2007	2006
Cash paid during the year for:			
Interest expense	$ 37,160	$ 49,687	42,438
Income taxes, net of income tax refunds	3,797	4,031	(2,249)
Non-cash activity:			
Real estate and other assets acquired in settlement of loans	$ 1,185	$ 2,443	2,502
Dividends declared and unpaid	1,497	1,805	1,392
Increase in unsettled security purchases	1,453	336	

(d.) Investment Securities

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

FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
December 31, 2008, 2007 and 2006

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

Purchase premiums and discounts are recognized in interest income using the interest method over the terms of the securities. Securities are evaluated periodically to determine whether a decline in their fair value is other than temporary. Management utilizes criteria such as, the magnitude and duration of the decline and, when appropriate, consideration of negative changes in expected cash flows, in addition to the reasons underlying the decline, including creditworthiness, capital adequacy and near term prospects of issuers, the level of credit subordination, estimated loss severity, prepayments and future delinquencies, to determine whether the loss in value is other than temporary. The term other than temporary is not intended to indicate that the decline is permanent, but indicates that the prospect for a near-term recovery of value is not necessarily favorable. Declines in the fair value of investment securities below their cost that are deemed to be other than temporary are reflected in earnings as realized losses resulting in a new cost basis for the securities. Gains and losses on the sale of securities are recorded on the trade date and are determined using the specific identification method.

(e.) Loans Held for Sale

Loans held for sale are recorded at the lower of aggregated cost or fair value. If necessary, a valuation allowance is recorded by a charge to income for unrealized losses attributable to changes in market interest rates. Subsequent increases in fair value are adjusted through the valuation allowance, but only to the extent of the valuation allowance. Gains and losses on the disposition of loans held for sale are determined on the specific identification method. Loan servicing fees are recognized on an accrual basis.

The Company originates and sells certain residential real estate loans in the secondary market. The Company typically retains the right to service the mortgages upon sale. The Company makes the determination of whether or not to identify the mortgage as a loan held for sale at the time the application is received from the borrower based on the Company s intent and ability to hold the loan.

Capitalized mortgage servicing rights are recorded at their fair value at the time a loan is sold and servicing rights are retained. Capitalized mortgage servicing rights are reported in other assets in the consolidated statements of financial position and are amortized to noninterest income in the consolidated statements of operations in proportion to and over the period of estimated net servicing income. The Company uses a valuation model that calculates the present value of future cash flows to determine the fair value of servicing rights. In using this valuation method, the Company incorporates assumptions to estimate future net servicing income, which include estimates of the cost to service the loan, the discount rate, an inflation rate and prepayment speeds. The carrying value of originated mortgage servicing rights is periodically evaluated for impairment. Impairment is determined by stratifying rights by predominant risk characteristics, such as interest rates and terms, using discounted cash flows and market-based assumptions. Impairment is recognized through a valuation allowance, to the extent that fair value is less than the capitalized asset. Subsequent increases in fair value are adjusted through the valuation allowance, but only to the extent of the valuation allowance.

The Company also extends rate lock commitments to borrowers related to the origination of residential mortgage loans. To mitigate the interest rate risk inherent in these rate lock commitments, as well as closed mortgage loans held for sale, the Company enters into forward sale commitments to sell individual mortgage loans. Rate lock and forward sale commitments are considered derivatives and are recorded at fair value in accordance with SFAS No. 133. These amounts are not significant at December 31, 2008 and 2007. The mortgage forward sale commitments are primarily with Federal Home Loan Mortgage Corporation (FHLMC), State of New York Mortgage Agency (SONYMA) or Federal Housing Agency (FHA).

Loan servicing income (a component of noninterest income in the consolidated statements of operations) consists of fees earned for servicing mortgage loans sold to third parties, net of amortization expense and impairment losses associated with capitalized mortgage servicing assets.

(f.) Loans

Loans are stated at the principal amount outstanding, net of unearned income and deferred direct loan origination fees and costs, which are accreted or amortized to interest income based on the interest method. Accrual of interest on loans is suspended and all unpaid accrued interest is reversed when management believes that reasonable doubt exists with respect to the collectibility of principal or interest.

Loans, including impaired loans, are generally classified as nonaccruing if they are past due as to maturity or payment of principal or interest for a period of more than 90 days, unless such loans are well-collateralized and in the process of collection. Loans that are on a current payment status or past due less than 90 days may also be classified as nonaccruing if repayment in full of principal and/or interest is uncertain.

FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
December 31, 2008, 2007 and 2006

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

Loans may be returned to accrual status when all principal and interest amounts contractually due (including arrearages) are reasonably assured of repayment and there is a sustained period of repayment performance (generally a minimum of six months) in accordance with the contractual terms of the loan.

While a loan is classified as nonaccruing, payments received are generally used to reduce the principal balance. When the future collectibility of the recorded loan balance is expected, interest income may be recognized on a cash basis. In the case where a nonaccruing loan had been partially charged-off, recognition of interest on a cash basis is limited to that which would have been recognized on the recorded loan balance at the contractual interest rate. Interest collections in excess of that amount are recorded as recoveries to the allowance for loan losses until prior charge-offs have been fully recovered.

Commercial-related loans are considered impaired when, based on current information and events, it is probable that a creditor will be unable to collect all amounts of principal and interest under the original terms of the agreement and all loans that are restructured in a troubled debt restructuring. Accordingly, the Company evaluates impaired commercial and agricultural loans individually based on the present value of future cash flows discounted at the loan s effective interest rate, or at the loan s observable market price or fair value of the collateral, if the loan is collateral dependent. The majority of the Company s impaired loans are collateral dependent.

(g.) Allowance for Loan Losses

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

The Company periodically evaluates the allowance for loan losses in order to maintain the allowance at a level that represents management s estimate of probable losses in the loan portfolio at the statement of financial condition date. Management s evaluation of the allowance is based on a continuing review of the loan portfolio.

For larger balance commercial-related loans, the Company conducts a periodic assessment on a loan-by-loan basis of losses, when it is deemed probable, based upon known facts and circumstances, that full contractual interest and principal on an individual loan will not be collected in accordance with its contractual terms, and the loan is considered impaired. An impairment reserve is typically established based upon the net realizable value of the collateral, as a majority of the Company s loans are collateral dependent. Generally, impaired loans include loans in nonaccruing status, loans that have been assigned a specific allowance for credit losses, loans that have been partially charged off, and loans designated as a troubled debt restructuring. Problem commercial loans are assigned various risk ratings under the Company s loan monitoring procedures.

The allowance for loan losses for smaller balance homogeneous loans are estimated based on historical charge-off experience, levels and trends of delinquent and nonaccruing loans, trends in volume and terms, effects of changes in lending policy, the experience, ability and depth of management, national and local economic trends and conditions, and concentrations of credit risk.

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

(h.) Company owned Life Insurance

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

would receive a death benefit which would be recorded as noninterest income.

FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
December 31, 2008, 2007 and 2006

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

(i.) Premises and Equipment

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

(j.) Goodwill and Other Intangible Assets

Goodwill represents the excess of the purchase price over the fair value of net assets acquired in accordance with the purchase method of accounting for business combinations. Goodwill is not being amortized, but is required to be tested for impairment annually or more often if certain events occur. Goodwill impairment testing is performed at the segment (or reporting unit) level. Currently, the Company s goodwill is evaluated at the entity level as there is only one reporting unit. Goodwill is assigned to reporting units at the date it is initially recorded. Once goodwill has been assigned to reporting units, it no longer retains its association with a particular acquisition, and all of the activities within a reporting unit, whether acquired or organically grown, are available to support the value of the goodwill.

Other intangible assets are being amortized on the straight-line method, over the expected periods to be benefited. Other intangible assets are periodically reviewed for impairment or when events or changed circumstances may affect the underlying basis of the assets.

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

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

As a member of the FHLB system, the Company is required to maintain a specified investment in FHLB New York stock in proportion to the volume of certain transactions with the FHLB. FHLB New York stock totaled $3.2 million and $3.1 million as of December 31, 2008 and 2007, respectively. Deterioration in the soundness of the FHLB System may increase the potential that the investments in FHLB stock recorded on the Company s consolidated statements of financial condition be designated as impaired and that the Company may incur a write-down in the future.

As a member of the FRB system, the Company is required to maintain a specified investment in FRB stock based on a ratio relative to the Company s capital. FRB stock totaled $2.8 million as of December 31, 2008 and 2007.

(l.) Equity Method Investments

The Company has investments in limited partnerships and accounts for these investments under the equity method. These investments are included in other assets in the consolidated statements of financial condition and totaled $2.4 million and $2.0 million as of December 31, 2008 and 2007, respectively.

(m.) Other Real Estate Owned

Other real estate owned consists of properties formerly pledged as collateral to loans, which have been acquired by the Company through foreclosure proceedings or acceptance of a deed in lieu of foreclosure. Upon transfer of a loan to foreclosure status, an appraisal is obtained and any difference of the loan balance over the fair value, less estimated costs to sell, is recorded against the allowance for loan losses. Other real estate owned is subsequently recorded at the lower of cost or fair value, less estimated costs to sell. Expenses and subsequent adjustments to the fair value are treated as other noninterest expense in the consolidated statements of operations.

(n.) Treasury Stock

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

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FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
December 31, 2008, 2007 and 2006

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

(o.) Employee Benefits

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

The Company accounts for the pension and post-retirement plans in accordance with SFAS No. 158 Employers Accounting for Defined Benefit Pension and Other Postretirement Plans, which requires recognition in the consolidated financial statements of an asset for the respective plans overfunded status or a liability for a plan s underfunded status. The Company reports changes in the funded status of the pension and postretirement plan as a component of other comprehensive income, net of applicable taxes, in the year in which changes occur.

Beginning in 2008, the plans assets and obligations that determine its future funded status was measured as of the end of the Company s fiscal year as required by SFAS No. 158.

(p.) Share-Based Compensation Plans

The Company maintains two stock benefit plans under which fixed award stock options and restricted stock may be granted to certain directors and key employees. These plans are accounted for under SFAS No. 123(R), Share-Based Payment, which requires the recognition of compensation expense in the consolidated statements of operations over the requisite service period, based on the grant-date fair value of stock options and other equity-based compensation (such as restricted stock) issued to directors and certain employees. The fair values of options are estimated using a pricing model. For restricted stock awards, compensation expense is recognized on a straight-line basis over the vesting period for the fair value of the award, measured at the grant date. The Company chose to apply the modified prospective approach as the transition method upon adoption of SFAS No. 123(R) as of January 1, 2006. Accordingly, awards that were granted, modified, or settled after this date are accounted for in accordance with SFAS No. 123(R) and any unvested equity awards granted prior to that date are being recognized in the consolidated statements of operations as service is rendered based on their grant-date fair value, calculated in accordance with SFAS No. 123 Accounting for Stock-Based Compensation.

The Company records share-based compensation expense for awards under the Management Stock Incentive Plan in salaries and employee benefits in the Consolidated Statements of Operations. Expense related to awards granted under the Director s Stock Incentive Plan is included in other noninterest expense in the consolidated statements of operations.

(q.) Income Taxes

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

(r.) (Loss) Earnings Per Share

Basic (loss) earnings per share (EPS) is computed by dividing net income (or loss) available to common shareholders by the weighted average number of our common shares outstanding for the period. Diluted EPS reflects the potential dilution that could occur if securities or other contracts to issue common stock, such as stock options and warrants, were exercised or converted into common stock or resulted in the issuance of common stock that then shared in earnings. Anti-dilutive common stock equivalents are not included in the determination of diluted EPS when a company is in a net loss position for a reporting period, as all common stock equivalents are considered to be anti-dilutive.

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FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
December 31, 2008, 2007 and 2006

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

(s.) Financial Instruments with Off-Balance Sheet Risk

The Company s financial instruments with off-balance sheet risk are commercial stand-by letters of credit and loan commitments. These financial instruments are reflected in the statements of financial condition upon funding.

(t.) Recent Accounting Pronouncements

In January 2009, the Financial Accounting Standards Board (FASB) issued FASB Staff Position (FSP) Emerging Issues Task Force (EITF) 99-20-1*, Amendments to the Impairment Guidance of EITF Issue No. 99-20* (FSP EITF 99-20-1). This FSP amends EITF Issue No. 99-20, *Recognition of Interest Income and Impairment on Purchased Beneficial Interests and Beneficial Interests That Continue to Be Held by a Transferor in Securitized Financial Assets,* by eliminating the requirement that a holder s best estimate of cash flows be based upon those that a market participant would use. Instead, FSP EITF 99-20-1 eliminates the use of market participant assumptions and requires the use of management s judgment in the determination of whether it is probable there has been an adverse change in estimated cash flow. This FSP was effective for reporting periods ending after December 15, 2008, but could not be retro-actively applied to periods prior to September 30, 2008, and did not have a material impact on the Company s consolidated financial statements.

In June 2008, the FASB issued FSP EITF 03-6-1, *Determining Whether Instruments Granted in Share-Based Payment Transactions Are Participating Securities*. FSP EITF 03-6-1 was issued to specify that unvested share-based payment awards that contain non-forfeitable rights to dividends or dividend equivalents (whether paid or unpaid) are participating securities and shall be included in the computation of earnings per share pursuant to the two-class method. FSP EITF 03-6-1 is effective for financial statements issued for fiscal years beginning after December 15, 2008 and interim periods within those years. The Company has issued annual share-based compensation awards in the form of restricted stock, which are considered participating securities under FSP EITF 03-6-1. Beginning for the quarter ending March 31, 2009, the Company s earnings per share will be presented using the two-class method, however, the Company does not expect adoption of this statement to have a material effect on its consolidated financial position, consolidated results of operations, or liquidity.

In May 2008, the FASB issued SFAS No. 162, *The Hierarchy of Generally Accepted Accounting Principles* (SFAS 162). SFAS 162 is intended to improve financial reporting by identifying a consistent framework, or hierarchy, for selecting accounting principles to be used in preparing financial statements that are presented in conformity with generally accepted accounting principles in the United States for non-governmental entities. SFAS 162 is effective 60 days following approval by the Securities and Exchange Commission of the Public Company Accounting Oversight Board s amendments to AU Section 411, *The Meaning of Present Fairly in Conformity with Generally Accepted Accounting Principles*. The Company does not expect adoption of this statement to have a material effect on its consolidated financial position, consolidated results of operations, or liquidity.

In April 2008, the FASB Staff Position (FSP) No. 142-3, *Determination of the Useful Life of Intangible Assets* was issued, which amends the factors an entity should consider in developing renewal or extension assumptions used in determining the useful life of recognized intangible assets under SFAS No. 142, *Goodwill and Other Intangible Assets* (SFAS 142). This new guidance applies prospectively to intangible assets that are acquired individually or with a group of other assets in business combinations and asset acquisitions. The Company is required to adopt this statement for its fiscal year beginning after December 15, 2008. The Company plans to adopt this statement on January 1, 2009 and does not expect the adoption to have a material effect on its consolidated financial position, consolidated results of operations, or liquidity.

In March 2008, the FASB issued SFAS No. 161, *Disclosures about Derivative Instruments and Hedging Activities an amendment of FASB Statement No. 133* (SFAS 161). The statement requires enhanced disclosures regarding the use of derivative instruments, the accounting for derivative instruments under SFAS No. 133 and related interpretations, and the impact of derivative instruments and related hedged items on financial position, financial performance, and cash flows, particularly from a risk perspective. SFAS No. 161 is effective for fiscal years beginning

after November 15, 2008. The Company plans to adopt this statement on January 1, 2009 and does not expect adoption to have a material effect on its consolidated financial position, consolidated results of operations, or liquidity.

FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES
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(1.) SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

In February 2007, the FASB issued SFAS No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities, including an amendment of FASB Statement No. 115* (SFAS 159). SFAS 159 allows entities to irrevocably elect fair value as the initial and subsequent measurement attribute for certain financial assets and financial liabilities that are not otherwise required to be measured at fair value, with changes in fair value recognized in earnings as they occur. SFAS 159 also requires entities to report those financial assets and financial liabilities measured at fair value in a manner that separates those reported fair values from the carrying amounts of similar assets and liabilities measured using another measurement attribute on the face of the statement of financial condition. Lastly, SFAS 159 establishes presentation and disclosure requirements designed to improve comparability between entities that elect different measurement attributes for similar assets and liabilities. The Company adopted this statement on January 1, 2008 and did not elect the SFAS 159 fair value option for any of its financial assets or liabilities, therefore the adoption did not have an impact on its consolidated financial position, consolidated results of operations, or liquidity.

In September 2006, the FASB issued SFAS No. 158, *Employers Accounting for Defined Benefit Pension and Other Postretirement Plans an amendment of FASB Statements No. 87, 88, 106, and 132(R)* (SFAS 158). SFAS 158 requires companies to recognize the over-funded or under-funded status of a defined benefit plan (other than a multi-employer plan) as an asset or liability in its balance sheet and to recognize changes in that funded status in the year in which the changes occur through comprehensive income. The Company adopted this provision of SFAS 158 for the year ended December 31, 2006.

SFAS 158 also requires companies to measure the funded status of a plan as of the date of the Company s fiscal year-end, with limited exceptions. In 2008, the Company adopted the measurement date provisions of SFAS 158 and changed the measurement date for its defined benefit plans to December 31. Prior to 2008, the Company measured its defined benefit plans assets and obligations as of September 30 of each year. See Note 16, Employee Benefit Plans, for further information relating to the adoption of this provision of SFAS 158.

In September 2006, the FASB issued SFAS No. 157, *Fair Value Measurements* (SFAS 157). SFAS 157 defines fair value, establishes a framework for measuring fair value under generally accepted accounting principles and expands disclosures about fair value measurements. SFAS 157 emphasizes that fair value is a market-based measurement, not an entity-specific measurement, and states that a fair value measurement should be determined based on assumptions that market participants would use in pricing the asset or liability. In February 2008, the FASB issued FSP SFAS 157-1, *Application of FASB Statement No. 157 to FASB Statement No. 13 and Other Accounting Pronouncements That Address Fair Value Measurements for Purposes of Lease Classification or Measurement under Statement 13*, which removes certain leasing transactions from the scope of SFAS 157, and FSP SFAS 157-2, *Effective Date of FASB Statement No. 157*, which defers the effective date of SFAS 157 for one year for certain nonfinancial assets and nonfinancial liabilities, except those that are recognized or disclosed at fair value in the financial statements on a recurring basis. In October 2008, the FASB also issued FSP SFAS 157-3, *Determining the Fair Value of a Financial Asset When the Market for That Asset Is Not Active*, which clarifies the application of SFAS 157 in an inactive market and illustrates how an entity would determine fair value when the market for a financial asset is not active. On January 1, 2008, the Company adopted the provisions of SFAS 157 related to financial assets and liabilities and to nonfinancial assets and liabilities measured at fair value on a recurring basis. See Note 16, Employee Benefit Plans, for further details.

Beginning January 1, 2009, the Company will adopt the provisions for nonfinancial assets and nonfinancial liabilities that are not required or permitted to be measured at fair value on a recurring basis, which include those measured at fair value in goodwill impairment testing, indefinite-lived intangible assets measured at fair value for impairment assessment, nonfinancial long-lived assets measured at fair value for impairment assessment, asset retirement obligations initially measured at fair value, and those initially measured at fair value in a business combination. The Company does not expect the provisions of SFAS 157 related to these items to have a material impact on its consolidated financial statements. See Note 17, Fair Value of Financial Instruments, for further details.

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FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES
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(1.) SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

In September 2006, the EITF reached a final consensus on Issue 06-04, *Accounting for Deferred Compensation and Postretirement Benefit Aspects of Endorsement Split Dollar Life Insurance Arrangements* (EITF 06-04). In accordance with EITF 06-04, an agreement by an employer to share a portion of the proceeds of a life insurance policy with an employee during the postretirement period is a postretirement benefit arrangement required to be accounted for in accordance with SFAS 106 or Accounting Principles Board Opinion No. 12, *Omnibus Opinion 1967* (APB 12). Furthermore, the purchase of a split dollar life insurance policy does not constitute a settlement under SFAS No. 106 and, therefore, a liability for the postretirement obligation must be recognized under SFAS 106 if the benefit is offered under an arrangement that constitutes a plan or under APB 12 if it is not part of a plan. The provisions of EITF 06-04 are to be applied through either a cumulative-effect adjustment to retained earnings as of the beginning of the year of adoption or retrospective application. The Company adopted this statement on January 1, 2008 and recorded a liability (included in other liabilities in the consolidated statement of financial position) of $284 thousand and a corresponding cumulative-effect adjustment to retained earnings as disclosed in the consolidated statement of changes in shareholders equity.

(2.) INVESTMENT SECURITIES

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

	December 31, 2008			
	Adjusted Amortized Cost	Unrealized Gains	Unrealized Losses	Fair Value
Securities available for sale:				
U.S. Government agency and government-sponsored enterprise securities	$ 67,871	$ 609	$ 307	$ 68,173
Mortgage-backed securities	339,574	6,813	3,835	342,552
Other asset-backed securities	3,918			3,918
State and municipal obligations	129,572	2,181	42	131,711
Equity securities	923	281	52	1,152
Total available for sale securities	$ 541,858	$ 9,884	$ 4,236	$ 547,506
Securities held to maturity:				
State and municipal obligations	$ 58,532	$ 619	$ 4	$ 59,147

	December 31, 2007			
	Amortized Cost	Unrealized Gains	Unrealized Losses	Fair Value
Securities available for sale:				
U.S. Government agency and government-sponsored enterprise securities	$ 158,920	$ 344	$ 324	$ 158,940
Mortgage-backed securities	297,798	832	2,758	295,872
Other asset-backed securities	34,115	55	972	33,198
State and municipal obligations	171,294	1,568	261	172,601
Equity securities	33,930	700		34,630

Total available for sale securities	$	696,057	$	3,499	$	4,315	$	695,241
Securities held to maturity:								
State and municipal obligations	$	59,479	$	431	$	8	$	59,902

The U.S. Government agency and government-sponsored enterprise (GSE) securities portfolio, all of which was classified as available for sale, is comprised of debt obligations issued directly by U.S. Government agencies or GSEs and totaled $68.2 million and $158.9 million as of December 31, 2008 and 2007, respectively.

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(2.) INVESTMENT SECURITIES (Continued)

The MBS portfolio, all of which was classified as available for sale, totaled $342.6 million as of December 31, 2008, which was comprised of $239.5 million of mortgage-backed pass-through securities (pass-through) and $103.1 million of collateralized mortgage obligations (CMO). As of December 31, 2007, the MBS portfolio totaled $295.9 million, which consisted of $160.0 million of pass-throughs and $135.9 million of CMOs. The pass-throughs were primarily issued by GNMA, FNMA and FHLMC. The CMO portfolio consisted of two principal groups, with balances as of December 31, 2008 as follows: (1) $63.6 million of fixed and variable rate CMOs issued by GNMA, FNMA or FHLMC that carried a full guaranty by the issuing agency of both principal and interest, and (2) $39.5 million of privately issued whole loan CMOs.

The ABS portfolio, all of which was classified as available for sale, totaled $3.9 million as of December 31, 2008 and was comprised of positions in 14 different pooled trust preferred securities issues and one Student Loan Marketing Association (SLMA) floater or variable rate security backed by student loans. All of the trust preferred securities are backed by preferred debt issued by many different financial institutions and insurance companies. As of December 31, 2007, the ABS portfolio, all of which was classified as available for sale, totaled $33.2 million and was comprised of 14 pooled trust preferred securities issues and one SLMA security.

As of December 31, 2008, the Company had $1.2 million in equity securities including $528 thousand of auction rate preferred equity securities collateralized by FNMA and FHLMC preferred stock and $624 thousand of common equity securities. As of December 31, 2007, the Company had $34.6 million in equity securities, including $33.8 million of auction rate preferred equity securities collateralized by FNMA and FHLMC preferred stock and $780 thousand of common equity securities. The dividend income related to both the common and auction rate preferred equity securities qualifies for the Federal income tax dividend received deduction.

Interest and dividends on securities for the years ended December 31, 2008, 2007 and 2006 is summarized as follows (in thousands):

	2008	2007	2006
Taxable interest	$ 21,882	$ 25,414	$ 23,859
Tax-exempt interest	7,299	8,501	8,881
Tax-preferred interest	1,474	1,075	38
Total interest and dividends on securities	$ 30,655	$ 34,990	$ 32,778

The following tables show the investments gross unrealized losses (excluding unrealized losses that have been written down through the consolidated statements of operations) and fair value, aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position at December 31, 2008 and 2007 (in thousands).

	December 31, 2008					
	Less than 12 months		12 months or longer		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
Securities available for sale:						
U.S. Government agency and government-sponsored enterprise securities	$ 50	$ 1	$ 11,704	$ 306	$ 11,754	$ 307
Mortgage-backed securities	41,445	2,128	26,923	1,707	68,368	3,835

State and municipal obligations	6,191	41	84	1	6,275	42
Equity securities	310	52			310	52
Total available for sale securities	47,996	2,222	38,711	2,014	86,707	4,236
Securities held to maturity:						
State and municipal obligations	554	4			554	4
Total temporarily impaired securities	$ 48,550	$ 2,226	$ 38,711	$ 2,014	$ 87,261	$ 4,240

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(2.) INVESTMENT SECURITIES (Continued)

	December 31, 2007					
	Less than 12 months		12 months or longer		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
Securities available for sale:						
U.S. Government agency and government-sponsored enterprise securities	$ 18,287	$ 45	$ 64,937	$ 279	$ 83,224	$ 324
Mortgage-backed securities	38,479	398	170,532	2,360	209,011	2,758
Other asset-backed securities	26,418	971	808	1	27,226	972
State and municipal obligations	701	17	45,657	244	46,358	261
Total available for sale securities	83,885	1,431	281,934	2,884	365,819	4,315
Securities held to maturity:						
State and municipal obligations	7,153	4	875	4	8,028	8
Total temporarily impaired securities	$ 91,038	$ 1,435	$ 282,809	$ 2,888	$ 373,847	$ 4,323

The Company reviews investment securities on an ongoing basis for the presence of other-than-temporary-impairment (OTTI) with formal reviews performed quarterly. OTTI losses on individual investment securities are recognized as a realized loss through earnings when it is probable that not all of the contractual cash flows will be collected or it is determined that the Company will be unable to hold the securities until a recovery of fair value, which may be maturity.

Based upon the evaluations performed throughout the year, the Company recorded impairment charges totaling $68.2 million during 2008 related to certain debt and equity securities in the available for sale portfolio considered to be other-than-temporarily impaired. The decision to deem these securities OTTI was based on a specific analysis of the structure of each security and an evaluation of the underlying collateral, the creditworthiness, capital adequacy and near term prospects of issuers, the level of credit subordination, estimates of loss severity, prepayments and future delinquencies, using information and industry knowledge available to the Company. Future reviews for OTTI will consider the particular facts and circumstances during the reporting period in review. There were no securities deemed OTTI, and therefore no impairment charges were recorded, during the year ended December 31, 2007.

The following summarizes the amounts of OTTI recognized during the year ended December 31, 2008 by investment category (in thousands):

Mortgage-backed securities	Privately issued whole loan CMOs	$ 6,463
Other asset-backed securities	Trust preferred securities	29,429
Equity securities	Auction rate securities	32,323
		$ 68,215

The Company has both the ability and intent to hold debt securities in an unrealized loss position, other than those for which an impairment charge was taken at December 31, 2008, until such time as the value recovers or the securities mature and management believes that the unrealized losses on these debt securities at December 31, 2008 represent temporary impairments. Also, at December 31, 2008, certain of the Company s equity securities were in an unrealized loss position for a short duration. The Company has the ability and intent to hold these securities until market recovery. Therefore, management has determined that these unrealized losses on equity securities at December 31, 2008 are temporary.

Further deterioration in credit quality and/or a continuation of the current imbalances in liquidity that exist in the marketplace might adversely effect the fair values of the Company s investment portfolio and may increase the potential that certain unrealized losses will be designated as other than temporary in future periods and that the Company will incur additional write-downs in the future.

FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES
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(2.) INVESTMENT SECURITIES (Continued)

At December 31, 2008, the amortized cost and fair value of debt securities by contractual maturity were as follows (in thousands):

	Adjusted Amortized Cost	Fair Value
Debt securities available for sale:		
Due in one year or less	$ 78,701	$ 79,298
Due from one to five years	174,291	177,645
Due after five years through ten years	77,902	79,231
Due after ten years	210,041	210,180
	$ 540,935	$ 546,354
Debt securities held to maturity:		
Due in one year or less	$ 45,124	$ 45,313
Due from one to five years	10,773	11,031
Due after five years through ten years	2,063	2,188
Due after ten years	572	615
	$ 58,532	$ 59,147

Maturities of mortgage-backed and asset-backed securities are classified in accordance with their final contractual maturities; however the effective lives are expected to be significantly shorter due to prepayments of the underlying loans and the nature of the securities.

(3.) LOANS HELD FOR SALE

Loans held for sale were entirely comprised of residential real estate mortgages and totaled $1.0 million and $906 thousand as of December 31, 2008 and 2007, respectively.

The Company sells certain qualifying newly originated or refinanced residential real estate mortgages on the secondary market. Residential real estate mortgages serviced for others, which are not included in the consolidated statements of financial condition, amounted to $315.7 million and $338.1 million as of December 31, 2008 and 2007, respectively.

The activity in capitalized mortgage servicing assets, included in other assets in the consolidated statements of financial condition, is summarized as follows for the years ended December 31 (in thousands):

	2008	2007	2006
Mortgage servicing assets, beginning of year	$ 1,000	$ 1,165	$ 1,557
Originations	230	307	224
Amortization	(305)	(472)	(616)
Mortgage servicing assets, end of year	925	1,000	1,165
Valuation allowance	(362)	(19)	(2)
Mortgage servicing assets, net, end of year	$ 563	$ 981	$ 1,163

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FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES
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(4.) LOANS

Loans receivable, including net unearned income and net deferred fees and costs of $12.3 million and $5.9 million as of December 31, 2008 and December 31, 2007, respectively, are summarized as follows (in thousands):

	2008	2007
Commercial	$ 158,543	$ 136,780
Commercial real estate	262,234	245,797
Agricultural	44,706	47,367
Residential real estate	177,683	166,863
Consumer indirect	255,054	134,977
Consumer direct and home equity	222,859	232,389
Total loans	1,121,079	964,173
Less: Allowance for loan losses	18,749	15,521
Total loans, net	$ 1,102,330	$ 948,652

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

Parts of the country have experienced a significant decline in real estate values that has led, in some cases, to the debt on the real estate exceeding the value of the real estate. The Western and Central New York State markets the Company serves have not generally experienced, to this point, such conditions. Should deterioration in real estate values in the markets we serve occur, the value and liquidity of real estate securing the Company s loans could become impaired. While the Company is not engaged in the business of sub-prime lending, a decline in the value of residential or commercial real estate could have a material adverse effect on the value of property used as collateral for our loans.

The table below details additional information on the loan portfolio as of December 31 of the year indicated (in thousands):

	2008	2007	2006
Non-accruing loans	$ 8,189	$ 8,075	$ 15,837
Interest income that would have been recorded if loans had been performing in accordance with original terms	546	713	1,542
Accruing loans 90 days or more delinquent	7	2	3
Balance of impaired loans, end of period	3,180	4,132	11,702
Balance of impaired loans requiring a specific allowance, end of period	599	1,572	5,281
Allowance relating to impaired loans included in allowance for loan losses	142	454	450
Average balance of impaired loans	3,088	6,446	11,972
Interest income recognized on impaired loans			

There were no restructured loans outstanding at December 31, 2008 or 2007.

In the ordinary course of business, the Company grants loans to related parties including directors, executive officers and others. Such loans totaled $823 thousand and $911 thousand at December 31, 2008 and 2007, respectively. These loans were made substantially on the same terms, including interest rates and required collateral coverage ratios, as

those prevailing at the time for comparable transactions with other unrelated persons. These loans do not involve more than the normal risk of collectibility. During 2008, total principal additions on these related party loans were $35 thousand and total principal reductions were $123 thousand.

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

	2008	2007	2006
Balance, beginning of year	$ 15,521	$ 17,048	$ 20,231
Charge-offs	5,459	3,895	4,199
Recoveries	2,136	2,252	2,858
Net charge-offs	3,323	1,643	1,341
Provision (credit) for loan losses	6,551	116	(1,842)
Balance, end of year	$ 18,749	$ 15,521	$ 17,048

FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES
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(5.) PREMISES AND EQUIPMENT, NET

Major classes of premises and equipment at December 31, 2008 and 2007 are summarized as follows (in thousands):

	2008	2007
Land and land improvements	$ 4,334	$ 4,344
Buildings and leasehold improvements	39,298	35,020
Furniture, fixtures, equipment and vehicles	24,480	23,039
Premises and equipment	68,112	62,403
Accumulated depreciation and amortization	(31,400)	(28,246)
Premises and equipment, net	$ 36,712	$ 34,157

Depreciation and amortization expense, included in occupancy and equipment expense in the consolidated statements of operations, amounted to $3.7 million for each of the years ended December 31, 2008, 2007 and 2006.

(6.) GOODWILL AND OTHER INTANGIBLE ASSETS

The carrying amount of goodwill totaled $37.4 million as of December 31, 2008 and 2007. In accordance with SFAS 142, the Company performed the required annual goodwill impairment tests and determined that goodwill was not impaired at September 30, 2008. During the fourth quarter of 2008 the Company sustained a significant decrease in market capitalization, which combined with the current adverse industry conditions and recent operating losses, were triggering indicators that goodwill should be re-evaluated for potential impairment. The Company re-tested its goodwill for impairment as of December 31, 2008 and determined that no impairment existed.

At December 31, 2008, the Company s market capitalization related to its common stock was $155.0 million which exceeded the book value of its common stock. Further declines in the market value of the Company s publicly traded stock price or declines in the Company s ability to generate future cash flows may increase the potential that goodwill recorded on the Company s consolidated statement of financial position be designated as impaired and that the Company may incur a goodwill write-down in the future.

Other intangible assets, included in other assets in the consolidated statements of financial condition, consist entirely of core deposit intangibles and are summarized as follows as of December 31 (in thousands):

	2008	2007
Other intangible assets	$ 11,263	$ 11,263
Accumulated amortization	(10,983)	(10,676)
Other intangible assets, net	$ 280	$ 587

Intangible amortization expense for these other intangible assets amounted to $307 thousand for each of the years ended December 31, 2008 and 2007, and $420 thousand for the year ended December 31, 2006. Amortization of other intangible assets was computed using the straight-line method over the estimated lives of the respective assets (primarily 5 and 7 years). The remaining balance of $280 thousand is scheduled to be fully amortized during 2009.

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(7.) DEPOSITS

A summary of deposits at December 31, 2008 and 2007 are as follows (dollars in thousands):

	2008	2007
Noninterest-bearing demand	$ 292,586	$ 286,362
Interest-bearing demand	344,616	335,314
Savings and money market	348,594	346,639
Certificates of deposit, due:		
Within one year	546,266	547,243
One to two years	78,963	40,824
Two to three years	7,625	12,012
Three to five years	14,102	6,995
Thereafter	511	582
Total certificates of deposits	647,467	607,656
Total deposits	$ 1,633,263	$ 1,575,971

Certificates of deposit in denominations of $100,000 or more at December 31, 2008, 2007 and 2006 amounted to $164.6 million, $154.5 million and $195.4 million, respectively. Interest expense on those certificates totaled $5.7 million, $9.5 million and $9.0 million in 2008, 2007 and 2006, respectively.

Interest expense by deposit type for the years ended December 31, 2008, 2007 and 2006 is summarized as follows (in thousands):

	2008	2007	2006
Interest-bearing demand	$ 3,246	$ 5,760	$ 6,705
Savings and money market	3,773	5,863	4,320
Certificates of deposit	22,330	31,091	26,420
Total interest expense on deposits	$ 29,349	$ 42,714	$ 37,445

(8.) BORROWINGS

Outstanding borrowings are summarized as follows as of December 31 (in thousands):

	2008	2007
Short-term borrowings:		
Federal funds purchased and repurchase agreements	$ 23,465	$ 22,833
FHLB advances		2,810
Total short-term borrowings	23,465	25,643
Long-term borrowings:		
FHLB advances and repurchase agreements	30,653	25,865

Junior subordinated debentures		16,702		16,702
Total long-term borrowings		47,355		42,567
Total borrowings	$	70,820	$	68,210

The Company classifies borrowings as short-term or long-term in accordance with the original terms of the agreement. The Company s FHLB advances bear fixed interest rates ranging from 5.50% to 7.81% and had a weighted average rate of 6.03% at December 31, 2008. Long-term repurchase agreements bear fixed interest rates ranging from 3.48% to 3.98% and had a weighted average rate of 3.67% at December 31, 2008.

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(8.) BORROWINGS (Continued)

Interest expense on borrowings for the years ended December 31, 2008, 2007 and 2006 is summarized as follows (in thousands):

	2008	2007	2006
Short-term borrowings	$ 721	$ 864	$ 571
Long-term borrowings (excluding junior subordinated debentures)	1,819	1,833	3,860
Junior subordinated debentures	1,728	1,728	1,728
Total interest expense on borrowings	$ 4,268	$ 4,425	$ 6,159

The Company has lines of credit with the FHLB, FRB and several commercial banks that provide a secondary funding source for lending, liquidity and asset and liability management. FHLB advances are collateralized by FHLB stock owned by the Bank and certain qualifying loans. At December 31, 2008 the Company had additional borrowing capacity available of approximately $81.1 million at the FHLB. As of December 31, 2008, there were no borrowings outstanding on the FRB and commercial bank lines of credit which totaled $73.9 million. The commercial bank lines are unsecured but generally require the Company to maintain certain standard financial covenants.

As of December 31, 2008, the Company had entered into repurchase agreements with the FHLB, whereby securities available for sale with a carrying value of $31.9 million were pledged to collateralize the borrowings. There were no FHLB repurchase agreements outstanding at December 31, 2007. These transactions are accounted for as secured financings and the obligation to repurchase is reflected as a liability in the Company s Consolidated Statements of Condition. The dollar amount of securities underlying the agreements is included in securities available for sale in the Company s Consolidated Statements of Financial Condition. These securities however, are delivered to the FHLB, who may sell, loan or otherwise dispose of these securities to other parties in the normal course of their business, but they agree to resell to us the same securities at the maturity of the agreements. The Company also retains the right of substitution of collateral throughout the terms of the agreements. At December 31, 2008, there were no amounts at risk under repurchase agreements with any individual counterparty or group of related counterparties that exceeded 10% of shareholders equity. The amount at risk to the Company is equal to the excess of the carrying value (or fair value if greater) of the securities sold under agreements to repurchase over the amount of our repurchase liability.

The aggregate maturities of FHLB advances and repurchase agreements, by year of maturity, at December 31, 2008 are as follows (in thousands):

2009	$ 508
2010	20,080
2011	10,065
	$ 30,653

In February 2001, the Company formed Financial Institutions Statutory Trust I (the Trust) for the sole purpose of issuing trust preferred securities. The Company accounts for the Trust in accordance with FASB Interpretation No. 46, Consolidation of Variable Interest Entities and, as such, the Trust is not consolidated. The Company s $502 thousand investment in the common equity of the Trust is classified in the consolidated statements of financial condition as other assets and $16.7 million of related debentures are classified as liabilities. In 2001, the Company incurred costs relating to the issuance of the debentures totaling $487 thousand. These costs, which are included in other assets on the consolidated statements of financial condition, were deferred and are being amortized to interest expense using the

straight-line method over a twenty year period.

The Company, through the Trust, issued 16,200 fixed rate pooled trust preferred securities with a liquidation preference of $1,000 per security. The trust preferred securities represent an interest in the related subordinated debentures of the Company, which were purchased by the Trust and have substantially the same payment terms as these trust preferred securities. The subordinated debentures are the only assets of the Trust and interest payments from the debentures finance the distributions paid on the trust preferred securities. Distributions on the debentures are payable semi-annually at a fixed interest rate of 10.20%.

The trust preferred securities are subject to mandatory redemption at the liquidation preference, in whole or in part, upon repayment of the subordinated debentures at maturity or their earlier redemption. The subordinated debentures are redeemable prior to the maturity date of February 1, 2031, at the option of the Company on or after February 1, 2011, in whole at any time thereafter or in part from time to time thereafter. The subordinated debentures are also redeemable at any time, in whole, but not in part, upon the occurrence of specific events defined within the trust indenture. The Company has the option to defer distributions on the subordinated debentures from time to time for a period not to exceed 20 consecutive quarters.

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(9.) COMMITMENTS AND CONTINGENCIES

Financial Instruments with Off-Balance Sheet Risk

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

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

At December 31, 2008 and 2007, the off-balance sheet commitments consist of the following (in thousands):

	2008	2007
Commitments to extend credit	$ 339,454	$ 273,354
Standby letters of credit	7,902	7,277

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

The Company also extends rate lock agreements to borrowers related to the origination of residential mortgage loans. To mitigate the interest rate risk inherent in these rate lock agreements when the Company intends to sell the related loan, once originated, as well as closed residential mortgage loans held for sale, the Company enters into forward commitments to sell individual residential mortgages. Rate lock agreements and forward commitments are considered derivatives and are recorded at fair value in accordance with SFAS No. 133, *Accounting for Derivative Instruments and Hedging Activities*. As of December 31, 2008 and 2007, the total notional amount of these derivatives held by the Company amounted to $21.3 million and $6.3 million, respectively. The fair value of these derivatives in a gain position were recorded as other assets, while the fair value of these derivatives in a loss position were recorded as other liabilities in the consolidated statements of financial condition. In addition, 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 operations. These fair values and changes in fair values were not significant as of or for the years ended December 31, 2008 and 2007.

Lease Obligations

The Company is obligated under a number of noncancellable operating lease agreements for land, buildings and equipment. Certain of these leases provide for escalation clauses and contain renewal options calling for increased rentals if the lease is renewed. Future minimum payments by year and in the aggregate, under the noncancellable leases with initial or remaining terms of one year or more, are as follows at December 31, 2008 (in thousands):

2009	$ 1,237
2010	1,051
2011	999
2012	977

2013	838
Thereafter	5,215
	$ 10,317

Rent expense relating to these operating leases, included in occupancy and equipment expense in the statements of operations, was $1.1 million, $970 thousand and $899 thousand in 2008, 2007 and 2006, respectively.

Contingent Liabilities

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

FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES
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(10.) REGULATORY MATTERS

General

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

Federal Reserve Requirements

The Bank is required to maintain a reserve balance at the Federal Reserve Bank of New York. The reserve requirement for the Bank totaled $1.0 million as of December 31, 2008 and 2007.

Dividend Restrictions

In the ordinary course of business, the Company is dependent upon dividends from Five Star Bank to provide funds for the payment of interest expense on the junior subordinated debentures, 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. Based upon the financial results for the year ended December 31, 2008, the Bank will be required to obtain approval from the New York State Banking Department for future dividends payments.

In addition, pursuant to the terms of the Treasury s TARP Capital Purchase Program (see Note 11, Shareholders Equity), the Company may not declare or pay any cash dividends on its common stock other than regular quarterly cash dividends of not more than $0.10 without the consent of the U.S. Treasury.

Capital

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 initiate certain mandatory, and possibly additional discretionary, actions by regulators that, if undertaken, could have a direct material impact on the Company s 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.

Quantitative measures established by regulation to ensure capital adequacy require the Company and the Bank to maintain minimum amounts and ratios of Total and Tier 1 capital to risk-weighted assets and of Tier 1 capital to average assets (all as defined in the regulations). These minimum amounts and ratios are included in the table below.

The Company s and the Bank s Tier 1 capital consists of shareholders equity excluding unrealized gains and losses on securities available for sale (except for unrealized losses which have been determined to be other than temporary and recognized as expense in the consolidated statements of operations), goodwill and other intangible assets and disallowed portions of deferred tax assets. Tier 1 capital for the Company also includes, subject to limitation, $16.7 million of trust preferred securities issued by FISI Statutory Trust I and $37.5 million of preferred stock issued to the U.S. Department of Treasury (the Treasury) through the Treasury s Troubled Asset Relief Program (TARP) (see Note 11, Shareholders Equity). The Company and the Bank s total capital are comprised of Tier 1 capital for each entity plus a permissible portion of the allowance for loan losses.

The Tier 1 and total capital ratios are calculated by dividing the respective capital amounts by risk-weighted assets. Risk-weighted assets are calculated based on regulatory requirements and include total assets, excluding goodwill and other intangible assets and disallowed portions of deferred tax assets, allocated by risk weight category and certain off-balance-sheet items (primarily loan commitments). The leverage ratio is calculated by dividing Tier 1 capital by

adjusted quarterly average total assets, which exclude goodwill and other intangible assets and disallowed portions of deferred tax assets.

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(10.) REGULATORY MATTERS (Continued)

The Company s and the Bank s actual and required capital ratios as of December 31, 2008 and 2007 were as follows (dollars in thousands):

	Actual		For Capital Adequacy Purposes		Well Capitalized	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
December 31, 2008:						
Tier 1 leverage:						
Company	$ 150,426	8.05%	$ 74,764	4.00%	$ 93,456	5.00%
Bank (FSB)	120,484	6.46	74,586	4.00	93,232	5.00
Tier 1 capital (to risk-weighted assets):						
Company	150,426	11.83	50,881	4.00	76,322	6.00
Bank (FSB)	120,484	9.52	50,624	4.00	75,936	6.00
Total risk-based capital (to risk-weighted assets):						
Company	166,362	13.08	101,762	8.00	127,203	10.00
Bank (FSB)	136,340	10.77	101,248	8.00	126,560	10.00
December 31, 2007:						
Tier 1 leverage:						
Company	$ 172,899	9.35%	$ 73,943	4.00%	$ 92,429	5.00%
Bank (FSB)	157,312	8.54	73,718	4.00	92,148	5.00
Tier 1 capital (to risk-weighted assets):						
Company	172,899	15.74	49,939	4.00	65,909	6.00
Bank (FSB)	157,312	14.40	43,710	4.00	65,565	6.00
Total risk-based capital (to risk-weighted assets):						
Company	186,652	16.99	87,878	8.00	109,848	10.00
Bank (FSB)	170,994	15.65	87,420	8.00	109,275	10.00

Five Star Bank has been notified by its regulator that, as of its most recent regulatory examination, it is regarded as well capitalized under the regulatory framework for prompt corrective action. Such determination has been made based on the Bank s Tier 1, total capital, and leverage ratios. There have been no conditions or events since this notification that management believes would change the Bank s categorization as well capitalized under the aforementioned ratios.

(11.) SHAREHOLDERS EQUITY

The Company s authorized capital stock consists of 50,210,000 shares of capital stock, 50,000,000 of which are common stock, par value $0.01 per share, and 210,000 of which are preferred stock, par value $100.00 per share, which is designated into two classes, Class A of which 10,000 shares are authorized, and Class B of which 200,000 shares are authorized. There are two series of Class A Preferred Stock; Series A 3% Preferred Stock and the Series A Preferred Stock. There is one series of Class B Preferred Stock; Series B-1 8.48% Preferred Stock. As of December 31, 2008, there were 183,259 shares of preferred stock issued and outstanding.

Common Stock

The changes in shares of common stock outstanding were as follows for the years ended December 31:

	2008	**2007**
Shares outstanding at beginning of period	11,011,151	11,342,771
Restricted stock awards issued	51,500	17,100
Stock options exercised	2,317	14,776
Directors retainer	5,912	5,319
Treasury stock purchases	(272,861)	(368,815)
Shares outstanding at end of period	10,798,019	11,011,151

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(11.) SHAREHOLDERS EQUITY (Continued)

Treasury Stock

The Company repurchased 272,861 shares, 368,815 shares, and 20,351 shares of its common stock in open market transactions at an aggregate cost of $4.8 million, $7.2 million and $335 thousand during the years ended December 31, 2008, 2007 and 2006, respectively.

Preferred Stock and Warrant

Series A 3% Preferred Stock. As of December 31, 2008, there were 1,533 shares of Series A 3% Preferred Stock issued and outstanding. Holders of Series A 3% Preferred Stock are entitled to receive an annual dividend of $3.00 per share, which is cumulative and payable quarterly. Holders of Series A 3% Preferred Stock have no pre-emptive right in, or right to purchase or subscribe for, any additional shares of the Company s capital stock and have no voting rights. Dividend or dissolution payments to the Class A shareholders must be declared and paid, or set apart for payment, before any dividends or dissolution payments can be declared and paid, or set apart for payment, to the holders of Class B Preferred Stock or Common Stock. The Series A 3% Preferred Stock is not convertible into any other of the Company s securities.

Series A Preferred Stock and Warrant. In December 2008, under the U.S. Department of the Treasury s (Treasury) TARP Capital Purchase Program, the Company entered into a Securities Purchase Agreement Standard Terms with the U.S. Treasury pursuant to which, among other things, the Company sold to the U.S. Treasury for an aggregate purchase price of $37.5 million, 7,503 shares of fixed rate cumulative perpetual preferred stock, Series A (Series A Preferred Stock) and a warrant to purchase up to 378,175 shares of common stock, par value $0.01 per share (the Warrant), of the Company.

The Series A Preferred Stock ranks senior to the Company s common shares and *pari passu*, which is at an equal level in the capital structure, with existing preferred shares (Series A 3% Preferred Stock), other than preferred shares which by their terms rank junior to any other existing preferred shares (Series B-1 8.48% Preferred Stock). The Series A Preferred Stock pays a compounding cumulative dividend, in cash, at a rate of 5% per annum through February 15, 2014, and 9% per annum thereafter on the liquidation preference of $5,000 per share. The Company is prohibited from paying any dividend with respect to shares of common stock, other junior securities or preferred stock ranking *pari passu* with the Series A Preferred Stock or repurchasing or redeeming any shares of the Company s common shares, other junior securities or preferred stock ranking *pari passu* with the Series A Preferred Stock in any quarter unless all accrued and unpaid dividends are paid on the Series A Preferred Stock for all past dividend periods (including the latest completed dividend period), subject to certain limited exceptions. The Series A Preferred Stock is non-voting, other than class voting rights on matters that could adversely affect the Series A Preferred Stock. The U.S. Treasury may also transfer the Series A Preferred Stock to a third party at any time.

The Company s Series A Preferred Stock qualifies as Tier 1 capital in accordance with regulatory capital requirements (see Note 10, Regulatory Matters).

The Warrant has a term of 10 years and is exercisable at any time, in whole or in part, at an exercise price of $14.88 per share (subject to certain anti-dilution adjustments). The U.S. Treasury may not exercise the Warrant for, or transfer the Warrant with respect to, more than half of the initial shares of common stock underlying the Warrant prior to the earlier of (i) the date on which the Company receives aggregate gross proceeds of not less than $37.5 million from one or more qualified equity offerings and (ii) December 31, 2009. The number of shares to be delivered upon settlement of the Warrant will be reduced by 50% if the Company receives aggregate gross proceeds of at least 100% of the aggregate liquidation preference of the Series A Preferred Stock ($37.5 million) from one or more qualified equity offerings prior to December 31, 2009.

Under the original terms of the CPP, the Company could not redeem the Series A Preferred Stock prior to February 15, 2012 except with proceeds from a qualified offering. However, the American Recovery and Reinvestment Act of 2009 (ARRA), provides that the Secretary of Treasury shall permit a recipient of funds under TARP, subject to consultation with the recipient s appropriate Federal banking agency, to repay such assistance

without regard to whether the recipient has replaced such funds from any other source or to any waiting period. ARRA further provides that when the recipient repays such assistance, the Secretary of Treasury shall liquidate the warrants associated with the assistance at the current market price. While Treasury has not yet issued implementing regulations, it appears that ARRA will permit the Company, if it so elects and following consultation with the FRB, to redeem the Series A Preferred Stock at any time without restriction.

FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES
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(11.) SHAREHOLDERS EQUITY (Continued)

The $37.5 million in proceeds was allocated to the Series A Preferred Stock and the Warrant based on their relative fair values at issuance ($35.5 million was allocated to the Series A Preferred Stock and $2.0 million to the Warrant). The difference between the initial value allocated to the Series A Preferred Stock of $35.5 million and the liquidation value of $37.5 million will be charged to retained earnings from the issue date through February 15, 2014, which is the commencement of the perpetual dividend, as an adjustment to the dividend yield using the effective yield method. The amount charged to retained earnings will be deducted from the numerator in calculating basic and diluted earnings per share during the related reporting period (see Note 15, (Loss) Earnings per Share).

Series B-1 8.48% Preferred Stock. As of December 31, 2008, there were 174,223 shares of Series B-1 8.48% Preferred Stock issued and outstanding. Holders of Series B-1 8.48% Preferred Stock are entitled to receive an annual dividend of $8.48 per share, which is cumulative and payable quarterly. Holders of Series B-1 8.48% Preferred Stock have no pre-emptive right in, or right to purchase or subscribe for, any additional shares of the Company s capital stock and have no voting rights. Accumulated dividends on the Series B-1 8.48% Preferred Stock do not bear interest, and the Series B-1 8.48% Preferred Stock is not subject to redemption. Dividend or dissolution payments to the Class B shareholders must be declared and paid, or set apart for payment, before any dividends or dissolution payments are declared and paid, or set apart for payment, to the holders of Common Stock. The Series B-1 8.48% Preferred Stock is not convertible into any other of the Company s securities.

(12.) OTHER COMPREHENSIVE INCOME (LOSS)

Total comprehensive income (loss) is reported in the accompanying consolidated statements of changes in shareholders equity. Information related to net other comprehensive income (loss) for the years ended December 31 was as follows (in thousands):

	Pre-tax Amount	Tax Expense (Benefit)	Net-of-tax Amount
2008			
Securities available for sale:			
Change in net unrealized gain/loss during the period	$ (61,464)	$ (23,778)	$ (37,686)
Reclassification adjustment for gains included in income	(288)	(111)	(177)
Reclassification adjustment for impairment charges included in income	68,215	26,389	41,826
	6,463	2,500	3,963
Change in net actuarial gain/loss and prior service benefit (cost) on defined benefit pension and post-retirement plans	(14,098)	(5,455)	(8,643)
Other comprehensive loss	$ (7,635)	$ (2,955)	$ (4,680)
2007			
Securities available for sale:			
Change in net unrealized gain/loss during the period	$ 10,530	$ 4,103	$ 6,427
Reclassification adjustment for gains included in income	(207)	(80)	(127)
	10,323	4,023	6,300
Change in net actuarial gain/loss and prior service benefit (cost) on defined benefit pension and post-retirement plans	4,531	1,760	2,771

Other comprehensive income	$	14,854	$	5,783	$	9,071
2006						
Securities available for sale:						
Change in net unrealized gain/loss during the period	$	(833)	$	(229)	$	(604)
Reclassification adjustment for gains included in income		(30)		(12)		(18)
Other comprehensive loss	$	(863)	$	(241)	$	(622)

The components of accumulated other comprehensive income (loss), net of tax, as of December 31 were as follows (in thousands):

		2008		**2007**
Net actuarial gain (loss) and prior service benefit (cost) on defined benefit pension and post-retirement plans	$	(7,476)	$	1,167
Net unrealized gain (loss) on securities available for sale		3,463		(500)
	$	(4,013)	$	667

FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES
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(13.) SHARE-BASED COMPENSATION

The Company has a Management Stock Incentive Plan and a Director s Stock Incentive Plan (the Plans). Under the Plans, the Company may grant stock options to purchase shares of common stock, shares of restricted stock or stock appreciation rights to its directors and key employees. Grants under the plans may be made up to 10% of the number of shares of common stock issued, including treasury shares. The exercise price of each option equals the market price of the Company s stock on the date of the grant. All options have a 10-year term and become fully exercisable over a period of 3 to 5 years from the grant date. When option recipients exercise their options, the Company issues shares from treasury stock and record the proceeds as additions to capital.

The share-based compensation expense included in the Consolidated Statements of Operations for the years ended December 31, 2008, 2007 and 2006 was as follows (in thousands):

	2008	2007	2006
Stock options:			
Management Stock Incentive Plan	$ 378	$ 571	$ 522
Director Stock Incentive Plan	40	220	299
	418	791	821
Restricted stock awards:			
Management Stock Incentive Plan	215	164	44
Total share-based compensation	$ 633	$ 955	$ 865

The restricted stock award expense for 2008 includes $30 thousand of dividends for unearned shares in the restricted stock plan which is accounted for as compensation expense.

The following is a summary of stock option activity for the year ended December 31, 2008 (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	534,987	$ 19.40		
Granted	61,100	16.98		
Exercised	(2,317)	13.77		
Forfeited	(5,775)	19.03		
Expired	(5,110)	22.18		
Outstanding at end of year	582,885	$ 19.14	5.37 years	$ 59
Exercisable at end of year	402,357	$ 19.28	4.02 years	$ 59

As of December 31, 2008, there was $430 thousand of unrecognized compensation expense related to unvested stock options that is expected to be recognized over a weighted average period of 1.99 years.

The aggregate intrinsic value (the amount by which the market price of the stock on the date of exercise exceeded the market price of the stock on the date of grant) of option exercises for the years ended December 31, 2008, 2007 and

2006 was $10 thousand, $52 thousand, and $54 thousand, respectively. The total cash received as a result of option exercises under stock compensation plans for the years ended December 31, 2008, 2007 and 2006 was $32 thousand, $251 thousand, and $208 thousand, respectively. The tax benefits realized in connection with these stock option exercises were not significant.

FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES
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(13.) SHARE-BASED COMPENSATION (Continued)

The Company uses the Black-Scholes valuation method to estimate the fair value of its stock option awards. This method is dependent on certain assumption. The following is a summary of the stock options granted for the periods indicated as well as the weighted average assumptions used to compute the fair value of the options:

	2008	2007	2006
Options granted	61,100	90,700	99,597
Grant date weighted average fair value per share	$ 5.09	$ 7.09	$ 8.14
Grant date weighted average share price	$ 16.98	$ 19.49	$ 19.73
Risk-free interest rate	3.40%	4.76%	4.96%
Expected dividend yield	3.48%	2.21%	1.65%
Expected stock price volatility	38.60%	39.36%	41.75%
Expected life (in years)	6.19	5.94	6.19

In the table above the risk-free interest rate is the U.S. Treasury rate commensurate with the expected life of option on the date of their grant. The expected stock price volatility is based upon historical activity of the Company s stock over a span of time equal to the expected life of the options. The expected life for options granted subsequent to 2006 is based upon based on historical experience for the Plans. Prior to that, the Company estimated the expected life of the stock options using the simplified method prescribed by SEC Staff Accounting Bulletin (SAB) No. 107.

The following is a summary of restricted stock award activity for the year ended December 31, 2008:

	Number of Shares	Weighted Average Market Price at Grant Date
Outstanding at beginning of year	30,300	$ 19.56
Granted	51,500	19.22
Vested		
Forfeited		
Outstanding at end of year	81,800	$ 19.35

As of December 31, 2008, there was $238 thousand of unrecognized compensation expense related to unvested restricted stock awards that is expected to be recognized over a weighted average period of 1.38 years.

(14.) INCOME TAXES

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

	2008	2007	2006
Income tax (benefit) expense	$ (21,301)	$ 4,800	$ 6,245
Shareholder s equity	(2,955)	5,783	(1,272)

The income tax (benefit) provision for the years ended December 31, 2008, 2007 and 2006 consisted of the following (in thousands):

	2008	2007	2006
Current tax expense:			
Federal	$ 2,043	$ 3,572	$ 6,152
State	504	513	30
	2,547	4,085	6,182
Deferred tax (benefit) expense:			
Federal	(19,640)	126	(1,498)
State	(4,208)	589	1,561
	(23,848)	715	63
Total income tax (benefit) expense:	$ (21,301)	$ 4,800	$ 6,245

FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES
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(14.) INCOME TAXES (Continued)

Income tax expense (benefit) differed from the statutory federal income tax rate as follows:

	2008	2007	2006
Statutory federal tax rate	(34.0)%	34.0%	34.0%
Increase (decrease) resulting from:			
Tax exempt interest income	(5.2)	(13.6)	(12.8)
Disallowed interest expense	0.5	1.8	1.5
State taxes, net of federal tax benefit	(5.2)	3.4	4.4
Non-taxable earnings on company owned life insurance	(0.4)	(2.0)	(0.8)
Dividend received deduction	(0.8)	(1.5)	(0.3)
Other, net	0.2	0.5	0.5
Effective tax rate	(44.9)%	22.6%	26.5%

The Company s net deferred tax asset is included in other assets in the Consolidated Statements of Condition. The tax effects of temporary differences that give rise to the deferred tax assets and deferred tax liabilities at December 31, 2008 and 2007 are as follows (in thousands):

	2008	2007
Deferred tax assets:		
Allowance for loan losses	$ 6,619	$ 5,435
Net unrealized loss on securities available for sale		315
Other than temporary impairment of investment securities	26,389	
Tax attribute carryforward benefits	2,689	2,070
Accrued pension costs	2,494	
Interest on nonaccruing loans	595	678
Share-based compensation	794	569
Core deposit intangible	332	500
Other	374	318
Gross deferred tax assets	40,286	9,885
Valuation allowance		
Deferred tax assets, net of valuation allowance	40,286	9,885
Deferred tax liabilities:		
Deferred loan origination costs	4,458	1,873
Net unrealized gain on securities available for sale	2,185	
Prepaid pension costs		1,288
Depreciation and amortization	1,342	1,056
Loan servicing assets	218	380
Other	2	9
Gross deferred tax liabilities	8,205	4,606

Net deferred tax asset	$	32,081	$	5,279

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

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(14.) INCOME TAXES (Continued)

The following are examples of certain evidence that management considered in evaluating its ability to realize its deferred tax assets at December 31, 2008:

- While current and anticipated banking industry conditions are challenging, the Company remains well capitalized.
- The Company sustained a strong earnings history for many years prior to 2008.
- The cumulative three-year loss (based on pre-tax income for financial reporting purposes) of approximately $2.6 million includes an impairment charge of $68.2 million related to the OTTI charge on certain securities. The Company would have been profitable for the three-year period without this charge.
- The Company s cumulative loss in recent years includes only one year (2008) with a pre-tax loss. Notwithstanding the loss, the Company s estimated 2008 taxable income for federal income tax return purposes is approximately $4.0 million.
- There are prudent and feasible tax planning strategies available to sustain the recognition of certain tax assets, such as the strategy of holding temporarily impaired securities until a market recovery, which may be until maturity, the timing of contributions to the defined benefit pension plan and the de-emphasis on tax-exempt interest income, among other things.
- Taxes paid within the Company s two year federal tax loss carry-back period were approximately $5.6 million.
- Taxable temporary differences related to deferred tax liabilities of approximately $8.2 million are scheduled to reverse and offset deductible temporary differences in the future.

Based upon the Company s historical and projected future levels of pre-tax and taxable income, the scheduled reversals of taxable temporary differences to offset future deductible amounts, and prudent and feasible tax planning strategies, management believes it is more likely than not that the deferred tax assets will be realized.

The Company and its subsidiaries are subject to federal and New York State (NYS) income taxes. The federal and NYS income tax years currently open for audit are 2006 through 2008.

At December 31, 2008, the Company has federal and NYS net operating loss carryforwards of approximately $58 thousand and $86 thousand, respectively. The federal and NYS net operating loss carryforwards begin to expire in 2021. The Company also has federal and NYS tax credits of approximately $2.7 million and $8 thousand, respectively, which have an unlimited carryforward period. The federal and NYS net operating loss carryforwards are subject to annual limitations imposed by the Internal Revenue Code (IRC). The Company believes the limitations will not prevent the carryforward benefits from being utilized.

As of December 31, 2007, the Company s unrecognized tax benefits totaled $50 thousand. The unrecognized tax benefits were associated with a NYS examination of the Company s 2002 through 2005 tax years that remained in process as of December 31, 2007. In 2008 the NYS examination was concluded and the unrecognized tax benefits were recognized. The Company had no unrecognized tax benefits at December 31, 2008 and does not expect unrecognized tax benefits to significantly increase or decrease in the next twelve months. There were no interest or penalties recorded in the income statement in income tax expense for the year ended December 31, 2008. As of December 31, 2008, there were no amounts accrued for interest or penalties related to uncertain tax positions.

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(15.) (LOSS) EARNINGS PER SHARE

Basic (loss) earnings per share represents income applicable to common shareholders divided by the weighted-average number of common shares outstanding during the period excluding unvested restricted stock. Diluted earnings per share reflects additional common shares (common stock equivalents) that would have been outstanding if dilutive potential common shares had been issued. Potential common shares that may be issued by the Company relate to outstanding stock-based awards and a warrant to purchase stock and are determined using the treasury stock method. Assumed conversion of the outstanding dilutive stock-based awards and the warrant to purchase stock would increase the shares outstanding but would not require an adjustment to income as a result of the conversion.

Earnings per common share have been computed based on the following for the years ended December 31, (dollars and shares in thousands, except per share amounts):

	2008	2007	2006
Net (loss) income applicable to common shareholders	$ (27,696)	$ 14,926	$ 15,876
Weighted average number of common shares used to calculate basic (loss) earnings per common share	10,818	11,154	11,328
Add: Effect of common stock equivalents		30	36
Weighted average number of common shares used to calculate diluted (loss) earnings per common share	10,818	11,184	11,364
(Loss) earnings per common share:			
Basic	$ (2.56)	$ 1.34	$ 1.40
Diluted	$ (2.56)	$ 1.33	$ 1.40

Due to the loss applicable to common shareholders reported for the year ended December 31, 2008, the effect of all share-based awards and the warrant were anti-dilutive and therefore are not included in the calculation of diluted earnings per share. There were approximately 384,000 and 251,000 weighted average common stock equivalents for the years ended December 31, 2007 and 2006, respectively, that were not considered in the calculation of diluted earnings per share since their effect would have been anti-dilutive.

(16.) EMPLOYEE BENEFIT PLANS

Defined Benefit Pension Plan

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

The System was established in 1938 to provide for the payment of benefits to employees of participating banks and is overseen by a Board of Trustees who meet quarterly to set the investment policy guidelines. The System utilizes two investment management firms where one firm is managing approximately 68% of the portfolio and the second firm is managing approximately 32% of the portfolio. The System s investment objective is to exceed the investment benchmarks in each asset category. Each firm operates under a separate written investment policy approved by the Trustees and designed to achieve an allocation approximating 60% (may vary from 50%-70%) invested in equity securities and 40% (may vary from 30%-50%) invested in debt securities. Each firm reports at least quarterly to the

Investment Committee and semi-annually to the Board.

In September 2006, the FASB issued SFAS 158, which requires the recognition of the overfunded or underfunded status of a defined benefit postretirement plan in the Company s Consolidated Statements of Condition. This portion of the new guidance was adopted by the Company on December 31, 2006. Additionally, the pronouncement eliminates the option for the Company to use a measurement date prior to the Company s fiscal year-end effective December 31, 2008. SFAS 158 provides two approaches to transition to a fiscal year-end measurement date, both of which are to be applied prospectively. The Company elected to apply the transition option under which a 15-month measurement was determined as of September 30, 2007 that covered the period until the fiscal year-end measurement was required on December 31, 2008. The effect of changing the measurement date resulted in a $43 thousand increase to retained earnings.

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(16.) EMPLOYEE BENEFIT PLANS (Continued)

The following table provides a reconciliation of the changes in the plan s benefit obligations, fair value of assets and a statement of the funded status at their respective measurement dates (in thousands):

	December 31, 2008[(a)]	September 30, 2007
Change in projected benefit obligation:		
Projected benefit obligation at of beginning of period	$ (25,102)	$ (25,806)
Service cost	(1,820)	(1,498)
Interest cost	(1,953)	(1,473)
Actuarial (loss) gain	(3,767)	2,310
Benefits paid and plan expenses	1,764	1,365
Projected benefit obligation as of end of period	(30,878)	(25,102)
Change in plan assets:		
Fair value of plan assets as of beginning of period	28,431	25,921
Actual (loss) return on plan assets	(7,436)	3,875
Employer contributions	5,200	
Benefits paid and plan expenses	(1,764)	(1,365)
Fair value of plan assets as of end of period	24,431	28,431
(Unfunded) funded status at end of period	$ (6,447)	$ 3,329

(a) The measurement date for 2008 and 2007 is December 31 and September 30, respectively. As a result, 2008 includes 15 months of activity.

The accumulated benefit obligation was $27.1 million and $22.0 million at December 31, 2008 and 2007, respectively.

Net periodic pension cost consists of the following components for the years ended December 31 (in thousands):

	2008	2007	2006
Service cost	$ 1,456	$ 1,498	$ 1,725

		2008		2007		2006
Interest cost on projected benefit obligation		1,562		1,473		1,341
Expected return on plan assets		(2,094)		(1,907)		(1,866)
Amortization of net transition asset						(26)
Amortization of unrecognized loss				31		223
Amortization of unrecognized prior service cost		11		11		14
Net periodic pension cost	$	935	$	1,106	$	1,411

The actuarial assumptions used to determine the net periodic pension cost were as follows:

	2008	2007	2006
Weighted average discount rate	6.35%	5.82%	5.25%
Rate of compensation increase	3.50%	3.50%	3.50%
Expected long-term rate of return	7.50%	7.50%	7.50%

The actuarial assumptions used to determine the projected benefit obligation were as follows:

	2008	2007	2006
Weighted average discount rate	6.03%	6.35%	5.82%
Rate of compensation increase	3.50%	3.50%	3.50%

The weighted average discount rate was based upon the projected benefit cash flows and the market yields of high grade corporate bonds that are available to pay such cash flows.

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(16.) EMPLOYEE BENEFIT PLANS (Continued)

The expected long-term rate-of-return on plan assets reflects long-term earnings expectations on existing plan assets and those contributions expected to be received during the current plan year. In estimating that rate, appropriate consideration was given to historical returns earned by plan assets in the fund and the rates of return expected to be available for reinvestment.

The Company s funding policy is to contribute, at a minimum, an actuarially determined amount that will satisfy the minimum funding requirements determined under the appropriate sections of Internal Revenue Code. The Company expects to make the minimum required contribution of $1.6 million to its pension plan in fiscal year 2009, however a greater amount may be contributed, especially if the current market disruption continues or worsens.

Estimated benefit payments under the pension plan over the next ten years at December 31, 2008 are as follows (in thousands):

2009	$	1,160
2010		1,222
2011		1,348
2012		1,451
2013		1,521
2014 2018		10,037

The pension plan asset allocations by asset category are as follows as of December 31 (in thousands):

	2008		2007	
Asset category:				
Equity securities	$	50%	$	54%
Debt securities		43		40
Other		7		6
Total	$	100%	$	100%

Postretirement Benefit Plan

Prior to December 31, 2001, an entity acquired by the Company provided health and dental care benefits to retired employees who met specified age and service requirements through a postretirement health and dental care plan in which both the acquired entity and the retirees shared the cost. The plan provided for substantially the same medical insurance coverage as for active employees until their death and was integrated with Medicare for those retirees aged 65 or older. In 2001, the plan s eligibility requirements were amended to curtail eligible benefit payments to only retired employees and active participants who were fully vested under the Plan. In 2003, retirees under age 65 began contributing to health coverage at the same cost-sharing level as that of active employees. The retirees aged 65 or older were offered new Medicare supplemental plans as alternatives to the plan historically offered. The cost sharing of medical coverage was standardized throughout the group of retirees aged 65 or older. In addition, to be consistent with the administration of the Company s dental plan for active employees, all retirees who continued dental coverage began paying the full monthly premium. The accrued liability included in other liabilities in the consolidated statements of financial condition related to this plan amounted to $144 thousand and $207 thousand as of December 31, 2008 and 2007, respectively. The postretirement expense for the plan that was included in salaries and employee benefits in the consolidated statements of operations was not significant for the years ended December 31, 2008, 2007 and 2006. The plan is not funded.

The components of accumulated other comprehensive income (loss) related to the defined benefit plan and postretirement benefit plan, on a pre-tax basis at December 31, are summarized below (in thousands):

	2008	2007
Defined benefit plan:		
Net actuarial gain (loss)	$ (12,579)	$ 1,518
Prior service (cost) benefit	(155)	(169)
	(12,734)	1,349
Postretirement benefit plan:		
Net actuarial gain (loss)	(238)	(308)
Prior service (cost) benefit	778	863
	540	555
Total recognized in accumulated other comprehensive income (loss)	$ (12,194)	$ 1,904

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FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES
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(16.) EMPLOYEE BENEFIT PLANS (Continued)

Changes in plan assets and benefit obligations recognized in other comprehensive income (loss) on a pre-tax basis during the years ended December 31 are as follows (in thousands):

	2008	2007
Defined benefit plan:		
Net actuarial gain (loss)	$ (14,097)	$ 4,308
Prior service (cost) benefit	14	12
	(14,083)	4,320
Postretirement benefit plan:		
Net actuarial gain (loss)	70	85
Prior service (cost) benefit	(85)	126
	(15)	211
Total recognized in other comprehensive income (loss)	$ (14,098)	$ 4,531

For the year ending December 31, 2009, the estimated amount of prior service cost that will be amortized from accumulated other comprehensive income into net periodic benefit cost is $12 thousand.

Defined Contribution Plan

Employees that meet certain age and service requirements are eligible to participate in the Company sponsored 401(k) plan. Under the plan, participants may make contributions, in the form of salary deferrals, up to the maximum Internal Revenue Code limit. The Company matches a participant s contributions up to 4.5% of compensation, calculated as 100% of the first 3% of compensation and 50% of the next 3% of compensation deferred by the participant. In 2006, the Company matched 25% of the first 8% of participant compensation deferral. The Company may also make additional discretionary matching contributions, although no such additional discretionary contributions were made in 2008, 2007 or 2006. The expense included in salaries and employee benefits in the consolidated statements of operations for this plan amounted to $993 thousand, $869 thousand and $553 thousand in 2008, 2007 and 2006, respectively.

Supplemental Executive Retirement Plans

During 2008, the Company maintains a non-qualified supplemental executive retirement plan (SERP) for two active executives. The Company has accrued a liability, all of which is unfunded, and recorded expense of $309 thousand at and for the year ended December 31, 2008. There were no amounts recorded for these SERPs prior to 2008.

FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES
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(17.) FAIR VALUE MEASUREMENTS

Determination of Fair Value Assets Measured at Fair Value on a Recurring and Nonrecurring Basis

Valuation Hierarchy

SFAS 157 defines fair value as the exchange price that would be received for an asset or paid to transfer a liability (an exit price) in the principal or most advantageous market for the asset or liability in an orderly transaction between market participants on the measurement date. For SFAS 157 disclosures, SFAS 157 establishes a fair value hierarchy that prioritizes the inputs to valuation techniques used to measure fair value into three levels.

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

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

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

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

Assets Measured at Fair Value on a Recurring Basis

Assets measured and recorded at fair value on a recurring basis as of December 31, 2008 are summarized as follows (in thousands):

	Assets Measured and Recorded at Fair Value			
	Total	Level 1	Level 2	Level 3
Securities available for sale	$ 547,506	$ 624	$ 543,110	$ 3,772

Changes in Level 3 Fair Value Measurements

The reconciliation for all assets measured at fair value on a recurring basis using significant unobservable inputs (Level 3) for the year ended December 31, 2008, is as follows (in thousands):

Securities available for sale (Level 3), beginning of year	$	
Transfers into Level 3		33,307
Impairment charges included in earnings		(29,429)
Principal paydowns and amortization of premiums		(106)
Securities available for sale (Level 3), end of year	$	3,772

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(17.) FAIR VALUE MEASUREMENTS (Continued)

Assets Measured at Fair Value on a Nonrecurring Basis

The Company measures or monitors certain of its assets on a nonrecurring fair value basis. Examples of these nonrecurring uses of fair value include: loans held for sale, mortgage servicing assets and collateral dependent impaired loans.

Collateral dependent impaired loans totaling $599 thousand were recorded at fair value on a nonrecurring basis as of December 31, 2008, resulting in a charge of $109 thousand included in the provision for loan losses for the year ended December 31, 2008. The collateral dependent impaired loans are a Level 2 fair measurement, as fair value is determined based upon estimates of the fair value of the collateral underlying the impaired loans typically using appraisals of comparable property or valuation guides.

Mortgage servicing rights were written down to fair value of $563 thousand at December 31, 2008, resulting in a charge of $343 thousand that was recorded in noninterest income. The mortgage servicing rights are a Level 3 fair value measurement, as fair value is determined by calculating the present value of the future servicing cash flows from the underlying mortgage loans.

Fair Value of Financial Instruments

The Company uses fair value measurements to record fair value of certain assets and to estimate fair value of financial instruments not recorded at fair value but required to be disclosed at fair value under SFAS No. 107, Disclosure About Fair Value of Financial Instruments (SFAS 107).

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

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

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

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

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

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

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

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

The fair value of a financial instrument is the current amount that would be exchanged between willing parties, other than in a forced liquidation. Fair value is best determined based upon quoted market prices. However, in many instances, there are no quoted market prices for the Company s various financial instruments. In cases where quoted market prices are not available, fair values are based on estimates using present value or other valuation techniques. Those techniques are significantly affected by the assumptions used, including the discount rate and estimates of future cash flows. Accordingly, the fair value estimates may not be realized in an immediate settlement of the instrument. The accounting guidelines exclude certain financial instruments and all non-financial instruments from its disclosure requirements. Accordingly, the aggregate fair value amounts presented at December 31, 2008 and 2007 may not necessarily represent the underlying fair value of the Company.

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(17.) FAIR VALUE MEASUREMENTS (Continued)

The carrying values and fair values of financial instruments at December 31, 2008 and 2007 are as follows (in thousands):

	2008		2007	
	Carrying Amount	Fair Value	Carrying Amount	Fair Value
Financial assets:				
Cash and cash equivalents	$ 55,187	$ 55,187	$ 46,673	$ 46,673
Securities held to maturity	58,532	59,147	59,479	59,902
Loans held for sale	1,013	1,032	906	914
Loans	1,102,330	1,169,660	948,652	963,022
Company owned life insurance	23,692	23,692	3,017	3,017
Accrued interest receivable	7,556	7,556	9,170	9,170
FHLB and FRB stock	6,035	6,035	5,972	5,972
Financial liabilities:				
Demand, savings and money market deposits	985,796	985,796	968,315	968,315
Time deposits	647,467	654,334	607,656	607,656
Short-term borrowings	23,465	23,465	25,643	25,643
Long-term borrowings (excluding junior subordinated debentures)	30,653	32,005	25,865	26,446
Junior subordinated debentures	16,702	12,232	16,702	17,258
Accrued interest payable	7,041	7,041	10,584	10,584

(18.) PARENT COMPANY FINANCIAL INFORMATION

The following condensed statements of condition of the Company as of December 31, 2008 and 2007 and the related condensed statements of operations and cash flows for 2008, 2007 and 2006 should be read in conjunction with Consolidated Financial Statements and related notes (in thousands):

Condensed Statements of Condition	**2008**	**2007**
Assets:		
Cash and due from subsidiaries	$ 27,163	$ 13,228
Securities available for sale, at fair value	624	780
Note receivable	300	300
Investment in and receivables due from subsidiaries	176,780	196,449
Other assets	4,585	4,010
Total assets	$ 209,452	$ 214,767
Liabilities and shareholders equity:		
Junior subordinated debentures	$ 16,702	$ 16,702
Other liabilities	2,450	2,743
Shareholders equity	190,300	195,322
Total liabilities and shareholders equity	$ 209,452	$ 214,767

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(18.) PARENT COMPANY FINANCIAL INFORMATION (Continued)

Condensed Statements of Operations	**2008**	**2007**	**2006**
Dividends from subsidiaries and associated companies	$ 11,251	$ 14,151	$ 35,455
Management and service fees from subsidiaries	418	631	643
Other income	74	94	427
Total income	11,743	14,876	36,525
Operating expenses	4,363	4,684	6,319
Income before income tax benefit and equity in undistributed earnings (distributions in excess of earnings) of subsidiaries	7,380	10,192	30,206
Income tax benefit	1,499	1,491	2,164
Income before equity in undistributed earnings (distributions in excess of earnings) of subsidiaries	8,879	11,683	32,370
(Distributions in excess of earnings) equity in undistributed earnings of subsidiaries	(35,037)	4,726	(15,008)
Net (loss) income	$ (26,158)	$ 16,409	$ 17,362

Condensed Statements of Cash Flows	**2008**	**2007**	**2006**
Cash flows from operating activities:			
Net (loss) income	$ (26,158)	$ 16,409	$ 17,362
Adjustments to reconcile net (loss) income to net cash provided by operating activities:			
Distributions in excess of earnings (equity in undistributed earnings) of subsidiaries	35,037	(4,726)	15,008
Depreciation and amortization	427	521	642
Share-based compensation	633	955	865
Increase in other assets	(763)	(242)	(1,076)
(Decrease) increase in other liabilities	(258)	(2,421)	1,120
Net cash provided by operating activities	8,918	10,496	33,921
Cash flows from investing activities:			
(Purchase) sale of securities available for sale	(27)		21
Purchase of premises and equipment, net of disposals	(72)	189	528
Capital investment in subsidiary bank	(20,000)		
Net cash (used in) provided by investing activities	(20,099)	189	549
Cash flows from financing activities:			
Repayment on long-term borrowings			(25,000)
Purchase of preferred and common shares	(4,821)	(7,245)	(346)
Proceeds from issuance of preferred and common shares	35,602	105	112
Proceeds from issuance of common stock warrant	2,025		

Proceeds from stock options exercised	32	251	204
Dividends paid	(7,722)	(6,199)	(5,226)
Net cash provided by (used in) financing activities	25,116	(13,088)	(30,256)
Net (decrease) increase in cash and cash equivalents	13,935	(2,403)	4,214
Cash and cash equivalents as of beginning of year	13,228	15,631	11,417
Cash and cash equivalents as of end of the year	$ 27,163	$ 13,228	$ 15,631

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ITEM 9. CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE

None.

ITEM 9A. CONTROLS AND PROCEDURES

Effectiveness of Controls and Procedures

As of the end of the period covered by this report, the Company carried out an evaluation, under the supervision and with the participation of the Company s management, including the Company s Chief Executive Officer 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 Securities and Exchange Commission (SEC) under the Securities Exchange Act of 1934 (Exchange Act). Based upon that evaluation, the Chief Executive Officer and Chief Financial Officer concluded that the Company s disclosure controls and procedures were effective as of the end of the period covered by this annual report.

Disclosure controls and procedures are the controls and other procedures that are designed to ensure that information required to be disclosed in the reports that the Company files or submits under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the SEC s rules and forms. Disclosure controls and procedures include, without limitation, controls and procedures designed to ensure that information required to be disclosed in the reports that the Company files or submits under the Exchange Act is accumulated and communicated to management, including the Chief Executive Officer and Chief Financial Officer, as appropriate, to allow timely decisions regarding required disclosure.

All internal control systems, no matter how well designed, have inherent limitations. Therefore, even those systems determined effective can provide only reasonable assurance with respect to financial statement preparation and presentation.

Management Report on Internal Control over Financial Reporting and Attestation Report of Independent Registered Public Accounting Firm

Management of Financial Institutions, Inc. (the Company) is responsible for establishing and maintaining adequate internal control over financial reporting. Management assessed the Company s internal control over financial reporting based on criteria established in Internal Control Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). Based on this assessment, management has concluded that, as of December 31, 2008, the Company maintained effective internal control over financial reporting. Management s Report on Internal Control over Financial Reporting is included under Item 8 Financial Statements and Supplementary Data in Part II of this Form 10-K.

KPMG LLP, a registered public accounting firm, has audited the consolidated financial statements included in the annual report, and has issued an attestation report on the effectiveness of the Company s internal control over financial reporting. The Report of Independent Registered Public Accounting Firm that attests the effectiveness of internal control over financial reporting is included under Item 8 Financial Statements and Supplementary Data in Part II of this Form 10-K.

Changes in Internal Control over Financial Reporting

There were no changes in the Company s internal control over financial reporting that occurred during the quarter ended December 31, 2008 that have materially affected, or are reasonably likely to materially affect, the Company s internal control over financial reporting.

ITEM 9B. OTHER INFORMATION

Not applicable.

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PART III

ITEM 10. DIRECTORS, EXECUTIVE OFFICERS AND CORPORATE GOVERNANCE

In response to this Item, the information set forth in the Company s Proxy Statement for its 2009 Annual Meeting of Shareholders (the 2009 Proxy Statement) to be filed within 120 days following the end of the Company s fiscal year, under the headings Election of Directors and Information with Respect to Board of Directors, and Section 16(a) Beneficial Ownership Reporting Compliance is incorporated herein by reference.

The information under the heading Executive Officers of the Registrant in Part I, Item 1 of this Form 10-K is also incorporated herein by reference.

Information concerning the Company s Audit Committee and the Audit Committee s financial expert is set forth under the caption Corporate Governance Information in the 2009 Proxy Statement and is incorporated herein by reference.

The Company has adopted a Code of Business Conduct and Ethics that applies to its principal executive officer, principal financial officer, principal accounting officer or controller, or persons performing similar functions. The Code of Business Conduct and Ethics is posted on the Company s internet website at www.fiiwarsaw.com. In addition, the Company will provide a copy of the Code of Business Conduct and Ethics to anyone, without charge, upon request addressed to Director of Human Resources at Financial Institutions, Inc., 220 Liberty Street, Warsaw, NY 14569. The Company intends to disclose any amendment to, or waiver from, a provision of its Code of Business Conduct and Ethics that applies to the Company s principal executive officer, principal financial officer, principal accounting officer or controller, or persons performing similar functions, and that relates to any element of the Code of Business Conduct and Ethics, by posting such information on the Company s website.

ITEM 11. EXECUTIVE COMPENSATION

In response to this Item, the information set forth in the 2009 Proxy Statement under the heading Executive Compensation is incorporated herein by reference.

ITEM 12. SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT AND RELATED SHAREHOLDER MATTERS

In response to this Item, the information set forth in the 2009 Proxy Statement under the heading Stock Ownership is incorporated herein by reference. The information under the heading Equity Compensation Plan Information in Part II, Item 5 of this Form 10-K is also incorporated herein by reference.

ITEM 13. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS, AND DIRECTOR INDEPENDENCE

In response to this Item, the information set forth in the 2009 Proxy Statement under the headings Certain Relationships and Related Party Transactions and Corporate Governance Information is incorporated herein by reference.

ITEM 14. PRINCIPAL ACCOUNTANT FEES AND SERVICES

In response to this Item, the information set forth in the 2009 Proxy Statement under the headings Audit Committee Report and Independent Auditors is incorporated herein by reference.

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PART IV

ITEM 15. EXHIBITS AND FINANCIAL STATEMENT SCHEDULES

(a) **FINANCIAL STATEMENTS**

Reference is made to the Index to Consolidated Financial Statements of Financial Institutions, Inc. and Subsidiaries under Item 8 Financial Statements and Supplementary Data in Part II of this Form 10-K.

(b) **EXHIBITS**

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

Exhibit Number	Description	Location
3.1	Amended and Restated Certificate of Incorporation of the Company	Filed Herewith
3.2	Certificate of Amendment to the Certificate of Incorporation of the Company relating to the Series A Preferred Stock	Filed Herewith
3.3	Certificate of Amendment to the Certificate of Incorporation of the Company relating to the Series A 3% Preferred Stock	Filed Herewith
3.4	Amended and Restated Bylaws of the Company	Filed Herewith
4.1	Warrant to Purchase Common Stock, dated December 23, 2008 issued by the Registrant to the United States Department of the Treasury	Incorporated by reference to Exhibit 4.2 of the Form 8-K, dated December 19, 2008
10.1	1999 Management Stock Incentive Plan	Incorporated by reference to Exhibit 10.1 of the S-1 Registration Statement
10.2	Amendment Number One to the FII 1999 Management Stock Incentive Plan	Incorporated by reference to Exhibit 10.1 of the Form 8-K, dated July 28, 2006
10.3	Form of Non-Qualified Stock Option Agreement Pursuant to the FII 1999 Management Stock Incentive Plan	Incorporated by reference to Exhibit 10.2 of the Form 8-K, dated July 28, 2006
10.4	Form of Restricted Stock Award Agreement Pursuant to the FII 1999 Management Stock Incentive Plan	Incorporated by reference to Exhibit 10.3 of the Form 8-K, dated July 28, 2006
10.5		

	Form of Restricted Stock Award Agreement Pursuant to the FII 1999 Management Stock Incentive Plan	Incorporated by reference to Exhibit 10.1 of the Form 8-K, dated January 23, 2008
10.6	1999 Directors Stock Incentive Plan	Incorporated by reference to Exhibit 10.2 of the S-1 Registration Statement
10.7	Amendment to the 1999 Director Stock Incentive Plan	Filed Herewith
10.8	Amended Stock Ownership Requirements, dated December 14, 2005	Incorporated by reference to Exhibit 10.19 of the Form 10-K for the year ended December 31, 2005, dated March 15, 2006
10.9	Executive Agreement with Peter G. Humphrey	Incorporated by reference to Exhibit 10.1 of the Form 8-K, dated September 30, 2005
10.10	Executive Agreement with James T. Rudgers	Incorporated by reference to Exhibit 10.2 of the Form 8-K, dated September 30, 2005

Exhibit Number	Description	Location
10.11	Executive Agreement with Ronald A. Miller	Incorporated by reference to Exhibit 10.3 of the Form 8-K, dated September 30, 2005
10.12	Executive Agreement with Martin K. Birmingham	Incorporated by reference to Exhibit 10.4 of the Form 8-K, dated September 30, 2005
10.13	Agreement with Peter G. Humphrey	Incorporated by reference to Exhibit 10.6 of the Form 8-K, dated September 30, 2005
10.14	Executive Agreement with John J. Witkowski	Incorporated by reference to Exhibit 10.7 of the Form 8-K, dated September 14, 2005
10.15	Executive Agreement with George D. Hagi	Incorporated by reference to Exhibit 10.7 of the Form 8-K, dated February 2, 2006
10.16	Voluntary Retirement Agreement with James T. Rudgers	Incorporated by reference to Exhibit 10.1 of the Form 8-K, dated September 24, 2008
10.17	Voluntary Retirement Agreement with Ronald A. Miller	Incorporated by reference to Exhibit 10.2 of the Form 8-K, dated September 24, 2008
10.18	Letter Agreement, dated December 23, 2008, including the Securities Purchase Agreement-Standard Terms attached thereto, by and between the Company and the United States Department of the Treasury	Incorporated by reference to Exhibit 10.1 of the Form 8-K, dated December 19, 2008
11.1	Statement of Computation of Per Share Earnings	Incorporated by reference to Note 15 of the Registrant s unaudited consolidated financial statements under Item 8 filed herewith.
12	Ratio of Earnings to Fixed Charges and Preferred Dividends	Filed Herewith
21	Subsidiaries of Financial Institutions, Inc.	Filed Herewith

23	Consent of Independent Registered Public Accounting Firm	Filed Herewith
31.1	Certification pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 Principal Executive Officer	Filed Herewith
31.2	Certification pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 Principal Financial Officer	Filed Herewith
32	Certification pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002	Filed Herewith

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SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Exchange Act, the registrant caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

FINANCIAL INSTITUTIONS, INC.

March 12, 2009

/s/ Peter G. Humphrey
Peter G. Humphrey
President & Chief Executive Officer

Pursuant to the requirements of the Securities Exchange Act of 1934, the following persons on behalf of the Registrant and in the capacities and on the date indicated have signed this report below.

Signatures	Title	Date
/s/ Peter G. Humphrey Peter G. Humphrey	Director, President and Chief Executive Officer (Principal Executive Officer)	March 12, 2009
/s/ Ronald A. Miler Ronald A. Miler	Executive Vice President and Chief Financial Officer (Principal Financial and Accounting Officer)	March 12, 2009
/s/ Karl V. Anderson, Jr. Karl V. Anderson, Jr.	Director	March 12, 2009
/s/ John E. Benjamin John E. Benjamin	Director	March 12, 2009
/s/ Thomas P. Connolly Thomas P. Connolly	Director	March 12, 2009
/s/ Barton P. Dambra Barton P. Dambra	Director	March 12, 2009
/s/ Samuel M. Gullo Samuel M. Gullo	Director	March 12, 2009
/s/ Susan R. Holliday Susan R. Holliday	Director	March 12, 2009
/s/ Erland E. Kailbourne Erland E. Kailbourne	Director, Chairman	March 12, 2009

/s/ Robert N. Latella	Director	March 12, 2009
Robert N. Latella		
/s/ James L. Robinson	Director	March 12, 2009
James L. Robinson		
/s/ John R. Tyler, Jr.	Director	March 12, 2009
John R. Tyler, Jr.		
/s/ James H. Wyckoff	Director	March 12, 2009
James H. Wyckoff		

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