FINANCIAL INSTITUTIONS INC
Form 10-K
March 12, 2010

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, 2009

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 regsitrant 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 whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§ 232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes o 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 regsitrant 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 equity held by non-affiliates of the registrant, as computed by reference to the June 30, 2009 closing price reported by NASDAQ, was $138,170,500.

As of March 1, 2010, there were issued and outstanding, exclusive of treasury shares, 10,919,608 shares of the registrant s common stock.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the Proxy Statement for the 2010 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 United States (U.S.) Department of Treasury (the 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;

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FORWARD LOOKING INFORMATION (Continued)

- 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;
- 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.

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ITEM 1. BUSINESS

GENERAL

Financial Institutions, Inc. is a financial holding company organized in 1931 under the laws of New York State (New York or NYS). 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. 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 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. FII capitalized the Trust with a $502 thousand investment in the Trust s common securities. 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.

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 51 offices and over 70 ATMs in fourteen contiguous counties of Western and Central New York: 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 outside of New York City, with combined metropolitan area populations of over two million people. The Company anticipates increasing its presence in and around these metropolitan statistical areas in the coming years.

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.

LENDING ACTVITIES

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 continually evaluates and updates its lending policy. 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, Commercial Real Estate 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, 2009, $49.5 million, or 27%, of the aggregate commercial loan portfolio were at fixed rates, while $136.9 million, or 73%, were at variable rates. The Company utilizes government loan guarantee programs where available and appropriate. See Government Guarantee Programs below.

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, 2009, $78.2 million, or 25%, of the aggregate commercial real estate loan portfolio were at fixed rates, while $230.7 million, or 75%, were at variable rates.

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, 2009, $11.3 million, or 27%, of the agricultural loan portfolio were at fixed rates, while $30.6 million, or 73%, were at variable rates. The Company utilizes government loan guarantee programs where available and appropriate. See Government Guarantee Programs below.

Government Guarantee Programs

The Company participates in government loan guarantee programs offered by the Small Business Administration (SBA), U.S. Department of Agriculture, Rural Economic and Community Development and Farm Service Agency, among others. As of December 31, 2009, the Company had loans with an aggregate principal balance of $44.4 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, 2009, 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 84 months. The Company has expanded its relationships with franchised new car dealers, primarily in our general market area, and has selectively originated a mix of new and used automobile loans from those dealers. As of December 31, 2009, the consumer indirect portfolio totaled $352.6 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, 2009, $121.5 million, or 53%, of consumer and home equity loans were at fixed rates, while $108.5 million, or 47%, 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 Federal Home Loan Mortgage Corporation (FHLMC) as part of its standard loan policy. As of December 31, 2009, the residential mortgage servicing portfolio totaled $349.8 million, the majority of which have been sold to FHLMC. As of December 31, 2009, $103.5 million, or 72%, of residential real estate loans retained in portfolio were at fixed rates, while $40.7 million, or 28%, 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 and Risk Oversight committees 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, including impaired loans, are generally classified as non-accruing if they are past due as to maturity or payment of principal or interest for a period of more than 90 days, unless such loans are well-collateralized and in the process of collection. Loans that are on a current payment status or past due less than 90 days may also be classified as non-accruing if repayment in full of principal and/or interest is uncertain.

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Allowance for Loan Losses

The allowance for loan losses is established through charges 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 non-accruing loans;
- Trends in volume and terms;
- Effects of changes in lending policy;
- Experience, ability and depth of management;
- National and local economic trends and conditions;
- Concentrations of credit;
- Interest rate environment;
- Customer leverage;
- Information (availability of timely financial information); and
- Collateral values.

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, generally in excess of $50 thousand are reviewed individually and assigned a specific loss allowance, if considered necessary, in accordance with U.S. generally accepted accounting principles (GAAP).
2. The remaining portfolios of commercial, 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 and non-accruing loans; trends in volume and terms of loans; effects of changes in lending policy; experience, ability, and depth of management; national and local economic conditions; concentrations of credit, interest rate environment; customer leverage; information (availability of timely financial information); and collateral values, 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. Allowance allocations for the real estate related loan portfolios (residential and home equity) are based on the average loss experience for the previous eight quarters, supplemented with qualitative factors similar to the elements described above. Allowance allocations for the consumer direct and consumer indirect portfolios are based on vintage analyses performed with loss data collected over the previous 48 months and 36 months, respectively. The allocations on these portfolios are also supplemented with qualitative factors. The allowance allocation for overdrafts is based on an analysis of the aging of overdrafts as of each quarter end with larger loss assumptions assigned by the aging of accounts.

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, pledgeable nature 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 credit risks, managing overall interest rate risks and maximizing portfolio yield. The Company s current policy generally limits security purchases to the following:

- U.S. treasury securities;
- U.S. government agency securities, which are securities issued by official Federal government bodies (e.g. the Government National Mortgage Association (GNMA)) and U.S. government-sponsored enterprise (GSE) securities, which are securities issued by independent organizations that are in part sponsored by the federal government (e.g. the Federal Home Loan Bank (FHLB) system, the Federal National Mortgage Association (FNMA), FHLMC, SBA and the Federal Farm Credit Bureau (FFCB));
- Mortgage-backed securities (MBS) include mortgage-backed pass-through securities (pass-throughs) and collateralized mortgage obligations (CMO) issued by GNMA, FNMA and FHLMC. See also the section titled Investing Activities in Part II, Item 7, Management s Discussion and Analysis of Financial Condition and Results of Operations;
- Investment grade municipal securities, including revenue, tax and bond anticipation notes, statutory installment notes and general obligation bonds;
- Certain creditworthy un-rated securities issued by municipalities;
- Certificates of deposit;
- Equity securities at the holding company level; and
- Limited partnership investments 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, 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. The Company has also utilized certificate of deposit sales in the national brokered market (brokered deposits) as a wholesale funding source, however, the Company had no brokered deposits at December 31, 2009. The Company s borrowings consist mainly of advances entered into with the FHLB, the Federal Reserve s Term Auction Facility, 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 applicable thresholds 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.

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, 2009, the Company s ratio of Tier 1 capital to total risk-weighted assets was 11.95% and the ratio of total capital to total risk-weighted assets was 13.21%. 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, 2009, the Company s leverage ratio was 7.96%.

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.

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Regulation of FSB

Five Star Bank (FSB or the Bank) is a New York chartered bank and a member of the Federal Reserve System. The FDIC, through the Deposit Insurance Fund (DIF), 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 (NYSBD). 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 NYSBD, 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 GAAP, 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, 2009, the ratio of Tier 1 capital to total risk-weighted assets for the Bank was 11.33% and the ratio of total capital to total risk-weighted assets was 12.58%. 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, 2009, the ratio of Tier 1 capital to quarterly average total assets (leverage ratio) was 7.53% for FSB. For further discussion, see Note 10, Regulatory Matters, of the notes to consolidated financial statements included in Item 8 of this Annual Report on Form 10-K.

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 FDIC maintains the DIF by assessing depository institutions an insurance premium on a quarterly basis. The amount of the assessment is a function of the institution s risk category, of which there are four, and assessment base. An institution s risk category is determined according to its supervisory ratings and capital levels and is used to determine the institution s assessment rate. The assessment rate for risk categories are calculated according to a formula, which relies on supervisory ratings and either certain financial ratios or long-term debt ratings. An insured bank s assessment base is determined by the balance of its insured deposits. Because the system is risk-based, it allows banks to pay lower assessments to the FDIC as their capital level and supervisory ratings improve. By the same token, if these indicators deteriorate, the institution will have to pay higher assessments to the FDIC.

Under the Federal Deposit Insurance Act, the FDIC Board has the authority to set the annual assessment rate range for the various risk categories within certain regulatory limits and to impose special assessments upon insured depository institutions when deemed necessary by the FDIC s Board. As part of the Deposit Insurance Fund Restoration Plan adopted by the FDIC in October 2008, on February 27, 2009, the FDIC adopted the final rule modifying the risk-based assessment system, which set initial base assessment rates between 12 and 45 basis points, beginning April 1, 2009. The FDIC imposed an emergency special assessment on June 30, 2009, which totaled $923 thousand and was collected in September 2009. In addition, in September 2009, the FDIC extended the Restoration Plan period to eight years. On November 12, 2009, the FDIC adopted a final rule requiring prepayment of 13 quarters of FDIC premiums. The Bank s required prepayment amounted to $9.9 million and was collected in December 2009.

DIF-insured institutions pay a Financing Corporation (FICO) assessment in order to fund the interest on bonds issued in the 1980s in connection with the failures in the thrift industry. For the fourth quarter of 2009, the FICO assessment is equal to 1.06 basis points for each $100 in domestic deposits. These assessments will continue until the bonds mature in 2019. The FDIC bills and collects this assessment on behalf of FICO.

***Enforcement Powers*.** The FDIC, the NYSBD 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 branches. The FHLB System provides a central credit facility primarily for member institutions. As members of the FHLB of New York (FHLBNY), 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, 2009, FSB complied with these requirements.

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. The Financial Institutions Reform, Recovery and Enforcement Act of 1989 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. FSB 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.

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.

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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.

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.

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, President Bush signed into law the Emergency Economic Stabilization Act of 2008 (EESA), giving the Treasury authority to take certain actions to restore liquidity and stability to the U.S. banking markets. Based upon its authority in the EESA, a number of programs to implement EESA have been announced. Those programs include the following:

Capital Purchase Program. Pursuant to this program, the Treasury, on behalf of the U.S. government, purchased preferred stock, along with warrants to purchase common stock, from certain financial institutions, including bank holding companies, savings and loan holding companies and banks or savings associations not controlled by a holding company. The investment has a dividend rate of 5% per year, until the fifth anniversary of the Treasury s investment and a dividend of 9% thereafter.

During the time the Treasury holds securities issued pursuant to this program, participating financial institutions are required to comply with certain provisions regarding executive compensation and corporate governance. Participation in this program also imposes certain restrictions upon an institution s dividends to common shareholders and stock repurchase activities. As described further herein, we elected to participate in the CPP and received $37.5 million pursuant to the program.

While any senior preferred stock is outstanding, we may pay dividends on our common stock, provided that all accrued and unpaid dividends for all past dividend periods on the senior preferred stock are fully paid. Prior to the third anniversary of the UST s purchase of the Senior Preferred Stock, unless the senior preferred stock has been redeemed or the UST has transferred all of the senior preferred stock to third parties, the consent of the UST will be required for us to increase our quarterly common stock dividend above $0.10 per share.

Temporary Liquidity Guarantee Program. This program contained both (i) a debt guarantee component (Debt Guarantee Program), whereby the FDIC will guarantee until June 30, 2012, the senior unsecured debt issued by eligible financial institutions between October 14, 2008 and October 31, 2009 (although a limited, six-month emergency guarantee facility has been established by the FDIC whereby certain participating entities can apply to the FDIC for permission to issue FDIC-guaranteed debt during the period from October 31, 2009 through April 30, 2010); and (ii) a transaction account guarantee (TAG) component (TAG Program), whereby the FDIC will insure 100% of noninterest bearing deposit transaction accounts held at eligible financial institutions, such as payment processing accounts, payroll accounts and working capital accounts through December 31, 2009. The Company opted into the TAG Program but not the Debt Guarantee Program, which concluded on October 31, 2009. On August 26, 2009, the FDIC approved the final rule extending the TAG Program for six months until June 30, 2010, and increased the applicable TAG assessment fees during that six month period. The Company did not opt out of the TAG program extension, which is expected to increase future FDIC insurance costs.

Temporary increase in deposit insurance coverage. Pursuant to the EESA, the FDIC temporarily raised the basic limit on federal deposit insurance coverage from $100,000 to $250,000 per depositor. The EESA provides that the basic deposit insurance limit will return to $100,000 after December 31, 2009, but the temporary increase has been extended through December 31, 2013, and is permanent for certain retirement accounts (including IRAs).

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 as an ordinary loss the other-than-temporary-impairment (OTTI) charge on its investment in auction rate preferred equity securities,

which were collateralized by FNMA and FHLMC preferred stock, for the year ended December 31, 2008.

Impact of Inflation and Changing Prices

The Company s financial statements included herein have been prepared in accordance with GAAP, which 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, 2009, the Company had 513 full-time and 107 part-time employees. None of the employees are subject to a collective bargaining agreement and management believes its relations with employees are good.

EXECUTIVE OFFICERS OF REGISTRANT

The following table sets forth current information regarding the Company s executive officers and certain other significant employees (ages are as of the 2010 Annual Meeting).

Name	Age	Starting In	Positions/Offices
Peter G. Humphrey	55	1977	President and Chief Executive Officer of FII and Five Star Bank.
Karl F. Krebs	54	2009	Executive Vice President and Chief Financial Officer of FII and Five Star Bank. Senior Financial Specialist at West Valley Environmental Services, LLC prior to joining FII in 2009. President of Robar General Funding Corp. from 2006 to 2008. Senior Vice President and Line-of-Business Finance Director at Five Star Bank from 2005 to 2006 and Senior Vice President at Wyoming County Bank from 2004 to 2005.
Martin K. Birmingham	43	2005	Executive 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	57	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.
Richard J. Harrison	64	2003	Executive Vice President and Senior Retail Lending Administrator of Five Star Bank. Executive Vice President and Chief Credit Officer at Savings Bank of the Finger Lakes from 2000 to 2003.
Kevin B. Klotzbach	57	2001	Senior Vice President and Treasurer of Five Star Bank.
R. Mitchell McLaughlin	52	1981	Executive Vice President and Chief Information Officer of Five Star Bank.

Matthew T. Murtha	55	2000	Senior Vice President and Director of Sales and Marketing of Five Star Bank.
Bruce H. Nagle	61	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.
John L. Rizzo	60	2010	Senior Vice President and Corporate Secretary of FII and Five Star Bank. Counsel (in-house) for FII and Five Star Bank from 2007 to 2010. Genesee County (New York) Attorney from 1976 to 2010.
John J. Witkowski	47	2005	Executive 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.

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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:

- An impairment of securities in our investment portfolio;
- 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, the Company 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 and/or loan portfolio, which, depending upon market conditions, could result in our realizing a loss.

The soundness of other financial institutions, including the FHLB, 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. An important counterparty for the Company, in terms of liquidity, is the FHLBNY, which the Company uses as its primary source of long-term wholesale funding. At December 31, 2009, the Company had a total of $30.1 million in borrowed funds with FHLBNY.

There are twelve regional branches of the FHLB, including FHLBNY. 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, 2009 was $3.3 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 Company s municipal bond portfolio may be adversely affected by the political, economic and legislative environment in New York State.

Approximately 20% of our investment securities portfolio at December 31, 2009, is comprised of municipal securities issued by or on behalf of New York and its political subdivisions, agencies or instrumentalities, the interest on which is exempt from regular federal income tax. Risks associated with investing in municipal securities include political, economic and regulatory factors which may affect the issuers.

In response to the current national economic downturn, governmental cost burdens may be reallocated among federal, state and local governments. In addition, laws enacted in the future by Congress or state legislatures or referenda could extend the time for payment of principal and/or interest, or impose other constraints on enforcement of such obligations, or on the ability of municipalities to levy taxes. Other factors including national economic, social and environmental policies and conditions, which are not within the control of the issuers of the bonds, could affect or have an adverse impact on the financial condition of the issuers. Issuers of municipal securities might seek protection under the bankruptcy laws. Investments in municipal securities are subject to the risk that the issuer could default on its obligations. Such a default could result from the inadequacy of the sources of revenues from which interest and principal payments are to be made or the assets collateralizing such obligations.

The current fiscal situation in New York may lead nationally recognized rating agencies to downgrade its debt obligations. It is uncertain how the financial markets may react to any potential future ratings downgrade in New York s debt obligations. However, the fallout from the recent budgetary crisis and a possible ratings downgrade could adversely affect the value of New York s obligations, which could result in 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 uncertainty 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.

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

The limitations placed on incentive compensation in the interim final TARP regulations issued under the ARRA have created restrictions on the amount and form of incentive compensation that may impact negatively the Company s ability to create a compensation structure that permits it to retain its highest performing employees.

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.

Negative perceptions associated with our continued participation in the Treasury s TARP may adversely affect our ability to retain customers, attract investors, and compete for new business opportunities.

Several financial institutions which also participated in the CPP have repurchased their TARP preferred stock. There can be no assurance as to the timing or manner in which the Company may repurchase its TARP preferred stock from the Treasury. Our customers, employees and counterparties in our current and future business relationships could draw negative implications regarding the strength of the Company as a financial institution based on our continued participation in the TARP following the exit of one or more of our competitors or other financial institutions. Any such negative perceptions could impair our ability to effectively compete with other financial institutions for business or to retain high performing employees. If this were to occur, the Company s business, financial condition, and results of operations may be adversely affected, perhaps materially.

The Company has not yet attempted to obtain permission to repay TARP funds.

In order to repay the TARP funds we received, we must first receive approval from our primary federal regulator who will then forward our application to the Treasury. To date, we have not attempted to obtain the necessary governmental approval to repay such funds. Until we repay our TARP funds, we will continue to be subject to the constraints imposed on us by the federal government in connection with such funds.

FDIC insurance premiums may increase materially.

During 2008 and continuing in 2009, higher levels of bank failures have dramatically increased resolution costs of the FDIC, and depleted the DIF. In addition, the FDIC and the U.S. Congress have taken action to increase federal deposit insurance coverage, placing additional stress on the DIF. In order to maintain a strong funding position and restore reserve ratios of the DIF, the FDIC increased assessment rates of insured institutions uniformly by seven cents for every $100 of deposits beginning with the first quarter of 2009, with additional changes beginning April 1, 2009, which require riskier institutions to pay a larger share of premiums by factoring in rate adjustments based on secured liabilities and unsecured debt levels. To further support the rebuilding of the DIF, the FDIC imposed a special assessment on each insured institution, equal to five basis points of the institution s total assets minus Tier 1 capital as of September 30, 2009. For our Bank, there was a charge of $923 thousand, which was recorded during the second quarter of 2009. The FDIC has indicated that future special assessments are possible, although it has not determined the magnitude or timing of any future assessments. In December 2009, we paid a pre-payment of the FDIC s estimated assessment total for the next three years for our Bank, totaling approximately $9.9 million. This amount was included in Other Assets in the consolidated balance sheet at December 31, 2009, and will be amortized, subject to adjustments imposed by the FDIC, over the next three years.

We are generally unable to control the amount of premiums that we are required to pay for FDIC insurance. If there are additional bank or financial institution failures, we may be required to pay even higher FDIC premiums. Our expenses for 2009 were significantly and adversely affected by the increased premiums and the special assessment. These increases and assessment and any future increases in insurance premiums or additional special assessments could have a material adverse impact on the Company s business, financial condition, results of operations or liquidity.

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 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 FSB 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.

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FII is a financial 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 FSB. 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. The Bank is currently required to obtain approval from the NYS Banking Department for dividend payments. 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.

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. In July 2009, the Company filed a Form S-3 registration statement for issuance of up to $50 million of common stock, where proceeds from an offering would be used for general corporate purposes. 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 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.

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.

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

The Company s goodwill is evaluated for impairment on an annual basis or when triggering events or circumstances indicate impairment may exist. 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.

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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.

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 2014
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 2011
Erwin	Branch	Leased	October 2010
Geneseo	Branch	Owned	
Geneva	Branch	Owned	
Geneva	Drive-up Branch	Owned	
Geneva (Plaza)	Branch	Ground Leased	January 2016
Greece	Branch	Leased	June 2023
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		Leased	April 2017

	Administrative Offices		
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	
Wyoming	Branch	Leased	March 2010
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. RESERVED

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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, 2009, 10,820,268 shares of the Company s stock were outstanding and held by approximately 1,100 shareholders of record. During 2009, the high sales price of our common stock was $15.99 and the low sales price was $3.27. The closing price per share of common stock on December 31, 2009, the last trading day of the Company s fiscal year, was $11.78. The Company declared dividends of $0.40 per common share during the year ended December 31, 2009. See additional information regarding the market price and dividends paid filed herewith in Part II, Item 6, Selected Financial Data.

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.

Equity Compensation Plan Information

The following table sets forth, as of December 31, 2009, 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	536,506(1)	$ 20.30(1)	923,646(2)
Equity compensation plans not approved by shareholders		$	

(1) Includes 77,772 shares of unvested restricted stock

awards outstanding as of December 31, 2009. The weighted average exercise price excludes such awards.

(2) Represents the 940,000 aggregate shares approved for issuance under the Company s two active equity compensation plans, reduced by 16,354 shares, which is the 9,972 restricted stock awards issued under these plans to date plus an adjustment of 6,382 shares. Pursuant to the terms of the plans, for purposes of calculating the number of shares available for issuance, each share of common stock granted pursuant to a restricted stock award shall count as 1.64 shares of common stock.

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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, 2004 as reported by the NASDAQ Global Market, through December 31, 2009, (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, LC and is expressed in dollars based on an assumed investment of $100.

	Period Ending					
Index	**12/31/04**	**12/31/05**	**12/31/06**	**12/31/07**	**12/31/08**	**12/31/09**
Financial Institutions, Inc.	100.00	86.17	102.86	81.43	67.72	58.08
NASDAQ Composite	100.00	101.37	111.03	121.92	72.49	104.31
SNL Bank $1B-$5B Index	100.00	98.29	113.74	82.85	68.72	49.26

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ITEM 6. SELECTED FINANCIAL DATA

(Dollars in thousands, except per share data)	At or for the year ended December 31, 2009	2008	2007	2006	2005
Selected financial condition data:					
Total assets	$ 2,062,389	$ 1,916,919	$ 1,857,876	$ 1,907,552	$ 2,022,392
Loans, net	1,243,265	1,102,330	948,652	909,434	972,090
Investment securities	620,074	606,038	754,720	775,536	833,448
Deposits	1,742,955	1,633,263	1,575,971	1,617,695	1,717,261
Borrowings	106,390	70,820	68,210	87,199	115,199
Shareholders equity	198,294	190,300	195,322	182,388	171,757
Common shareholders equity[1]	144,876	137,226	177,741	164,765	154,123
Tangible common shareholders equity[2]	107,507	99,577	139,786	126,502	115,440
Selected operations data:					
Interest income	$ 94,482	$ 98,948	$ 105,212	$ 103,070	$ 103,887
Interest expense	22,217	33,617	47,139	43,604	36,395
Net interest income	72,265	65,331	58,073	59,466	67,492
Provision (credit) for loan losses	7,702	6,551	116	(1,842)	28,532
Net interest income after provision (credit) for loan losses	64,563	58,780	57,957	61,308	38,960
Noninterest income (loss) [3]	18,795	(48,778)	20,680	21,911	29,384
Noninterest expense	62,777	57,461	57,428	59,612	65,492
Income (loss) from continuing operations before income taxes	20,581	(47,459)	21,209	23,607	2,852
Income tax expense (benefit) from continuing operations	6,140	(21,301)	4,800	6,245	(1,766)
Income (loss) from continuing operations	14,441	(26,158)	16,409	17,362	4,618
Loss on discontinued operations, net of tax					2,452
Net income (loss)	$ 14,441	$ (26,158)	$ 16,409	$ 17,362	$ 2,166
Preferred stock dividends and accretion	3,697	1,538	1,483	1,486	1,488
Net income (loss) applicable to common shareholders	$ 10,744	$ (27,696)	$ 14,926	$ 15,876	$ 678
Stock and related per share data:					
Earnings (loss) from continuing operations per common share:					
Basic	$ 0.99	$ (2.54)	$ 1.34	$ 1.40	$ 0.28
Diluted	0.99	(2.54)	1.33	1.40	0.28
Earnings (loss) per common share:					
Basic	0.99	(2.54)	1.34	1.40	0.06

Diluted	0.99	(2.54)	1.33	1.40	0.06
Cash dividends declared on common stock	0.40	0.54	0.46	0.34	0.40
Common book value per share [(1)]	13.39	12.71	16.14	14.53	13.60
Tangible common book value per share [(2)]	9.94	9.22	12.69	11.15	10.19
Market price (NASDAQ: FISI):					
High	15.99	22.50	23.71	25.38	24.93
Low	3.27	10.06	16.18	17.43	15.52
Close	11.78	14.35	17.82	23.05	19.62

(1) Excludes preferred shareholders equity.

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

(3) The 2009 and 2008 figures include OTTI charges of $4.7 million and $68.2 million, respectively. 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, 2009	2008	2007	2006	2005
Selected financial ratios and other data:					
Performance ratios:					
Net income (loss) (returns on):					
Average assets	0.71%	-1.37%	0.86%	0.90%	0.10%
Average equity	7.43	-14.30	8.84	9.86	1.22
Average common equity [1]	7.61	-16.84	8.89	10.02	0.43
Average tangible common equity [2]	10.37	-21.87	11.50	13.23	0.56
Common dividend payout ratio [3]	40.40	NA	34.33	24.29	666.67
Net interest margin (fully tax-equivalent)	4.04	3.93	3.53	3.55	3.65
Efficiency ratio [4]	65.52%	64.07%	68.77%	69.78%	70.18%
Capital ratios:					
Leverage ratio	7.96%	8.05%	9.35%	8.91%	7.60%
Tier 1 risk-based capital	11.95	11.83	15.74	15.85	13.75
Total risk-based capital	13.21	13.08	16.99	17.10	15.01
Equity to assets [5]	9.55	9.60	9.73	9.08	8.37
Common equity to assets [1] [5]	6.94	8.63	8.81	8.17	7.54
Tangible common equity to tangible assets [2] [5]	5.19%	6.78%	6.95%	6.32%	5.80%
Asset quality [6]:					
Non-performing loans	$ 8,681	$ 8,196	$ 8,077	$ 15,840	$ 18,037
Non-performing assets	10,442	9,252	9,498	17,043	19,713
Allowance for loan losses	20,741	18,749	15,521	17,048	20,231
Net loan charge-offs	$ 5,710	$ 3,323	$ 1,643	$ 1,341	$ 47,487
Total non-performing loans to total loans	0.69%	0.73%	0.84%	1.71%	1.82%
Total non-performing assets to total assets	0.51	0.48	0.51	0.89	0.97
Net charge-offs to average loans	0.47	0.32	0.18	0.14	4.27
Allowance for loan losses to total loans	1.64	1.67	1.61	1.84	2.04
Allowance for loan losses to non-performing loans	239%	229%	192%	108%	112%
Other data:					
Number of branches	51	52	50	50	50
Full time equivalent employees	572	600	621	640	700

[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

	2009			
(Dollars in thousands, except per share data)	Fourth Quarter	Third Quarter	Second Quarter	First Quarter
Interest income	$ 24,390	$ 23,697	$ 23,302	$ 23,093
Interest expense	5,175	5,619	5,657	5,766
Net interest income	19,215	18,078	17,645	17,327
Provision for loan losses	1,088	2,620	2,088	1,906
Net interest income, after provision for loan losses	18,127	15,458	15,557	15,421
Noninterest income	5,183	4,406	4,515	4,691
Noninterest expense	15,117	15,142	16,440	16,078
Income before income taxes	8,193	4,722	3,632	4,034
Income tax expense	2,756	1,313	1,004	1,067
Net income	$ 5,437	$ 3,409	$ 2,628	$ 2,967
Preferred stock dividends	927	927	925	918
Net income applicable to common shareholders	$ 4,510	$ 2,482	$ 1,703	$ 2,049
Earnings per common share [1]:				
Basic	$ 0.42	$ 0.23	$ 0.16	$ 0.19
Diluted	0.42	0.23	0.16	0.19
Market price (NASDAQ: FISI):				
High	$ 12.25	$ 15.00	$ 15.99	$ 14.95
Low	9.71	9.90	6.98	3.27
Close	11.78	9.97	13.66	7.62
Dividends declared	$ 0.10	$ 0.10	$ 0.10	$ 0.10

	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

[1] Earnings (loss) 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.

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

GENERAL

The following discussion is management s analysis to assist in the understanding and evaluation of the consolidated financial condition and results of operations of the Company. It 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.

OVERVIEW

Financial Institutions, Inc. is a financial holding company headquartered in New York State, providing banking and nonbanking financial services to individuals and businesses primarily in its Central and Western New York footprint. The Company, principally through its wholly-owned banking subsidiary, provides a wide range of services, including business and consumer loan and depository services, as well as other traditional banking services. Through its nonbanking subsidiary, the Company provides brokerage services to supplement the banking business.

The Company s primary sources of revenue, through its banking subsidiary, are net interest income (predominantly from loans and deposits, and also from investment securities and other funding sources), and noninterest income, particularly fees and other revenue from financial services provided to customers or ancillary services tied to loans and deposits. Business volumes and pricing drive revenue potential, and tend to be influenced by overall economic factors, including market interest rates, business spending, consumer confidence, economic growth, and competitive conditions within the marketplace.

Net income allocated to common shareholders for 2009 was $10.7 million (compared to net loss allocated to shareholders of $27.7 million in 2008), diluted earnings per common share were $0.99 (versus diluted loss per common share of $2.54 for 2008), net interest income was $72.3 million on a margin of 4.04% (compared to $65.3 million on a margin of 3.93% for 2008), and the provision for loan losses was $7.7 million with net charge offs to average loans of 0.47% (compared to a provision of $6.6 million and a net charge off ratio of 0.32% for 2008).

Total loans increased $142.9 million or 13% between year-end 2009 and 2008, with increases in most loan categories (including commercial loans up $71.6 million and consumer indirect loans up $97.6 million). On average, loans increased $184.9 million or 18%, primarily from a $128.0 million in consumer indirect loans.

Total deposits increased $109.7 million or 7% between year-end 2009 and 2008, primarily attributable to noninterest-bearing demand and certificates of deposits. On average, total deposits increased $113.2 million or 7% over 2008, primarily in certificates of deposit. Deposit growth remains a key to improving net interest income and the quality of earnings in 2010. Competition for deposits remains high. The changes in FDIC insurance have been beneficial to deposit growth. Future deposit levels could be affected by changes in these programs. For example, deposits could be affected by the termination of the TAG Program at June 30, 2010 (see Part I, Item 1, Section Emergency Economic Stabilization Act of 2008 for a detailed discussion of the TAG Program).

Noninterest income of $18.8 million in 2009 included OTTI write-downs of $4.7 million and net gains from security sales of $3.4 million. Noninterest loss of $48.8 million in 2008 included OTTI write-downs of $68.2 million and net gains from security sales of $288 thousand. Excluding those securities transactions, noninterest income was up $883 thousand in 2009 from 2008, primarily from income from company owned life insurance and mortgage banking income (including a $360 increase in gains on sales of loans to the secondary market and a $644 thousand increase in loan servicing income), partially offset by a decrease in net core fee-based revenue categories (down $571 thousand, and defined as service charges on deposit accounts, ATM and debit fees, and broker-dealer fees and commissions).

Noninterest expense of $62.8 million grew $5.3 million or 9% over 2008. Salaries and employee benefits were $33.6 million, up $2.2 million or 7% versus 2008, of which $2.1 million was fringe benefits expense. On average, full time equivalent employees decreased 4% between 2009 and 2008 (from 610 for 2008 to 586 for 2009). Non-personnel noninterest expenses on an aggregate basis were up $3.1 million or 12% over 2008, primarily due to higher FDIC insurance assessments.

The Company s sale of preferred shares under the Treasury s TARP in December 2008 increased shareholders equity by $37.5 million. The Company is evaluating repayment alternatives relative to the TARP funds to determine the most economically beneficial option for the Company and shareholders.

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MANAGEMENT S DISCUSSION AND ANALYSIS

PERFORMANCE SUMMARY

The Company s reported net income of $14.4 million for the year ended December 31, 2009, compared to a net loss of $26.2 million for the year ended December 31, 2008. For 2009, net income allocated to common shareholders was $10.7 million, or $0.99 for both basic and diluted earnings per common share. Net loss allocated to common shareholders was $27.7 million for 2008, or a net loss of $2.54 for both basic and diluted earnings per common share. Cash dividends of $0.40 per common share were paid in 2009, compared to cash dividends of $0.54 per common share paid in 2008. Key factors behind these results are discussed below.

The recent market conditions have been marked with general economic and industry declines with an impact on consumer confidence, business and personal financial performance, and commercial and residential real estate markets, resulting in an increase in nonperforming loans, net charge offs, and provision for loan losses. Nonperforming loans were $8.7 million at December 31, 2009, compared to $8.2 million at December 31, 2008. Net charge offs were $5.7 million in 2009 (or 0.47% of average loans) compared to $3.3 million in 2008 (or 0.32% of average loans). The provision for loan losses was $7.7 million and $6.6 million, respectively, for 2009 and 2008. At year-end 2009, the allowance for loan losses represented 1.64% of total loans (covering 239% of non-performing loans), compared to 1.67% (covering 229% of nonperforming loans) at year-end 2008. See also sections, Allowance for Loan Losses and Non-performing and Potential Problem Loans for additional information on net charge-offs and non-performing loans.

At December 31, 2009, total loans were $1.264 billion, up 13% from year-end 2008, primarily in commercial based and indirect auto loans. Total deposits at December 31, 2009, were $1.743 billion, up 7% from year-end 2008, primarily attributable to higher noninterest-bearing demand and certificates of deposits.

Taxable equivalent net interest income was $75.0 million for 2009 or 8% higher than $69.6 million in 2008. Taxable equivalent interest income decreased $6.1 million, while interest expense decreased by $11.4 million. The increase in taxable equivalent net interest income was a function of both favorable volume variances (increasing taxable equivalent net interest income by $2.6 million) and rate variances (increasing taxable equivalent net interest income by $2.7 million). See also section, Net Interest Income for additional information on taxable equivalent net interest income and net interest margin.

The net interest margin for 2009 was 4.04%, 11 basis points higher than 3.93% in 2008. The increase in net interest margin was attributable to a 30 basis point increase in interest rate spread (the net of a 90 basis point decrease in the cost of interest-bearing liabilities and a 60 basis decrease in the yield on earning assets), partially offset by a 19 basis point lower contribution from net free funds (primarily attributable to lower rates on interest-bearing liabilities reducing the value of noninterest-bearing deposits and other net free funds).

Noninterest income was $18.8 million for 2009. Core fee-based revenues (defined as service charges on deposit accounts, ATM and debit fees, and broker-dealer fees and commissions) totaled $14.7 million for 2009, down $571 thousand or 4% from $15.3 million for 2008. Net mortgage banking income was $2.0 million for 2009, compared to $1.0 million in 2008, an increase of $1.0 million from 2008, primarily attributable to higher secondary mortgage production experienced during 2009 due to the low interest rate environment and the favorable impact on refinance activity. For additional discussion concerning noninterest income see section, Noninterest Income.

Net investment securities losses (defined as net gain on disposal of investment securities and impairment charges on investment securities) were $1.2 million and for 2009, compared to net investment securities losses of $67.9 million for 2008, primarily attributable to other-than-temporary write-downs on investment securities.

Noninterest expense for 2009 was $62.8 million, an increase of $5.3 million or 9% over 2008. FDIC assessments increased $3.0 million, salaries and employee benefits increased $2.2 million, and collectively all remaining noninterest expense categories were up $142 thousand compared to 2008. The efficiency ratio (as defined under Part II, Item 6, Selected Financial Data) was 65.52% for 2009 and 64.07% for 2008. For additional discussion regarding noninterest expense see section, Noninterest Expense.

Income tax expense for 2009 was $6.1 million, compared to income tax benefit of $21.3 million for 2008. The change in income tax was primarily due to the increase to pretax income from a pretax loss between the years. For additional discussion concerning income tax see section, Income Taxes.

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MANAGEMENT S DISCUSSION AND ANALYSIS

ANALYSIS OF FINANCIAL CONDITION

OVERVIEW

At December 31, 2009, the Company had total assets of $2.062 billion, an increase of 8% from $1.917 billion as of December 31, 2008, primarily a result of the continued growth of its core business of loans and deposits. Loans totaled $1.264 billion as of December 31, 2009, up $142.9 million, or 13%, when compared to $1.121 billion as of December 31, 2008. The increase in loans was primarily attributed to the expansion of the indirect lending program and commercial business development efforts. Nonperforming assets totaled $10.4 million as of December 31, 2009, up $1.2 million from a year ago, primarily due to the addition of non-performing investment securities for which the Company has stopped accruing interest. Total deposits amounted to $1.743 billion and $1.633 billion as of December 31, 2009 and 2008, respectively. As of December 31, 2009, total borrowed funds were $106.4 million, comparable to $70.8 million as of December 31, 2008. Book value per common share was $13.39 and $12.71 as of December 31, 2009 and 2008, respectively. As of December 31, 2009 the Company s total shareholders equity was $198.3 million compared to $190.3 million a year earlier.

INVESTING ACTIVITIES

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

	Investment Securities Portfolio Composition At December 31,					
	2009		2008		2007	
	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	$ 134,564	$ 134,105	$ 67,871	$ 68,173	$ 158,920	$ 158,940
State and political subdivisions	80,812	83,659	129,572	131,711	171,294	172,601
Mortgage-backed securities:						
Agency mortgage-backed securities	356,044	356,355	297,278	303,105	239,427	238,101
Non-Agency mortgage-backed securities	5,087	5,160	42,296	39,447	58,371	57,771
Asset-backed securities	1,295	1,222	3,918	3,918	34,115	33,198
Equity securities			923	1,152	33,930	34,630
Total available for sale securities	577,802	580,501	541,858	547,506	696,057	695,241
Securities held to maturity:						
State and political subdivisions	39,573	40,629	58,532	59,147	59,479	59,902
Total investment securities	$ 617,375	$ 621,130	$ 600,390	$ 606,653	$ 755,536	$ 755,143

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MANAGEMENT S DISCUSSION AND ANALYSIS

Impairment Assessment

The Company reviews investment securities on an ongoing basis for the presence of other-than-temporary-impairment (OTTI) with formal reviews performed quarterly. Declines in the fair value of held-to-maturity and available-for-sale securities below their cost that are deemed to be other than temporary are reflected in earnings as realized losses to the extent the impairment is related to credit losses or the security is no longer intended to be held until the recovery of amortized cost. The amount of the impairment related to other factors is recognized in other comprehensive income. Evaluating whether the impairment of a debt security is other than temporary involves assessing i.) the intent to sell the debt security or ii.) the likelihood of being required to sell the security before the recovery of its amortized cost basis. In determining whether the other-than temporary impairment includes a credit loss, the Company uses its best estimate of the present value of cash flows expected to be collected from the debt security considering factors such as: a.) the length of time and the extent to which the fair value has been less than the amortized cost basis, b.) adverse conditions specifically related to the security, an industry, or a geographic area, c.) the historical and implied volatility of the fair value of the security, d.) the payment structure of the debt security and the likelihood of the issuer being able to make payments that increase in the future, e.) failure of the issuer of the security to make scheduled interest or principal payments, f.) any changes to the rating of the security by a rating agency, and g.) recoveries or additional declines in fair value subsequent to the balance sheet date.

As of December 31, 2009, management does not have the intent to sell any of the securities in a loss position and believes that it is likely that it will not be required to sell any such securities before the anticipated recovery of amortized cost. The unrealized losses are largely due to increases in market interest rates over the yields available at the time the underlying securities were purchased. The fair value is expected to recover as the bonds approach their maturity date or repricing date or if market yields for such investments decline. Management does not believe any of the securities in a loss position are impaired due to reasons of credit quality. Accordingly, as of December 31, 2009, management has concluded that unrealized losses on its investment securities are temporary and no further impairment loss has been realized in the Company s consolidated statements of operations. The following discussion provides further details of the Company s assessment of the securities portfolio by investment category.

The table below summarizes unrealized losses in each category of the securities portfolio at the end of the periods indicated (in thousands).

	Unrealized Losses on Investment Securities At December 31,					
	2009		2008		2007	
	Unrealized Losses	% of Total	Unrealized Losses	% of Total	Unrealized Losses	% of Total
Securities available for sale:						
U.S. Government agency and government-sponsored enterprise securities	$ 545	19.8%	$ 307	7.3%	$ 324	7.5%
State and political subdivisions	3	0.1	42	1.0	261	6.0
Mortgage-backed securities:						
Agency mortgage-backed securities	1,638	59.3	981 &			