

**Broadening
horizons.
Building
opportunities.**

Financial Institutions, Inc. provides diversified financial services through its subsidiaries Five Star Bank, SDN Insurance Agency, LLC, Courier Capital, LLC and HNP Capital, LLC.

Five Star Bank provides a wide range of consumer and commercial banking and lending services to individuals, municipalities and businesses through a network of more than 45 offices throughout Western and Central New York State and a commercial loan production office in Ellicott City (Baltimore), Maryland. Additional Five Star Bank information is available at www.five-starbank.com.

SDN Insurance Agency provides a broad range of insurance services to personal and business clients.

Courier Capital and HNP Capital provide customized investment management, investment consulting, and retirement plan services to individuals, businesses, institutions, foundations, and retirement plans.

Financial Institutions, Inc. and its subsidiaries employ more than 600 individuals. The company's stock is listed on the Nasdaq Global Select Market under the symbol FISL. Additional information is available at www.fiiwarsaw.com.

To Our Shareholders, Customers, Associates, Community Leaders, and Partners



It is my pleasure to share with you the 2021 Financial Institutions, Inc. Annual Report.

The following pages detail how your company once again fulfilled our purpose to make financial lives better in ways that benefited customers, associates, shareholders, and the communities we serve. Against the backdrop of a global pandemic and its ongoing challenges, 2021 performance was strong.

We generated the highest net interest income and pre-tax pre-provision income in company history. Continued improvement in the economy, healthy commercial and consumer indirect loan pipelines, interest and fee revenue related to Paycheck Protection Program ("PPP") loans, the prudent deployment of excess liquidity into low-risk securities, growth in revenue from our wealth and insurance subsidiaries, a relatively benign credit environment, and expense discipline contributed to record-setting net income of \$77.7 million or \$4.78 per diluted share.

We also completed two bolt-on insurance acquisitions, opened two new bank branches in Buffalo, relocated a third urban branch in Elmira to a new location in an area undergoing redevelopment, and identified and made strategic investments for our future. All this was accomplished during a time when the world navigated a pandemic and experienced increased social and geopolitical volatility.

As we managed through a frustrating time of shutdowns and openings, we remained steadfast in our critical mission to support customers and communities. We offered a robust set of products and services designed to meet the needs of customers and delivered education, advice, and

solutions to help them improve their financial well-being. We invested in people and resources to address the needs of the communities we serve, and supported organizations across our operating footprint through donations, grants, and community sponsorships. We also provided debt and equity financing for numerous affordable and special needs housing projects. I encourage you to read the Five Star Bank 2021 Community Report, available on the Five Star Bank and Financial Institutions, Inc. websites, to better understand these initiatives and many more ways that our company and our people gave back to their communities.

We were an active participant in the second round of the PPP program, helping 1,200 businesses obtain \$107 million of loans and assisting customers through the loan forgiveness process. During the first quarter of 2021, we worked with community partners to provide program information and assistance to low-income and minority communities. Many minority businesses either missed out or felt as though they missed out on much-needed funding in the first PPP round. In partnership with Rochester-based community partners, we provided a webinar titled "Ensuring Access for All," providing information on the program and letting businesses know that Five Star Bank was there to help, no matter how large or small the loan. We also provided hands-on support at two of our urban Rochester branches.

In mid-June, Susan Holliday was named chair of our board of directors. Susan has been on the board since 2002, most recently serving as vice chair of the board and chair of the Nominating & Governance Committee. She also served as past chair of the Management Development & Compensation Committee. Susan is the CEO of web application design and development firm Dumbwaiter Design and, from 1988 to 2016, she was the owner, >



president, and publisher of the *Rochester Business Journal*. Her community involvement is extensive, and she has served on a multitude of non-profit boards in the Rochester and Finger Lakes Region over the past 30 years.

Susan's committed service to the board, leadership of key committees, and history of strong community support and non-profit board participation position her well for great success as board chair. She brings strong integrity, inquisitiveness, willingness to challenge, and a collaborative approach to the role. I have known Susan for many years and am honored to partner with her to lead our company.

I'd like to thank Bob Latella for his dedicated service and leadership as board chair from 2014 to June 2021. We benefitted greatly from Bob's leadership and are grateful that he remains on our board, providing valuable insights and mentorship to newer board members.

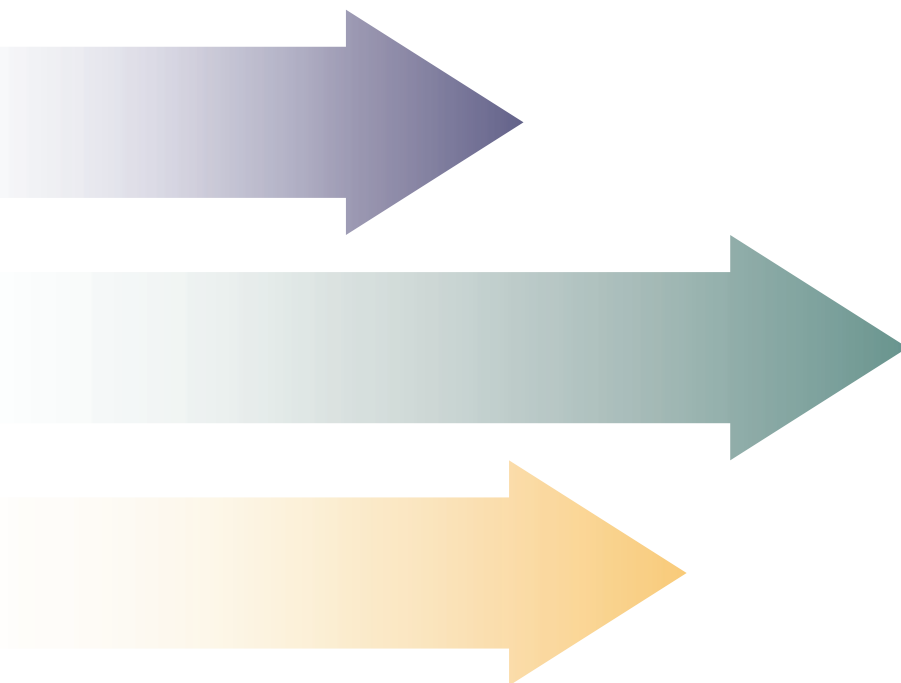
Mauricio Riveros and Mark Zupan were elected to our board at last June's annual meeting of shareholders. Mauricio and Mark are exceptional additions as they bring diverse work and life experiences and market knowledge that will benefit our entire organization.

Our board is committed to diversity and inclusion. Through thoughtful succession planning and refreshment, the following levels of diversity and tenure have been achieved:

- Five new directors have been added to the board over the past six years.
- The board is more diverse by both gender and ethnicity. Fifty percent of independent directors represent diverse groups—three are women and two belong to a racial or ethnic minority group. Four of our diverse directors hold key board leadership positions as chair of the board and Executive Committee and chairs of the Nominating & Governance, Risk Oversight, and Technology & Data Committees.
- Board tenure remains balanced, with four independent members between zero and five years; three members between six and ten years; and three members with tenure of more than ten years.

Advancing diversity, equity, and inclusion is an area of focus for management as well. I am confident that with the commitment of our executive team and board of directors and input from our associates, we are forging a strategic path forward to become a more diverse and equitable place to work. A passion for progress is at the heart of our human capital strategy and we have already begun to make investments in our people that will create career opportunities while also setting the highest standards for inclusive leadership.

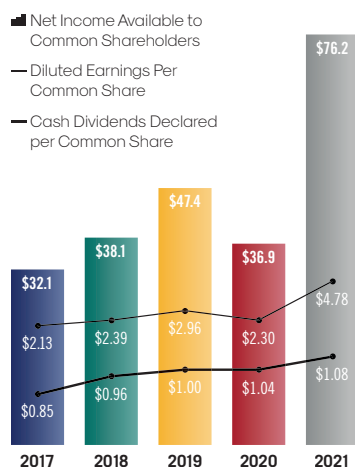
We are coming up on the two-year mark since the launch of our internal Diversity and Inclusion Advisory Council. Through the engagement and ideas of associate volunteers, we receive healthy feedback, viewpoints, and recommended actions that advance our mission to create an inclusive and safe culture for all. This group has initiated trainings our entire management-level population has participated in, on topics including Unconscious Bias, Conflict Without Contempt, and Conversations on Race. I am incredibly honored to support the Council's efforts and proud of our associates for their courage to make this an even better place to work.



Financial Results and Capital Actions

Net Income, Earnings per Share & Dividends

(\$ in Millions, except per share amounts)



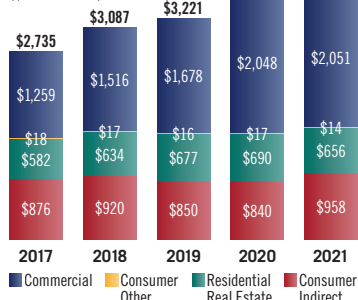
Net income for the year was \$77.7 million compared to \$38.3 million in 2020. After preferred dividends, net income available to common shareholders was \$76.2 million, or \$4.78 per diluted share, compared to \$36.9 million, or \$2.30 per diluted share in 2020. Net income was higher in 2021 primarily due to growth in net interest income and noninterest income and the positive impact of an \$8.3 million benefit for credit losses.

Improvement in the national unemployment forecast, positive trends in qualitative factors, lower specific reserves and lower net charge-offs resulted in the release of credit loss reserves and a benefit for credit losses in 2021. In the prior year, we recognized a higher than historical provision for credit losses of \$27.2 million because of uncertainty regarding the long-term impact of the COVID-19 pandemic on the economic environment combined with the impact of the adoption of the current expected credit loss standard, or CECL.

Net interest income was \$154.7 million for the year, a \$15.7 million increase from 2020, primarily due to growth in average interest-earnings assets and the impact of interest and fee revenue related to Paycheck Protection Program ("PPP") loans.

Total Loans

(\$ in Millions)



Growing Noninterest Income

(\$ in Millions)



Noninterest income was \$3.7 million higher, at \$46.9 million.

- Insurance income was \$1.3 million higher as a result of acquisition activity and growth in the legacy SDN insurance business.
- Investment advisory income increased \$2.1 million due to growth in assets under management, driven by a combination of market gains, new customer accounts, and contributions to existing accounts.
- Income from investments in limited partnerships was \$2.0 million higher based on the performance of underlying investments.
- Income from derivative instruments, net decreased \$2.8 million from the prior year, primarily as a result of fewer swap transactions with commercial customers.

Noninterest expense of \$112.8 million was \$3.5 million, or 3%, higher than 2020, driven by increases in personnel and computer and data processing expenses. Higher expense in these categories reflects investments we are making in people and systems to support strategic initiatives including digital banking, new bank branches, an enhanced customer relationship management

solution, customer experience, and Banking as a Service.

Our ongoing program of providing debt and equity financing for affordable and special needs housing resulted in federal and state tax benefits related to historic and low-income housing tax credit investments, reducing income tax expense by \$2.6 million in 2021 and \$1.5 million in 2020. Our effective tax rate for 2021 was 20.1% compared to 16.2% in 2020. The 2021 higher tax rate was primarily the result of higher pre-tax earnings.

Pre-tax pre-provision income¹ was \$88.9 million, the highest in company history and an increase of \$16.0 million from the previous year.

Investment securities increased by \$484.1 million during 2021 and totaled \$1.38 billion at December 31. Excess liquidity has represented a challenge for the last two years. Throughout 2021 our investment focus remained consistent as we deployed excess liquidity into high-quality low-risk agency mortgage-backed securities. Incremental performance was driven by the reallocation of excess Federal Reserve cash balances into securities with higher relative yields.

Total loans increased by 2% to \$3.68 billion in 2021, driven by increases in commercial mortgage loans and consumer indirect loans of 13% and 14%, respectively. We experienced strong demand for commercial real estate loans in 2021 from known, experienced sponsors with what we believe are high-quality, viable projects, driving growth in commercial mortgage loans. Our consumer indirect auto portfolio grew in 2021 as we benefitted from high auto valuations, good access to quality credits through our dealer network of more than 500 franchised new auto dealerships and strong credit discipline. This asset class provided the opportunity to deploy excess liquidity in a loan category with short duration, strong credit

1: Non-GAAP measure; refer to GAAP to Non-GAAP reconciliations on page Appendix A.

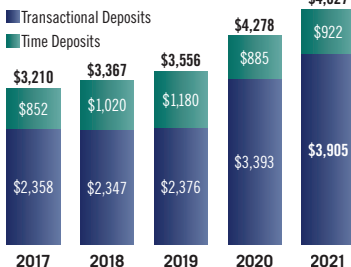
Total Investment Securities

(\$ in Millions)



Total Deposits

(\$ in Millions)



performance and relatively higher yield characteristics.

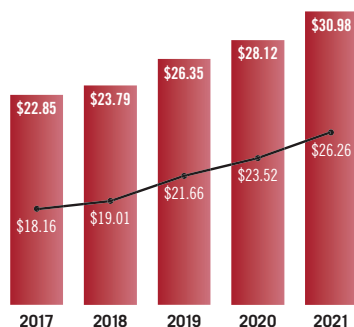
Commercial business loans decreased 20% in 2021 as a result of the forgiveness or repayment of PPP loans. Excluding the impact of these loans, commercial business loans grew 7%.

The credit profile of our loan portfolio continued to demonstrate stability with total net charge-offs of \$5.8 million, or 0.16% of total average loans, compared to \$13.8 million, or 0.40% of average loans, in 2020. The allowance for credit losses moderated in 2021 after a significant increase in the prior year due to the adoption of

Common Book Value & Tangible Common Book Value¹

(per share)

■ Common Book Value
— Tangible Common Book Value¹



the CECL standard and pandemic-related uncertainty. The allowance for credit losses on loans to total loans was 1.08% at year-end, down 38 basis points from December 31, 2020.

Total deposits increased \$548.7 million in 2021, driven by growth in all deposit categories and contributing to excess liquidity.

Common book value per share increased 10%, to \$30.98 at December 31, 2021. Tangible common book value per share¹ ("TCBV") grew for the 14th consecutive year, from \$23.52 to \$26.26 at year-end 2021, representing an increase of 12%. Over the four-year period from

year-end 2017 through 2021, TCBV increased at a compound annual growth rate of 10%.

Stock Repurchase Program

In November 2020, we announced a stock repurchase program for up to 801,879 shares of common stock or approximately 5% of outstanding shares. We repurchased 340,688 shares in 2021 for an average price of \$26.44 per share, inclusive of transaction costs.

We repurchased 461,191 shares in the first quarter of 2022 for an average price of \$31.99 per share, completing the program. Our buyback strategy allowed us to efficiently deploy capital in a scenario with a short earn-back period. We remain focused on deploying capital in an efficient and optimal fashion.

Dividends

We declared common stock dividends of \$1.08 per share in 2021, representing an increase of 4% from the prior year. In early 2022, our board of directors increased the dividend by 7%, to \$0.29 per share per quarter, or \$1.16 per share annualized. This was the company's twelfth consecutive annual dividend increase, demonstrating our ongoing commitment to shareholder return.

Insurance Acquisitions

In February 2021, our Buffalo-based SDN Insurance Agency acquired the assets of Landmark Group. Landmark, a staple of the Rochester community since 1984, was an independent insurance brokerage firm delivering insurance, surety and risk management solutions across several business sectors. Landmark's principals remained with SDN to lead our Rochester insurance operations and continue their long-term relationships with clients. The Landmark acquisition expands our insurance business in the important growth markets of Rochester and nine-county Finger Lakes region.

SDN completed a second bolt-on transaction in early August with the acquisition of North Woods Capital Benefits, a Buffalo-based employee benefits and human resources advisory firm. This acquisition expands SDN's employee benefits business and adds important expertise to the organization. North Woods' founder and director of client service also joined SDN to continue their long-term client relationships and build new ones.

New Branches

We opened two new Five Star Bank branches in the City of Buffalo during a time when many banks are closing branches in urban markets. Growth in the Buffalo market has been and continues to be an important component of our long-term strategic plan and we see great opportunity here. The new branches are located in areas undergoing significant redevelopment and revitalization and we look forward to contributing to the positive momentum in these neighborhoods.



451 Elmwood Avenue — This 2,500 square-foot Five Star Bank branch is located at the corner of Elmwood and Bryant Street on the first floor of the new Pardee Building at Elmwood Crossing, an adaptive redevelopment project. The vibrant Elmwood Village neighborhood is a diverse community of locally owned shops and restaurants, public art, and unique special events.

2222 Seneca Street — This 3,000 square-foot-freestanding Five Star Bank branch is located on a historic avenue in the heart of Buffalo. We join other businesses in this neighborhood that are building a brighter future through redevelopment and reinvention.

We also relocated our existing Five Star Bank branch in the **City of Elmira** in the summer of 2021. The 2,400-square-foot branch is located on the first floor of a new development included in the NYS Downtown Revitalization Initiative.

All three branches opened in 2021 are designed to serve as financial solution centers, with no teller lines and no barriers between bank associates and customers. They feature a blend of new technology including Interactive Teller Machines and the comfort of community banking with Certified Personal Bankers. Our new design provides a cost-effective, lower-square-footage approach to aligning services with shifting customer needs and preferences, including rapid advancements in financial technology that enable consumers to bank anywhere, anytime.

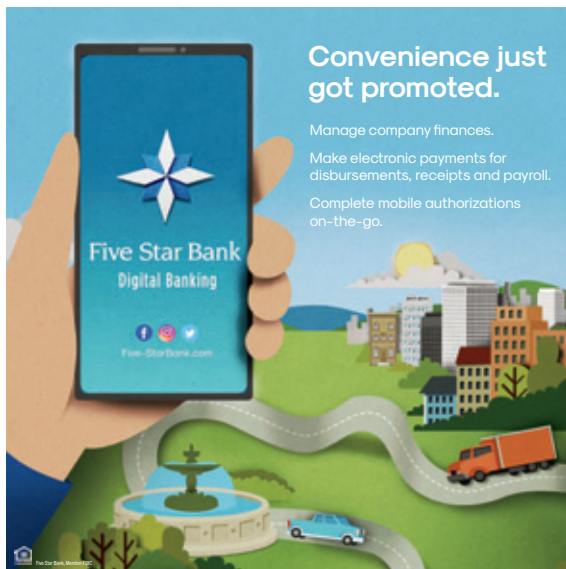
We are committed to the use of green and energy efficient materials in construction and we sourced materials certified by Cradle to Cradle, Declare, Forest Stewardship Council, Green Square, and GreenGuard for all three new branches. Materials with a high percentage of recycled content were used when possible and energy-efficient LED lighting was used throughout interiors and exteriors. Insulation performance and HVAC system air exchange rates exceed building code requirements at all new locations.

Strategic Investments in Our Future



While the fundamental strategic outcomes of sustained deposit growth, credit-disciplined loan growth, diversification of revenue, expense discipline, and sustainable business practices remain critical and highly correlated to high performance of a financial institution, our strategy continues to evolve. During the 2021 planning cycle, we added a sixth strategic outcome: Exceptional Digital Experiences enabled by complementary fintech and digital partnerships.

In recent years, we developed a roadmap to respond to and capitalize on industry changes. We have made critical investments in people, processes, and technology. Following our successful 2020 conversion to Five Star Bank Digital Banking, we're now focused on the acceleration of offerings through this digital banking platform. Our digital transformation efforts are advancing, and we've made several recent announcements.



Payments are rapidly rising in importance as the primary touch point between customers and their banks, forming the heart of active, primary banking relationships. Along with other banks in the Alloy Labs consortium, we announced the launch of CHUCK™, an open network

for peer-to-peer payments for consumers and small businesses. CHUCK™ is part of a broader payments strategy that leverages the power of collaboration to reach economies of scale in both innovation investment and operating cost while promoting customer choice, flexibility and empowerment.

We also entered into an agreement to enable our customers to transact in Bitcoin seamlessly and securely inside the Five Star Bank Digital Banking platform. Partners in this initiative are our digital banking platform provider Q2 and leading New York State Department of Financial Services-regulated Bitcoin company NYDIG. We are pleased to be among the first banks to deliver secure and seamless Bitcoin services where customers can buy, sell and hold Bitcoin in their Five Star accounts. We believe this initiative is a testament to our commitment to evolve and respond to quickly changing market conditions and opportunities.

Through legacy and ongoing investments in infrastructure, talent, technology and partnerships, we created an “operating system” that enables us to deliver Banking-as-a-Service (BaaS) capabilities to fintech partners and wealth management firms looking to offer banking products and services to their customers. For example, we teamed up with Autobooks, a Detroit-based digital payments provider for small businesses, to enable the use of Five Star Bank’s digital banking platform. Partnerships such as this provide the opportunity for additional fee revenue, interest income, and insight into consumer trends. We are collaborating with partners on several additional initiatives that will drive our BaaS line of business and will announce them as they come to fruition.

We remain focused on the strength and stability of our company through collaboration and partnership among our bank, insurance, and investment lines of business as we embrace innovation, technology and data. We will leverage the cultural momentum, enhanced capabilities and experience of our team to embrace industry changes that represent opportunities for our company and all stakeholders related to digital transformation that complements traditional banking.

Conclusion

Another outcome of our 2021 strategy update was a refresh of our human capital strategy in response to the new normal way of working, the great resignation, and the great reimagination. Long-term growth and success are linked to our ability to attract, develop, and retain associates in the context of a diverse and inclusive workplace where everyone can thrive. Simply put: we are ensuring we have the right people or access to the right people, today and tomorrow, who are supported by an organizational framework that nurtures a strong and healthy culture.

One of the components of the strategy is the 2022 rollout of Five Star Fulfilled, or our “new way of working.” Workforce norms have changed dramatically since the onset of the pandemic, and we are committed to embracing what we’ve learned and emerging from the last two years with a stronger culture. We recognize that working styles are not one-size-fits-all and adopted a flexible philosophy that embraces the benefits of both remote and in-office work. Both styles of work are purposeful and meaningful, and we are working with all associates to find the right balance that fits each individual and the Five Star team.

Building on our strong track record of credit-disciplined loan growth, combined with well-defined strategic and risk frameworks that guide the evolution of our company, we are open to leveraging available talent to expand our commercial platform through the recruitment of commercial professionals and establishment of loan production offices in viable markets outside of our existing footprint.

In the first quarter of 2022, we announced our first such expansion. John G. Mangan was named senior vice president, commercial real estate executive and mid-

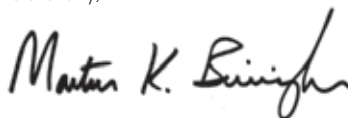
Atlantic president and he will lead three commercial real estate relationship managers in the Baltimore and Washington, D.C. region for Five Star Bank.

Consolidation within the Baltimore and D.C. financial services sector created an opening for us to capitalize on opportunities where a community banking approach provides a competitive advantage. We are taking advantage of experienced and available talent to expand to the Baltimore and Washington, D.C. region and I’m very pleased that John and his team have joined us.

I believe that our resilience, nimbleness, and commitment to process improvement from lessons learned enabled us to successfully address unprecedented operating conditions over the past two years and position us well for the ongoing delivery of positive short-term results and long-term value. These are exciting times and I am incredibly proud of our accomplishments—my thanks and deep appreciation to all our associates whose efforts and dedication made them possible.

As a financial institution, our success has and continues to be dependent on the success of our customers, strength of our communities, and well-being of our employees. On behalf of my teammates, our management team, and the board of directors, I thank you for your support and investment in Financial Institutions, Inc.

Cordially,



Martin K. Birmingham
President and Chief Executive Officer

Our Five Star Promise

In March 2022, the Five Star Promise Purpose Statement and Core Values were refreshed to support corporate strategy and provide clarity on our culture and goals. The purpose statement incorporates prior elements, presented in a new and fresh way that directs us toward our goals.

Our Refreshed Purpose

By keeping the people of Five Star’s well-being at the heart of everything we do, our team, our customers, and our communities will thrive and realize their dreams.

Our Values – focusing on the: H.E.A.R.T of everything we do. We Are:

Humble: Take genuine interest. Listen. Value diverse perspectives.

Empowered: Develop expertise. Share your knowledge. Take action.

Ambitious: Aim for excellence. Bring others with you. Celebrate our successes.

Resilient: Embrace change. Learn from experiences. Be part of the solution.

Transparent: Do the right thing. Communicate clearly and often. Welcome feedback.

Five Star Leadership

Five Star Bank

James M. Ahrens

Director of Mortgage

Scott D. Bader

Technology Services Director

Adolph T. Barclift

Chief Information Security Officer

Amy M. Barone

Director of Operations

Adam J. Bickel

Business Banking Area Manager

Justin K. Bigham^{1,2}

Executive Vice President, Chief Community Banking Officer

Martin K. Birmingham^{1,2}

President and Chief Executive Officer

Samuel J. Burruano Jr.^{1,2}

Executive Vice President, Chief Legal Officer and Corporate Secretary

Craig J. Burton

Commercial Real Estate Executive and Finger Lakes/Southern Tier NY Regional President

Diane M. Camelio

Director of Retail Relationships

David G. Case

Chief Credit Officer

Jonathan W. Chase

Retail Lending Administrator

Laurie R. Collins¹

Chief Human Resources Officer

Shelly J. Doran

Director of Investor and External Relations

Sonia M. Dumbleton²

Principal Accounting Officer and Controller

Karla J.L. Gadley

Community Development Officer

Michael D. Grover

Director of Financial Planning and Analysis and Tax

Leonid Gurevich

Deputy Chief Risk Officer

Kathryn Q. Lewis

Chief Compliance Officer

Jillian M. Mangiafesto

Senior Corporate Counsel and Assistant Corporate Secretary

Laura J. Marlowe

Director of Marketing

Alison K. Miller

Commercial and Industrial Executive and Central NY Regional President

W. Jack Plants II^{1,2}

Chief Financial Officer and Treasurer

Randall R. Phillips¹

Chief Risk Officer

Steven D. Przybyl

Director of Total Rewards and Analytics

Kevin B. Quinn¹

Chief Commercial Banking Officer

Kathleen R. Robbins

Director of Product Management

Abraham Rojo

Director of Digital Banking and BaaS Solutions

Brenda B. Schell

Internal Audit Director

Sean M. Willett^{1,2}

Executive Vice President, Chief Administrative Officer

Taylor S. Veenema

Director of Corporate Strategy and Execution

Laurie L. Wisniewski

Director of Corporate Planning and Facilities

Jennifer L. Yungbluth

Chief Experience Officer

SDN Insurance Agency, LLC

William E. Gallagher

President

Andrea B. Heffler

Director of Client Services

Courier Capital, LLC

Thomas J. Hanlon

President

Heather L. Wisinski

Senior Director of Operations

HNP Capital, LLC

Rebecca L. Westervelt

Managing Director

Board of Directors

Martin K. Birmingham

President and CEO of Financial Institutions, Inc. and Five Star Bank

Donald K. Boswell^{6,8}

President and CEO Emeritus of the Western New York Public Broadcasting Association (WNED-TV and WBFO-FM)

Dawn H. Burlew^{5,7,8}

Director of Government Affairs & Business Development, Global Government Division of Corning Incorporated

Andrew W. Dorn Jr.^{4,5,7}

Chairman of Coal Ash Recycling, LLC

Robert M. Glaser^{3,4}

President of Glaser Consulting, LLC

Samuel M. Gullo^{3,5}

Owner and Operator of Family Furniture

Susan R. Holliday⁴

Chair of the Board of Financial Institutions, Inc. and Five Star Bank; CEO of Dumbwaiter Design, LLC

Robert N. Latella^{4,6,8}

Of Counsel at Barclay Damon, LLP

Mauricio F. Riveros⁸

Chief Operating Officer of The Pike Companies, LTD.

Kim E. VanGelder^{6,7,8}

Chief Information Officer of Eastman Kodak Company

Mark A. Zupan, PhD^{3,7}

President of Alfred University

1: Executive Management Committee Member

2: Also a Financial Institutions, Inc. corporate officer

3: Audit Committee; Robert M. Glaser, Chair

4: Executive Committee; Susan R. Holliday, Chair

5: Management Development and Compensation Committee; Andrew W. Dorn Jr., Chair

6: Nominating and Governance Committee; Donald K. Boswell, Chair

7: Risk Oversight Committee; Kim E. VanGelder, Chair

8: Technology and Data Committee; Dawn H. Burlew, Chair

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

Form 10-K

(Mark One)

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

For the fiscal year ended December 31, 2021

OR

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

For the transition period from _____ to _____

Commission file number **000-26481**

FINANCIAL INSTITUTIONS, INC.

(Exact name of registrant as specified in its charter)

NEW YORK

(State or other jurisdiction of incorporation or organization)

16-0816610

(I.R.S. Employer Identification No.)

220 LIBERTY STREET, WARSAW, NEW YORK

(Address of principal executive offices)

14569

(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
Common stock, par value \$0.01 per share

Trading Symbol(s)
FISI

Name of exchange on which registered
Nasdaq Global Select Market

Securities registered under Section 12(g) of the Exchange Act:

NONE

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

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

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

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

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

Large accelerated filer

Non-accelerated filer

Accelerated filer

Smaller reporting company

Emerging growth company

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

Indicate by check mark whether the registrant has filed a report on and attestation to its management's assessment of the effectiveness of its internal control over financial reporting under Section 404(b) of the Sarbanes-Oxley Act (15 U.S.C. 7262(b)) by the registered public accounting firm that prepared or issued its audit report.

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

The aggregate market value of the registrant's common stock, par value \$0.01 per share, held by non-affiliates of the registrant, as computed by reference to the June 30, 2021 closing price reported by Nasdaq, was approximately \$466,346,000.

As of February 28, 2022, there were outstanding, exclusive of treasury shares, 15,526,641 shares of the registrant's common stock.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the registrant's proxy statement for the 2022 Annual Meeting of Shareholders are incorporated by reference in Part III of this Annual Report on Form 10-K.

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PART I

FORWARD LOOKING INFORMATION

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

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

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

- Governmental and individual efforts to address the COVID-19 pandemic have introduced volatility into the U.S. and global economy which has and may continue to adversely affect our business, financial condition and results of operations;
- Changes in our operations in response to the COVID-19 pandemic have exposed us to additional risks;
- Mandatory COVID-19 vaccination of employees could impact our workforce and have a material adverse effect on our business and results of operations;
- If we experience greater credit losses than anticipated, earnings may be adversely impacted;
- Geographic concentration may unfavorably impact our operations;
- Our commercial business and mortgage loans increase our exposure to credit risks;
- Our indirect and consumer lending involves risk elements in addition to normal credit risk;
- Lack of seasoning in portions of our loan portfolio could increase risk of credit defaults in the future;
- We accept deposits that do not have a fixed term, and which may be withdrawn by the customer at any time for any reason;
- We are subject to environmental liability risk associated with our lending activities;
- We operate in a highly competitive industry and market area;
- Changes to and replacement of the LIBOR Benchmark Interest Rate may adversely affect our business, financial condition, and results of operations;
- Legal and regulatory proceedings and related matters, such as the action brought by a class of consumers against us as described in Part I, Item 3, “Legal Proceedings,” could adversely affect us and the banking industry in general;
- Any future FDIC insurance premium increases may adversely affect our earnings;
- We are highly regulated, and any adverse regulatory action may result in additional costs, loss of business opportunities, and reputational damage;
- The policies of the Federal Reserve have a significant impact on our earnings;
- Our insurance brokerage subsidiary is subject to risk related to the insurance industry;
- Our investment advisory and wealth management operations are subject to risk related to the regulation of the financial services industry and market volatility;
- We make certain assumptions and estimates in preparing our financial statements that may prove to be incorrect, which could significantly impact our results of operations, cash flows and financial condition, and we are subject to new or changing accounting rules and interpretations, and the failure by us to correctly interpret or apply these evolving rules and interpretations could have a material adverse effect;
- The value of our goodwill and other intangible assets may decline in the future;
- We may be unable to successfully implement our growth strategies, including the integration and successful management of newly-acquired businesses;
- Acquisitions may disrupt our business and dilute shareholder value;
- Our tax strategies and the value of our deferred tax assets and liabilities could adversely affect our operating results and regulatory capital ratios;
- Liquidity is essential to our businesses;
- We rely on dividends from our subsidiaries for most of our revenue;
- If our risk management framework does not effectively identify or mitigate our risks, we could suffer losses;

- We face competition in staying current with technological changes and banking alternatives to compete and meet customer demands;
- We rely on other companies to provide key components of our business infrastructure;
- A breach in security of our or third party information systems, including the occurrence of a cyber incident or a deficiency in cybersecurity, or a failure by us to comply with New York State cybersecurity regulations, may subject us to liability, result in a loss of customer business or damage our brand image;
- We are subject to interest rate risk, and a rising rate environment may reduce our income and result in higher defaults on our loans, whereas a falling rate environment may result in earlier loan prepayments than we expect, which may reduce our income;
- The soundness of other financial institutions could adversely affect us;
- We may need to raise additional capital in the future and such capital may not be available on acceptable terms or at all;
- We may not pay or may reduce the dividends on our common stock;
- We may issue debt and equity securities or securities convertible into equity securities, any of which may be senior to our common stock as to distributions and in liquidation, which could dilute our current shareholders or negatively affect the value of our common stock;
- Our certificate of incorporation, our bylaws, and certain banking laws may have an anti-takeover effect;
- The market price of our common stock may fluctuate significantly in response to a number of factors;
- We may not be able to attract and retain skilled people;
- We use financial models for business planning purposes that may not adequately predict future results;
- We depend on the accuracy and completeness of information about or from customers and counterparties;
- Our business may be adversely affected by conditions in the financial markets and economic conditions generally; and
- Severe weather, natural disasters, public health emergencies and pandemics, acts of war or terrorism, and other external events could significantly impact our business.

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

ITEM 1. BUSINESS

GENERAL

The Parent is a financial holding company organized in 1931 under the laws of New York State (“New York” or “NYS”). The principal office of the Parent is located at 220 Liberty Street, Warsaw, New York 14569 and its telephone number is (585) 786-1100. The Parent was incorporated on September 15, 1931, but the continuity of the Company’s banking business is traced to the organization of the National Bank of Geneva on March 28, 1817. Except as the context otherwise requires, the Parent and its direct and indirect subsidiaries are collectively referred to in this report as the “Company.” Five Star Bank is referred to as “FSB” or “the Bank,” SDN Insurance Agency, LLC is referred to as “SDN,” Courier Capital, LLC is referred to as “Courier Capital,” HNP Capital, LLC is referred to as “HNP Capital” and Corn Hill Innovation Labs, LLC is referred to as “CHIL.” The consolidated financial statements include the accounts of the Parent, the Bank, SDN, Courier Capital, HNP Capital and CHIL. The Parent’s common stock is traded on the Nasdaq Global Select Market under the ticker symbol “FISI.”

At December 31, 2021, the Company had consolidated total assets of \$5.52 billion, deposits of \$4.83 billion and shareholders' equity of \$505.1 million.

The Parent's primary business is the operation of its subsidiaries. It does not engage in any other substantial business activities. The Parent's five direct wholly-owned subsidiaries are: (1) the Bank, which provides a full range of banking services to consumer, commercial and municipal customers in Western and Central New York; (2) SDN, which sells various premium-based insurance policies on a commission basis to commercial and consumer customers; (3) Courier Capital and (4) HNP Capital, which both provide customized investment advice, wealth management, investment consulting and retirement plan services to individuals, businesses, institutions, foundations and retirement plans; and (5) CHIL, which oversees the Company's Banking as a Service and Fintech relationships. At December 31, 2021, the Bank represented 99.3%, SDN represented 0.3%, Courier Capital and HNP Capital combined represented 0.4% and CHIL represented 0.0% of the consolidated assets of the Company.

Five Star Bank

The Bank is a New York-chartered bank that has its headquarters at 55 North Main Street, Warsaw, NY, and a total of 48 full-service banking offices in the New York State counties of Allegany, Cattaraugus, Cayuga, Chemung, Erie, Genesee, Livingston, Monroe, Ontario, Orleans, Seneca, Steuben, Wyoming and Yates counties.

At December 31, 2021, the Bank had total assets of \$5.48 billion, investment securities of \$1.38 billion, net loans of \$3.64 billion, deposits of \$4.85 billion and shareholders' equity of \$521.4 million. The Bank offers deposit products, which include checking and NOW accounts, savings accounts, and certificates of deposit, as its principal source of funding. The Bank's deposits are insured up to the maximum permitted by the Bank Insurance Fund (the "Insurance Fund") of the Federal Deposit Insurance Corporation ("FDIC"). The Bank offers a variety of loan products to its customers, including commercial and consumer loans.

SDN Insurance Agency, LLC

SDN is a full-service insurance agency founded in 1923 and headquartered in Amherst, NY. SDN offers personal, commercial and financial services products. For the year ended December 31, 2021, SDN had total revenue of \$5.7 million. During 2021, SDN completed the acquisition of assets of Landmark Group, an independent insurance brokerage firm, on February 1, 2021 and North Woods Capital Benefits LLC, an employee benefits and human resources advisory firm, on August 2, 2021.

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

Courier Capital, LLC

Courier Capital is an SEC-registered investment advisory and wealth management firm founded in 1967 and based in Western New York, with offices in Buffalo and Jamestown. With \$2.19 billion in assets under management as of December 31, 2021, Courier Capital offers customized investment advice, wealth management, investment consulting and retirement plan services to individuals, businesses and institutions. For the year ended December 31, 2021, Courier Capital had total revenue of \$6.4 million.

HNP Capital, LLC

HNP Capital is an SEC-registered investment advisory and wealth management firm founded in 2009 and based in Western New York, with offices in Rochester, New York. With \$819.4 million in assets under management as of December 31, 2021, HNP Capital offers customized investment advice, wealth management, investment consulting and retirement plan services to individuals, businesses and institutions. For the year ended December 31, 2021, HNP Capital had total revenue of \$4.2 million.

Corn Hill Innovation Labs, LLC

CHIL was initially established in 2021 to manage a joint venture with Alloy Labs Alliance, a group of innovative community banks, to launch CHUCK, an open network for peer-to-peer payments for consumers and small businesses. CHIL's scope has since expanded to oversee the Company's Banking as a Service and Fintech relationships. CHIL is based in Western New York, with its main office in Rochester, New York.

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

Business Strategy

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

A key aspect of our current business strategy is to foster a community-oriented culture where our customers and employees establish long-standing and mutually beneficial relationships. We believe that we are well-positioned to be a strong competitor within our market area because of our focus on community banking needs and customer service, our comprehensive suite of deposit, loan, insurance and wealth management products typically found at larger banks, our highly experienced management team and our strategically located banking centers. We have also broadened our service offerings to include financial advice and insurance solutions along with traditional banking needs.

We have evolved to meet changing customer needs by opening what we refer to as financial solution center branches. These financial solution centers have a smaller footprint than our traditional branches, focus on technology to provide solutions that fit our customer preferences for transacting business with us, and these branches are staffed by certified personal bankers who are trained to meet a broad array of customer needs. In recent years, we have opened four financial solution centers in the Rochester and Buffalo markets, and in February 2020, the Federal Reserve Bank of New York and the New York State Department of Financial Services approved our application to open two additional financial solution centers in Buffalo that opened in 2021. In addition, we are focused on continued expansion of product delivery channels and are investing in our digital banking platform to allow for greater flexibility in the customer experience. We believe that the foregoing factors all help to grow our core deposits, which supports a central element of our business strategy - the growth of a diversified and high-quality loan portfolio.

Acquisition Strategy

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

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

HUMAN CAPITAL RESOURCES STRATEGY

In order to continue to deliver on our mission of financial inclusion for all, it is crucial that we attract and retain talent who desire to enable financial equality through delivery of capable solutions, thoughtful innovation and equitable consumer options in the markets that we serve. To facilitate talent attraction and retention, we strive to make the Company an inclusive, safe and healthy workplace, with opportunities for our employees to grow and develop in their careers, supported by strong compensation, benefits, health and welfare programs.

Employee Profile

As of December 31, 2021, we had 625 employees situated across the United States. This represents an increase of 12 employees or 2% from December 31, 2020.

As of December 31, 2021, approximately 65% of our current workforce is female, 35% male, and our average tenure is 6.56 years, a decrease of 16% from an average tenure of 7.77 years as of December 31, 2020.

Total Rewards

As part of our compensation philosophy, we believe that we must offer and maintain market competitive total rewards programs for our employees in order to attract and retain superior talent. In addition to market competitive base wages, our rewards programs include performance-based bonus opportunities, equity compensation, Company-sponsored retirement plans, healthcare and insurance benefits, health savings and flexible spending accounts, paid time off, family leave, family care resources, remote work arrangements, flexible work schedules, adoption assistance, and employee assistance programs.

Health and Safety

The success of our business is fundamentally connected to the well-being of our people. Accordingly, we are committed to the health, safety and wellness of our employees. We provide our employees and their families with access to a variety of flexible and convenient health and welfare programs, including benefits that support their physical and mental health by providing tools and resources to help them improve or maintain their health status and that offer choice where possible so they can customize their benefits to meet their needs and the needs of their families. In response to the COVID-19 pandemic, we implemented significant operating environment changes that we determined were in the best interest of our employees, as well as the communities in which we operate, and which comply with government regulations. This includes supporting a majority of our employees to work from home or remotely, while implementing additional safety measures for employees continuing critical on-site work. Many employees continue to work from home as we transition to a more flexible work environment.

Talent

A core tenet of our talent system is to both develop talent from within and supplement with external hires. This approach has yielded loyalty and commitment among our employees which in turn grows our business, our products, and our customers, while also adding new talent, skillsets and ideas to support a continuous improvement mindset and our goals of a diverse and inclusive workforce.

We have conducted intentional, strategic hiring in 2021 to supplement the organization with new skill sets and perspectives. Our talent acquisition team uses internal and external resources to recruit highly skilled and talented workers, and additionally we incentivize employee referrals for open positions.

Our performance management framework positions our leaders as coaches who continuously develop and grow talent through ongoing performance and development discussions, formal talent and development assessments, goal setting and feedback and performance-based compensation programs.

Diversity and Inclusion

We strive toward having a powerful and diverse team of employees, knowing we are better together with our combined wisdom and intellect. With a commitment to equality, inclusion and workplace diversity, we focus on understanding, accepting, and valuing the differences between people. To accomplish this, we established a Diversity & Inclusion Advisory Council in 2020 made up of 18 employee representatives throughout our operating footprint. The Council meets regularly to provide feedback and ideas that guide our DEI strategy. We have begun a series of DEI-focused trainings to raise awareness of unconscious bias and equip leaders to build inclusive team experiences. We continued our commitment to equal employment opportunity through a robust affirmative action plan which includes annual compensation analyses and ongoing reviews of our selection and hiring practices alongside a continued focus on building and maintaining a diverse workforce.

MARKET AREAS AND COMPETITION

We provide a wide range of banking and financial services to individuals, municipalities and businesses through a network of over 45 offices and an extensive ATM network throughout Western and Central New York. The region includes the counties of Allegany, Cattaraugus, Cayuga, Chautauqua, Chemung, Erie, Genesee, Livingston, Monroe, Ontario, Orleans, Schuyler, Seneca, Steuben, Wayne, Wyoming and Yates counties. Our banking activities, though concentrated in the communities where we maintain branches, also extend into neighboring counties. In addition, our consumer indirect lending presence includes the Capital District of New York and Northern and Central Pennsylvania.

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

areas and complementary market areas in the coming years. For example, we opened two additional financial solution centers in Buffalo in 2021.

We face significant competition in both making loans and attracting deposits, as Western and Central New York have a high density of financial institutions. Our competition for loans comes principally from commercial banks, savings banks, savings and loan associations, mortgage banking companies, credit unions, and other financial services companies. Our most direct competition for deposits has historically come from commercial banks, savings banks and credit unions. We face additional competition for deposits from non-traditional fintech firms and non-depository competitors such as the mutual fund industry, securities and brokerage firms and insurance companies. We generally compete with other financial service providers on factors such as level of customer service, responsiveness to customer needs, availability and pricing of products, and geographic location. Our industry frequently experiences merger activity, which affects competition by eliminating some institutions while potentially strengthening the franchises of others.

The following table presents the Bank’s market share percentage for total deposits as of June 30, 2021, in each county where we have operations. The table also indicates the ranking by deposit size in each market. All information in the table was obtained from S&P Global Market Intelligence, which compiles deposit data published by the FDIC as of June 30, 2021 and updates the information for any bank mergers and acquisitions completed subsequent to the reporting date.

County	Market Share	Market Rank	Number of Branches ⁽¹⁾
Allegany	7.8%	2	1
Cattaraugus	24.0%	2	4
Cayuga	6.9%	6	1
Chemung	13.9%	3	2
Erie	0.4%	11	6
Genesee	18.6%	2	2
Livingston	32.6%	1	5
Monroe	2.2%	8	8
Ontario	13.1%	2	4
Orleans	23.7%	2	2
Seneca	26.2%	1	2
Steuben	32.2%	2	5
Wyoming	66.2%	1	4
Yates	32.7%	1	2

(1) Number of branches current as of December 31, 2021.

INVESTMENT ACTIVITIES

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

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

- U.S. treasury securities;
- U.S. government agency securities, which are securities issued by official Federal government bodies (e.g., the Government National Mortgage Association (“GNMA”) and the Small Business Administration (“SBA”)), and U.S. government-sponsored enterprise securities, which are securities issued by independent organizations that are in part sponsored by the federal government (e.g., the Federal Home Loan Bank (“FHLB”) system, the Federal National Mortgage Association (“FNMA”), the Federal Home Loan Mortgage Corporation (“FHLMC”) and the Federal Farm Credit Bureau);
- Mortgage-backed securities (“MBS”), which include mortgage-backed pass-through securities, collateralized mortgage obligations and multi-family MBS issued by GNMA, FNMA and FHLMC;
- Investment grade municipal securities, including revenue, tax and bond anticipation notes, statutory installment notes and general obligation bonds;
- Certain creditworthy unrated securities issued by municipalities;
- Certificates of deposit;

- Equity securities at the holding company level;
- Derivative instruments; and
- Limited partnership investments.

LENDING ACTIVITIES

General

We offer a broad range of loans including commercial business and revolving lines of credit, commercial mortgages, equipment loans, residential mortgage loans and home equity loans and lines of credit, home improvement loans, automobile loans and personal loans. Newly originated and refinanced fixed rate residential mortgage loans are either retained in our portfolio or sold to the secondary market with servicing rights retained.

We continually evaluate and update our lending policy. The key elements of our lending philosophy include the following:

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

Commercial Business and Commercial Mortgage Lending

We primarily originate commercial business loans in our market areas and underwrite them based on the borrower's ability to service the loan from operating income. We offer a broad range of commercial lending products, including term loans and lines of credit. Short and medium-term commercial loans, primarily collateralized, are made available to businesses for working capital (including inventory and receivables), business expansion (including acquisition of real estate, expansion and improvements) and the purchase of equipment. We offer commercial business loans to customers in the agricultural industry for short-term crop production, farm equipment and livestock financing. As a general practice, where possible, a first position collateral lien is placed on any available real estate, equipment or other assets owned by the borrower and a personal guarantee of the owner is obtained. As of December 31, 2021, \$229.0 million, or 36%, of our aggregate commercial business loan portfolio were at fixed rates, while \$409.3 million, or 64%, were at variable rates.

We also offer commercial mortgage loans to finance the purchase of real property, which generally consists of real estate with completed structures. Commercial mortgage loans are secured by first liens on the real estate and are typically amortized over a 10 to 20-year period. The underwriting analysis includes credit verification, appraisals and a review of the borrower's financial condition and repayment capacity. As of December 31, 2021, \$659.6 million, or 47%, of the loans in our aggregate commercial mortgage portfolio were at fixed rates, while \$753.2 million, or 53%, were at variable rates.

We utilize government loan guarantee programs where available and appropriate.

Government Guarantee Programs

The Coronavirus Aid, Relief, and Economic Security Act (the "CARES Act") was passed by Congress and signed into law on March 27, 2020. The CARES Act established the Paycheck Protection Program ("PPP"), an expansion of the SBA's 7(a) loan program and the Economic Injury Disaster Loan Program ("EIDL"), administered directly by the SBA. As of December 31, 2021, we had PPP loans with an aggregate principal balance of \$57.5 million that were covered by guarantees under this program.

We participate in other government loan guarantee programs offered by the SBA, U.S. Department of Agriculture, Rural Economic and Community Development and Farm Service Agency, among others. As of December 31, 2021, we had loans with an aggregate principal balance of \$30.1 million that were covered by guarantees under these programs. The guarantees typically only cover a certain percentage of these loans. By participating in these programs, we are able to broaden our base of borrowers while reducing credit risk.

Residential Real Estate Lending

We originate fixed and variable rate one-to-four family residential mortgages collateralized by owner-occupied properties located in our market areas. We offer a variety of real estate loan products, including home improvement loans, closed-end home equity loans, and home equity lines of credit, which are generally amortized over periods of up to 30 years. Loans collateralized by one-to-four family residential real estate generally have been originated in amounts of no more than 80% of appraised value or have mortgage insurance. Mortgage title insurance and hazard insurance are normally required. We sell certain one-to-four family residential mortgages to the secondary mortgage market and typically retain the right to service the mortgages. We typically follow the underwriting and appraisal guidelines of the secondary market, including the FHLMC and the Federal Housing Administration, and service the loans in a manner that satisfies the secondary market agreements. As of December 31, 2021, our residential mortgage servicing portfolio totaled \$272.7 million, the majority of which has been sold to the FHLMC. As of December 31, 2021, our residential real estate loan portfolio totaled \$577.3 million, or 16% of our total loan portfolio. As of December 31, 2021, our residential real estate lines portfolio totaled \$78.5 million, or 2% of our total loan portfolio. As of December 31, 2021, \$528.1 million, or 91%, of the loans in our residential real estate loan portfolio were at fixed rates, while \$49.2 million, or 9%, were at variable rates. The residential real estate lines portfolio primarily consists of variable rate lines. Approximately 93% of the loans and lines in our residential real estate portfolios were in first lien positions at December 31, 2021. We do not engage in sub-prime or other high-risk residential mortgage lending as a line-of-business.

Consumer Lending

We offer a variety of loan products to our consumer customers, including automobile loans, secured installment loans and other types of secured and unsecured personal loans. At December 31, 2021, outstanding consumer loan balances were concentrated in indirect automobile loans.

We originate indirect consumer loans for a mix of new and used vehicles through franchised new car dealers. The consumer indirect loan portfolio is primarily comprised of loans with terms that typically range from 36 to 84 months. We have developed relationships with franchised new car dealers in Western, Central and the Capital District of New York, and Northern and Central Pennsylvania. As of December 31, 2021, our consumer indirect portfolio totaled \$958.0 million, or 26% of our total loan portfolio. The consumer indirect loan portfolio primarily consists of fixed rate loans with relatively short durations.

We also originate, independently of the indirect loans described above, consumer automobile loans, recreational vehicle loans, boat loans, personal loans (collateralized and uncollateralized) and deposit account collateralized loans. The terms of these loans typically range from 12 to 60 months and vary based upon the nature of the collateral and the size of loan. A portion of the consumer lending program is underwritten on a secured basis using the customer's financed automobile, mobile home, boat or recreational vehicle as collateral. The other loans in our consumer portfolio totaled \$14.5 million as of December 31, 2021, all of which were fixed rate loans.

Credit Administration

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

Our credit objectives are to:

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

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

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

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

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

We have several procedures in place to assist in maintaining the overall quality of our loan portfolio. Delinquent loan reports are monitored by credit administration to identify adverse levels and trends. Loans, including loans individually evaluated for impairment, 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.

Allowance for Credit Losses

The allowance for credit losses is established through charges to earnings in the form of a provision for credit losses. The allowance reflects management's estimate of the amount of probable credit losses in the portfolio, based on factors including, but not limited to:

- Specific allocations for individually evaluated credits;
- Segmentation of credit exposures by similar credit characteristics;
- Historical net charge-off experience by segment;
- Correlation of segmented historical losses to a loss driver;
- Evaluation of historical loss emergence by segment;
- Evaluation and establishment of look-back periods by segment;
- Evaluation of prepayment and curtailment experience by segment;
- Evaluation of average life for each segment;
- Levels and trends in delinquent and non-accruing loans;
- Trends in volume and terms of loans;
- Effects of changes in lending policy;
- National and local economic trends and conditions excluding the loss driver;
- Regulatory environment;
- Portfolio administration;
- Potential funding of unfunded commitments;
- Evaluation of held to maturity investments; and
- Evaluation of deferred interest receivable.

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

1. Collateral dependent commercial business and commercial mortgage loans, as well as, non-collateral dependent criticized loans of two-million dollars and greater are typically reviewed individually and assigned a specific loss allowance, if considered necessary, in accordance with U.S. generally accepted accounting principles ("GAAP"). In addition, reflective of the heightened risk resulting from long-term deferrals afforded under the CARES Act of certain commercial business and commercial mortgage loans and individual evaluation was performed on certain of the most at risk longer term deferrals and a specific loss allowance was placed on them. Collectively, this is referred to as the Individually Evaluated component of the allowance for credit losses estimate.
2. Loans not analyzed for a specific reserve are segmented into "pools" of loans based upon similar risk characteristics. This is referred to as the pooled loan component of the allowance for credit losses estimate. The Company has identified six portfolio segments of loans including commercial loans/lines, commercial mortgage, indirect loans, direct loans, residential lines of credit, and residential loans. Each segment, or pool, is quantitatively analyzed using a discounted cash flow approach over the life of the loan. The pooled loans estimate is based upon periodic review of the collectability of the loans quantitatively correlating historical loan experience with reasonable and supportable forecasts using forward looking information. Adjustments to the quantitative evaluation may be made for differences in current or expected qualitative risk characteristics such as changes in: underwriting standards, delinquency level, regulatory environment, economic condition, Company management and the status of portfolio administration including the Company's credit risk review function.

3. The Company's held to maturity ("HTM") debt securities are also required to utilize the current expected credit losses approach to estimate expected credit losses. The Company's HTM debt securities included securities that are issued by U.S. government or U.S. government-sponsored enterprises. These securities carry the explicit and/or implicit guarantee of the U.S. government, are widely recognized as "risk free," and have a long history of zero credit loss. The Company also carries a portfolio of HTM municipal bonds. The Company measures its allowance for credit losses on HTM debt securities on a collective basis by major security type. The estimate is based on historical credit losses, if any, adjusted for current conditions and reasonable and supportable forecasts. The Company considers the nature of the collateral, potential future changes in collateral values and available loss information.
4. The Company had made the election with the adoption of ASU 2016-13 of not measuring an allowance for credit losses for accrued interest receivable due to the Company's policy of writing off uncollectible accrued interest receivable balances in a timely manner, as described above.
5. The reserve for unfunded commitments (the "Unfunded Reserve") represents the expected credit losses on off-balance sheet commitments such as unfunded commitments to extend credit and standby letters of credit. However, a liability is not recognized for commitments unconditionally cancellable by the Company. The unfunded reserve is recognized as a liability (other liabilities in the consolidated statements of financial condition), with adjustments to the reserve recognized as a provision for credit loss expense in the consolidated statements of income. The unfunded reserve is determined by estimating expected future fundings, under each segment, and applying the expected loss rates. Expected future fundings are based on historical averages of funding rates (i.e., the likelihood of draws taken). To estimate future fundings on unfunded balances, current funding rates are compared to historical funding rates.

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

SOURCES OF FUNDS

Our primary sources of funds are deposits and borrowed funds.

Deposits

We maintain a full range of deposit products and accounts to meet the needs of the residents and businesses in our primary service area. Products include an array of checking and savings account programs for individuals and businesses, including money market accounts, certificates of deposit, sweep investment capabilities as well as Individual Retirement Accounts and other qualified plan accounts. We rely primarily on competitive pricing of our deposit products, customer service and long-standing relationships with customers to attract and retain these deposits and seek to make our services convenient to the community by offering a choice of several delivery systems and channels, including telephone, mail, online, automated teller machines ("ATMs"), debit cards, point-of-sale transactions, automated clearing house transactions ("ACH"), remote deposit, and mobile banking via telephone or wireless devices. We also take advantage of the use of technology by offering business customers banking access via the Internet and various advanced cash management systems.

We also participate in reciprocal deposit programs, which enable depositors to receive FDIC insurance coverage for deposits exceeding the maximum insurable amount. Through these programs, deposits in excess of the maximum insurable amount are placed with multiple participating financial institutions. Reciprocal deposits totaled \$771.4 million at December 31, 2021.

Borrowings

We have access to a variety of borrowing sources and use both short-term and long-term borrowings to support our asset base. Borrowings from time-to-time include federal funds purchased, securities sold under agreements to repurchase, FHLB advances and borrowings from the discount window of the FRB, as defined below.

Other sources of funds include scheduled amortization and prepayments of principal from loans and mortgage-backed securities, maturities and calls of investment securities and funds provided by operations.

OTHER INFORMATION

We also make available, free of charge through our website, all reports filed with or furnished to the Securities and Exchange Commission (“SEC”), including our Annual Reports on Form 10-K, Quarterly Reports on Form 10-Q and Current Reports on Form 8-K, as well as any amendments to those reports, as soon as reasonably practicable after those documents are filed with or furnished to the SEC. These filings may be viewed by accessing the *SEC Filings* subsection of the *Financials* section of our website (www.fiiwarsaw.com). Information available on our website is not a part of, and is not incorporated into, this Annual Report on Form 10-K.

All of the reports we file with the SEC, including this Annual Report on Form 10-K, Quarterly Reports on Form 10-Q and Current Reports on Form 8-K, as well as any amendments thereto may be accessed at www.sec.gov.

SUPERVISION AND REGULATION

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

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

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

- Acquiring, directly or indirectly, ownership or control of any voting shares of another bank, financial holding company or bank holding company if, after such acquisition, it would own or control more than 5% of such shares (unless it already owns or controls the majority of such shares);
- Acquiring all or substantially all of the assets of another bank, financial holding company or bank holding company, or
- Merging or consolidating with another financial holding company or bank holding company.

The BHC Act generally prohibits a bank holding company from acquiring direct or indirect ownership or control of more than 5% of the voting shares of any company which is not a bank or bank holding company, or from engaging directly or indirectly in activities other than those of banking, managing or controlling banks, or providing services for its subsidiaries. However, the Gramm-Leach-Bliley Act amended portions of the BHC Act to authorize financial holding companies, such as us, to directly or through non-bank subsidiaries engage in securities, insurance and other activities that are financial in nature or incidental to a financial activity. In order to undertake and maintain these activities, a financial holding company must certify that all of the depository institutions controlled by the company are well capitalized and well managed.

The Dodd-Frank Act, Economic Growth Act, and Volcker Rule. The Dodd-Frank Act significantly changed the regulation of financial institutions, such as community banks, thrifts, and small bank and thrift holding companies, and the financial services industry.

Although it was enacted in 2010, certain provisions of the Dodd-Frank Act have yet to be fully implemented and may be impacted by future legislation, rulemaking or executive orders. Our management continues to monitor the ongoing implementation of the Dodd-Frank Act and as new regulations are issued, will assess their effect on our business, financial condition and results of operations.

In May 2018, the Economic Growth, Regulatory Relief and Consumer Protection Act (“Economic Growth Act”) was enacted and impacted several of the provisions of the Dodd-Frank Act. The law provided certain regulatory relief to community banks, like us, with less than \$10 billion in total consolidated assets. This relief includes an exemption from the Volcker Rule, as discussed below.

The Dodd-Frank Act prohibits banks and their affiliates from engaging in proprietary trading and from investing and sponsoring hedge funds and private equity funds. The statutory provision implementing these restrictions is commonly called the “Volcker Rule.” The Economic Growth Act exempts banks with less than \$10 billion in total consolidated assets that does not engage in any covered activities other than trading in certain government, agency, state or municipal obligations, from any significant compliance obligations under the Volcker Rule. Because the Bank falls within the category of exempted banks, the Volcker Rule will not have a material effect on our

business, financial condition and results of operations. We cannot predict whether we may become subject to the Volcker Rule, or a similar rule, following additional legislative or regulatory action concerning community banks.

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

- Real estate lending standards, which provide guidelines concerning loan-to-value ratios for various types of real estate loans;
- Risk-based capital rules, including accounting for interest rate risk, concentration of credit risk and the risks posed by non-traditional activities;
- Rules requiring depository institutions to develop and implement internal procedures to evaluate and control credit and settlement exposure to their correspondent banks;
- Rules restricting types and amounts of equity investments; and
- Rules addressing various safety and soundness issues, including operations and managerial standards, standards for asset quality, earnings and compensation standards.

Capital Requirements. The Company and the Bank are each required to comply with applicable capital adequacy standards established by the Federal Reserve. The current risk-based capital standards applicable to the Company and the Bank are based on the final capital framework for strengthening international capital standards, known as Basel III, of the Basel Committee on Banking Supervision.

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

Under the Basel III Rules, the current minimum capital ratios, including an additional capital conservation buffer applicable to the Company and the Bank, are:

- 7.0% CET1 to risk-weighted assets;
- 8.5% Tier 1 capital (that is, CET1 plus Additional Tier 1 capital) to risk-weighted assets; and
- 10.5% Total capital (that is, Tier 1 capital plus Tier 2 capital) to risk-weighted assets.

Banking institutions that do not hold capital above the required minimum levels, including the capital conservation buffer, will face constraints on paying dividends and compensation based on the amount of the shortfall.

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

The Basel III Rules prescribe a standardized approach for risk weightings for a variety of asset classes that, depending on the nature of the assets, generally ranges from 0% for U.S. government and agency securities, to 600% for certain equity exposures.

The Economic Growth Act provided for a potential exception from the Basel III Rules for community banks that maintain a Community Bank Leverage Ratio (“CBLR”) of at least 8.0% to 10.0%. The CBLR is calculated by dividing Tier 1 capital by the bank’s average total consolidated assets. In the final rules approved by the FDIC in September 2019, qualifying community banking organizations that opt in to using the CBLR are considered to be in compliance with the Basel III Rules as long as the bank maintains a CBLR of greater than 9.0%. If a bank is not a qualifying community banking organization, does not opt in to using the CBLR, or cannot maintain a CBLR of greater than 9.0%, the bank would have to comply with the Basel III Rules. We determined to comply with the Basel III Rules instead of using the CBLR framework.

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

Liquidity Regulation. The liquidity coverage ratio (“LCR”), provided for in the Basel III liquidity framework, is designed to ensure that a bank maintains an adequate level of unencumbered high quality liquid assets equal to the bank’s expected net cash outflows for a thirty-day time horizon under an acute liquidity stress scenario. The rules as adopted apply in their most comprehensive form only to advanced approaches financial or bank holding companies and depository institution subsidiaries of such financial or bank holding companies and, in a modified form, to banking organizations having \$50 billion or more in total consolidated assets. Accordingly, they do not apply to either the Company or the Bank.

Similarly, the Basel III framework included a standard, referred to as the net stable funding ratio (“NSFR”), which is designed to promote more medium-and long-term funding of the assets and activities of banks over a one-year time horizon. Effective July 1, 2021, the NSFR standard requires large financial institutions to maintain a 1.0 ratio of available stable funding to required stable funding. The scope of financial institutions to which this standard applies is consistent with the LCR standard, and accordingly, neither the Company nor the Bank is required to comply with this standard. As a result, we do not manage our balance sheet to be compliant with these rules.

Prompt Corrective Action. The Federal Deposit Insurance Act, as amended (“FDIA”), requires, among other things, the federal banking agencies to take “prompt corrective action” in respect of depository institutions that do not meet minimum capital requirements. The FDIA establishes five capital categories for FDIC-insured banks: well capitalized, adequately capitalized, under-capitalized, significantly under-capitalized and critically under-capitalized. A depository institution is deemed to be “well-capitalized” if the institution has a total risk-based capital ratio of 10.0% or greater, a CET 1 ratio of 6.5% or greater, a Tier 1 risk-based capital ratio of 8.0% or greater, and a leverage ratio of 5.0% or greater and the institution is not subject to an order, written agreement, capital directive or prompt corrective action directive to meet and maintain a specific level for any capital measure.

The FDIA imposes progressively more restrictive constraints on operations, management and capital distributions, depending on the capital category in which an institution is classified.

For further information regarding the capital ratios and leverage ratio of the Company and the Bank see the section titled “Sources and Uses of Capital Resources” in Part II, Item 7, “Management’s Discussion and Analysis of Financial Condition and Results of Operations,” included in this Annual Report on Form 10-K. The current requirements and the actual levels for the Company and the Bank are detailed in Note 15, Regulatory Matters, of the notes to consolidated financial statements, included in this Annual Report on Form 10-K.

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

The primary source of cash for dividends we pay is the dividends we receive from the Bank. The Bank is subject to various regulatory policies and requirements relating to the payment of dividends, including requirements to maintain capital above regulatory minimums. Approval of the New York State Department of Financial Services (the “NY DFS”) is required prior to paying a dividend if the dividend declared by the Bank exceeds the sum of the Bank’s net profits for that year and its retained net profits for the preceding two calendar years. At January 1, 2022, the Bank could declare dividends of \$77.0 million from retained net profits of the preceding two years. The Bank declared dividends of \$24.0 million and \$23.0 million in 2021 and 2020, respectively.

Federal Deposit Insurance Assessments. The Bank is a member of the FDIC and pays an insurance premium to the FDIC to fund the Deposit Insurance Fund (“DIF”) based upon the bank's assessable assets on a quarterly basis. Deposits are insured up to applicable limits by the FDIC and such insurance is backed by the full faith and credit of the U.S. Government.

The current level of deposit insurance is \$250,000. The coverage limit is per depositor, per insured depository institution for each account ownership category.

The minimum designated reserve ratio for the DIF is 1.35% of estimated insured deposits. Under the Dodd-Frank Act, the FDIC defined the deposit insurance assessment base for an insured depository institution as an amount equal to the institution’s average consolidated total assets during the assessment period minus average tangible equity. Deposit insurance premiums for the Bank are calculated based upon the average balance of total assets minus average tangible equity as of the close of business for each day during the calendar quarter. As of September 30, 2018, the FDIC had exceeded the minimum reserve ratio of 1.35%. We received credits for the portion of our regular assessments that contributed to growth in the reserve ratio to 1.35%, which applied to reduce regular assessments for quarters when the reserve ratio is at least 1.38%. We used these credits to reduce our regular assessments through the first quarter of 2020.

The FDIC has the flexibility to adopt actual rates that are higher or lower than the total base assessment rates adopted without notice and comment, if certain conditions are met.

The FDIC is authorized to conduct examinations of and require reporting by FDIC-insured institutions. It is also authorized to terminate a depository bank’s deposit insurance upon a finding by the FDIC that the bank’s financial condition is unsafe or unsound or that the institution has engaged in unsafe or unsound practices or has violated any applicable rule, regulation, order or condition enacted or imposed by the bank’s regulatory agency. The termination of deposit insurance for the Bank would have a material adverse effect on our earnings, operations and financial condition.

Consumer Laws and Regulations. In addition to the laws and regulations discussed herein, the Bank is also subject to certain consumer federal and state laws and regulations that are designed to protect consumers in transactions with banks. While the list set forth herein is not exhaustive, these laws and regulations include, among others, the Fair Credit Reporting Act, the Truth in Lending Act, the Truth in Savings Act, the Electronic Funds Transfer Act, the Expedited Funds Availability Act, the Equal Credit Opportunity Act, the Fair Housing Act, the Home Mortgage Disclosure Act, the Real Estate Settlement Procedures Act, the Fair Debt Collection Practices Act, the Service Members Civil Relief Act and these laws' respective state-law counterparts, as well as state usury laws and laws regarding unfair and deceptive acts and practices. These and other federal and state laws, among other things, require disclosures of the cost of credit and terms of deposit accounts, provide substantive consumer rights, prohibit discrimination in credit transactions, regulate the use of credit report information, provide financial privacy protections, prohibit unfair, deceptive and abusive practices, restrict the Company's ability to raise interest rates and subject the Company to substantial regulatory oversight. Violations of applicable consumer protection laws can result in significant potential liability from litigation brought by customers, including actual damages, restitution and attorneys' fees. Federal and state bank regulators, federal law enforcement agencies, state attorneys general and state and local consumer protection agencies may also seek to enforce consumer protection requirements and obtain these and other remedies, including regulatory sanctions, customer rescission rights, fines and civil money penalties. Failure to comply with consumer protection requirements may also result in our failure to obtain any required bank regulatory approval for merger or acquisition transactions the Company may wish to pursue or our prohibition from engaging in such transactions even if approval is not required.

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

- Risks to consumers and compliance with the federal consumer financial laws, when it evaluates the policies and practices of a financial institution;
- The markets in which firms operate and risks to consumers posed by activities in those markets;
- Depository institutions that offer a wide variety of consumer financial products and services or a more specialized focus; and
- Non-depository companies that offer one or more consumer financial products or services.

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

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

Community Reinvestment Act. Pursuant to the Community Reinvestment Act (the "CRA"), under federal and New York State law, the Bank is obligated, consistent with safe and sound banking practices, to help meet the credit needs of its entire community, including low- and moderate-income neighborhoods. The FRB of New York and NY DFS periodically assess the Bank's record of performance under the CRA and issue one of the following ratings: "Outstanding," "Satisfactory," "Needs to Improve," or "Substantial Noncompliance."

The most recently completed evaluation of the Bank's performance under the CRA was conducted by the FRB of New York from January 1, 2013 through September 30, 2018 and resulted in an overall rating of "Satisfactory." In reaching this rating, the FRB of New York evaluated HMDA-reportable, small business, small farm, consumer loans, community development loans, investments, philanthropic grants, and services provided.

The last CRA evaluation completed by NY DFS was for the time period from January 1, 2012 through September 30, 2017. This performance evaluation resulted in an overall rating by the NY DFS of "Satisfactory." In reaching this rating the NY DFS considered the Bank's lending practices by the areas served, the geographic distribution of loans, borrower characteristics and use in community development projects, along with testing the ability of the Bank's investment and service activities to meet community credit needs

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

The NY DFS requires New York State-chartered or licensed banks regulated by the NY DFS, such as us, to adopt broad cybersecurity protections. In particular, we have established a program designed to ensure the safety of our information systems, adopted a written cybersecurity policy, and designated an information security officer. We are subject to ongoing compliance and reporting requirements of the NY DFS.

Anti-Money Laundering and the USA Patriot Act. A major focus of governmental policy on financial institutions is combating money laundering and terrorist financing. The USA PATRIOT Act of 2001 substantially broadened the scope of U.S. anti-money laundering laws and regulations by imposing significant new compliance and due diligence obligations, creating new crimes and penalties and expanding the extra-territorial jurisdiction of the United States. Financial institutions are prohibited from entering into specified financial transactions and account relationships and must use enhanced due diligence procedures in their dealings with certain types of high-risk customers and implement a written customer identification program. Financial institutions must take certain steps to assist government agencies in detecting and preventing money laundering and report certain types of suspicious transactions. Regulatory authorities routinely examine financial institutions for compliance with these obligations, and for the failure of a financial institution to maintain and implement adequate programs to combat money laundering and terrorist financing, or to comply with all of the relevant laws and regulations, could have serious legal and reputational consequences for the institution, including causing applicable bank regulatory authorities not to approve merger or acquisition transactions when regulatory approval is required or to prohibit such transactions even if approval is not required. Regulatory authorities have imposed cease and desist orders and civil money penalties against institutions found to be violating these obligations.

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

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

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

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

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

Investment Advisory Regulation. Courier Capital and HNP Capital are providers of investment consulting and financial planning services and, as such, are each considered an "investment adviser" under the U.S. Investment Advisers Act of 1940, as amended (the "Advisers Act"). An investment adviser is any person or entity that provides advice to others, or that issues reports or analyses, regarding securities for compensation. While a FHC is generally excluded from regulation under the Advisers Act, the SEC has stated that this exclusion does not apply to investment adviser subsidiaries of FHCs, such as Courier Capital and HNP Capital. Because Courier Capital and HNP Capital each have over \$100 million in assets under management, each is individually considered a "large adviser," which requires registration with the SEC by filing Form ADV, including Part 3 to Form ADV, or Form CRS, which discloses the material terms of the advisor's relationship with retail customers. Courier Capital and HNP Capital must update these forms at least once each year and more frequently under certain specified circumstances. This registration covers Courier Capital or HNP Capital and its

employees as well as other persons under their control and supervision, such as independent contractors, provided that their activities are undertaken on behalf of Courier Capital or HNP Capital.

In addition to these registration requirements, the Advisers Act contains numerous other provisions that impose obligations on investment advisors. For example, Section 206 includes anti-fraud provisions that courts have interpreted as establishing fiduciary duties extending to all services undertaken on behalf of the client. These duties include, but are not limited to, the disclosure of all material facts to clients, providing only suitable investment advice, and seeking best price execution of trades. Section 206 also has specific rules relating to, among other things, advertising, safeguarding client assets, the engagement of third-parties, the duty to supervise persons acting on the investment adviser's behalf, and the establishment of an effective internal compliance program and a code of ethics.

Courier Capital and HNP Capital are subject to each of these obligations and, as applicable, restrictions, and are also subject to examination by the SEC's Office of Compliance, Investigations, and Examinations to assess their overall compliance with the Advisers Act and the effectiveness of their internal controls.

Commencing in October 2013, prior to the Parent's acquisition of Courier Capital and HNP Capital, the Bank entered into a partnership with LPL Financial, one of the nation's largest independent financial services companies ("LPL"), to provide investment advisory and broker-dealer services to the Bank's customers through LPL. This partnership continues and the Bank employs wealth advisors, who are licensed by LPL, to provide investment advisory and broker-dealer services to the Bank's customers. LPL is an investment adviser registered under the Advisers Act and is subject to its provisions.

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

The Dodd-Frank Act requires the federal banking agencies to establish joint regulations or guidelines prohibiting incentive-based payment arrangements at specified regulated entities having at least \$1 billion in total consolidated assets (which would include the Company and the Bank) that encourage inappropriate risks by providing an executive officer, employee, director or principal shareholder with excessive compensation, fees or benefits or that could lead to material financial loss to the entity. In addition, the agencies must establish regulations or guidelines requiring enhanced disclosure to regulators of incentive-based compensation arrangements. In May 2016, six federal agencies, including the FRB, the FDIC and the SEC, invited public comments on a proposed rule to accomplish this mandate; no final rule has since been issued, however, and it is uncertain at this time whether the agencies intend to further pursue the rule for the foreseeable future.

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

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

Regulatory and Economic Policies

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

ITEM 1A. RISK FACTORS

An investment in our common stock is subject to risks inherent to our business. The material risks and uncertainties that management believes could affect us are described below. Before making an investment decision, you should carefully consider the risks and uncertainties described below, together with all of the other information included or incorporated by reference herein. This Annual Report on Form 10-K is qualified in its entirety by these risk factors. Further, to the extent that any of the information contained in this Annual Report on Form 10-K constitutes forward-looking statements, the risk factors set forth below also are cautionary statements identifying important factors that could cause our actual results to differ materially from those expressed in any forward-looking statements made by or on behalf of us.

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

Risks Related to the COVID-19 Pandemic

Governmental and individual efforts to address the COVID-19 pandemic have introduced volatility into the U.S. and global economy which has and may continue to adversely affect our business, financial condition and results of operations.

In response to the COVID-19 pandemic and resulting economic downturn in early 2020, the Federal Reserve reduced the target federal funds rate to a range of 0.00% to 0.25%. This lower rate reduces the rate of interest we earn on loans and pay on borrowings and interest-bearing deposits and can affect the value of financial instruments we hold. In an environment with lower interest rates, we will not be able to earn as much on our interest-earning assets, which may reduce net interest margin and our ability to earn interest and receive dividend income from investment securities will be reduced. While the FRB has indicated that it expects to raise the target federal funds rate in response to inflationary pressure and labor market challenges, we cannot assure you that interest rates will increase or that such an increase would increase our net income.

Since the start of the COVID-19 pandemic, we have been confronted with a significant and unfamiliar degree of uncertainty in estimating the impact of the pandemic on credit quality, revenues, and asset values. Our credit risk has fluctuated along with the changes in the U.S. economy: we increased our allowance for credit losses in early 2020 in response to higher unemployment levels, but in 2021, we experienced a benefit from the provision for credit losses as employment levels improved. We make various assumptions and judgments about the collectability of our loan portfolio, including the creditworthiness of our borrowers and the value of the real estate and other assets serving as collateral, and we provide an allowance for credit losses based on a number of factors. We believe that the allowance for credit losses is adequate. However, if our assumptions or judgments are wrong, the allowance for credit losses may not be sufficient to cover the actual credit losses. We may have to increase the allowance in the future in response to the COVID-19 pandemic and resulting changes to the U.S. economy. The actual amount of future provisions for credit losses may vary from the amount of past provisions.

If the borrower of a PPP loan under the CARES Act fails to qualify for loan forgiveness under the program, we will have to hold the loan at an unfavorable interest rate as compared to a loan we may otherwise have extended to our customer. Even though those loans are guaranteed by the SBA, we may not be able to collect from the SBA as quickly as those payments come due, and our cash flow and earnings may be reduced accordingly. In the event of a loss resulting from a default on a PPP loan and a determination by the SBA that there was a deficiency in the manner in which we originated, funded or serviced the PPP loan, the SBA may deny its liability under the guaranty, reduce the amount of the guaranty, or, if it has already made payment under the guaranty, seek recovery of any loss related to the deficiency from us.

As a lender, we are exposed to the risk that customers will be unable to repay their loans according to their terms and that any collateral securing the payment of their loans may not be sufficient to assure repayment. The collateral securing our indirect loan portfolio in particular may not be sufficient to cover the full value of an outstanding loan because the collateral, namely automobiles, are depreciating assets. If a significant proportion of our customers are unable to repay their loans and the collateral securing repayment is insufficient to cover our losses, we may have to increase our allowance for credit losses, the quality of our loan portfolio will decline, our net income will decrease, and our results of operations will be materially adversely impacted. In addition, our capital and leverage ratios may be adversely impacted.

Continued economic disruption and fear of the spread of COVID-19 could result in business shutdowns, limitations on commercial activity and financial transactions, labor shortages, supply chain interruptions, increased unemployment and commercial property vacancy rates and reduced profitability and ability for property owners to make mortgage payments.

We believe our most significant exposure to COVID-19-impacted businesses is within the following industries, representing the following percentage of commercial real estate and commercial loan balances as of December 31, 2021:

- retail and retail building, 14%;
- hotel, motel and lodging, 4% ;
- health care, 3%;
- restaurants and food services, 2%;
- entertainment and recreation, 2%; and
- mining, quarrying and oil & gas, less than 1%.

We have experienced charge-offs that were precipitated by the COVID-19 pandemic, such as the \$8.2 million charge-off of a \$11.9 million commercial loan in the hotel, motel and lodging industry in the first quarter of 2020 and related foreclosure in the third quarter of 2020. We may experience additional charge-offs or credit losses related to the COVID-19 pandemic and other economic disruptions.

Changes in our operations in response to the COVID-19 pandemic have exposed us to additional risks.

Social distancing efforts imposed by state and local governments to address the COVID-19 pandemic caused us to change how we operate our bank branches, with the interior of some branches closing to customers when required to comply with state or local laws. In addition, to curb the spread of COVID-19, a significant proportion of our employees transitioned to working remotely. Both of these changes may slow response times to customers' inquiries or preclude providing the level of service our employees are typically able to offer in person. Our reputation and results of operations may be impacted if our competitors are better able to adjust to the restrictions on in-person interactions and remote work.

Furthermore, as some of our employees continue to work from home, our operational risk, including data security risk, is higher than it would otherwise be, as cybercriminal activity has increased in an attempt to profit from the disruption to pre-pandemic operations. The cybersecurity-related risks we face include more phishing, malware, and other cybersecurity attacks, vulnerability to disruptions of our information technology infrastructure and telecommunications systems for remote operations, and unauthorized dissemination, misuse or destruction of confidential or valuable information.

We continue to follow Centers for Disease Control and Prevention ("CDC") guidelines and governmental mandates regarding COVID-19 protocols and vaccinations. While it is not possible to predict the administrative costs, compliance costs or impacts to our available workforce, we are developing compliance processes for implementing the Occupational Safety and Health Administration ("OSHA") testing and vaccination mandates while monitoring legal actions and state legislation regarding the mandates for further guidance.

Mandatory COVID-19 vaccination of employees could impact our workforce and have a material adverse effect on our business and results of operations.

The imposition of government mandated vaccination or testing may impact our ability to retain current employees and attract new employees. In the event of a vaccine mandate, some of our employees who are not vaccinated may seek exemptions or otherwise resist vaccination. The imposition of vaccine mandates could potentially cause labor shortages if employees refuse to get vaccinated and their employment is terminated, either voluntarily or involuntarily. Although the previously proposed vaccine mandates provide for the alternative of weekly testing for the virus and allow employers to shift the cost burden of this testing to employees, labor markets, competitive forces, and practical application may dictate that we would shoulder the cost of such testing, which could result in meaningful costs that have not been incurred to date. If federal, state or local mandates take effect, those mandates may result in employee attrition, which could adversely affect revenues and costs and could have an adverse effect on our business and results of operations.

Credit Risks and Risks Related to Banking Activities

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

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

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

a result of any deterioration in the quality of our loan portfolio. The actual amount of future provisions for credit losses may vary from the amount of past provisions.

Geographic concentration may unfavorably impact our operations.

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

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

Generally, we make loans to small to mid-sized businesses whose success depends on the regional economy. These businesses generally have fewer financial resources in terms of capital or borrowing capacity than larger entities. Adverse economic and business conditions in our market areas, including the impacts of the COVID-19 pandemic could reduce our growth rate, affect our borrowers' ability to repay their loans and, consequently, adversely affect our business, financial condition and performance. For example, we place substantial reliance on real estate as collateral for our loan portfolio. A sharp downturn in real estate values in our market area could leave many of these loans inadequately collateralized. If we are required to liquidate the collateral securing a loan to satisfy the debt during a period of reduced real estate values, the impact on our results of operations could be materially adverse.

Our commercial business and mortgage loans increase our exposure to credit risks.

At December 31, 2021, our portfolio of commercial business and mortgage loans totaled \$2.05 billion, or 56% of total loans. We plan to continue to emphasize the origination of these types of loans, which generally expose us to a greater risk of nonpayment and loss than residential real estate or consumer loans because repayment of such loans often depends on the successful operations and income stream of the borrowers. Additionally, such loans typically involve larger loan balances to single borrowers or groups of related borrowers compared to consumer loans or residential real estate loans. A sudden downturn in the economy, or a prolonged downturn for specific industries, could result in borrowers being unable to repay their loans, thus exposing us to increased credit risk.

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

A portion of our current lending involves the purchase of consumer automobile installment sales contracts from automobile dealers located in Western, Central and the Capital District of New York, and Northern and Central Pennsylvania. These loans are for the purchase of new or used automobiles. We serve customers that cover a range of creditworthiness, and the required terms and rates are reflective of those risk profiles. While these loans have higher yields than many of our other loans, such loans involve risk elements in addition to normal credit risk. Additional risk elements associated with indirect lending include the limited personal contact with the borrower as a result of indirect lending through non-bank channels, namely automobile dealers. While indirect automobile loans are secured, such loans are secured by depreciating assets and characterized by loan-to-value ratios that could result in us not recovering the full value of an outstanding loan upon default by the borrower. If the losses from our indirect loan portfolio are higher than anticipated, it could have a material adverse effect on our financial condition and results of operations. In addition, our consumer lending activities are subject to numerous consumer protection laws and regulations, and if we were unable to comply with the regulations applicable to our consumer lending activities, our financial condition and results of operations may be adversely affected.

Lack of seasoning in portions of our loan portfolio could increase risk of credit defaults in the future.

As a result of our growth over the past several years, certain portions of our loan portfolio, such as the increased size of our commercial loan portfolio and in particular the PPP loans we originated, are of relatively recent origin. Loans may not begin to show signs of credit deterioration or default until they have been outstanding for some period of time, a process referred to as "seasoning." As a result, a portfolio of older loans will usually behave more predictably than a newer portfolio. Because these portions of our portfolio are relatively new, the current level of delinquencies and defaults may not represent the level that may prevail as the portfolio becomes more seasoned. If delinquencies and defaults increase, we may be required to increase our provision for loan losses, which could have an adverse effect on our business, financial condition and results of operations.

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

At December 31, 2021, we had \$3.91 billion of deposit liabilities that have no maturity and, therefore, may be withdrawn by the depositor at any time. These deposit liabilities include our checking, savings, and money market deposit accounts.

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

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

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

We operate in a highly competitive industry and market area.

We face substantial competition in all areas of our operations from a variety of different competitors, many of which are larger and may have more financial resources than us. Such competitors primarily include national, regional and internet banks within the markets in which we operate. We also face competition from many other types of financial institutions, including, without limitation, savings and loan associations, credit unions, finance companies, brokerage firms, insurance companies and other financial intermediaries. The financial services industry could become even more competitive as a result of legislative, regulatory and technological changes and continued consolidation. Banks, securities firms and insurance companies can merge under the umbrella of a financial holding company, which can offer virtually any type of financial service, including banking, securities underwriting, insurance (both agency and underwriting), and merchant banking. Technology has lowered barriers to entry and made it possible for nonbanks to offer products and services traditionally provided by banks, such as automatic transfer and automatic payment systems. More recently, peer to peer lending has emerged as an alternative borrowing source for our customers and many other non-banks offer lending and payment services, such as consumer credit through buy now - pay later offerings, in competition with banks. Many of these competitors have fewer regulatory constraints and may have lower cost structures. Additionally, due to their size, many of our larger competitors may be able to achieve economies of scale and, as a result, may offer a broader range of products and services than we can at competitive prices or with low or no fees.

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

- the ability to develop, maintain and build upon long-term customer relationships based on top quality service, high ethical standards and safe, sound assets;
- the ability to expand our market position;
- the scope, relevance and pricing of products and services offered to meet customer needs and demands;
- the rate at which we introduce new products and services relative to our competitors;
- customer satisfaction with our level of service; and
- industry and general economic trends.

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

Changes to and replacement of the LIBOR Benchmark Interest Rate may adversely affect our business, financial condition, and results of operations.

In 2017, the United Kingdom's Financial Conduct Authority, a regulator of financial services firms and financial markets in the United Kingdom, stated that it will only support the regulatory oversight of the London Interbank Offered Rate ("LIBOR") interest rate indices through 2021. This announcement, and, more generally, financial benchmark reforms and changes in the interbank lending markets, have resulted in uncertainty about the interest rate benchmarks that will be used in the future. In the United States, efforts to identify a set of alternative U.S. dollar reference interest rates are ongoing, and the Alternative Reference Rate Committee formally recommended the use of a Secured Overnight Funding Rate ("SOFR"). SOFR is different from LIBOR in that it is a retrospective-looking secured rate rather than a forward-looking unsecured rate. These differences could lead to a greater disconnect between our and the Bank's costs to raise funds for SOFR as compared to LIBOR. In addition to the discontinuance of LIBOR, there may be future changes in the rules or methodologies used to calculate SOFR or other benchmarks, which may have a material adverse effect on the value of or return on our financial assets and liabilities that are based on or are linked to LIBOR and other benchmarks. Once LIBOR rates are no longer available, and we are required to implement replacement reference rates for the calculation of interest rates under our loan agreements with borrowers, we may incur significant expense in effecting the transition and we may be subject to disputes or litigation with our borrowers over the appropriateness or comparability to LIBOR of the replacement reference rates. The transition date for existing LIBOR loan contracts is currently set as June 30, 2023 and impacts loans that have not yet matured or have been refinanced by that date. The uncertainty related to these changes may have an unpredictable impact on the financial markets and could adversely impact our financial condition or results of operations.

Legal and Regulatory Risks

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

We have been, and may in the future be, subject to various legal and regulatory proceedings, including class action litigation. It is inherently difficult to assess the outcome of these matters, and there can be no assurance that we will prevail in any proceeding or litigation. Legal and regulatory matters of any degree of significance could result in substantial cost and diversion of our efforts, which by itself could have a material adverse effect on our financial condition and operating results.

As disclosed in Part I, Item 3, "Legal Proceedings," an action has been brought against us by four individuals who sought and were granted class certification to represent classes of consumers who allege to have obtained direct or indirect financing from us for the purchase of vehicles that we later repossessed. On September 30, 2021, the court granted plaintiffs' motion for class certification and certified four different classes (two classes of New York consumers and two classes of Pennsylvania consumers). There are approximately 5,200 members in the New York classes and approximately 300 members in the Pennsylvania classes. If we settle these claims or the litigation is not resolved in our favor, we may suffer reputational damage and incur legal costs, settlements or judgments that exceed the amounts covered by our existing insurance policies. We can provide no assurances that our insurer will insure the legal costs, settlements or judgments we incur in excess of our deductible. If we are not successful in defending ourselves from these claims, or if our insurer does not insure us against legal costs we incur in excess of our deductible, the result may materially adversely affect our business, results of operations and financial condition. Further, adverse determinations in such matters could result in actions by our regulators that could materially adversely affect our business, financial condition or results of operations. There can be no guarantee that proceedings that may have a material adverse effect on our business, results of operations or financial condition will not arise in the near or long-term future.

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

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

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

If there are financial institution failures, we may be required to pay higher FDIC premiums. Such increases of FDIC insurance premiums may adversely impact our earnings. See the section captioned "Supervision and Regulation" included in Part I, Item 1 "Business" for more information about FDIC insurance premiums.

We are highly regulated, and any adverse regulatory action may result in additional costs, loss of business opportunities, and reputational damage.

As described in the section captioned “Supervision and Regulation” included in Part I, Item 1, “Business,” we are subject to extensive supervision, regulation and examination. The various regulatory authorities with jurisdiction over us have significant latitude in addressing our compliance with applicable laws and regulations including, but not limited to, those governing consumer credit, fair lending, anti-money laundering, anti-terrorism, capital adequacy, asset quality and risk, management ability and performance, earnings, liquidity, and various other factors affecting us. As part of this regulatory structure, we are subject to policies and other guidance developed by the regulatory agencies with respect to, among other things, capital levels, the timing and amount of dividend payments, the classification of assets and the establishment of adequate loan loss reserves for regulatory purposes. Our regulators have broad discretion to impose monetary fines or restrictions and limitations on our operations if they determine, for any reason, that our operations are unsafe or unsound, fail to comply with applicable law or are otherwise inconsistent with laws and regulations or with the supervisory policies of these agencies.

This supervisory framework could materially impact the conduct, growth and profitability of our operations. Any failure on our part to comply with current laws, regulations, other regulatory requirements or safe and sound banking, insurance, or investment advisory practices or concerns about our financial condition, or any related regulatory sanctions or adverse actions against us, could increase our costs or restrict our ability to expand our business and result in damage to our reputation.

Additionally, shareholder activism and potential regulatory reform may lead to substantial new regulations and disclosure obligations, including with respect to environmental, social, and governance matters, which may lead to additional compliance costs and impact the manner in which we operate our business in ways that may materially adversely impact our results of operations and financial condition.

The policies of the Federal Reserve have a significant impact on our earnings.

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

Risks Related to Non-Banking Activities

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

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

Our investment advisory and wealth management operations are subject to risk related to the regulation of the financial services industry and market volatility.

The financial services industry is subject to extensive regulation at the federal and state levels. It is very difficult to predict the future impact of the legislative and regulatory requirements affecting our business. The securities laws and other laws that govern the activities of our registered investment advisor are complex and subject to change. The activities of our investment advisory and wealth management operations are subject primarily to provisions of the Advisers Act and the Employee Retirement Income Act of 1940, as amended (“ERISA”). We are a fiduciary under ERISA. Our investment advisory services are also subject to state laws including anti-fraud laws and regulations.

In addition, the broker-dealer services provided by Courier Capital and HNP Capital are subject to Regulation Best Interest, which requires a broker-dealer to act in the best interest of a retail customer when making a recommendation to that customer of any securities transaction or investment strategy involving securities. The regulation imposes heightened standards on broker-dealers and will require us to review and modify the policies and procedures of our wealth management operations, as well as associated supervisory and compliance controls.

Any claim of noncompliance, regardless of merit or ultimate outcome, could subject us to investigation by the SEC or other regulatory authorities. Our compliance processes may not be sufficient to prevent assertions that we failed to comply with any applicable law, rule or regulation. If our investment advisory and wealth management operations are subject to investigation by the SEC or other regulatory authorities or if litigation is brought by clients based on our failure to comply with applicable regulations, our results of operations could be materially adversely affected.

Our investment advisory revenue may decrease as a result of poor investment performance, in either relative or absolute terms, which could decrease our revenues and net income.

Our investment advisory business derives a significant amount of its revenues from investment management fees based on assets under management. Our ability to maintain or increase assets under management is subject to a number of factors, including our clients' evaluation of the past performance of our investment advisory business, in either relative or absolute terms, general market and economic conditions, and competition from other investment management firms. A decline in the fair value of the assets under management would decrease our investment advisory revenue.

Investment performance is one of the most important factors in retaining existing investment advisory clients and competing for new investment advisory clients. Poor investment performance could reduce our investment advisory revenues and impede the growth of our investment advisory business in the following ways: existing clients may withdraw funds from our investment advisory business in favor of better performing products or firms; asset-based management fees could decline from a decrease in assets under management; our ability to attract funds from existing and new clients might diminish; and the investment advisory personnel may depart to join a competitor or otherwise.

Strategic and Operational Risks

We make certain assumptions and estimates in preparing our financial statements that may prove to be incorrect, which could significantly impact our results of operations, cash flows and financial condition, and we are subject to new or changing accounting rules and interpretations, and the failure by us to correctly interpret or apply these evolving rules and interpretations could have a material adverse effect.

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

As indicated in Note 1, Summary of Significant Accounting Policies - Recent Accounting Pronouncements, to the Consolidated Financial Statements included in Item 8 of this Annual Report on Form 10-K, the regulations, rules, standards, policies, and interpretations underlying GAAP are constantly evolving and may change significantly over time. In particular, effective January 1, 2020, we have implemented FASB's Accounting Standards Update 2016-13, *Financial Instruments – Credit Losses (Topic 326) – Measurement of Credit Losses on Financial Instruments*, which requires us to recognize an allowance for credit losses based on historical experience, current conditions and reasonable and supportable forecasts, as opposed to recognizing an allowance when it is probable that a loss has been incurred. This change in GAAP increased our allowance for credit losses and created more volatility in the level of our allowance for credit losses, and has been, and will continue to be, impacted by the Company's loan and securities portfolios' composition, attributes and quality. If we fail to interpret any one or more of these GAAP provisions correctly, or if our methodology in applying them to our financial reporting or disclosures is at all flawed, our financial statements may contain inaccuracies that, if severe enough, could warrant a later restatement by us, which in turn could result in a material adverse event.

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

As of December 31, 2021, we had \$67.1 million of goodwill and \$7.3 million of other intangible assets. Significant and sustained declines in our stock price and market capitalization, significant declines in our expected future cash flows, significant adverse changes in the business climate or slower growth rates may necessitate our taking charges in the future related to the impairment of our goodwill. Future regulatory actions could also have a material impact on assessments of goodwill for impairment. If the fair value of our net assets improves at a faster rate than the market value of our reporting units, or if we were to experience increases in book values of a reporting unit in excess of the increase in fair value of equity, we may also have to take charges related to the impairment of our goodwill. If we were to conclude that a future write-down of our goodwill is necessary, we would record the appropriate charge, which could have a material adverse effect on our results of operations.

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

We may be unable to successfully implement our growth strategies, including the integration and successful management of newly-acquired businesses.

Our current growth strategy is multi-faceted. We seek to expand our branch network into nearby areas, continue to invest in our digital banking strategy, develop new sustainable revenue streams through Banking as a Service (BaaS), make strategic acquisitions of loans, portfolios, other regional banks and non-banking firms whose businesses we feel may be complementary with ours, and to continue to organically grow our core deposits. Any failure by us to effectively implement any one or more of these growth strategies could have several negative effects, including a possible decline in the size or the quality, or both, of our loan portfolio or a decrease in profitability caused by an increase in operating expenses.

We hope to continue an active merger and acquisition strategy. However, even if we use our common stock as the predominant form of consideration, we may need to raise capital to negotiate a transaction on terms acceptable to us and there can be no assurance that we will be able to raise a sufficient amount of capital to enable us to complete an acquisition. It is also possible that even with adequate capital we may still be unable to complete an acquisition on favorable terms, causing us to miss opportunities to increase our earnings and expand or diversify our operations.

Our growth strategy is also dependent upon the successful integration of new businesses and any future acquisitions into our existing operations. While our senior management team has had extensive experience in acquisitions and post-acquisition integration, there is no guarantee that our current or future integration efforts will be successful, and if our senior management is forced to spend a disproportionate amount of time on integrating recently-acquired businesses, it may distract their attention from operating our business or pursuing other growth opportunities.

Acquisitions may disrupt our business and dilute shareholder value.

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

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

- difficulty in estimating the value of the target company;
- payment of a premium over book and market values that may dilute our tangible book value and earnings per share in the short and long term;
- potential exposure to unknown or contingent liabilities of the target company;
- exposure to potential asset quality issues of the target company;
- volatility in reported income as goodwill impairment losses could occur irregularly and in varying amounts;
- challenge and expense of integrating the operations and personnel of the target company;
- inability to realize the expected revenue increases, cost savings, increases in geographic or product presence, and other projected benefits;
- potential disruption to our business;

- potential diversion of our management’s time and attention;
- the possible loss of key employees and customers of the target company;
- potential changes in banking or tax laws or regulations that may affect the target company; and
- additional regulatory burdens associated with new lines of business.

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

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

Liquidity is essential to our businesses.

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

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

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

If our risk management framework does not effectively identify or mitigate our risks, we could suffer losses.

Our risk management framework seeks to mitigate risk and appropriately balance risk and return. We have established processes and procedures intended to identify, measure, monitor and report the types of risk to which we are subject, including credit risk, operations risk, compliance risk, reputation risk, strategic risk, market risk, and liquidity risk. We seek to monitor and control our risk exposure through a framework of policies, procedures and reporting requirements. Management of our risks in some cases depends upon the use of analytical and/or forecasting models. If the models used to mitigate these risks are inadequate, we may incur losses. In addition, there may be risks that exist, or that develop in the future, that we have not appropriately anticipated, identified or mitigated. If our risk management framework does not effectively identify or mitigate our risks, we could suffer unexpected losses and could be materially adversely affected.

Negative public opinion could damage our reputation and impact business operations and revenues.

As a financial institution, our earnings and capital are subject to risk associated with negative public opinion. Negative public opinion could result from our actual or alleged conduct in any number of activities, including lending practices, the failure of any of our products or services to meet our clients’ expectations or applicable regulatory requirements, corporate governance and acquisitions, social media and other marketing activities, the implementation of environmental, social and governance practices or actions taken by government regulators and community organizations in response to any of the foregoing. Negative public opinion could affect our ability to attract and/or retain clients, could expose us to litigation and regulatory action, and could have a material adverse effect on our stock price or result in heightened volatility. Negative public opinion could also affect our ability to borrow funds in the unsecured wholesale debt markets.

Technology and Cybersecurity Risks

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

The financial services market, including banking services, faces rapid changes with frequent introductions of new technology-driven products and services. Our future success may depend, in part, on our ability to use technology to provide products and services that provide convenience to customers and to create additional efficiencies in our operations. Some of our competitors have substantially greater resources to invest in technological improvements than we currently have. We may not be able to effectively implement new technology-driven products and services or be successful in marketing these products and services to our customers. In addition, technology and other changes are allowing consumers to utilize alternative methods to complete financial transactions that have historically involved banks. For example, consumers can now maintain funds in brokerage accounts or mutual funds that would have historically been held as bank deposits. Consumers can also complete transactions such as paying bills and transferring funds directly without using a traditional bank as an intermediary. The process of eliminating banks as intermediaries could result in the loss of customer deposits, the related income generated from those deposits and additional fee income. We may not be able to effectively compete with these banking alternatives for consumer deposits. As a result, our ability to effectively compete to retain or acquire new business may be impaired, and our business, financial condition or results of operations, may be adversely affected.

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

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

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

A breach in security of our or third party information systems, including the occurrence of a cyber incident or a deficiency in cybersecurity, or a failure by us to comply with New York State cybersecurity regulations, may subject us to liability, result in a loss of customer business or damage our brand image.

We rely heavily on communications, information systems (both internal and provided by third parties) and the internet to conduct our business. Our business depends on our ability to process and monitor a large volume of daily transactions in compliance with legal, regulatory and internal standards and specifications. In addition, a significant portion of our operations relies heavily on the secure processing, storage and transmission of personal and confidential information of our customers and clients. These risks may increase in the future as our customers continue to adapt to mobile payment and other internet-based product offerings and we expand the availability of web-based products and applications.

In addition, several U.S. financial institutions have experienced significant distributed denial-of-service attacks, some of which involved sophisticated and targeted attacks intended to disable or degrade service or sabotage systems. Other potential attacks have attempted to obtain unauthorized access to confidential information or destroy data, often through the introduction of computer viruses or malware, cyber-attacks and other means. Such security attacks can originate from a wide variety of sources, including persons who are involved with organized crime or who may be linked to terrorist organizations or hostile foreign governments. These cybersecurity concerns are further heightened due to the recent Russian invasion into Ukraine. Those same parties may also attempt to fraudulently induce employees, customers or other users of our systems to disclose sensitive information in order to gain access to our data or that of our customers or clients. We are also subject to the risk that our employees may intercept and transmit unauthorized confidential or proprietary information. An interception, misuse or mishandling of personal, confidential or proprietary information being sent to or received from a customer or third party could result in legal liability, remediation costs, regulatory action and reputational harm, any of which could adversely affect our results of operations and financial condition.

We are subject to cybersecurity regulations promulgated by the NY DFS. Any failure by us to comply with these regulations could also result in regulatory sanctions, public disclosure and reputational damage even if we do not experience a significant cybersecurity breach.

Furthermore, as the threat of cyber attacks continue to evolve, we may be required to expend significant additional resources to continue to modify or enhance our systems, or to investigate and remediate vulnerabilities in our systems. Due to the complexity and interconnectedness of information technology systems, the process of enhancing our systems can itself create a risk of systems disruptions and security issues.

Market Risks

We are subject to interest rate risk, and a rising rate environment may reduce our income and result in higher defaults on our loans, whereas a falling rate environment may result in earlier loan prepayments than we expect, which may reduce our income.

Our earnings and cash flows depend largely upon our net interest income. Interest rates are highly sensitive to many factors that are beyond our control, including general economic conditions and policies of governmental and regulatory agencies, particularly the Federal Reserve. Changes in monetary policy, including changes in interest rates, could influence not only the interest we receive on loans and investments and the amount of interest we pay on deposits and borrowings, but such changes could also affect (i) our ability to originate loans and obtain deposits; (ii) the fair value of our financial assets and liabilities; and (iii) the average duration of our mortgage-backed securities portfolio and other interest-earning assets.

If the interest rates paid on deposits and other borrowings increase at a faster rate than the interest rates received on loans and other investments, our net interest income, and therefore earnings, could be adversely affected. In addition, our net interest margin may contract in a rising rate environment because our funding costs may increase faster than the yield we earn on our interest-earning assets. In a rising rate environment, loans with adjustable interest rates are more likely to experience a higher rate of default. The combination of these events may adversely affect our financial condition and results of operations.

Earnings could also be adversely affected if the interest rates received on loans and other investments fall more quickly than the interest rates paid on deposits and other borrowings. In addition, in a falling rate environment or the recent environment where the Federal Reserve has held the federal reference rate near 0.00%, loans may be prepaid sooner than we expect, which could result in a delay between when we receive the prepayment and when we are able to redeploy the funds into new interest-earning assets and in a decrease in the amount of interest income we are able to earn on those assets. If we are unable to manage these risks effectively, our financial condition and results of operations could be materially adversely affected.

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

The soundness of other financial institutions could adversely affect us.

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

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

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

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

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

Risks Related to our Common Stock

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

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

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

In the future, we may attempt to increase our capital resources by entering into debt or debt-like financing that is unsecured or secured by all or up to all of our assets, or by issuing additional debt or equity securities, which could include issuances of secured or unsecured commercial paper, medium-term notes, senior notes, subordinated notes, preferred stock or securities convertible into or exchangeable for equity securities. In the event of our liquidation, our lenders and holders of our debt and preferred securities would receive a distribution of our available assets before distributions to the holders of our common stock. For example, our outstanding shares of Series A 3% and Series B-1 8.48% Preferred Stock have a preferential right to receive dividends before holders of our common stock. We must declare and pay annual dividends of \$3 per share to Series A 3% Preferred Stock holders and of \$8.48 per share to Series B-1 8.48% Preferred Stock holders before any dividends or dissolution payments can be paid to holders of common stock. Because our decision to incur debt and issue securities in our future offerings will depend on market conditions and other factors beyond our control, we cannot predict or estimate the amount, timing or nature of our future offerings and debt financings. Further, market conditions could require us to accept less favorable terms for the issuance of our securities in the future. We may also issue additional shares of our common stock or securities convertible into or exchangeable for our common stock that could dilute our current shareholders and effect the value of our common stock.

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

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

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

Our quarterly and annual operating results have varied in the past and could vary significantly in the future, which makes it difficult for us to predict our future operating results. Our operating results may fluctuate due to a variety of factors, many of which are outside of our control, including the changing U.S. economic environment and changes in the commercial and residential real estate market, any of which may cause our stock price to fluctuate. If our operating results fall below the expectations of investors or securities analysts, the price of our common stock could decline substantially. Our stock price can fluctuate significantly in response to a variety of factors including, among other things:

- volatility of stock market prices and volumes in general;
- changes in market valuations of similar companies;
- changes in conditions in credit markets;
- changes in accounting policies or procedures as required by the FASB or other regulatory agencies;
- legislative and regulatory actions subjecting us to additional or different regulatory oversight which may result in increased compliance costs and/or require us to change our business model;
- government intervention in the U.S. financial system and the effects of and changes in trade and monetary and fiscal policies and laws, including the interest rate policies of the Federal Reserve Board;
- political instability and uncertainty, including the Russian invasion of Ukraine;
- additions or departures of key members of management;
- fluctuations in our quarterly or annual operating results; and
- changes in analysts' estimates of our financial performance.

General Risk Factors

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

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

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

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

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

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

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

Our financial performance generally, and in particular the ability of borrowers to pay interest on and repay principal of outstanding loans and the value of collateral securing those loans, as well as demand for loans and other products and services we offer, is highly dependent on the business environment in the markets where we operate, in the State of New York and in the United States as a whole. The acts of war in Ukraine and the impact of sanctions on Russia and Russian companies may impact global markets, which may create unfavorable or uncertain economic conditions. A favorable business environment is generally characterized by, among other factors, economic growth, efficient capital markets, low inflation, low unemployment, high business and investor confidence, and strong business earnings. Unfavorable or uncertain economic and market conditions can be caused by declines in economic growth, business activity or investor or business confidence; limitations on the availability or increases in the cost of credit and capital; increases in inflation or interest rates; high unemployment, natural disasters; or a combination of these or other factors. The occurrence of any of these conditions could have a material adverse effect on our financial condition and results of operations.

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

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

ITEM 1B. UNRESOLVED STAFF COMMENTS

None.

ITEM 2. PROPERTIES

We own a 27,400 square foot building in Warsaw, New York that serves as our headquarters, and principal executive and administrative offices. We lease a 52,300 square foot regional administrative facility located in Rochester, New York. This lease expires in August 2027, with options for two additional ten-year extensions.

We are engaged in the banking business through 48 branch offices, of which 31 are owned and 17 are leased, in the following fourteen contiguous counties of Western and Central New York: Allegany, Cattaraugus, Cayuga, Chemung, Erie, Genesee, Livingston, Monroe, Ontario, Orleans, Seneca, Steuben, Wyoming and Yates Counties. The operating leases for our branch offices expire at various dates through the year 2061 and generally include options to renew. The Bank also has administrative operations at a leased facility in Amherst, New York, for which the lease expired in September 2021 and is continuing on the same terms on a month-to-month basis.

SDN operates from a leased 14,400 square foot office located in Williamsville, New York. The lease expired in September 2021 and is continuing on the same terms on a month-to-month basis. SDN also has operations at a leased facility in Rochester, New York.

The Bank has executed a lease for a 28,500 square foot administrative office located in Amherst, New York that will commence July 2022. This new location will replace the leased facility in Amherst, New York and the SDN leased facility in Williamsville, New York.

Courier Capital operates from an owned 11,000 square foot office, located in Buffalo, New York. Courier Capital also has operations at an owned facility in Jamestown, New York.

We believe that our properties have been adequately maintained, are in good operating condition and are suitable for our business as presently conducted, including meeting the prescribed security requirements. For additional information, see Note 7, Premises and Equipment, Net, and Note 14, Commitments and Contingencies, in the accompanying financial statements included in Part II, Item 8, of this Annual Report on Form 10-K.

ITEM 3. LEGAL PROCEEDINGS

From time to time we are a party to or otherwise involved in legal proceedings arising out of the normal course of business. Regardless of the outcome, litigation can have an adverse impact on us because of prosecution, defense and settlement costs, unfavorable awards, diversion of management resources and other factors.

We are party to an action filed against us on May 16, 2017 by Matthew L. Chipeco, Charlene Mowry, Constance C. Churchill and Joseph W. Ewing in the Court of Common Pleas in Philadelphia, Pennsylvania. Plaintiffs sought and were granted class certification to represent classes of consumers in New York and Pennsylvania seeking to recover statutory damages, interest and declaratory relief. The plaintiffs allege that they obtained direct or indirect financing from us for the purchase of vehicles that we later repossessed. The plaintiffs specifically claim that the notices the Bank sent to defaulting consumers after their vehicles were repossessed did not comply with the relevant portions of the Uniform Commercial Code in New York and Pennsylvania. We dispute and believe we have meritorious defenses against these claims and plan to continue to vigorously defend ourselves.

On September 30, 2021, the Court granted plaintiffs' motion for class certification and certified four different classes (two classes of New York consumers and two classes of Pennsylvania consumers). There are approximately 5,200 members in the New York classes and approximately 300 members in the Pennsylvania classes. Our motion seeking permission to appeal the class certification ruling and a stay of proceedings pending any such appeal was denied. We are currently awaiting a ruling from the Superior Court of Pennsylvania on our motion seeking permission to appeal the denial of our motion to dismiss the action for lack of standing. On February 8, 2022, plaintiffs filed a motion for partial summary judgment for most of the relief they seek. We intend to oppose and file cross motions for partial summary judgment. The parties agreed that our opposition and cross motion papers will be filed by March 21, 2022. Through a Case Management Order dated February 10, 2022, the trial court directed, among other things, that discovery be completed by October 3, 2022, pre-trial motions be submitted by November 21, 2022, and that the case be ready for trial on March 6, 2023. We have not accrued a contingent liability for this matter at this time because, given our defenses, we are unable to conclude whether a liability is reasonably probable to occur nor are we able to currently reasonably estimate the amount of potential loss.

If we settle these claims or the action is not resolved in our favor, we may suffer reputational damage and incur legal costs, settlements or judgments that exceed the amounts covered by our existing insurance policies. We can provide no assurances that our insurer will insure the legal costs, settlements or judgements we incur in excess of our deductible. If we are unsuccessful in defending ourselves from these claims or if our insurer does not insure us against legal costs we incur in excess of our deductible, the result may materially adversely affect our business, results of operations and financial condition.

ITEM 4. MINE SAFETY DISCLOSURES

Not applicable.

PART II

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

Our common stock is traded on the Nasdaq Global Select Market under the ticker symbol "FISI." At February 28, 2022, 15,526,641 shares of our common stock were outstanding and there were 206 registered shareholders of record.

We have paid regular quarterly cash dividends on our common stock and our Board of Directors presently intends to continue this practice, subject to our results of operations and the need for those funds for debt service and other purposes. See the discussions in the section captioned "Supervision and Regulation" included in Part I, Item 1, "Business," in the section captioned "Liquidity and Capital Management" included in Part II, Item 7, in "Management's Discussion and Analysis of Financial Condition and Results of Operations" and in Note 15, 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.

In November 2020, the Company's Board of Directors authorized a share repurchase program for up to 801,879 shares of common stock (the "2020 Repurchase Program"). The program will expire at the earlier of the completion of all share repurchases or a Board vote to retire the program.

The Company's repurchases of its common stock during the fourth quarter of 2021 were as follows:

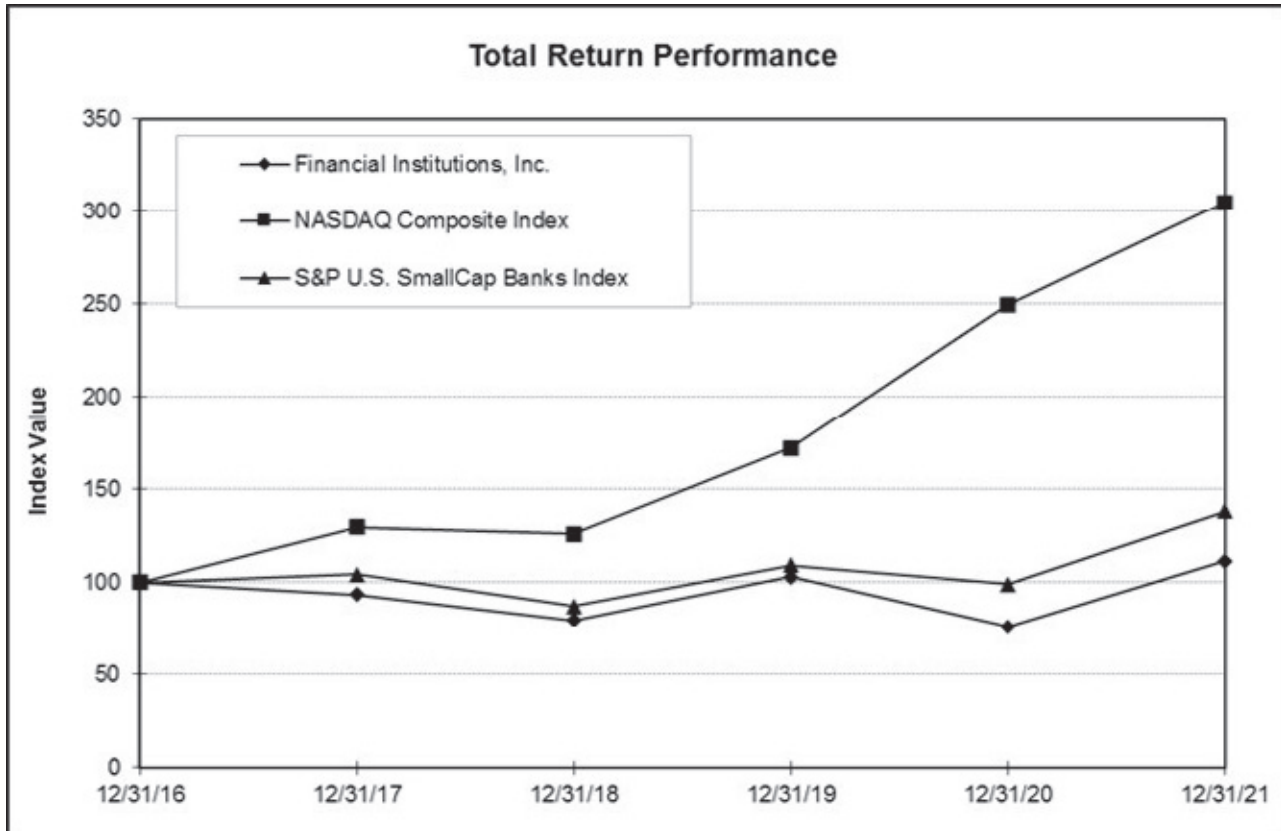
Issuer Purchases of Equity Securities

Period	Total Number of Shares Purchased ⁽¹⁾	Average Price Paid Per Share	Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs	Maximum Number of Shares that May Yet Be Purchased Under the Plans or Programs
October 1 - 31, 2021	7,356	\$ 31.31	6,364	557,076
November 1 - 30, 2021	19,400	31.00	19,400	537,676
December 1 -31, 2021	77,164	31.58	76,485	461,191
Total	<u>103,920</u>	<u>\$ 31.45</u>	<u>102,249</u>	

(1) This column reflects (i) the deemed surrender to us of 1,671 shares of common stock to satisfy tax withholding obligations in connection with the vesting of employee restricted stock units and (ii) the purchase of an aggregate of 102,249 shares of common stock under the 2020 Repurchase Program.

Stock Performance Graph

The stock performance graph below compares (a) the cumulative total return on our common stock for the period beginning December 31, 2016 as reported by the Nasdaq Global Select Market, through December 31, 2021, (b) the cumulative total return on stocks included in the NASDAQ Composite Index over the same period, and (c) the cumulative total return of the Standard and Poor's ("S&P") U.S. SmallCap Banks Index over the same period. Cumulative return assumes the reinvestment of dividends. During 2021, all SNL indices were replaced with S&P Dow Jones indices. The SNL Bank \$1B-\$5B Index that has historically been used in our performance graph has therefore been replaced with the comparable S&P U.S. SmallCap Banks Index. The graph was prepared by S&P Global Market Intelligence and is expressed in dollars based on an assumed investment of \$100.



Index	Period Ending					
	12/31/16	12/31/17	12/31/18	12/31/19	12/31/20	12/31/21
Financial Institutions, Inc.	100.00	93.48	79.67	102.93	76.16	111.48
NASDAQ Composite Index	100.00	129.64	125.96	172.18	249.51	304.85
S&P U.S. SmallCap Banks Index	100.00	104.33	87.06	109.22	99.19	138.09

ITEM 6. [RESERVED]

MANAGEMENT'S DISCUSSION AND ANALYSIS

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

The following is a discussion and analysis of our financial position and results of operations and should be read in conjunction with the information set forth under Part I, Item 1A, "Risks Factors," and our consolidated financial statements and notes thereto appearing under Part II, Item 8, "Financial Statements and Supplementary Data" of this Annual Report on Form 10-K.

INTRODUCTION

Financial Institutions, Inc. (the "Parent" and together with all its subsidiaries, "we," "our," or "us"), is a financial holding company headquartered in New York State. We offer a broad array of deposit, lending, and other financial services to individuals, municipalities and businesses in Western and Central New York through our wholly-owned New York-chartered banking subsidiary, Five Star Bank (the "Bank"). Our indirect lending network includes relationships with franchised automobile dealers in Western and Central New York, the Capital District of New York and Northern and Central Pennsylvania. We offer insurance services through our wholly-owned subsidiary, SDN Insurance Agency, LLC ("SDN"), a full-service insurance agency. We offer customized investment advice, wealth management, investment consulting and retirement plan services through our wholly-owned subsidiaries Courier Capital, LLC ("Courier Capital") and HNP Capital, LLC ("HNP Capital"), SEC-registered investment advisory and wealth management firms. In addition, we offer Banking as a Service and Fintech solutions through our wholly-owned subsidiary Corn Hill Innovation Labs, LLC ("CHIL").

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

EXECUTIVE OVERVIEW

2021 Financial Performance Review

Net income increased \$39.4 million to \$77.7 million for 2021, compared to \$38.3 million for 2020. This resulted in a 1.46% return on average assets and a 16.01% return on average equity. Net income available to common shareholders was \$76.2 million or \$4.78 per diluted share for 2021, compared to \$36.9 million or \$2.30 per diluted share for 2020. We declared cash dividends of \$1.08 per common share during 2021, an increase of \$0.04 per common share or 4% compared to the prior year.

Reflected in the increase in net income was an \$8.3 million benefit for credit losses in the current year as compared to a provision of \$27.2 million in 2020. Improvement in the national unemployment forecast, positive trends in qualitative factors, a reduction in specific reserves and lower net charge-offs resulted in the release of overall credit loss reserves and a corresponding benefit for credit losses in each quarter of 2021. Results for 2020 were negatively impacted by a higher than historical provision for credit losses, driven by the adoption of the current expected credit loss ("CECL") standard and uncertainty around the long-term impact of the COVID-19 pandemic on the economic environment.

Fully-taxable equivalent net interest income was \$155.4 million in 2021, an increase of \$15.5 million, or 11%, compared to 2020. The increase was the result of a \$603.5 million, or 14% increase in average interest-earning assets, partially offset by an eight-basis point decrease in the net interest margin, to 3.14%.

The provision for credit losses - loans was a benefit of \$7.0 million in 2021 compared to a provision of \$26.2 million in 2020. Net charge-offs decreased \$8.1 million from the prior year to \$5.8 million in 2021. Net charge-offs were an annualized 0.16% of average loans in the current year compared to 0.40% in 2020. Non-performing loans increased \$2.7 million to \$12.2 million compared to a year ago and represented 0.33% of total loans at December 31, 2021.

Noninterest income totaled \$46.9 million for the full year 2021, an increase of \$3.7 million, or 9%, when compared to the prior year. The increase is primarily attributed to increases in investment advisory income, investments in limited partnerships and insurance income, partially offset by decreases in income from derivatives instruments, and net gain on investment securities. The increase in investment advisory income of \$2.1 million was primarily due to an increase in assets under management driven by a combination of market gains, new customer accounts and contributions to existing accounts. Income from investments in limited partnerships increased \$2.0 million compared to the prior year based on performance of the underlying investments. The increase in insurance income of \$1.3 million was driven by the two 2021 bolt-on acquisitions (North Woods Capital Benefits LLC in August and Landmark Group in February) and growth in the legacy SDN business, including the impact of increasing insurance premiums. Income from derivative instruments, net was \$2.8 million lower than the prior year, primarily due to the execution of fewer swap transactions in 2021.

MANAGEMENT'S DISCUSSION AND ANALYSIS

Noninterest expense for the full year 2021 totaled \$112.8 million, a \$3.5 million increase compared to \$109.3 million in the prior year. Computer and data processing expense increased \$2.5 million year-over-year, as a result of strategic investments in technology, including digital banking initiatives and a customer relationship management solution that was deployed across all lines of business late in 2021. Salaries and benefits expense increased \$1.6 million year-over-year, primarily due to higher performance-based incentive compensation and commissions, investments in personnel and the impact of 2021 acquisitions.

Income tax expense for the year was \$19.5 million, representing an effective tax rate of 20.1% compared to an effective tax rate of 16.2% in 2020. The year-over-year increase in effective tax rate is primarily the result of higher pre-tax earnings in comparison to the prior year. Effective tax rates are impacted by items of income and expense not subject to federal or state taxation. The Company's effective tax rates differ from statutory rates primarily because of interest income from tax-exempt securities, earnings on company owned life insurance and tax credit investments placed in service.

Total assets were \$5.52 billion at December 31, 2021, up \$608.5 million from \$4.91 billion at December 31, 2020.

Investment securities were \$1.38 billion at December 31, 2021, up \$484.1 million from December 31, 2020. The increase from year-end 2020 was primarily due to the reinvestment of cash flow from the portfolio, coupled with the deployment of excess liquidity from higher deposit levels into cash flowing agency backed securities.

Total loans were \$3.68 billion at December 31, 2021, up \$84.3 million, or 2%, from December 31, 2020.

- Commercial mortgage loans totaled \$1.41 billion, an increase of \$158.9 million, or 13%, from December 31, 2020.
- Commercial business loans totaled \$638.3 million, a decrease of \$155.9 million, or 20%, from December 31, 2020. The decrease was primarily attributable to PPP loans. At December 31, 2021 the aggregate PPP loan balance was \$55.3 million, net of deferred fees compared to \$248.0 million, net of deferred fees at December 31, 2020.
- Residential real estate loans totaled \$577.3 million, a decrease of \$22.5 million, or 4%, from December 31, 2020.
- Consumer indirect loans totaled \$958.0 million, an increase of \$117.6 million, or 14%, from December 31, 2020.

Total deposits were \$4.83 billion at December 31, 2021, an increase of \$548.7 million from December 31, 2020, which was the result of growth in all deposit categories. Short-term borrowings were \$30.0 million at December 31, 2021, an increase of \$24.7 million from December 31, 2020. Short-term borrowings and brokered deposits have historically been utilized to manage the seasonality of public deposits.

Shareholders' equity was \$505.1 million at December 31, 2021, compared to \$468.4 million at December 31, 2020. Common book value per share was \$30.98 at December 31, 2021, an increase of \$2.86, or 10%, from \$28.12 at December 31, 2020. Tangible common book value per share⁽¹⁾ was \$26.26 at December 31, 2021, an increase of \$2.74, or 12%, from \$23.52 at December 31, 2020. The increase in shareholders' equity as compared to December 31, 2020, is primarily attributable to net income less dividends paid, net of the change in accumulated other comprehensive loss.

The Company's leverage ratio was 8.23% at December 31, 2021 compared to 8.25% at December 31, 2020. The Bank's leverage ratio and total risk-based capital ratio were 8.98% and 12.38%, respectively, at December 31, 2021, compared to 8.97% and 12.58%, respectively at December 31, 2020.

⁽¹⁾ This is a non-GAAP measure that we believe is useful in understanding our financial performance and condition. Refer to the "GAAP to Non-GAAP Reconciliation" section of this Item 7 for further information.

MANAGEMENT'S DISCUSSION AND ANALYSIS

Additional financial highlights of the Company are as follows:

	At or for the year ended December 31,		
	2021	2020	2019
Performance ratios:			
Net income, returns on:			
Average assets	1.46%	0.82%	1.14%
Average equity	16.01%	8.49%	11.61%
Net income available to common shareholders, returns on:			
Average common equity	16.29%	8.50%	11.74%
Average tangible common equity ⁽¹⁾	19.37%	10.25%	14.45%
Average tangible assets ⁽¹⁾	1.45%	0.80%	1.13%
Common dividend payout ratio	22.45%	45.22%	33.67%
Net interest margin (fully tax-equivalent)	3.14%	3.22%	3.28%
Effective tax rate	20.1%	16.2%	17.8%
Efficiency ratio ⁽²⁾	55.76%	60.22%	60.59%
Capital ratios:			
Leverage ratio	8.23%	8.25%	9.00%
Common equity Tier 1 capital ratio	10.28%	10.14%	10.31%
Tier 1 capital ratio	10.68%	10.59%	10.80%
Total risk-based capital ratio	13.12%	13.56%	12.77%
Average equity to average assets	9.10%	9.61%	9.82%
Common equity to assets	8.84%	9.18%	9.62%
Tangible common equity to tangible assets ⁽¹⁾	7.59%	7.80%	8.05%

⁽¹⁾ This is a non-GAAP measure that we believe is useful in understanding our financial performance and condition. Refer to the "GAAP to Non-GAAP Reconciliation" section of this Item 7 for further information.

⁽²⁾ The efficiency ratio provides a ratio of operating expenses to operating income. Efficiency ratio is calculated by dividing noninterest expense by net revenue, which is defined as the sum of tax-equivalent net interest income and noninterest income before net gains on investment securities. The efficiency ratio is not a financial measurement required by GAAP. However, the efficiency ratio is used by management in its assessment of financial performance specifically as it relates to noninterest expense control. Management also believes such information is useful to investors in evaluating Company performance.

Operational, Accounting and Reporting Impacts Related to the COVID-19 Pandemic

The COVID-19 pandemic has negatively impacted the global economy, including our operating footprint of Western and Central New York. In response to this crisis, the Coronavirus Aid, Relief, and Economic Security ("CARES") Act was passed by Congress and signed into law on March 27, 2020. The CARES Act provided an estimated \$2.2 trillion to fight the COVID-19 pandemic and stimulate the economy by supporting individuals and businesses through loans, grants, tax changes, and other types of relief. Some of the provisions applicable to the Company include, but are not limited to:

- *Accounting for Loan Modifications* - The CARES Act provides that a financial institution may elect to suspend (1) the application of GAAP for certain loan modifications related to COVID-19 that would otherwise be categorized as a troubled debt restructuring ("TDR") and (2) any determination that such loan modifications would be considered a TDR, including the related impairment for accounting purposes.
- *Paycheck Protection Program* - The CARES Act established the Paycheck Protection Program ("PPP"), an expansion of the Small Business Administration's ("SBA") 7(a) loan program and the Economic Injury Disaster Loan Program ("EIDL"), administered directly by the SBA. On December 27, 2020, the Consolidated Appropriations Act, 2021 provided approximately \$284 billion for PPP loans in an additional round of funding under the program and extended the PPP through March 31, 2021. This additional round of PPP loan funding was authorized for first-time borrowers and for second draws by certain borrowers who have previously received PPP loans. On March 30, 2021, the PPP Extension Act of 2021 was signed into law, which extended the program to May 31, 2021.
- *Mortgage Forbearance* - Under the CARES Act, a borrower with a federally backed mortgage loan that was experiencing financial hardship due to COVID-19 was able to request a forbearance until December 31, 2021.

MANAGEMENT'S DISCUSSION AND ANALYSIS

Also, in response to the COVID-19 pandemic, the Board of Governors of the Federal Reserve System ("FRB"), the Federal Deposit Insurance Corporation ("FDIC"), the National Credit Union Administration ("NCUA"), the Office of the Comptroller of the Currency ("OCC"), and the Consumer Financial Protection Bureau ("CFPB"), in consultation with the state financial regulators (collectively, the "agencies") issued a joint interagency statement (issued March 22, 2020; revised statement issued April 7, 2020). Some of the provisions applicable to the Company include, but are not limited to:

- *Accounting for Loan Modifications* - Loan modifications that do not meet the conditions of the CARES Act may still qualify as a modification that does not need to be accounted for as a TDR. The agencies confirmed with FASB staff that short-term modifications made on a good faith basis in response to COVID-19 to borrowers who were current prior to any relief are not TDRs. This includes short-term (e.g., six months) modifications such as payment deferrals, fee waivers, extensions of repayment terms, or insignificant delays in payment.
- *Past Due Reporting* - With regard to loans not otherwise reportable as past due, financial institutions are not expected to designate loans with deferrals granted due to COVID-19 as past due because of the deferral. A loan's payment date is governed by the due date stipulated in the legal agreement. If a financial institution agrees to a payment deferral, these loans would not be considered past due during the period of the deferral.
- *Nonaccrual Status and Charge-offs* - During short-term COVID-19 modifications, these loans generally should not be reported as nonaccrual or as classified.

Effective March 23, 2020 through July 9, 2020, for consumer customers, the Bank waived early CD penalty fees for withdrawals up to \$20,000 (limited to one penalty-free withdrawal per CD account); eliminated all insufficient funds (overdrafts) and returned item fees; eliminated all Pay by Phone fees; waived all late fees; offered the opportunity for monthly mortgage, home equity loan or home equity line payment relief; offered the opportunity to defer unsecured consumer loans or lines of credit and secured consumer loans and lines of credit payments; and offered unsecured personal loans up to \$5,000, up to 60 months at 2.95% APR subject to credit approval (additional terms and conditions may apply). In addition, ATM access fees were reinitiated on September 19, 2020.

As of December 31, 2021, we have helped more than 2,900 customers obtain more than \$370 million in loans through the PPP. We have helped customers complete the forgiveness process for approximately \$320 million of these PPP loans through December 31, 2021.

The Company had \$532.4 million of loans with modifications related to COVID-19 during 2020, with \$46.2 million and \$113.0 million still on deferral as of December 31, 2021 and 2020, respectively. As of December 31, 2021, we have provided payment deferrals for approximately 6,600 borrowers, the majority being consumer indirect loan customers. Less than 1% of our loan customers have active payment deferrals as of December 31, 2021 as the majority of customers whose loans were subject to COVID-19 related deferrals have returned to making regular payments.

MANAGEMENT'S DISCUSSION AND ANALYSIS

GAAP to Non-GAAP Reconciliation

(In thousands, except per share data)

	At or for the year ended December 31,		
	2021	2020	2019
Computation of ending tangible common equity:			
Common shareholders' equity	\$ 487,850	\$ 451,035	\$ 421,619
Less: goodwill and other intangible assets, net	74,400	73,789	74,923
Tangible common equity	<u>\$ 413,450</u>	<u>\$ 377,246</u>	<u>\$ 346,696</u>
Computation of ending tangible assets:			
Total assets	\$ 5,520,779	\$ 4,912,306	\$ 4,384,178
Less: goodwill and other intangible assets, net	74,400	73,789	74,923
Tangible assets	<u>\$ 5,446,379</u>	<u>\$ 4,838,517</u>	<u>\$ 4,309,255</u>
Tangible common equity to tangible assets ⁽¹⁾	7.59%	7.80%	8.05%
Common shares outstanding	15,747	16,042	16,003
Tangible common book value per share ⁽²⁾	\$ 26.26	\$ 23.52	\$ 21.66
Computation of average tangible common equity:			
Average common equity	\$ 468,085	\$ 433,908	\$ 403,689
Average goodwill and other intangible assets, net	74,411	74,364	75,557
Average tangible common equity	<u>\$ 393,674</u>	<u>\$ 359,544</u>	<u>\$ 328,132</u>
Computation of average tangible assets:			
Average assets	\$ 5,335,808	\$ 4,693,225	\$ 4,285,825
Average goodwill and other intangible assets, net	74,411	74,364	75,557
Average tangible assets	<u>\$ 5,261,397</u>	<u>\$ 4,618,861</u>	<u>\$ 4,210,268</u>
Net income available to common shareholders	\$ 76,237	\$ 36,871	\$ 47,401
Return on average tangible common equity ⁽³⁾	19.37%	10.25%	14.45%
Return on average tangible assets ⁽⁴⁾	1.45%	0.80%	1.13%

⁽¹⁾ Tangible common equity divided by tangible assets.

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

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

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

This table contains disclosure that includes calculations for tangible common equity, tangible assets, tangible common equity to tangible assets, tangible common book value per share, average tangible common equity, average tangible assets, return on average tangible common equity and return on average tangible assets, which are determined by methods other than in accordance with GAAP. We believe that these non-GAAP measures are useful to our investors as measures of the strength of our capital and ability to generate earnings on tangible common equity invested by our shareholders. These non-GAAP measures provide supplemental information that may help investors to analyze our capital position without regard to the effects of intangible assets. Non-GAAP financial measures have inherent limitations and are not uniformly utilized by issuers. Therefore, these non-GAAP financial measures should not be considered in isolation, or as a substitute for comparable measures prepared in accordance with GAAP.

MANAGEMENT'S DISCUSSION AND ANALYSIS

RESULTS OF OPERATIONS FOR THE YEARS ENDED

DECEMBER 31, 2021 AND DECEMBER 31, 2020

Net Interest Income and Net Interest Margin

Net interest income is our primary source of revenue, comprising 77% of revenue during the year ended December 31, 2021. Net interest income is the difference between interest income on interest-earning assets, such as loans and investment securities, and interest expense on interest-bearing deposits and other borrowings used to fund interest-earning and other assets or activities. Net interest income is affected by changes in interest rates and by the amount and composition of earning assets and interest-bearing liabilities, as well as the sensitivity of the balance sheet to changes in interest rates, including characteristics such as the fixed or variable nature of the financial instruments, contractual maturities and repricing frequencies.

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

The Federal Reserve influences the general market rates of interest, which impacts the deposit and loan rates offered by many financial institutions. The intended federal funds rate, which is the cost of immediately available overnight funds, remained at a range of 0.00% to 0.25% at year-end 2021. The Federal Reserve had previously decreased the intended federal funds rate by 150 basis points due to two rate cuts in March of 2020. On March 3, 2020 it decreased 50 basis points and on March 16, 2020 another 100 basis points, resulting in a range of 0.00% to 0.25% at year-end 2020. The Federal Reserve had previously decreased the intended federal funds rate by 25 basis points in each of August, September and October 2019, resulting in a range of 1.50% to 1.75% at year-end 2019. Our loan portfolio is significantly affected by changes in the prime interest rate and changes in the prime interest rate generally follow changes in the federal funds rate. The prime interest rate, which is the rate offered on loans to borrowers with strong credit, remained at 3.25% at year-end 2021. The prime interest rate had previously decreased to 3.25% in March 2020, reflecting the rate cuts of 50 and 100 basis points after the previous three 25 basis point decreases to 4.75% in 2019.

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

	2021	2020	2019
Interest income per consolidated statements of income	\$ 167,205	\$ 161,299	\$ 168,800
Adjustment to fully taxable equivalent basis	626	871	1,103
Interest income adjusted to a fully taxable equivalent basis	167,831	162,170	169,903
Interest expense per consolidated statements of income	12,475	22,314	38,888
Net interest income on a taxable equivalent basis	<u>\$ 155,356</u>	<u>\$ 139,856</u>	<u>\$ 131,015</u>

Analysis of Net Interest Income and Net Interest Margin

Net interest income on a taxable equivalent basis for 2021 was \$155.4 million, an increase of \$15.5 million compared to \$139.9 million for 2020. The increase in net interest income was due primarily to increases in average loans of \$212.7 million, or 6%, and average investment securities of \$334.1 million, or 42% compared to 2020 and a decrease in the cost of average interest-bearing liabilities. In addition, the increase in net interest income from 2020 included an increase in deferred fee amortization on PPP loans of \$5.1 million, due to accelerated amortization of fees on PPP loans paid-off, primarily through the forgiveness process.

Our net interest margin for 2021 was 3.14%, eight-basis points lower than 3.22% from the prior year. This decrease was a function of a nine-basis point lower contribution from net free funds and a one-basis point increase in the interest rate spread. The change in interest rate spread was a net result of a 34-basis point decrease in the yield on average interest-earning assets and a 35-basis point decrease in the cost of interest-bearing liabilities.

For the year ended December 31, 2021, the yield on average interest-earning assets of 3.39% was 34-basis points lower than 2020. Loan yields decreased 13-basis points during 2021 to 4.05%. The yield on investment securities decreased 56-basis points during 2021 to 1.75%. Overall, the interest-earning asset rate changes decreased interest income by \$9.4 million during 2021 while a favorable volume variance increased interest income by \$15.0 million, which collectively drove a \$5.7 million increase in interest income.

MANAGEMENT'S DISCUSSION AND ANALYSIS

Average interest-earning assets were \$4.95 billion for 2021 compared to \$4.35 billion for 2020, an increase of \$603.5 million, or 14%, with average loans up \$212.7 million from \$3.44 billion to \$3.65 billion and average securities up \$334.1 million from \$794.9 million to \$1.13 billion. The growth in average loans reflected increases in the commercial loans, residential real estate loans and consumer indirect loans categories. Commercial loans, in particular, were up \$162.2 million from \$1.90 billion to \$2.06 billion, or 9%, from 2020. Average balances of PPP loans net of deferred fees, which are included in commercial loans, were \$175.4 million and \$176.0 million for 2021 and 2020, respectively. Residential real estate loans were up \$5.8 million, or 1%, and residential real estate lines were down \$15.1 million, or 16%. Consumer indirect loans increased \$60.6 million, or 7%, and other consumer loans decreased by \$702 thousand, or 4%. Loans comprised 73.8% of average interest-earning assets during 2021 compared to 79.1% during 2020. Loans generally have significantly higher yields compared to securities and federal funds sold and interest-bearing deposits and, as such, can have a more positive effect on the net interest margin. The yield on average loans was 4.05% for 2021, a decrease of 13 basis points compared to 4.18% for 2020. An increase in the volume of average loans resulted in a \$9.0 million increase in interest income, partially offset by a \$4.6 million decrease due to the unfavorable rate variance. Securities comprised 22.8% of average interest-earning assets in 2021 compared to 18.3% in 2020. The taxable equivalent yield on average securities was 1.75% in 2021 compared to 2.31% in 2020. An increase in the volume of average securities resulted in a \$5.9 million increase in interest income, partially offset by a \$4.5 million decrease due to the unfavorable rate variance. Our asset mix negatively impacted net interest margin because loans constituted a smaller percentage and investment securities constituted a larger percentage of our interest-earning assets in 2021.

For the year ended December 31, 2021, the cost of average interest-bearing liabilities of 0.34% was 35 basis points lower than 2020 and the cost of average interest-bearing deposits of 0.23% was 34 basis points lower than 2020. Average short-term borrowings decreased \$86.0 million from \$86.5 million to \$538 thousand in 2021. The decrease in average short-term borrowings was a result of our use of brokered deposits as a cost effective alternative to Federal Home Loan Bank ("FHLB") borrowings. The cost of long-term borrowings decreased 34 basis points to 5.75%. Overall, interest-bearing liability rate and volume decreases resulted in \$9.8 million of lower interest expense during 2021.

Average interest-bearing liabilities of \$3.67 billion in 2021 were \$422.7 million, or 13%, higher than 2020. On average, interest-bearing deposits grew \$482.3 million and noninterest-bearing demand deposits (a principal component of net free funds) were up \$199.8 million. The increase in average deposits was due to growth in all deposit categories including non-public deposits, public deposits, reciprocal deposits and brokered deposits, which were utilized as a cost-effective alternative to FHLB borrowings during 2021. For further discussion of our reciprocal and brokered deposits, refer to the "Funding Activities – Deposits" section of this Management's Discussion and Analysis. Overall, interest-bearing deposit rate and volume changes resulted in \$9.7 million of lower interest expense during 2021. Average short-term and long-term borrowings were \$74.3 million in 2021, \$59.6 million lower than in 2020. Overall, short- and long-term borrowing rate and volume changes resulted in \$135 thousand of lower interest expense during 2021.

MANAGEMENT'S DISCUSSION AND ANALYSIS

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

	Years ended December 31,								
	2021			2020			2019		
	Average Balance	Interest	Average Rate	Average Balance	Interest	Average Rate	Average Balance	Interest	Average Rate
Interest-earning assets:									
Federal funds sold and other interest-earning deposits	\$ 169,504	\$ 216	0.13%	\$ 112,802	\$ 315	0.28%	\$ 22,023	\$ 395	1.80%
Investment securities:									
Taxable	1,007,420	16,736	1.66	626,221	14,186	2.27	610,251	14,382	2.36
Tax-exempt	121,592	2,981	2.45	168,687	4,149	2.46	212,493	5,253	2.47
Total investment securities	1,129,012	19,717	1.75	794,908	18,335	2.31	822,744	19,635	2.39
Loans:									
Commercial business	734,748	29,467	4.01	735,535	26,667	3.63	569,941	29,630	5.20
Commercial mortgage	1,327,772	51,719	3.90	1,164,827	49,962	4.29	1,021,220	52,514	5.14
Residential real estate loans	593,375	20,162	3.40	587,620	21,320	3.63	547,505	20,995	3.83
Residential real estate lines	82,210	2,784	3.39	97,321	3,802	3.91	107,654	5,508	5.12
Consumer indirect	896,769	42,181	4.70	836,168	40,003	4.78	882,056	39,235	4.45
Other consumer	15,305	1,585	10.36	16,007	1,766	11.03	16,047	1,991	12.41
Total loans	3,650,179	147,898	4.05	3,437,478	143,520	4.18	3,144,423	149,873	4.77
Total interest-earning assets	4,948,695	167,831	3.39	4,345,188	162,170	3.73	3,989,190	169,903	4.26
Less: Allowance for credit losses	(50,230)			(45,697)			(34,143)		
Other noninterest-earning assets	437,343			393,734			330,778		
Total assets	<u>\$ 5,335,808</u>			<u>\$ 4,693,225</u>			<u>\$ 4,285,825</u>		
Interest-bearing liabilities:									
Deposits:									
Interest-bearing demand	\$ 827,891	1,156	0.14	\$ 714,904	1,091	0.15	\$ 655,534	1,372	0.21
Savings and money market	1,864,567	3,363	0.18	1,443,692	4,788	0.33	983,447	4,365	0.44
Time deposits	907,973	3,599	0.40	959,541	11,943	1.24	1,098,440	22,757	2.07
Total interest-bearing deposits	3,600,431	8,118	0.23	3,118,137	17,822	0.57	2,737,421	28,494	1.04
Short-term borrowings	538	120	22.33	86,495	1,604	1.85	309,893	7,923	2.56
Long-term borrowings	73,749	4,237	5.75	47,387	2,888	6.09	39,235	2,471	6.30
Total borrowings	74,287	4,357	5.87	133,882	4,492	3.36	349,128	10,394	2.98
Total interest-bearing liabilities	3,674,718	12,475	0.34	3,252,019	22,314	0.69	3,086,549	38,888	1.26
Noninterest-bearing demand deposits	1,105,227			905,412			721,133		
Other noninterest-bearing liabilities	70,472			84,558			57,126		
Shareholders' equity	485,391			451,236			421,017		
Total liabilities and shareholders' equity	<u>\$ 5,335,808</u>			<u>\$ 4,693,225</u>			<u>\$ 4,285,825</u>		
Net interest income (tax-equivalent)		<u>\$ 155,356</u>			<u>\$ 139,856</u>			<u>\$ 131,015</u>	
Interest rate spread			3.05%			3.04%			3.00%
Net earning assets	<u>\$ 1,273,977</u>			<u>\$ 1,093,169</u>			<u>\$ 902,641</u>		
Net interest margin (tax-equivalent)			3.14%			3.22%			3.28%
Ratio of average interest-earning assets to average interest-bearing liabilities	<u>134.67%</u>			<u>133.62%</u>			<u>129.24%</u>		

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

MANAGEMENT'S DISCUSSION AND ANALYSIS

Rate /Volume Analysis

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

Increase (decrease) in:	Change from 2020 to 2021			Change from 2019 to 2020		
	Volume	Rate	Total	Volume	Rate	Total
Interest income:						
Federal funds sold and interest-earning deposits	\$ 117	\$ (216)	\$ (99)	\$ 488	\$ (568)	\$ (80)
Investment securities:						
Taxable	7,034	(4,484)	2,550	370	(566)	(196)
Tax-exempt	(1,155)	(13)	(1,168)	(1,077)	(27)	(1,104)
Total investment securities	5,879	(4,497)	1,382	(707)	(593)	(1,300)
Loans:						
Commercial business	(29)	2,829	2,800	7,333	(10,296)	(2,963)
Commercial mortgage	6,601	(4,844)	1,757	6,823	(9,375)	(2,552)
Residential real estate loans	207	(1,365)	(1,158)	1,490	(1,165)	325
Residential real estate lines	(548)	(470)	(1,018)	(493)	(1,213)	(1,706)
Consumer indirect	2,859	(681)	2,178	(2,104)	2,872	768
Other consumer	(75)	(106)	(181)	(5)	(220)	(225)
Total loans	9,015	(4,637)	4,378	13,044	(19,397)	(6,353)
Total interest income	15,011	(9,350)	5,661	12,825	(20,558)	(7,733)
Interest expense:						
Deposits:						
Interest-bearing demand	163	(98)	65	116	(397)	(281)
Savings and money market	1,148	(2,573)	(1,425)	1,707	(1,284)	423
Time deposits	(610)	(7,734)	(8,344)	(2,602)	(8,212)	(10,814)
Total interest-bearing deposits	701	(10,405)	(9,704)	(779)	(9,893)	(10,672)
Short-term borrowings	(3,047)	1,563	(1,484)	(4,576)	(1,743)	(6,319)
Long-term borrowings	1,524	(175)	1,349	499	(82)	417
Total borrowings	(1,523)	1,388	(135)	(4,077)	(1,825)	(5,902)
Total interest expense	(822)	(9,017)	(9,839)	(4,856)	(11,718)	(16,574)
Net interest income	\$ 15,833	\$ (333)	\$ 15,500	\$ 17,681	\$ (8,840)	\$ 8,841

Provision for Credit Losses

The provision for credit losses was a benefit of \$8.3 million for the year ended December 31, 2021 compared with a provision of \$27.2 million for 2020. There was a benefit for credit losses in each quarter of 2021 as a result of continued improvement in the national unemployment forecast, the designated loss driver for our current expected credit loss (“CECL”) model, positive trends in qualitative factors, a reduction in specific reserves and lower net charge-offs resulting in releases of credit loss reserves. The elevated level of provision for credit losses for 2020 was driven by the adoption of the CECL standard and the impact of COVID-19 pandemic on the economic environment. The designated loss driver for our CECL model is the national unemployment forecast, which spiked in early 2020 at the onset of the pandemic and improved in 2021. The provision for credit losses - loans varies based primarily on forecasted unemployment rates, loan growth, net charge-offs, collateral values associated with collateral dependent loans and qualitative factors.

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

MANAGEMENT'S DISCUSSION AND ANALYSIS

Noninterest Income

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

	2021	2020	2019
Service charges on deposits	\$ 5,571	\$ 4,810	\$ 7,241
Insurance income	5,750	4,403	4,570
Card interchange income	8,498	7,281	6,779
Investment advisory	11,672	9,535	9,187
Company owned life insurance	2,947	1,902	1,758
Investments in limited partnerships	2,081	104	352
Loan servicing	415	249	432
Income from derivative instruments, net	2,695	5,521	2,274
Net gain on sale of loans held for sale	2,950	3,858	1,352
Net gain on investment securities	71	1,599	1,677
Net gain (loss) on other assets	441	(61)	29
Net loss on tax credit investments	(431)	(275)	(528)
Other	4,246	4,250	5,258
Total noninterest income	<u>\$ 46,906</u>	<u>\$ 43,176</u>	<u>\$ 40,381</u>

Service charges on deposits increased \$761 thousand, or 16%, to \$5.6 million in 2021, compared to \$4.8 million in 2020. The increase in 2021 was primarily due to our COVID-19 relief initiatives implemented from March 23, 2020 to July 9, 2020.

Insurance income increased \$1.3 million, or 31%, to \$5.8 million in 2021, compared to \$4.4 million in 2020. The increase was primarily due to two 2021 bolt-on acquisitions and growth in the legacy SDN business, including the impact of increasing insurance premiums.

Card interchange income increased \$1.2 million, or 17%, to \$8.5 million in 2021, compared to \$7.3 million in 2020. The increase was primarily due to an increase in customer transactions.

Investment advisory income increased \$2.1 million, or 22%, to \$11.7 million in 2021, compared to \$9.5 million in 2020. The increase was primarily due to an increase in assets under management driven by a combination of market gains, new customer accounts and contributions to existing accounts.

Company owned life insurance income increased \$1.0 million, or 55%, to \$2.9 million in 2021, compared to \$1.9 million in 2020. We made additional investments in company-owned life insurance of \$20.0 million in the third quarter of 2021 and \$30.0 million in the fourth quarter of 2020.

Income from investments in limited partnerships increased \$2.0 million to \$2.1 million in 2021, compared to \$104 thousand in 2020. We have investments in limited partnerships, primarily small business investment companies, and account for these investments under the equity method. The income from these investments fluctuates based on the maturity and performance of the underlying investments.

Income from derivative instruments, net decreased \$2.8 million to \$2.7 million in 2021, compared to \$5.5 million in 2020. Fee income per transaction in 2021 was higher than in 2020, however, aggregate swap fee income decreased \$2.2 million as a result of fewer swap transactions. Mortgage derivative income was \$589 thousand lower than 2020, primarily as a result of fewer mortgage loans in the pipeline.

Net gain on sale of loans held for sale decreased \$908 thousand to \$3.0 million in 2021, compared to \$3.9 million in 2020. The decrease was primarily driven by lower transaction volumes and margins in 2021. Transaction volume and margin were at historically high levels in the second half of 2020, driven by mortgage refinancing activity.

Net gain on investment securities decreased \$1.5 million to \$71 thousand in 2021, compared to \$1.6 million in 2020. The amount and timing of our sale of investment securities is dependent on several factors, including our prudent efforts to realize gains while managing duration, premium and credit risk.

MANAGEMENT'S DISCUSSION AND ANALYSIS

Noninterest Expense

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

	2021	2020	2019
Salaries and employee benefits	\$ 60,893	\$ 59,336	\$ 56,330
Occupancy and equipment	14,371	13,655	13,552
Professional services	6,535	6,326	5,424
Computer and data processing	14,112	11,645	9,983
Supplies and postage	1,769	1,975	2,036
FDIC assessments	2,624	2,242	1,005
Advertising and promotions	1,704	2,609	3,577
Amortization of intangibles	1,060	1,134	1,250
Restructuring charges	111	1,492	-
Other	9,571	8,840	9,671
Total noninterest expense	\$ 112,750	\$ 109,254	\$ 102,828

Salaries and employee benefits expense increased \$1.6 million, or 3%, to \$60.9 million in 2021, compared to \$59.3 million in 2020. The increase was primarily attributable to higher performance-based incentive compensation and commissions, investments in personnel and the impact of 2021 acquisitions.

Occupancy and equipment expense increased \$716 thousand, or 5%, to \$14.4 million in 2021 compared to \$13.7 million in 2020. The increase was primarily due to the purchase of personal computers and security equipment for multiple locations and expenses related to two bank branches opened in June 2021.

Computer and data processing expense increased \$2.5 million, or 21%, to \$14.1 million in 2021, compared to \$11.6 million in 2020. The increase was primarily due to investments in technology, including digital banking initiatives and a customer relationship management solution that was deployed across all lines of business late in 2021.

Advertising and promotions expense decreased \$905 thousand, or 35%, to \$1.7 million in 2021, compared to \$2.6 million in 2020. The decrease was primarily related to a temporary reduction in external advertising expense. The Company decreased its total advertising spend in both 2021 and 2020 as a result of the COVID-19 pandemic and is continuing to evaluate its long-term marketing strategy.

Restructuring charges were \$1.5 million in 2020, representing non-recurring real estate related charges related to the 2020 closure of six branches and a staffing reduction. Additional related restructuring charges of \$111 thousand were incurred in 2021 as a result of property valuation adjustments.

The efficiency ratio for the year ended December 31, 2021 was 55.76% compared with 60.22% for 2020. The lower efficiency ratio is a result of higher net interest income associated with an increase in average interest-earning assets for the year, deferred fee amortization on PPP loans, an increase in noninterest income and a decrease in interest expense compared to the prior year. The efficiency ratio is calculated by dividing total noninterest expense by net revenue, defined as the sum of tax-equivalent net interest income and noninterest income before net gains on investment securities. An increase in the efficiency ratio indicates that more resources are being utilized to generate the same volume of income, while a decrease indicates a more efficient allocation of resources. The efficiency ratio, a banking industry financial measure, is not required by GAAP. However, the efficiency ratio is used by management in its assessment of financial performance specifically as it relates to noninterest expense control. Management also believes such information is useful to investors in evaluating Company performance.

Income Taxes

We recorded income tax expense of \$19.5 million for 2021, compared to \$7.4 million for 2020. In 2021 and 2020, we recognized tax credit investments resulting in a \$2.6 million and \$1.5 million reduction in income tax expense, respectively, and a \$431 thousand and \$275 thousand net loss recorded in noninterest income, respectively.

Our effective tax rate was 20.1% for 2021 compared to 16.2% for 2020. Effective tax rates are typically impacted by items of income and expense that are not subject to federal or state taxation. Our effective tax rates reflect the impact of these items, which include, but are not limited to, interest income from tax-exempt securities, earnings on company owned life insurance and the impact of tax credit investments. In addition, our effective tax rate for 2021 and 2020 reflects the New York State tax benefit generated by our real estate investment trust.

MANAGEMENT'S DISCUSSION AND ANALYSIS

RESULTS OF OPERATIONS FOR THE YEARS ENDED

DECEMBER 31, 2020 AND DECEMBER 31, 2019

A discussion regarding our financial condition and results of operations for the year ended December 31, 2019 and year-to-year comparisons between 2020 and 2019, which are not included in this Form 10-K, can be found under "Management's Discussion and Analysis of Financial Condition and Results of Operations" in Part II, Item 7 of the Company's Annual Report on Form 10-K for the fiscal year ended December 31, 2020 and are incorporated by reference herein.

ANALYSIS OF FINANCIAL CONDITION

OVERVIEW

At December 31, 2021, we had total assets of \$5.52 billion, an increase of 12% from \$4.91 billion as of December 31, 2020, largely attributable to organic loan growth and an increase in our investment securities portfolio. Net loans were \$3.64 billion as of December 31, 2021, up \$97.0 million, or 3%, when compared to \$3.54 billion as of December 31, 2020. The increase in net loans was primarily attributable to organic growth in our consumer indirect loans. Non-performing assets totaled \$12.2 million as of December 31, 2021, down \$317 thousand from a year ago. Total deposits amounted to \$4.83 billion as of December 31, 2021, up \$548.7 million, or 13%, compared to December 31, 2020. As of December 31, 2021, borrowed funds totaled \$103.9 million, compared to \$78.9 million as of December 31, 2020. Common book value per common share was \$30.98 and \$28.12 as of December 31, 2021 and 2020, respectively. As of December 31, 2021, our total shareholders' equity was \$505.1 million compared to \$468.4 million a year earlier.

INVESTING ACTIVITIES

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

	Investment Securities Portfolio Composition			
	At December 31,			
	2021		2020	
	Amortized Cost	Fair Value	Amortized Cost	Fair Value
Securities available for sale:				
U.S. Government agency and government-sponsored enterprise securities	\$ 15,793	\$ 15,891	\$ 6,239	\$ 6,635
Mortgage-backed securities:				
Agency mortgage-backed securities	1,169,042	1,162,214	601,426	620,989
Non-Agency mortgage-backed securities	-	410	-	435
Asset-backed securities	-	-	-	-
Total available for sale securities	1,184,835	1,178,515	607,665	628,059
Securities held to maturity:				
State and political subdivisions	111,399	113,511	144,506	148,984
Mortgage-backed securities	94,187	96,309	127,467	133,051
Total held to maturity securities	205,586	209,820	271,973	282,035
Allowance for credit losses - securities	(5)		(7)	
Total held to maturity securities, net	205,581		271,966	
Total investment securities	<u>\$ 1,390,416</u>	<u>\$ 1,388,335</u>	<u>\$ 879,631</u>	<u>\$ 910,094</u>

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

Our available for sale ("AFS") investment securities portfolio increased \$550.5 million from \$628.1 million at December 31, 2020 to \$1.18 billion at December 31, 2021. The increase from year-end 2020 was primarily due to the reinvestment of cash flow from the portfolio, coupled with the deployment of excess liquidity from higher deposit levels into cash flowing agency backed securities. Our AFS portfolio had a net unrealized loss totaling \$6.3 million at December 31, 2021 compared to a net unrealized gain of \$20.4 million at December 31, 2020. The fair value of most of the investment securities in the AFS portfolio fluctuates as market interest rates change.

MANAGEMENT'S DISCUSSION AND ANALYSIS

Impairment Assessment

For AFS securities in an unrealized loss position, we first assess whether (i) we intend to sell, or (ii) it is more likely than not that we will be required to sell the security before recovery of its amortized cost basis. If either case is affirmative, any previously recognized allowances are charged-off and the security's amortized cost is written down to fair value through income. If neither case is affirmative, the security is evaluated to determine whether the decline in fair value has resulted from credit losses or other factors. In making this assessment, management considers the extent to which fair value is less than amortized cost, any changes to the rating of the security by a rating agency and any adverse conditions specifically related to the security, among other factors. If this assessment indicates that a credit loss exists, the present value of cash flows expected to be collected from the security are compared to the amortized cost basis of the security. If the present value of cash flows expected to be collected is less than the amortized cost basis, a credit loss exists and an allowance for credit losses is recorded for the credit loss, limited by the amount that the fair value is less than the amortized cost basis. Any impairment that has not been recorded through an allowance for credit losses is recognized in other comprehensive income. Adjustments to the allowance are reported in our income statement as a component of credit loss expense. AFS securities are charged-off against the allowance or, in the absence of any allowance, written down through income when deemed uncollectible by management or when either of the aforementioned criteria regarding intent or requirement to sell is met. For the year ended December 31, 2021 and 2020 no allowance for credit losses has been recognized on AFS securities in an unrealized loss position as management does not believe any of the securities are impaired due to reasons of credit quality.

As of December 31, 2021, we do not have the intent to sell any of our securities in a loss position and we believe that it is not likely that we will be required to sell any such securities before the anticipated recovery of amortized cost. The unrealized losses are largely due to increases in market interest rates over the yields available at the time the underlying securities were purchased. The fair value is expected to recover as the bonds approach their maturity date, repricing date or if market yields for such investments decline. We do not believe any of the securities in a loss position are impaired due to reasons of credit quality. Accordingly, as of December 31, 2021, we concluded that unrealized losses on our AFS securities are not impaired due to reasons of credit quality and no allowance for credit losses has been recognized on AFS securities. The following discussion provides further details of our assessment of the AFS securities portfolio by investment category.

U.S. Government Agencies and Government Sponsored Enterprises ("GSE"). As of December 31, 2021, there was one security in an unrealized loss position for less than 12 months in the U.S. Government agencies and GSE portfolio with an unrealized loss totaling \$97 thousand. The decline in fair value is attributable to changes in interest rates, not to credit quality. We did not have the intent to sell this security and it was likely that we will not be required to sell the security before the anticipated recovery.

Agency Mortgage-backed Securities. With the exception of the non-Agency mortgage-backed securities ("non-Agency MBS") discussed below, all of the mortgage-backed securities held by us as of December 31, 2021, were issued by U.S. Government sponsored entities and agencies ("Agency MBS"), primarily FNMA and FHLMC. The contractual cash flows of our Agency MBS are guaranteed by FNMA, FHLMC or GNMA. The GNMA mortgage-backed securities are backed by the full faith and credit of the U.S. Government.

As of December 31, 2021, there were 116 securities in the AFS Agency MBS portfolio that were in an unrealized loss position with unrealized losses totaling \$14.7 million. Of these, 28 were in an unrealized loss position for 12 months or longer and had an aggregate fair value of \$172.2 million and unrealized losses of \$4.7 million dollars. The unrealized loss of these securities is driven by the timing of the purchases of fixed-rate securities during the extended low interest rate environments experienced over the past two years, which has been compounded with subsequent increases in benchmark interest rates. However, these fixed-rate securities were purchased with the expectation that they will continue to prepay principal and the proceeds will be invested at current market rates.

Given the high credit quality inherent in Agency MBS, we do not consider any of the unrealized losses as of December 31, 2021 on such Agency MBS to be credit related. As of December 31, 2021, we did not intend to sell any Agency MBS that were in an unrealized loss position, all of which were performing in accordance with their terms.

Non-Agency Mortgage-backed Securities. Our non-Agency MBS portfolio consists of positions in one privately issued whole loan collateralized mortgage obligations with a fair value and net unrealized gain of \$410 thousand as of December 31, 2021. As of that date, the one non-Agency MBS was rated below investment grade. This security was not in an unrealized loss position.

Other Investments. As a member of the FHLB, the Bank is required to hold FHLB stock. The amount of required FHLB stock is based on the Bank's asset size and the amount of borrowings from the FHLB. We have assessed the ultimate recoverability of our FHLB stock and believe that no impairment currently exists. As a member of the FRB system, we are required to maintain a specified investment in FRB stock based on a ratio relative to our capital. At December 31, 2021, our ownership of FHLB and FRB stock totaled \$4.4 million and \$6.4 million, respectively, and is included in other assets and recorded at cost, which approximates fair value.

MANAGEMENT'S DISCUSSION AND ANALYSIS

LENDING ACTIVITIES

Total loans were \$3.68 billion at December 31, 2021, an increase of \$84.3 million, or 2%, from December 31, 2020. Commercial loans represented 55.7% of total loans at the end of 2021. Consumer loans represented 44.3% of total loans at December 31, 2021. The composition of our loan portfolio, excluding loans held for sale and including net unearned income and net deferred fees and costs, is summarized as follows (in thousands):

	Loan Portfolio Composition			
	At December 31,			
	2021		2020	
	Amount	Percent	Amount	Percent
Commercial business	\$ 638,293	17.3%	\$ 794,148	22.1%
Commercial mortgage	1,412,788	38.4	1,253,901	34.9
Total commercial	2,051,081	55.7	2,048,049	57.0
Residential real estate loans	577,299	15.7	599,800	16.7
Residential real estate lines	78,531	2.2	89,805	2.5
Consumer indirect	958,048	26.0	840,421	23.4
Other consumer	14,477	0.4	17,063	0.4
Total consumer	1,628,355	44.3	1,547,089	43.0
Total loans	3,679,436	100.0%	3,595,138	100.0%
Less: Allowance for credit losses	39,676		52,420	
Total loans, net	<u>\$ 3,639,760</u>		<u>\$ 3,542,718</u>	

Commercial business loans decreased \$155.9 million from December 31, 2020 to \$638.3 million at December 31, 2021. The decrease was driven by the forgiveness or repayment of PPP loans. PPP loans net of deferred fees are included in commercial business loans and were \$55.3 million at December 31, 2021 and \$248.0 million at December 31, 2020. Accordingly, commercial business loans excluding the impact of PPP loans increased 7% from December 31, 2020. Commercial mortgage loans increased \$158.9 million, or 13%, from December 31, 2020 to \$1.41 billion at December 31, 2021. The credit risk related to commercial loans is largely influenced by general economic conditions, including the impact of the COVID-19 pandemic on small to mid-sized business in our market area, inflation, and the resulting impact on a borrower's operations or on the value of underlying collateral, if any.

Factors that are important to managing overall credit quality are sound loan underwriting and administration, systematic monitoring of existing loans and commitments, effective loan review on an ongoing basis, early identification of potential problems, an appropriate allowance for credit losses, and sound nonaccrual and charge off policies.

An active credit risk management process is used for commercial loans to further ensure that sound and consistent credit decisions are made. Credit risk is controlled by detailed underwriting procedures, comprehensive loan administration, and periodic review of borrowers' outstanding loans and commitments. Borrower relationships are formally reviewed and graded on an ongoing basis for early identification of potential problems. Further analyses by customer, industry, and geographic location are performed to monitor trends, financial performance, and concentrations.

We participate in various lending programs in which guarantees are supplied by U.S. government agencies, such as the SBA, U.S. Department of Agriculture, Rural Economic and Community Development and Farm Service Agency, among others. As of December 31, 2021, the principal balance of such loans (included in commercial loans) was \$87.6 million and the guaranteed portion amounted to \$72.7 million. Excluding PPP Loans, the principal balance of such loans (included in commercial loans) was \$30.1 million and the guaranteed portion amounted to \$15.2 million. Most of these loans were guaranteed by the SBA.

Commercial business loans were \$638.3 million at the end of 2021, down \$155.9 million, or 20%, since the end of 2020, and comprised 17.3% of total loans outstanding at December 31, 2021, compared to 22.1% at December 31, 2020. The decrease in commercial business loans was primarily driven by the forgiveness or repayment of PPP loans. As of December 31, 2021, we had \$55.3 million of PPP loans, net of deferred loan fees and costs compared to \$248.0 million at December 31, 2020. We typically originate business loans of up to \$15.0 million for small to mid-sized businesses in our market area for working capital, equipment financing, inventory financing, accounts receivable financing, or other general business purposes. Loans of this type are in a diverse range of industries. As of December 31, 2021, commercial business SBA loans including PPP loans accounted for a total of \$75.1 million, or 12% of our commercial business loan portfolio.

MANAGEMENT'S DISCUSSION AND ANALYSIS

Commercial mortgage loans totaled \$1.41 billion at December 31, 2021, up \$158.9 million, or 13%, from December 31, 2020, and comprised 38.4% of total loans, compared to 34.9% at December 31, 2020. Commercial mortgage loans include both owner occupied and non-owner occupied commercial real estate loans. Approximately 23% and 24% of our commercial mortgage portfolio at December 31, 2021 and 2020, respectively, was owner occupied commercial real estate. The majority of our commercial real estate loans are secured by office buildings, manufacturing facilities, distribution/warehouse facilities, and retail centers, which are generally located in our local market area. As of December 31, 2021, commercial mortgage SBA loans accounted for a total of \$5.4 million or less than one percent of our commercial mortgage loan portfolio.

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

Consumer loans totaled \$1.63 billion at December 31, 2021, up \$81.3 million compared to 2020, and represented 44.3% of the 2021 year-end loan portfolio versus 43.0% at year-end 2020. Loans in this classification include residential real estate loans, residential real estate lines, indirect consumer and other consumer installment loans. Credit risk for these types of loans is generally influenced by general economic conditions, including inflation, the impact of the COVID-19 pandemic on the employment income of these borrowers, the characteristics of individual borrowers, and the nature of the loan collateral. Risks of loss are generally on smaller average balances per loan spread over many borrowers. Once charged off, there is usually less opportunity for recovery on these smaller retail loans. Credit risk is primarily controlled by reviewing the creditworthiness of the borrowers, monitoring payment histories, and taking appropriate collateral and guaranty positions.

Residential real estate portfolios include conventional first lien mortgages and home equity loans and lines of credit. For conventional first lien mortgages, we generally limit the maximum loan to 85% of collateral value without credit enhancement (e.g. personal mortgage insurance). A portion of our fixed-rate conventional mortgage loans are sold in the secondary market with servicing rights retained. Our conventional mortgage products continue to be underwritten using FHLMC secondary marketing guidelines. Our underwriting guidelines for home equity products include a combination of borrower FICO (credit score), the LTV of the property securing the loan and evidence of the borrower having sufficient income to repay the loan. Currently, for home equity products, the maximum acceptable LTV is 90%. The average FICO score for new home equity production was 768 and 764 during the years ended December 31, 2021 and 2020, respectively.

Residential real estate loans totaled \$577.3 million at the end of 2021, down \$22.5 million, or 4%, from the end of the prior year and comprised 15.7% and 16.7% of total loans outstanding at December 31, 2021 and December 31, 2020, respectively. The residential real estate line portfolio amounted to \$78.5 million at December 31, 2021 down \$11.3 million, or 13%, compared to 2020 and represented 2.2% of the 2021 year-end loan portfolio versus 2.5% at year-end 2020. The residential real estate loans and lines portfolios had a weighted average LTV at origination of approximately 70% and 69% at December 31, 2021 and 2020, respectively. Approximately 93% and 92% of the loans and lines were first lien positions at December 31, 2021 and 2020, respectively.

Consumer indirect loans amounted to \$958.0 million at December 31, 2021 up \$117.6 million, or 14%, compared to 2020 and represented 26.0% of the 2021 year-end loan portfolio versus 23.4% at year-end 2020. The loans are primarily for the purchase of automobiles (both new and used) and light duty trucks primarily by individuals, but also by corporations and other organizations. The loans are originated through dealerships and assigned to us with terms that typically range from 36 to 84 months. During the year ended December 31, 2021, we originated \$504.3 million in indirect loans with a mix of approximately 25% new vehicles and 75% used vehicles. This compares with \$318.9 million in indirect loans with a mix of approximately 33% new vehicles and 67% used vehicles for the same period in 2020. We do business with over 450 franchised auto dealers located in Western, Central, and the Capital District of New York, and Northern and Central Pennsylvania. The average FICO score for indirect loan production was 706 and 712 during the years ended December 31, 2021 and 2020, respectively. Other consumer loans totaled \$14.5 million at December 31, 2021, down 2.6 million, or 15%, compared to 2020, and represented less than one percent of the 2021 and 2020 year-end loan portfolio. Other consumer loans consist of personal loans (collateralized and uncollateralized) and deposit account collateralized loans.

Our loan portfolio is widely diversified by types of borrowers, industry groups, and market areas within our operating footprint. Significant loan concentrations are considered to exist for a financial institution when there are amounts loaned to numerous borrowers engaged in similar activities that would cause them to be similarly impacted by economic or other conditions. At December 31, 2021, no significant concentrations, as defined above, existed in our portfolio in excess of 10% of total loans.

MANAGEMENT'S DISCUSSION AND ANALYSIS

Loans Held for Sale and Loan Servicing Rights. Loans held for sale (not included in the loan portfolio composition table) were entirely comprised of residential real estate loans and totaled \$6.2 million and \$4.3 million as of December 31, 2021 and 2020, respectively.

We sell certain qualifying newly originated or refinanced residential real estate loans on the secondary market. Residential real estate loans serviced for others, which are not included in the consolidated statements of financial condition, amounted to \$272.7 million and \$241.7 million as of December 31, 2021 and 2020, respectively.

Allowance for Credit Losses

The following table summarizes the activity in the allowance for credit losses - loans (in thousands).

	Credit Loss - Loans Analysis		
	Year Ended December 31,		
	2021	2020	2019
Allowance for credit losses - loans, beginning of period, prior to adoption of ASC 326	\$ 52,420	\$ 30,482	\$ 33,914
Impact of adopting ASC 326	-	9,594	-
Allowance for credit losses - loans, beginning of period, after adoption of ASC 326	52,420	40,076	33,914
Net charge-offs (recoveries):			
Commercial business	(212)	7,384	1,989
Commercial mortgage	3,814	1,755	2,980
Residential real estate loans	56	72	297
Residential real estate lines	141	(3)	7
Consumer indirect	1,256	4,278	5,420
Other consumer	705	329	783
Total net charge-offs	5,760	13,815	11,476
Provision (benefit) for credit losses - loans	(6,984)	26,159	8,044
Allowance for credit losses - loans, end of year	<u>\$ 39,676</u>	<u>\$ 52,420</u>	<u>\$ 30,482</u>
Net loan charge-offs (recoveries) to average loans:			
Commercial business	-0.03%	1.00%	0.35%
Commercial mortgage	0.29%	0.15%	0.29%
Residential real estate loans	0.01%	0.01%	0.05%
Residential real estate lines	0.17%	0.00%	0.01%
Consumer indirect	0.14%	0.51%	0.61%
Other consumer	4.61%	2.06%	4.88%
Total loans	0.16%	0.40%	0.37%
Allowance for credit losses - loans to total loans	1.08%	1.46%	0.95%
Allowance for credit losses - loans to nonaccrual loans	349%	564%	353%
Allowance for credit losses - loans to non-performing loans	326%	551%	353%

Net charge-offs of \$5.8 million in 2021 represented 0.16% of average loans compared to \$13.8 million, or 0.40%, in 2020. The decrease in commercial business net charge-offs in 2021 was primarily due to an \$8.2 million partial charge-off of an \$11.9 million commercial loan downgraded in the first quarter of 2020 and for which a foreclosure occurred in the third quarter of 2020. The borrower's business was related to the hospitality industry and the downgrade and charge-off were precipitated by the impact of the COVID-19 pandemic. The increase in commercial mortgage net charge-offs in 2021 was primarily due to a \$3.8 million partial charge off of an \$7.8 million commercial loan downgraded in the fourth quarter of 2021. The allowance for credit losses - loans was \$39.7 million at December 31, 2021, compared with \$52.4 million at December 31, 2020. The ratio of the allowance for credit losses - loans to total loans was 1.08% and 1.46% at December 31, 2021 and 2020, respectively. The ratio of allowance for credit losses - loans to non-performing loans was 326% at December 31, 2021, compared with 551% at December 31, 2020.

MANAGEMENT'S DISCUSSION AND ANALYSIS

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

Allowance for Credit Losses - Loans by Loan Category				
At December 31,				
	2021		2020	
	Credit Loss Allowance	Percentage of loans by category to total loans	Loan Loss Allowance	Percentage of loans by category to total loans
Commercial business	\$ 11,099	17.3%	\$ 13,580	22.1%
Commercial mortgage	14,777	38.4	21,763	34.9
Residential real estate loans	1,604	15.7	3,924	16.7
Residential real estate lines	379	2.2	674	2.5
Consumer indirect	11,611	26.0	12,165	23.4
Other consumer	206	0.4	314	0.4
Total	\$ 39,676	100.0%	\$ 52,420	100.0%

The Company adopted ASC 326 effective January 1, 2020, which resulted in an increase to the allowance for credit losses - loans of \$9.6 million and established a reserve for unfunded commitments of \$2.1 million, for a total pre-tax cumulative effect adjustment of \$11.7 million.

The allowance for credit losses for pooled loans estimate is based upon periodic review of the collectability of the loans quantitatively correlating historical loan experience with reasonable and supportable forecasts using forward looking information. Adjustments to the quantitative evaluation may be made for differences in current or expected qualitative risk characteristics such as changes in: underwriting standards, delinquency level, regulatory environment, economic condition, Company management and the status of portfolio administration including the Company's credit risk review function. The Company establishes a specific reserve for individually evaluated loans which do not share similar risk characteristics with the loans included in the forecasted allowance for credit losses. These individually evaluated loans are removed from the pooling approach discussed above for the forecasted allowance for credit losses, and include nonaccrual loans, TDRs, and other loans deemed appropriate by management. The process we use to determine the overall allowance for credit losses is based on this analysis. Based on this analysis, we believe the allowance for credit losses is adequate as of December 31, 2021.

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

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

The adequacy of the allowance for credit losses is subject to ongoing management review. While management evaluates currently available information in establishing the allowance for credit losses - loans, future adjustments to the allowance may be necessary if conditions differ substantially from the assumptions used in making the evaluations. In addition, various regulatory agencies, as an integral part of their examination process, periodically review our allowance for credit losses - loans. Such agencies may require us to increase the allowance based on their judgments about information available to them at the time of their examination.

MANAGEMENT'S DISCUSSION AND ANALYSIS

Non-performing Assets and Potential Problem Loans

The following table summarizes our non-performing assets (in thousands):

	Non-performing Assets At December 31,	
	2021	2020
Nonaccrual loans:		
Commercial business	\$ 602	\$ 1,975
Commercial mortgage	6,414	2,906
Residential real estate loans	2,373	2,587
Residential real estate lines	200	323
Consumer indirect	1,780	1,495
Other consumer	-	-
Total nonaccrual loans	11,369	9,286
Accruing loans 90 days or more delinquent	797	231
Total non-performing loans	12,166	9,517
Foreclosed assets	-	2,966
Total non-performing assets	\$ 12,166	\$ 12,483
Nonaccrual loans to total loans	0.31%	0.26%
Non-performing loans to total loans	0.33%	0.26%
Non-performing assets to total assets	0.22%	0.25%

Non-performing assets include non-performing loans and foreclosed assets. Non-performing assets at December 31, 2021 were \$12.2 million, a decrease of \$317 thousand from \$12.5 million at December 31, 2020. The primary component of non-performing assets is non-performing loans, which were \$12.2 million or 0.33% of total loans at December 31, 2021, compared with \$9.5 million or 0.26% of total loans at December 31, 2020. The increase in nonperforming loans was primarily due to the downgrade of a \$7.8 million commercial mortgage loan, with \$3.8 million partially charged-off, in the fourth quarter of 2021.

Approximately \$7.8 million, or 69%, of the \$11.4 million of nonaccrual loans, a component of non-performing loans, as of December 31, 2021 were current with respect to payment of principal and interest but were classified as non-accruing because repayment in full of principal and/or interest was uncertain. We had no TDRs included in nonaccrual loans at December 31, 2021 and \$200 thousand at December 31, 2020. Additionally, we had no TDRs that were accruing interest as of December 31, 2021 and December 31, 2020.

Foreclosed assets consist of real property formerly pledged as collateral for loans, which we have acquired through foreclosure proceedings or acceptance of a deed in lieu of foreclosure. We had no properties representing foreclosed asset holdings at December 31, 2021 and two properties totaling \$3.0 million at December 31, 2020. The decrease in foreclosed assets during 2021 was primarily the result of the sale of an asset on which foreclosure occurred in the third quarter of 2020. The borrower's business was related to the hospitality industry and the downgrade and partial charge-off in the first quarter of 2020 were precipitated by the impact of the COVID-19 pandemic.

Potential problem loans are loans that are currently performing, but information known about possible credit problems of the borrowers causes us to have concern as to the ability of such borrowers to comply with the present loan payment terms and may result in disclosure of such loans as nonperforming at some time in the future. These loans remain in a performing status due to a variety of factors, including payment history, the value of collateral supporting the credits, and/or personal or government guarantees. We consider loans classified as substandard, which continue to accrue interest, to be potential problem loans. We identified \$22.7 million and \$17.9 million in loans that continued to accrue interest which were classified as substandard as of December 31, 2021 and 2020, respectively.

MANAGEMENT'S DISCUSSION AND ANALYSIS

FUNDING ACTIVITIES

Deposits

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

	At December 31,			
	2021		2020	
	Amount	Percent	Amount	Percent
Noninterest-bearing demand	\$ 1,107,561	22.9%	\$ 1,018,549	23.8%
Interest-bearing demand	864,528	17.9	731,885	17.1
Savings and money market	1,933,047	40.0	1,642,340	38.4
Time deposits	921,954	19.1	885,593	20.7
Total deposits	\$ 4,827,090	100.0%	\$ 4,278,367	100.0%

As of December 31, 2021 and 2020, the aggregate amount of uninsured deposits (deposits in amounts greater than \$250,000, which is the maximum amount for federal deposit insurance) was \$1.29 billion and \$1.08 billion, respectively. The portion of our time deposits by account that were in excess of the FDIC insurance limit was \$182.3 million and \$155.3 million at December 31, 2021 and 2020, respectively. The maturities of our uninsured time deposits at December 31, 2021 were as follows: \$45.2 million in three months or less; \$74.7 million between three months and six months; \$62.1 million between six months and one year; and \$287 thousand over one year.

We offer a variety of deposit products designed to attract and retain customers, with the primary focus on building and expanding long-term relationships. At December 31, 2021, total deposits were \$4.83 billion, representing an increase of \$548.7 million, or 13%, for the year. The increase from December 31, 2020, was primarily due to growth in non-public, public and reciprocal deposits. Time deposits were approximately 19% and 21% of total deposits at December 31, 2021 and 2020, respectively.

Nonpublic deposits, the largest component of our funding sources, totaled \$2.70 billion and \$2.55 billion at December 31, 2021 and 2020, respectively, and represented 56% and 60% of total deposits as of the end of each period, respectively. We have managed this segment of funding through a strategy of competitive pricing that minimizes the number of customer relationships that have only a single service high cost deposit account.

As an additional source of funding, we offer a variety of public (municipal) deposit products to the towns, villages, counties and school districts within our market. Public deposits generally range from 20% to 30% of our total deposits. There is a high degree of seasonality in this component of funding, because the level of deposits varies with the seasonal cash flows for these public customers. We maintain the necessary levels of short-term liquid assets to accommodate the seasonality associated with public deposits. Total public deposits were \$1.10 billion and \$834.9 million at December 31, 2021 and December 31, 2020, respectively, and represented 23% and 20% of total deposits as of the end of each period, respectively.

We participate in reciprocal deposit programs, which enable depositors to receive FDIC insurance coverage for deposits otherwise exceeding the maximum insurable amount. Through these programs, deposits in excess of the maximum insurable amount are placed with multiple participating financial institutions. Reciprocal deposits totaled \$771.4 million at December 31, 2021, compared to \$612.3 million at December 31, 2020, and represented 16% and 14% of total deposits as of the end of each period, respectively.

Brokered deposits totaled \$254.7 million and \$279.6 million at December 31, 2021 and 2020, respectively, and represented 5% and 7% of total deposits as of the end of each period, respectively.

Borrowings

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

	2021	2020
Short-term borrowings:		
Short-term FHLB borrowings	\$ 30,000	\$ 5,300
Long-term borrowings:		
Subordinated notes, net	73,911	73,623
Total borrowings	\$ 103,911	\$ 78,923

MANAGEMENT'S DISCUSSION AND ANALYSIS

Short-term Borrowings

Short-term FHLB borrowings have original maturities of less than one year and include overnight borrowings which we typically utilize to address short term funding needs as they arise. Short-term FHLB borrowings at December 31, 2021 consisted of \$30.0 million in short-term borrowings. Short-term FHLB borrowings at December 31, 2020 consisted of \$5.3 million in short-term borrowings. The FHLB borrowings are collateralized by securities from the Company's investment portfolio and certain qualifying loans. At December 31, 2021 and 2020, the Company's borrowings had a weighted average rate of 0.34% and 1.70%, respectively.

We have credit capacity with the FHLB and can borrow through facilities that include amortizing and term advances or repurchase agreements. We had approximately \$201.7 million of immediate credit capacity with the FHLB as of December 31, 2021. We had approximately \$613.4 million in secured borrowing capacity at the FRB discount window, none of which was outstanding at December 31, 2021. The FHLB and FRB credit capacity are collateralized by securities from our investment portfolio and certain qualifying loans. We had approximately \$130.0 million of credit available under unsecured federal funds purchased lines with various banks as of December 31, 2021, with no amounts outstanding at December 31, 2021. Additionally, we had approximately \$534.6 million of unencumbered liquid securities available for pledging.

The Parent has a revolving line of credit with a commercial bank allowing borrowings up to \$20.0 million in total as an additional source of working capital. At December 31, 2021, no amounts have been drawn on the line of credit.

Long-term Borrowings

On October 7, 2020, we completed a private placement of \$35.0 million in aggregate principal amount of fixed-to-floating rate subordinated notes due 2030 to qualified institutional buyers and accredited institutional investors that were subsequently exchanged for subordinated notes with substantially the same terms (the "2020 Notes") registered under the Securities Act of 1933, as amended. The 2020 Notes have a maturity date of October 15, 2030 and bear interest, payable semi-annually, at the rate of 4.375% per annum, until October 15, 2025. Commencing on that date, the interest rate will reset quarterly to an interest rate per annum equal to the then current three-month SOFR plus 4.265%, payable quarterly until maturity. The 2020 Notes are redeemable by us, in whole or in part, on any interest payment date on or after October 15, 2025, and we may redeem the Notes in whole at any time upon certain other specified events. We used the net proceeds for general corporate purposes, organic growth and to support regulatory capital ratios at Five Star Bank.

On April 15, 2015, we issued \$40.0 million of subordinated notes (the "2015 Notes") in a registered public offering. The 2015 Notes bear interest at a fixed rate of 6.0% per year, payable semi-annually, for the first 10 years. From April 15, 2025 to the April 15, 2030 maturity date, the interest rate will reset quarterly to an annual interest rate equal to the then current three-month London Interbank Offered Rate ("LIBOR") plus 3.944%, payable quarterly. After the discontinuance of LIBOR, the interest rate will be determined by an alternate method as reasonably selected by the Company. The 2015 Notes are redeemable by us at any quarterly interest payment date beginning on April 15, 2025 to maturity at par, plus accrued and unpaid interest. Proceeds, net of debt issuance costs of \$1.1 million, were \$38.9 million. The 2020 and 2015 Notes qualify as Tier 2 capital for regulatory purposes.

Shareholders' Equity

Total shareholders' equity was \$505.1 million at December 31, 2021, an increase of \$36.8 million from \$468.4 million at December 31, 2020. Net income for the year increased shareholders' equity by \$77.7 million, partially offset by common and preferred stock dividends declared of \$18.5 million. Accumulated other comprehensive loss included in shareholders' equity increased \$15.3 million during the year due primarily to higher net unrealized losses on securities available for sale. Treasury stock included in shareholders' equity increased \$8.0 million primarily due to the purchase of shares of common stock in 2021 under our 2020 Repurchase Program. For detailed information on shareholders' equity, see Note 16, Shareholders' Equity, of the notes to consolidated financial statements. FII and the Bank are subject to various regulatory capital requirements. At December 31, 2021, both FII and the Bank exceeded all regulatory requirements. For detailed information on regulatory capital requirements, see Note 15, Regulatory Matters, of the notes to consolidated financial statements.

LIQUIDITY AND CAPITAL MANAGEMENT

The objective of maintaining adequate liquidity is to assure that we meet our financial obligations. These obligations include the withdrawal of deposits on demand or at their contractual maturity, the repayment of matured borrowings, the ability to fund new and existing loan commitments and the ability to take advantage of new business opportunities. We achieve liquidity by maintaining a strong base of both core customer funds and maturing short-term assets; we also rely on our ability to sell or pledge securities and lines-of-credit and our overall ability to access to the financial and capital markets.

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

MANAGEMENT'S DISCUSSION AND ANALYSIS

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

Cash and cash equivalents were \$79.1 million as of December 31, 2021, a decrease of approximately \$14.8 million from \$93.9 million as of December 31, 2020. During 2021, net cash provided by operating activities totaled \$59.4 million and the principal source of operating activity cash flow was net income adjusted for noncash income and expense items. Net cash used in investing activities totaled \$619.8 million, which included outflows of \$502.4 million from net investment securities transactions and outflows of \$90.1 million for net loan originations. Net cash provided by financing activities of \$545.7 million was attributed to a \$548.7 million increase in deposits and a \$24.7 million increase in short-term borrowings, partially offset by \$9.2 million in purchases of common stock for treasury and \$18.5 million in dividend payments.

Planned Uses of Capital Resources

The Company has various long-term contractual obligations as of December 31, 2021, which include:

- Time deposits for \$922.0 million;
- Supplemental executive retirement plans for \$1.0 million;
- Subordinated notes for \$75.0 million; and
- Operating leases for \$37.7 million.

For additional information on the Company's long-term contractual obligations above, see Note 11, Deposits, Note 21, Employee Benefit Plans, Note 12, Borrowings, and Note 9, Leases, in the accompanying consolidated financial statements.

MANAGEMENT'S DISCUSSION AND ANALYSIS

We have financial instruments with off-balance sheet risk established in the normal course of business to meet the financing needs of customers. These financial instruments include commitments to extend credit for \$936.3 million and standby letters of credit for \$24.9 million as of December 31, 2021. We do not expect all of the commitments to extend credit and standby letters of credit to be funded. Thus, the total commitment amounts do not necessarily represent our future cash requirements.

We have committed to investments in limited partnerships primarily related to small business investment companies and tax credit investments. As of December 31, 2021, the off-balance sheet commitments related to the limited partnership small business investment companies and tax credit investments totaled \$6.4 million and \$9.7 million, respectively. We have also recorded a \$20.2 million liability primarily related to committed contributions for tax credit investments in property placed in service on or before December 31, 2021. The timing of future contributions to be made to these tax credit investments cannot be specifically or reasonably determined.

With the exception of obligations in connection with our irrevocable loan commitments, limited partnership investments and tax credit investments as of December 31, 2021, we had no other off-balance sheet arrangements that have or are reasonably likely to have a current or future effect on our financial condition, changes in financial condition, revenues or expenses, results of operations, liquidity, capital expenditures or capital resources that is material to investors. For additional information on off-balance sheet arrangements, see Note 1, Summary of Significant Accounting Policies and Note 14, Commitments and Contingencies, in the notes to the accompanying consolidated financial statements.

Security Yields and Maturities Schedule

The following table sets forth certain information regarding the amortized cost ("Cost"), cost-weighted average yields ("Yield"), which is defined as the book yield weighted against the ending book value, and contractual maturities of our debt securities portfolio as of December 31, 2021. Mortgage-backed securities are included in maturity categories based on their stated maturity date. Actual maturities may differ from the contractual maturities presented because borrowers may have the right to call or prepay certain investments. No tax-equivalent adjustments were made to the weighted average yields. The tax-exempt portfolio book balance has decreased by \$43.3 million since December 31, 2020 due to maturities in 2021 (dollars in thousands).

	Due in less than one year		Due from one to five years		Due after five years through ten years		Due after ten years		Total	
	Cost	Yield	Cost	Yield	Cost	Yield	Cost	Yield	Cost	Yield
Available for sale debt securities:										
U.S. Government agencies and government-sponsored enterprises	\$ -	%-	\$ 6,258	2.42%	\$ 9,535	1.90%	\$ -	%-	\$ 15,793	2.11%
Mortgage-backed securities	1,469	2.01	58,268	2.59	169,383	1.87	939,922	1.49	1,169,042	1.60
	1,469	2.01	64,526	2.58	178,918	1.87	939,922	1.49	1,184,835	1.61
Held to maturity debt securities:										
State and political subdivisions	35,419	2.01	65,793	1.88	5,005	1.62	5,182	1.92	111,399	1.91
Mortgage-backed securities	-	-	2,261	2.27	14,204	2.21	77,722	2.38	94,187	2.36
	35,419	2.01	68,054	1.89	19,209	2.21	82,904	2.38	205,586	2.13
Total investment securities	\$ 36,888	2.01%	\$ 132,580	2.23%	\$ 198,127	1.89%	\$ 1,022,826	1.56%	\$ 1,390,421	1.68%

MANAGEMENT'S DISCUSSION AND ANALYSIS

Contractual Loan Maturity Schedule

The following table summarizes the contractual maturities of our loan portfolio at December 31, 2021. Loans, net of deferred loan origination costs, include principal amortization and non-accruing loans. Demand loans having no stated schedule of repayment or maturity and overdrafts are reported as due in one year or less (in thousands).

	Due in less than one year	Due from one to five years	Due from five to fifteen years	Due after fifteen years	Total
Commercial business	\$ 211,616	\$ 235,502	\$ 8,918	\$ 182,257	\$ 638,293
Commercial mortgage	400,396	689,943	319,429	3,020	1,412,788
Residential real estate loans	76,973	255,345	237,373	7,608	577,299
Residential real estate lines	3,133	10,364	31,668	33,366	78,531
Consumer indirect ⁽¹⁾	376,857	581,191	-	-	958,048
Other consumer	6,578	7,354	500	45	14,477
Total loans	<u>\$ 1,075,553</u>	<u>\$ 1,779,699</u>	<u>\$ 597,888</u>	<u>\$ 226,296</u>	<u>\$ 3,679,436</u>
Loans maturing after one year:					
With a predetermined interest rate					
Commercial business		\$ 88,389	\$ 2,323	\$ 14,787	\$ 105,499
Commercial mortgage		370,551	146,382	98	517,031
Residential real estate loans		235,649	218,619	3,055	457,323
Residential real estate lines		12	37	2	51
Consumer indirect ⁽¹⁾		581,191	-	-	581,191
Other consumer		7,354	500	45	7,899
With a floating or adjustable rate					
Commercial business		147,113	6,595	167,470	321,178
Commercial mortgage		319,392	173,047	2,922	495,361
Residential real estate loans		19,696	18,754	4,553	43,003
Residential real estate lines		10,352	31,631	33,364	75,347
Consumer indirect ⁽¹⁾		-	-	-	-
Other consumer		-	-	-	-
Total loans maturing after one year		<u>\$ 1,779,699</u>	<u>\$ 597,888</u>	<u>\$ 226,296</u>	<u>\$ 2,603,883</u>

(1) Amounts include prepayment assumptions based on actual historical experience.

MANAGEMENT'S DISCUSSION AND ANALYSIS

Capital Resources

The FRB has adopted a system using risk-based capital guidelines to evaluate the capital adequacy of bank holding companies on a consolidated basis. The final rules implementing the Basel Committee on Banking Supervision's ("BCBS") capital guidelines for U.S. banks were fully phased-in on January 1, 2019. As of December 31, 2021, the Company's capital levels remained characterized as "well-capitalized" under the BCBS rules. See Note 15, Regulatory Matters of the notes to consolidated financial statements and the "Basel III Capital Rules" section below for further discussion. The following table reflects the Company's ratios and their components as of December 31 (in thousands):

	2021	2020
Common shareholders' equity	\$ 487,850	\$ 451,035
Add: CECL transitional amount	8,537	12,061
Less: Goodwill and other intangible assets	71,748	71,235
Net unrealized loss on investment securities ⁽¹⁾	(4,971)	14,743
Hedging derivative instruments	1,160	(316)
Net periodic pension and postretirement benefits plan adjustments	(9,396)	(12,299)
Other	-	-
Common Equity Tier 1 ("CET1") capital	437,846	389,733
Plus: Preferred stock	17,292	17,328
Less: Other	-	-
Tier 1 Capital	455,138	407,061
Plus: Qualifying allowance for credit losses	29,938	40,509
Subordinated Notes	73,911	73,623
Total regulatory capital	\$ 558,987	\$ 521,193
Adjusted average total assets (for leverage capital purposes)	\$ 5,532,987	\$ 4,933,597
Total risk-weighted assets	\$ 4,260,101	\$ 3,844,380

Regulatory Capital Ratios

Tier 1 Leverage (Tier 1 capital to adjusted average assets)	8.23%	8.25%
CET1 Capital (CET1 capital to total risk-weighted assets)	10.28	10.14
Tier 1 Capital (Tier 1 capital to total risk-weighted assets)	10.68	10.59
Total Risk-Based Capital (Total regulatory capital to total risk-weighted assets)	13.12	13.56

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

We have elected to apply the 2020 CECL transition provision related to the impact of the CECL accounting standard on regulatory capital, as provided by the US banking agencies' March 2020 interim final rule. Under the 2020 CECL transition provision, the regulatory capital impact of the Day 1 adjustment to the allowance for credit losses (after-tax) upon the January 1, 2020 CECL adoption date has been deferred and will phase in to regulatory capital at 25% per year commencing January 1, 2022. For the ongoing impact of CECL, we are allowed to defer the regulatory capital impact of the allowance for credit losses in an amount equal to 25% of the change in the allowance for credit losses (pre-tax) recognized through earnings for each period between January 1, 2020, and December 31, 2021. The cumulative adjustment to the allowance for credit losses between January 1, 2020, and December 31, 2021, will also phase in to regulatory capital at 25% per year commencing January 1, 2022.

Basel III Capital Rules

Under the Basel III Rules, the current minimum capital ratios, including an additional capital conservation buffer applicable to the Company and the Bank, are:

- 7.0% CET1 to risk-weighted assets;
- 8.5% Tier 1 capital (that is, CET1 plus Additional Tier 1 capital) to risk-weighted assets; and
- 10.5% Total capital (that is, Tier 1 capital plus Tier 2 capital) to risk-weighted assets.

As of December 31, 2021, the Company's capital levels remained characterized as "well-capitalized" under the Basel III rules.

MANAGEMENT'S DISCUSSION AND ANALYSIS

CRITICAL ACCOUNTING ESTIMATES

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

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

Adequacy of the Allowance for Credit Losses

The allowance for credit losses represents management's estimate of probable credit losses inherent in the loan portfolio. Determining the amount of the allowance for credit losses is considered a critical accounting estimate because it requires significant judgment and the use of subjective measurements including, but not limited to, management's assessment of the internal risk classifications of loans, estimating future losses utilizing current forecasts, forward-looking estimates of qualitative factors including existing economic conditions, portfolio administration, delinquency, the regulatory environment and the Company's lending policies. Because current economic conditions and borrower strength can change, and future events are inherently difficult to predict, the anticipated amount of estimated loan losses, and therefore the appropriateness of the allowance for credit losses, could change significantly. As an integral part of their examination process, various regulatory agencies also review the allowance for credit losses. Such agencies may require additions to the allowance for credit losses or may require that certain loan balances be charged off or downgraded into criticized loan categories when their credit evaluations differ from those of management, based on their judgments about information available to them at the time of their examination. We believe the level of the allowance for credit losses is appropriate as recorded in the consolidated financial statements.

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

Valuation of Goodwill

Goodwill represents the excess of the purchase price over the fair value of net assets acquired in accordance with the purchase method of accounting for business combinations. Goodwill has an indefinite useful life and is not amortized but is tested for impairment. GAAP requires goodwill to be tested for impairment at our reporting unit level on an annual basis and more frequently if events or circumstances indicate that there may be impairment. We test goodwill for impairment as of October 1st of each year.

Impairment exists when a reporting unit's carrying value of goodwill exceeds its fair value. In testing goodwill for impairment, GAAP permits us to first assess qualitative factors to determine whether it is more likely than not that the fair value of a reporting unit is less than its carrying value. If, after assessing the totality of events and circumstances, we determine it is not more likely than not that the fair value of a reporting unit is less than its carrying value, no further testing is performed. However, if we conclude otherwise, we would then be required to perform a goodwill impairment test by comparing the fair value of the reporting unit with its carrying value. If the carrying value of the reporting unit exceeds its fair value, a goodwill impairment charge is recognized for the difference, but not to exceed the amount of goodwill allocated to the reporting unit.

MANAGEMENT'S DISCUSSION AND ANALYSIS

Valuation of Deferred Tax Assets and Liabilities

The determination of deferred tax expense or benefit is based on changes in the carrying amounts of assets and liabilities that generate temporary differences. The carrying value of our net deferred tax assets or liabilities assumes that we will be able to generate sufficient future taxable income based on estimates and assumptions (after consideration of historical taxable income as well as tax planning strategies). If these estimates and related assumptions change, we may be required to record valuation allowances against our deferred tax assets and liabilities resulting in additional income tax expense or benefit in the consolidated statements of income. We evaluate deferred tax assets and liabilities on a quarterly basis and assess the need for a valuation allowance, if any. A valuation allowance is established when management believes that it is more likely than not that some portion of its deferred tax assets and liabilities will not be realized. Changes in valuation allowance from period to period are included in our tax provision in the period of change. For additional discussion related to our accounting policy for income taxes see Note 19, Income Taxes, of the notes to consolidated financial statements.

Defined Benefit Pension Plan

We have a defined benefit pension plan covering substantially all employees. For employees hired prior to December 31, 2006, who met participation requirements on or before January 1, 2008 ("Tier 1 Participant"), the benefits are generally based on years of service and the employee's highest average compensation during five consecutive years of employment. For eligible employees who were hired on and after January 1, 2007 ("Tier 2 Participant"), the benefits are generally based on a cash balance benefit formula. Assumptions are made concerning future events that will determine the amount and timing of required benefit payments, funding requirements and defined benefit pension expense. The major assumptions are the weighted average discount rate used in determining the current benefit obligation, the weighted average expected long-term rate of return on plan assets, the rate of compensation increase and the estimated mortality rate. The weighted average discount rate was based upon the projected benefit cash flows and the market yields of high grade corporate bonds that are available to pay such cash flows as of the measurement date, December 31. The weighted average expected long-term rate of return is estimated based on current trends experienced by the assets in the plan as well as projected future rates of return on those assets and reasonable actuarial assumptions for long term inflation, and the real and nominal rate of investment return for a specific mix of asset classes. The current target asset allocation model for the plans is detailed in Note 21 to the consolidated financial statements. The expected returns on these various asset categories are blended to derive one long-term return assumption. The assets are invested in certain collective investment and mutual funds, common stocks, U.S. Treasury and other U.S. government agency securities, and corporate and municipal bonds and notes. The rate of compensation increase is based on reviewing the compensation increase practices of other plan sponsors in similar industries and geographic areas as well as the expectation of future increases. Mortality rate assumptions are based on mortality tables published by third-parties such as the Society of Actuaries ("SOA"), considering other available information including historical data as well as studies and publications from reputable sources. We review the pension plan assumptions on an annual basis with our actuarial consultants to determine if the assumptions are reasonable and adjust the assumptions to reflect changes in future expectations.

The assumptions used to calculate 2021 expense for the defined benefit pension plan were a weighted average discount rate of 2.32%, a weighted average long-term rate of return on plan assets of 5.25% and a rate of compensation increase of 3.00%. Defined benefit pension expense in 2022 is expected to decrease to \$1.8 million from the \$1.9 million recorded in 2021.

Due to the long-term nature of pension plan assumptions, actual results may differ significantly from the actuarial-based estimates. Differences resulting in actuarial gains or losses are required to be recorded in shareholders' equity as part of accumulated other comprehensive income (loss) and amortized to defined benefit pension expense in future years. For 2021, the actual return on plan assets in the qualified defined benefit pension plan was \$6.4 million, compared to an expected return on plan assets of \$5.2 million. Total pretax losses recognized in accumulated other comprehensive income (loss) at December 31, 2021 were \$12.6 million for the defined benefit pension plan. Actuarial pretax net gains recognized in other comprehensive income (loss) for the year ended December 31, 2021 were \$3.1 million for the defined benefit pension plan.

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

RECENT ACCOUNTING PRONOUNCEMENTS

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

ITEM 7A. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Asset-Liability Management

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

Portfolio Composition

Our balance sheet assets are a mix of fixed and variable rate assets with consumer indirect loans, commercial loans, and MBSs comprising a significant portion of our assets. Our consumer indirect loan portfolio comprised 17% of assets and is primarily fixed rate loans with relatively short durations. Our commercial loan portfolio totaled 37% of assets and is a combination of fixed and variable rate loans, lines and mortgages. The MBS portfolio, including collateralized mortgage obligations, totaled 23% of assets with durations averaging three to five years.

Our liabilities are comprised primarily of deposits, which account for 96% of total liabilities. Of these deposits, the majority, or 50%, is in nonpublic variable rate and noninterest bearing products including demand (both noninterest- and interest- bearing), savings and money market accounts. In addition, fixed rate nonpublic certificate of deposit products comprise 6% of total deposits. The Bank also has a significant amount of public deposits, which represented 23% of total deposits as of December 31, 2021.

Net Interest Income at Risk

A primary tool used to manage interest rate risk is “rate shock” simulation to measure the rate sensitivity. Rate shock simulation is a modeling technique used to estimate the impact of changes in rates on net interest income as well as economic value of equity.

Net interest income at risk is measured by estimating the changes in net interest income resulting from instantaneous and sustained parallel shifts in interest rates of different magnitudes over a period of 12 months. The following table sets forth the estimated changes to net interest income over the 12-month period ending December 31, 2022 assuming instantaneous changes in interest rates for the given rate shock scenarios (dollars in thousands):

	Changes in Interest Rate			
	-100 bp	+100 bp	+200 bp	+300 bp
Estimated change in net interest income	\$ (3,875)	\$ 548	\$ 1,346	\$ 2,035
% Change	(2.63)%	0.37%	0.91%	1.38%

In the rising rate scenarios, the model results indicate that net interest income is modeled to increase compared to the flat rate scenario over a one-year timeframe. This is a result of assumed commercial loan products and investment security cash flow repricing at a higher frequency than underlying borrowing and deposit costs. As intermediate and longer-term assets continue to mature and are replaced at higher yields, net interest income improves over longer term timeframes. Model results in the declining rate scenario indicate decreases in net interest income due to assets having the ability to reprice downward, while deposit and borrowing liabilities reach modeled floors.

In addition to the changes in interest rate scenarios listed above, other scenarios are typically modeled to measure interest rate risk. These scenarios vary depending on the economic and interest rate environment.

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

Economic Value of Equity At Risk

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

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

The analysis that follows presents the estimated EVE resulting from market interest rates prevailing at a given quarter-end (“Pre-Shock Scenario”), and under other interest rate scenarios (each a “Rate Shock Scenario”) represented by immediate, permanent, parallel shifts in interest rates from those observed at December 31, 2021 and 2020. The analysis additionally presents a measurement of the interest rate sensitivity at December 31, 2021 and 2020. EVE amounts are computed under each respective Pre-Shock Scenario and Rate Shock Scenario. An increase in the EVE amount is considered favorable, while a decline is considered unfavorable.

Rate Shock Scenario:	December 31, 2021			December 31, 2020		
	EVE	Change	Percentage Change	EVE	Change	Percentage Change
Pre-Shock Scenario	\$ 775,697			\$ 583,156		
- 100 Basis Points	746,770	\$ (28,927)	-3.73%	574,345	\$ (8,811)	-1.51%
+ 100 Basis Points	782,438	6,741	0.87	617,768	34,612	5.94
+ 200 Basis Points	786,362	10,665	1.37	638,224	55,068	9.44
+ 300 Basis Points	784,923	9,226	1.19	651,518	68,362	11.72

The Pre-Shock Scenario EVE was \$775.7 million at December 31, 2021, compared to \$583.2 million at December 31, 2020. The increase in the Pre-Shock Scenario EVE at December 31, 2021 compared to December 31, 2020 resulted primarily from growth in our investment securities portfolio, which is also the driver for the increased EVE Up Rate Shock Scenarios. The increase in sensitivity in the -100 basis point Rate Shock Scenario to EVE is a result of rates rising on a linked year basis, allowing for more sensitivity to downward rate movements. The sensitivity is further compounded by growth of fixed-rate long term assets which are not receiving the full value appreciation typically observed in down rate scenarios, due to discount rate flooring assumptions, coupled with continued growth of deposits through 2021.

Interest Rate Sensitivity Gap

The following table presents an analysis of our interest rate sensitivity gap position at December 31, 2021. All interest-earning assets and interest-bearing liabilities are shown based on the earlier of their contractual maturity or re-pricing date. The expected maturities are presented on a contractual basis or, if more relevant, based on projected call dates. Investment securities are at amortized cost for both securities available for sale and securities held to maturity. Loans, net of deferred loan origination costs, include principal amortization adjusted for estimated prepayments (principal payments in excess of contractual amounts) and non-accruing loans. Because the interest rate sensitivity levels shown in the table could be changed by external factors such as loan prepayments and liability decay rates or by factors controllable by us, such as asset sales, it is not an absolute reflection of our potential interest rate risk profile (in thousands).

	At December 31, 2021				
	Three Months or Less	Over Three Months Through One Year	Over One Year Through Five Years	Over Five Years	Total
INTEREST-EARNING ASSETS:					
Federal funds sold and other interest-earning deposits	\$ 29,304	\$ -	\$ 245	\$ -	\$ 29,549
Investment securities	69,248	171,911	643,549	505,713	1,390,421
Loans	1,386,180	551,159	1,324,897	423,402	3,685,638
Total interest-earning assets	<u>\$ 1,484,732</u>	<u>\$ 723,070</u>	<u>\$ 1,968,691</u>	<u>\$ 929,115</u>	<u>5,105,608</u>
Cash and due from banks					49,563
Other assets ⁽¹⁾					365,608
Total assets					<u>\$ 5,520,779</u>
INTEREST-BEARING LIABILITIES:					
Interest-bearing demand, savings and money market	\$ 2,797,575	\$ -	\$ -	\$ -	\$ 2,797,575
Time deposits	395,628	485,589	40,737	-	921,954
Borrowings	30,000	-	-	73,911	103,911
Total interest-bearing liabilities	<u>\$ 3,223,203</u>	<u>\$ 485,589</u>	<u>\$ 40,737</u>	<u>\$ 73,911</u>	<u>3,823,440</u>
Noninterest-bearing deposits					1,107,561
Other liabilities					84,636
Total liabilities					<u>5,015,637</u>
Shareholders' equity					505,142
Total liabilities and shareholders' equity					<u>\$ 5,520,779</u>
Interest sensitivity gap	<u>\$ (1,738,471)</u>	<u>\$ 237,481</u>	<u>\$ 1,927,954</u>	<u>\$ 855,204</u>	<u>\$ 1,282,168</u>
Cumulative gap	<u>\$ (1,738,471)</u>	<u>\$ (1,500,990)</u>	<u>\$ 426,964</u>	<u>\$ 1,282,168</u>	
Cumulative gap ratio ⁽²⁾	46.1%	59.5%	111.4%	133.5%	
Cumulative gap as a percentage of total assets	(31.5)%	(27.2)%	7.7%	23.2%	

⁽¹⁾ Includes net unrealized loss on securities available for sale and allowance for credit losses.

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

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

ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES
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Management's Report on Internal Control over Financial Reporting

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

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

The Company's management has, including the Company's principal executive officer and principal financial officer as identified below, assessed the effectiveness of the Company's internal control over financial reporting as of December 31, 2021. To make this assessment, we used the criteria for effective internal control over financial reporting described in *Internal Control – Integrated Framework (2013)*, issued by the Committee of Sponsoring Organizations of the Treadway Commission. Based on our assessment and based on such criteria, we believe that, as of December 31, 2021, the Company's internal control over financial reporting was effective.

RSM US LLP, the Company's independent registered public accounting firm that audited the Company's consolidated financial statements as of and for the year ended December 31, 2021 has issued a report on internal control over financial reporting as of December 31, 2021. That report appears herein.

/s/ *Martin K. Birmingham*
President and Chief Executive Officer
March 10, 2022

/s/ *W. Jack Plants, II*
Senior Vice President, Chief Financial Officer and Treasurer
March 10, 2022

Report of Independent Registered Public Accounting Firm

To the Shareholders and the Board of Directors of Financial Institutions, Inc.

Opinion on the Financial Statements

We have audited the accompanying consolidated statements of financial condition of Financial Institutions, Inc. and Subsidiaries (the Company) as of December 31, 2021 and 2020, the related consolidated statements of income, comprehensive income, changes in shareholders' equity and cash flows for each of the three years in the period ended December 31, 2021, and the related notes to the consolidated financial statements (collectively, the financial statements). In our opinion, the financial statements present fairly, in all material respects, the financial position of the Company as of December 31, 2021 and 2020, and the results of its operations and its cash flows for each of the three years in the period ended December 31, 2021, in conformity with accounting principles generally accepted in the United States of America.

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States) (PCAOB), the Company's internal control over financial reporting as of December 31, 2021, based on criteria established in *Internal Control — Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission in 2013, and our report dated March 10, 2022 expressed an unqualified opinion on the effectiveness of the Company's internal control over financial reporting.

Basis for Opinion

These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on the Company's financial statements based on our audits. We are a public accounting firm registered with the PCAOB and are required to be independent with respect to the Company in accordance with U.S. federal securities laws and the applicable rules and regulations of the Securities and Exchange Commission and the PCAOB.

We conducted our audits in accordance with the standards of the PCAOB. Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether due to error or fraud. Our audits included performing procedures to assess the risks of material misstatement of the financial statements, whether due to error or fraud, and performing procedures that respond to those risks. Such procedures included examining, on a test basis, evidence regarding the amounts and disclosures in the financial statements. Our audits also included evaluating the accounting principles used and significant estimates made by management, as well as evaluating the overall presentation of the financial statements. We believe that our audits provide a reasonable basis for our opinion.

Critical Audit Matter

The critical audit matter communicated below is a matter arising from the current period audit of the financial statements that was communicated or required to be communicated to the audit committee and that: (1) relates to accounts or disclosures that are material to the financial statements and (2) involved our especially challenging, subjective, or complex judgments. The communication of the critical audit matter does not alter in any way our opinion on the financial statements, taken as a whole, and we are not, by communicating the critical audit matter below, providing a separate opinion on the critical audit matter or on the accounts or disclosures to which it relates.

Allowance for Credit Losses – Loans

As described in Notes 1 and 6 to the financial statements, the Company's allowance for credit losses - loans was \$39,676,000 at December 31, 2021, which consisted of an allowance for credit losses for pooled loans (\$33,905,000) and a specific reserve for individually evaluated loans (\$5,771,000). Management estimates the allowance for credit losses for pooled loans utilizing a discounted cash flow (DCF) method. The DCF implements a probability of default with a loss given default applied to future cash flows that are adjusted to present value. The Company uses forecasts to predict how modeled economic factors will perform. In addition, qualitative factors that are likely to cause estimated credit losses to differ from historical loss experience, including but not limited to: national and local economic trends and conditions (excluding national unemployment), levels and trends in delinquencies, non-accrual loans and classified assets, trends in volume, terms and concentrations of loans, changes in lending policies and procedures, quality of credit review function and administration and changes in regulatory environment. The establishment of probability of default/loss given default, reasonable and supportable forecasts, and qualitative factor adjustments require a significant amount of judgement by management and involve a high degree of estimation uncertainty.

We identified the determination of the allowance for credit losses for pooled loans as a critical audit matter as auditing the underlying development of probability of default/loss given default, reasonable and supportable forecasts, and qualitative factor adjustments required significant auditor judgment as amounts determined by management rely on analyses that are highly subjective and include significant estimation uncertainty.

Our audit procedures related to the determination of the allowance for credit losses for pooled loans included the following, among others:

- We obtained an understanding of the relevant controls related to management’s establishment, review and approval of probability of default/loss given default, reasonable and supportable forecasts, and qualitative factor adjustments, and tested such controls for design and operating effectiveness.
- We tested the completeness and accuracy of data used by management in determining the probability of default/loss given default by agreeing this data to both internal and external information, as applicable.
- We evaluated the reasonableness of the forecasts utilized by management by comparing them to external information.
- We tested the completeness and accuracy of information, evaluated the appropriateness and agreed the qualitative factor adjustments included in the allowance for credit losses - loans calculation.

/s/ RSM US LLP

We have served as the Company’s auditor since 2018.

Chicago, Illinois

March 10, 2022

Report of Independent Registered Public Accounting Firm

To the Shareholders and the Board of Directors of Financial Institutions, Inc.

Opinion on the Internal Control Over Financial Reporting

We have audited Financial Institutions, Inc. and Subsidiaries' (the Company) internal control over financial reporting as of December 31, 2021, based on criteria established in *Internal Control — Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission in 2013. In our opinion, the Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 2021, based on criteria established in *Internal Control — Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission in 2013.

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States) (PCAOB), the consolidated statement of financial condition of the Company as of December 31, 2021, the related consolidated statements of income, comprehensive income, changes in shareholders' equity and cash flows for the year then ended, and the related notes to the consolidated financial statements of the Company and our report dated March 10, 2022 expressed an unqualified opinion.

Basis for Opinion

The Company's management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting in the accompanying Management's Report on Internal Control over Financial Reporting. Our responsibility is to express an opinion on the Company's internal control over financial reporting based on our audit. We are a public accounting firm registered with the PCAOB and are required to be independent with respect to the Company in accordance with U.S. federal securities laws and the applicable rules and regulations of the Securities and Exchange Commission and the PCAOB.

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

Definition and Limitations of Internal Control Over Financial Reporting

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

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

/s/ RSM US LLP

Chicago, Illinois
March 10, 2022

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

(in thousands, except share and per share data)

	December 31,	
	2021	2020
ASSETS		
Cash and due from banks	\$ 79,112	\$ 93,878
Securities available for sale, at fair value	1,178,515	628,059
Securities held to maturity, at amortized cost (net of allowance for credit losses of \$5 and \$7, respectively) (fair value of \$209,820 and \$282,035, respectively)	205,581	271,966
Loans held for sale	6,202	4,305
Loans (net of allowance for credit losses of \$39,676 and \$52,420, respectively)	3,639,760	3,542,718
Company owned life insurance	123,898	100,895
Premises and equipment, net	40,111	40,610
Goodwill and other intangible assets, net	74,400	73,789
Other assets	173,200	156,086
Total assets	\$ 5,520,779	\$ 4,912,306
LIABILITIES AND SHAREHOLDERS' EQUITY		
Deposits:		
Noninterest-bearing demand	\$ 1,107,561	\$ 1,018,549
Interest-bearing demand	864,528	731,885
Savings and money market	1,933,047	1,642,340
Time deposits	921,954	885,593
Total deposits	4,827,090	4,278,367
Short-term borrowings	30,000	5,300
Long-term borrowings, net of issuance costs of \$1,089 and \$1,377, respectively	73,911	73,623
Other liabilities	84,636	86,653
Total liabilities	5,015,637	4,443,943
Commitments and contingencies (Note 14)		
Shareholders' equity:		
Series A 3% preferred stock, \$100 par value; 1,533 shares authorized; 1,435 shares issued	143	143
Series B-1 8.48% preferred stock, \$100 par value; 200,000 shares authorized; 171,486 and 171,847 shares issued, respectively	17,149	17,185
Total preferred equity	17,292	17,328
Common stock, \$0.01 par value; 50,000,000 shares authorized; 16,099,556 shares issued	161	161
Additional paid-in capital	126,105	125,118
Retained earnings	384,007	324,850
Accumulated other comprehensive (loss) income	(13,207)	2,128
Treasury stock, at cost – 354,103 and 57,630 shares, respectively	(9,216)	(1,222)
Total shareholders' equity	505,142	468,363
Total liabilities and shareholders' equity	\$ 5,520,779	\$ 4,912,306

See accompanying notes to the consolidated financial statements.

FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES
Consolidated Statements of Income

(in thousands, except per share data)

	Years ended December 31,		
	2021	2020	2019
Interest income:			
Interest and fees on loans	\$ 147,898	\$ 143,520	\$ 149,873
Interest and dividends on investment securities	19,091	17,464	18,532
Other interest income	216	315	395
Total interest income	<u>167,205</u>	<u>161,299</u>	<u>168,800</u>
Interest expense:			
Deposits	8,118	17,822	28,494
Short-term borrowings	120	1,604	7,923
Long-term borrowings	4,237	2,888	2,471
Total interest expense	<u>12,475</u>	<u>22,314</u>	<u>38,888</u>
Net interest income	154,730	138,985	129,912
(Benefit) provision for credit losses	(8,336)	27,184	8,044
Net interest income after (benefit) provision for credit losses	<u>163,066</u>	<u>111,801</u>	<u>121,868</u>
Noninterest income:			
Service charges on deposits	5,571	4,810	7,241
Insurance income	5,750	4,403	4,570
Card interchange income	8,498	7,281	6,779
Investment advisory	11,672	9,535	9,187
Company owned life insurance	2,947	1,902	1,758
Investments in limited partnerships	2,081	104	352
Loan servicing	415	249	432
Income from derivative instruments, net	2,695	5,521	2,274
Net gain on sale of loans held for sale	2,950	3,858	1,352
Net gain on investment securities	71	1,599	1,677
Net gain (loss) on other assets	441	(61)	29
Net loss on tax credit investments	(431)	(275)	(528)
Other	4,246	4,250	5,258
Total noninterest income	<u>46,906</u>	<u>43,176</u>	<u>40,381</u>
Noninterest expense:			
Salaries and employee benefits	60,893	59,336	56,330
Occupancy and equipment	14,371	13,655	13,552
Professional services	6,535	6,326	5,424
Computer and data processing	14,112	11,645	9,983
Supplies and postage	1,769	1,975	2,036
FDIC assessments	2,624	2,242	1,005
Advertising and promotions	1,704	2,609	3,577
Amortization of intangibles	1,060	1,134	1,250
Restructuring charges	111	1,492	-
Other	9,571	8,840	9,671
Total noninterest expense	<u>112,750</u>	<u>109,254</u>	<u>102,828</u>
Income before income taxes	97,222	45,723	59,421
Income tax expense	19,525	7,391	10,559
Net income	<u>\$ 77,697</u>	<u>\$ 38,332</u>	<u>\$ 48,862</u>
Preferred stock dividends	1,460	1,461	1,461
Net income available to common shareholders	<u>\$ 76,237</u>	<u>\$ 36,871</u>	<u>\$ 47,401</u>
Earnings per common share (Note 20):			
Basic	\$ 4.81	\$ 2.30	\$ 2.97
Diluted	\$ 4.78	\$ 2.30	\$ 2.96
Cash dividends declared per common share	\$ 1.08	\$ 1.04	\$ 1.00
Weighted average common shares outstanding:			
Basic	15,841	16,022	15,972
Diluted	15,937	16,063	16,031

See accompanying notes to the consolidated financial statements.

FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES
Consolidated Statements of Comprehensive Income

(in thousands)

	Years ended December 31,		
	2021	2020	2019
Net income	\$ 77,697	\$ 38,332	\$ 48,862
Other comprehensive (loss) income, net of tax:			
Securities available for sale and transferred securities	(19,714)	13,870	9,323
Hedging derivative instruments	1,476	202	(242)
Pension and post-retirement obligations	2,903	2,569	470
Total other comprehensive (loss) income, net of tax	(15,335)	16,641	9,551
Comprehensive income	<u>\$ 62,362</u>	<u>\$ 54,973</u>	<u>\$ 58,413</u>

See accompanying notes to the consolidated financial statements.

FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES
Consolidated Statements of Changes in Shareholders' Equity
Years ended December 31, 2021, 2020 and 2019

<i>(in thousands, except per share data)</i>	Preferred Equity	Common Stock	Additional Paid-in Capital	Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Treasury Stock	Total Shareholders' Equity
Balance at December 31, 2018	\$ 17,328	\$ 161	\$ 122,704	\$ 279,867	\$ (21,281)	\$ (2,486)	\$ 396,293
Cumulative-effect adjustment	-	-	-	(710)	-	-	(710)
Balance at January 1, 2019	\$ 17,328	\$ 161	\$ 122,704	\$ 279,157	\$ (21,281)	\$ (2,486)	\$ 395,583
Comprehensive income:							
Net income	-	-	-	48,862	-	-	48,862
Other comprehensive income, net of tax	-	-	-	-	9,551	-	9,551
Reclassification of income tax effects	-	-	-	2,783	(2,783)	-	-
Common stock issued	-	-	1,151	-	-	-	1,151
Purchase of common stock for treasury	-	-	-	-	-	(293)	(293)
Share-based compensation plans:							
Share-based compensation	-	-	1,406	-	-	-	1,406
Restricted stock units released	-	-	(554)	-	-	554	-
Restricted stock awards issued, net	-	-	(165)	-	-	165	-
Stock awards	-	-	40	-	-	85	125
Cash dividends declared:							
Series A 3% Preferred-\$3.00 per share	-	-	-	(4)	-	-	(4)
Series B-1 8.48% Preferred-\$8.48 per share	-	-	-	(1,457)	-	-	(1,457)
Common-\$1.00 per share	-	-	-	(15,977)	-	-	(15,977)
Balance at December 31, 2019	\$ 17,328	\$ 161	\$ 124,582	\$ 313,364	\$ (14,513)	\$ (1,975)	\$ 438,947
Cumulative-effect adjustment	-	-	-	(8,719)	-	-	(8,719)
Balance at January 1, 2020	\$ 17,328	\$ 161	\$ 124,582	\$ 304,645	\$ (14,513)	\$ (1,975)	\$ 430,228
Comprehensive income:							
Net income	-	-	-	38,332	-	-	38,332
Other comprehensive income, net of tax	-	-	-	-	16,641	-	16,641
Purchase of common stock for treasury	-	-	-	-	-	(209)	(209)
Share-based compensation plans:							
Share-based compensation	-	-	1,333	-	-	-	1,333
Restricted stock units released	-	-	(511)	-	-	511	-
Restricted stock awards issued, net	-	-	(272)	-	-	272	-
Stock awards	-	-	(14)	-	-	179	165
Cash dividends declared:							
Series A 3% Preferred-\$3.00 per share	-	-	-	(4)	-	-	(4)
Series B-1 8.48% Preferred-\$8.48 per share	-	-	-	(1,457)	-	-	(1,457)
Common-\$1.04 per share	-	-	-	(16,666)	-	-	(16,666)
Balance at December 31, 2020	\$ 17,328	\$ 161	\$ 125,118	\$ 324,850	\$ 2,128	\$ (1,222)	\$ 468,363

Continued on next page

See accompanying notes to the consolidated financial statements.

FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES
Consolidated Statements of Changes in Shareholders' Equity (Continued)
Years ended December 31, 2021, 2020 and 2019

<i>(in thousands, except per share data)</i>	Preferred Equity	Common Stock	Additional Paid-in Capital	Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Treasury Stock	Total Shareholders' Equity
Balance at December 31, 2020	\$ 17,328	\$ 161	\$ 125,118	\$ 324,850	\$ 2,128	\$ (1,222)	\$ 468,363
Balance carried forward							
Comprehensive income:							
Net income	-	-	-	77,697	-	-	77,697
Other comprehensive loss, net of tax	-	-	-	-	(15,335)	-	(15,335)
Common stock issued	-	-	3	-	-	298	301
Purchases of common stock for treasury	-	-	-	-	-	(9,235)	(9,235)
Purchases of 8.48% preferred stock	(36)	-	(7)	-	-	-	(43)
Share-based compensation plans:							
Share-based compensation	-	-	1,743	-	-	-	1,743
Restricted stock units released	-	-	(574)	-	-	574	-
Restricted stock awards issued, net	-	-	(223)	-	-	223	-
Stock awards	-	-	45	-	-	146	191
Cash dividends declared:							
Series A 3% Preferred-\$3.00 per share	-	-	-	(4)	-	-	(4)
Series B-1 8.48% Preferred-\$8.48 per share	-	-	-	(1,456)	-	-	(1,456)
Common-\$1.08 per share	-	-	-	(17,080)	-	-	(17,080)
Balance at December 31, 2021	\$ 17,292	\$ 161	\$ 126,105	\$ 384,007	\$ (13,207)	\$ (9,216)	\$ 505,142

See accompanying notes to the consolidated financial statements.

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

(in thousands)

	Years ended December 31,		
	2021	2020	2019
Cash flows from operating activities:			
Net income	\$ 77,697	\$ 38,332	\$ 48,862
Adjustments to reconcile net income to net cash provided by operating activities:			
Depreciation and amortization	8,049	7,893	8,213
Net amortization of premiums on securities	5,493	3,474	2,069
(Benefit) provision for credit losses	(8,336)	27,184	8,044
Share-based compensation	1,743	1,333	1,406
Deferred income tax expense (benefit)	5,218	(4,523)	369
Proceeds from sale of loans held for sale	81,334	97,238	41,479
Originations of loans held for sale	(80,281)	(93,461)	(41,626)
Income on company owned life insurance	(2,947)	(1,902)	(1,758)
Net gain on sale of loans held for sale	(2,950)	(3,858)	(1,352)
Net gain on investment securities	(71)	(1,599)	(1,677)
Net (gain) loss on other assets	(441)	61	(29)
Noncash restructuring charges against assets	392	202	-
Increase in other assets	(9,342)	(37,565)	(21,263)
(Decrease) increase in other liabilities	(2,596)	10,646	14,973
Net cash provided by operating activities	<u>72,962</u>	<u>43,455</u>	<u>57,710</u>
Cash flows from investing activities:			
Purchases of investment securities:			
Available for sale	(784,064)	(396,879)	(195,660)
Held to maturity	(18,425)	(7,345)	(23,494)
Proceeds from principal payments, maturities and calls on investment securities:			
Available for sale	150,919	97,685	82,358
Held to maturity	83,684	93,046	83,508
Proceeds from sales of securities available for sale	51,891	107,098	178,059
Proceeds from sales of securities held to maturity	-	52	-
Net loan originations	(90,058)	(390,932)	(167,234)
Loans sold to others	-	-	21,077
Purchases of company owned life insurance, net of proceeds received	(20,056)	(30,051)	(68)
Proceeds from sales of other assets	3,510	519	360
Purchases of premises and equipment	(9,403)	(4,264)	(3,639)
Cash consideration paid for acquisition, net of cash acquired	(1,420)	-	-
Net cash used in investing activities	<u>(633,422)</u>	<u>(531,071)</u>	<u>(24,733)</u>
Cash flows from financing activities:			
Net increase in deposits	548,723	722,692	188,768
Net increase (decrease) in short-term borrowings	24,700	(270,200)	(194,000)
Repurchase of preferred stock	(43)	-	-
Issuance of long-term debt	-	35,000	-
Debt issuance costs	-	(779)	-
Purchases of common stock for treasury	(9,235)	(209)	(293)
Cash dividends paid to preferred shareholders	(1,460)	(1,461)	(1,461)
Cash dividends paid to common shareholders	(16,991)	(16,496)	(15,799)
Net cash provided by (used in) financing activities	<u>545,694</u>	<u>468,547</u>	<u>(22,785)</u>
Net (decrease) increase in cash and cash equivalents	(14,766)	(19,069)	10,192
Cash and cash equivalents, beginning of period	93,878	112,947	102,755
Cash and cash equivalents, end of period	<u>\$ 79,112</u>	<u>\$ 93,878</u>	<u>\$ 112,947</u>

See accompanying notes to the consolidated financial statements.

FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
December 31, 2021, 2020 and 2019

(1.) SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Financial Institutions, Inc. (individually referred to herein as the “Parent Company” and together with all of its subsidiaries, collectively referred to herein as the “Company”) is a financial holding company organized in 1931 under the laws of New York State (“New York”). At December 31, 2021, the Company conducted its business through its five subsidiaries: Five Star Bank (the “Bank”), a New York chartered bank; SDN Insurance Agency, LLC (“SDN”), a full service insurance agency; Courier Capital, LLC (“Courier Capital”) and HNP Capital, LLC (“HNP Capital”), SEC-registered investment advisory and wealth management firms; and Corn Hill Innovation Labs, LLC (“CHIL”), which oversees the Company's Banking as a Service and Fintech relationships. The Company provides a full range of banking and related financial services to consumer, commercial and municipal customers through its bank and nonbank subsidiaries.

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

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

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

(a.) Principles of Consolidation

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

(b.) Use of Estimates

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

(c.) Cash Flow Reporting

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

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

	2021	2020	2019
Supplemental information:			
Cash paid for interest	\$ 14,709	\$ 28,875	\$ 37,225
Cash paid for income taxes, net of refunds received	10,832	7,462	9,853
Noncash investing and financing activities:			
Real estate and other assets acquired in settlement of loans	\$ -	\$ 2,966	\$ 557
Accrued and declared unpaid dividends	4,624	4,535	4,365
Decrease in net unsettled security purchases	-	-	(2,650)
Securities transferred from held to maturity to available for sale (at cost)	-	-	26,175
Common stock issued for Courier Capital contingent earn-out	-	-	1,151
Common stock issued for acquisition	301	-	-
Assets acquired and liabilities assumed in business combinations:			
Fair value of assets acquired	712	-	-

FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
December 31, 2021, 2020 and 2019

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

(d.) Investment Securities

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

Purchase premiums and discounts are recognized in interest income using the interest method over the terms of the securities. Gains and losses on the sale of securities are recorded on the trade date and are determined using the specific identification method.

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

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

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

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

(f.) Loans

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

FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
December 31, 2021, 2020 and 2019

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

A loan is considered delinquent when a payment has not been received in accordance with the contractual terms. The accrual of interest income for commercial loans is discontinued when there is a clear indication that the borrower's cash flow may not be sufficient to meet payments as they become due, while the accrual of interest income for retail loans is discontinued when loans reach specific delinquency levels. Loans are generally placed on nonaccrual status when contractually past due 90 days or more as to interest or principal payments, unless the loan is well secured and in the process of collection. Additionally, if management becomes aware of facts or circumstances that may adversely impact the collectability of principal or interest on loans, it is management's practice to place such loans on a nonaccrual status immediately, rather than delaying such action until the loans become 90 days past due. When a loan is placed on nonaccrual status, previously accrued and uncollected interest is reversed, amortization of related deferred loan fees or costs is suspended, and income is recorded only to the extent that interest payments are subsequently received in cash and a determination has been made that the principal balance of the loan is collectible. If collectability of the principal is in doubt, payments received are applied to loan principal. A nonaccrual loan may be returned to accrual status when all delinquent principal and interest payments become current in accordance with the terms of the loan agreement, the borrower has demonstrated a period of sustained performance (generally a minimum of six months) and the ultimate collectability of the total contractual principal and interest is no longer in doubt.

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

A loan is accounted for as a troubled debt restructuring if the Company, for economic or legal reasons related to the borrower's financial condition, grants a significant concession to the borrower that it would not otherwise consider. A troubled debt restructuring may involve the receipt of assets from the debtor in partial or full satisfaction of the loan, or a modification of terms such as a reduction of the stated interest rate or face amount of the loan, a reduction of accrued interest, an extension of the maturity date at a stated interest rate lower than the current market rate for a new loan with similar risk, or some combination of these concessions. Troubled debt restructurings generally remain on nonaccrual status until there is a sustained period of payment performance (usually six months or longer) and there is a reasonable assurance that the payments will continue. See Allowance for Credit Losses below for further policy discussion and see Note 6 – Loans for additional information.

(g.) Off-Balance Sheet Financial Instruments

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

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

(h.) Allowance for Credit Losses

The allowance for credit losses ("ACL") is evaluated on a regular basis and established through charges to earnings in the form of a provision (benefit) for credit losses. When a loan or portion of a loan is determined to be uncollectible, the portion deemed uncollectible is charged against the allowance and subsequent recoveries, if any, are credited to the allowance. This evaluation is inherently subjective as it requires estimates that are susceptible to significant revision as more information becomes available.

FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
December 31, 2021, 2020 and 2019

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

Portfolio Segmentation and “Pooled Loans” Calculation

Loans are pooled based on their homogeneous risk characteristics. Once loans have been segmented into pools, a loss rate is applied to the amortized cost basis. The Company has divided its portfolio into six segments, as the loans within the segments have similar characteristics. Characteristics considered include: purpose, tenor, amortization, repayment source, payment frequency, collateral and recourse. The Company has identified six portfolio segments of loans including Commercial Loans/Lines, Commercial Mortgage, Indirect Loans, Direct Loans, Residential Lines of Credit, and Residential Loans.

The Company utilizes the Discounted Cash Flow (“DCF”) method for its pooled segment calculation. The DCF method implements a probability of default with loss given default and exposure at default estimation. The probability of default and loss given default are applied to future cash flows that are adjusted to present value and these discounted expected losses become the Allowance for Credit Losses.

DCF analysis is reliant upon a variety of loan-level data, peripheral model outputs and key assumptions. The data fields required to create the contractual portion of the forward-looking cash flow schedule relate to the terms of each loan and include information regarding payment amount, payment frequency, interest rate, interest type, maturity date, amortization term, etc. Contractual terms must be adjusted for prepayments to arrive at expected cashflows. The Company modeled amortizing/installment notes with a prepayment rate, annualized to one-year. For loans where principal collection is dominated by borrower election, e.g. lines of credit, interest-only, etc., and not by contractual obligation, the Company modeled a statistical tendency to repay as a curtailment rate, normalized to a one-year rate.

The Company uses forecasts to predict how modeled economic factors will perform. The Company currently elects to forecast economic factors over a period for which it can produce a reliable and defensible forecast from widely accepted economic forecast resources. After the forecast period, the following eight quarters are reverted on a straight-line basis to the economic factor’s average. The Company uses an eight-quarter straight-line reversion to reduce the potential for a spike impact on the model caused by a rapid reversion. Additionally, as the Company is past its point of forecast, a straight-line reversion represents a most-likely scenario absent a reasonable and supportable forecast.

In the Company’s analysis at the portfolio level, it found that the best model for predicting defaults considers the National Unemployment Rate. With the large number of observations afforded by using peer data, the default curve is less sensitive to unusual loss events and has a much smoother shape. The national unemployment rate is an extremely strong predictor of defaults and explains almost all variation in the default rate.

The reserve is calculated based on a life of loan basis. The life of loan is assumed with consideration of prepayments and contractual maturity dates. If a given loan does not have a populated maturity date, based upon historical experience, the Company elected to amortize the loan for a length of time equal to the average life of the loan’s segment before the remaining balance will balloon with the exception of Commercial Demand Lines of Credit where the Company uses one year, reflecting the demand nature of these exposures with annual review.

Management also considers Qualitative Factors (“QF”) that are likely to cause estimated credit losses with the Company’s existing portfolio to differ from historical loss experience, including but not limited to: national and local economic trends and conditions (excluding national unemployment), levels and trends in delinquencies, non-accrual loans and classified assets, trends in volume, terms and concentrations of loans, changes in lending policies and procedures, quality of credit review function and administration, and changes in regulatory environment. The Company will periodically assess what adjustments are necessary to qualitatively adjust the ACL based on their assessment of current expected credit losses.

The range for the QF in a specific pool represents the difference, in basis points, between the portfolio segment loss explained by the regression analysis (r-squared factor) and the total loss for that period, looking back to 2006, when the Company experienced its highest four quarter loss rate. In this approach, the Company is capturing, based upon historical experience, its largest potential loss rate. Where possible, the QFs are calculated using available data sources to support the allocation of basis points within the ranges. For example, delinquency for a segment is mapped backed to 2006 and current delinquency is allocated a QF based upon where it lies in that range.

FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
December 31, 2021, 2020 and 2019

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

Individually Evaluated Loans

Excluded from pooled analysis are loans to be individually evaluated due to the assets not maintaining similar risk characteristics to those in the six designated segments. These loans are generally considered to be collateral dependent and, therefore, an analysis of the collateral position versus the pooled loan discounted cash flow approach better reflects the potential loss. Individually evaluated accounts include: loans over 90 days past due, loans marked as Trouble Debt Restructure (“TDR”), loans placed on non-accrual status and criticized assets with exposure greater than \$2.0 million.

In addition, certain commercial loans are on long-term deferral due to the impacts of the COVID-19 pandemic. While not criticized assets, these loans reflect unique characteristics and warrant individual analysis. Management reviewed these loans and elected to remove certain loans from the pooled loan analysis based upon characteristics including industry, which evidence a higher risk of loss from the impact of the pandemic. These loans were individually evaluated, and reserves allocated to them based upon collateral position. Management continues to assess the status of these loans for risk characteristics.

Held to Maturity (“HTM”) Debt Securities

The Company’s HTM debt securities are also required to utilize the current expected credit losses approach to estimate expected credit losses. The Company’s HTM debt securities included securities that are issued by U.S. government agencies or U.S. government-sponsored enterprises. These securities carry the explicit and/or implicit guarantee of the U.S. government, are widely recognized as “risk free,” and have a long history of zero credit loss. The Company also carries a portfolio of HTM municipal bonds. The Company measures its allowance for credit losses on HTM debt securities on a collective basis by major security type. The estimate is based on historical credit losses, if any, adjusted for current conditions and reasonable and supportable forecasts. The Company considers the nature of the collateral, potential future changes in collateral values and available loss information.

Available for Sale (“AFS”) Debt Securities

For AFS securities in an unrealized loss position, we first assess whether (i) we intend to sell, or (ii) it is more likely than not that we will be required to sell the security before recovery of its amortized cost basis. If either case is affirmative, any previously recognized allowances are charged-off and the security's amortized cost is written down to fair value through income. If neither case is affirmative, the security is evaluated to determine whether the decline in fair value has resulted from credit losses or other factors. In making this assessment, management considers the extent to which fair value is less than amortized cost, any changes to the rating of the security by a rating agency and any adverse conditions specifically related to the security, among other factors. If this assessment indicates that a credit loss exists, the present value of cash flows expected to be collected from the security are compared to the amortized cost basis of the security. If the present value of cash flows expected to be collected is less than the amortized cost basis, a credit loss exists and an allowance for credit losses is recorded for the credit loss, limited by the amount that the fair value is less than the amortized cost basis. Any impairment that has not been recorded through an allowance for credit losses is recognized in other comprehensive income. Adjustments to the allowance are reported in our income statement as a component of provision for credit losses. AFS securities are charged-off against the allowance or, in the absence of any allowance, written down through income when deemed uncollectible by management or when either of the aforementioned criteria regarding intent or requirement to sell is met.

FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
December 31, 2021, 2020 and 2019

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

Accrued Interest Receivable

Upon adoption of ASU 2016-13 and its related amendments on January 1, 2020, the Company made the following elections regarding accrued interest receivable:

- Presenting accrued interest receivable balances separately within other assets on the statement of financial condition.
- Excluding accrued interest receivable that is included in the amortized cost of financing receivables and debt securities from related disclosure requirements.
- Continuing our policy to write off accrued interest receivable by reversing interest income. For commercial loans, the write off typically occurs upon becoming 90 days past due. For consumer loans, the write off typically occurs upon becoming 120 days past due. Historically, the Company has not experienced uncollectible accrued interest receivable on its investment securities. However, the Company would generally write off accrued interest receivable by reversing interest income if the Company does not reasonably expect to receive payments. Due to the timely manner in which accrued interest receivables are written off, the amounts of such write offs are immaterial.
- The Company had made the election with the adoption of ASU 2016-13 of not measuring an allowance for credit losses for accrued interest receivable due to the Company's policy of writing off uncollectible accrued interest receivable balances in a timely manner, as described above.

Reserve for Unfunded Commitments

The reserve for unfunded commitments (the "Unfunded Reserve") represents the expected credit losses on off-balance sheet commitments such as unfunded commitments to extend credit and standby letters of credit. However, a liability is not recognized for commitments unconditionally cancellable by the Company. The Unfunded Reserve is recognized as a liability (other liabilities in the consolidated statements of financial condition), with adjustments to the reserve recognized as a provision for credit loss expense in the consolidated statements of income. The Unfunded Reserve is determined by estimating expected future fundings, under each segment, and applying the expected loss rates. Expected future fundings are based on historical averages of funding rates (i.e., the likelihood of draws taken). Average funding rates are determined based on the most recent 20 quarters (5 years) of actual fundings on lines of credit. The average funding rate for each segment is compared to the current funding rate on each line to determine the average fundings available to be drawn. The fund up rate (the difference between the average funding rate and the current funding rate) for each segment is then applied within the CECL model to the unfunded commitment balance to estimate the expected future fundings under each segment. The loss rate derived for each segment in the current CECL calculation is then applied to the expected future fundings to derive the estimate of allowance for credit losses for unfunded commitments.

(i.) Other Real Estate Owned

Other real estate owned consists of properties acquired through foreclosure or by acceptance of a deed in lieu of foreclosure. These assets are initially recorded at fair value less estimated costs to sell, which establishes the cost basis. Subsequently, other real estate owned is carried at the lower of the cost basis or fair value less estimated selling costs. At the time of foreclosure, or when foreclosure occurs in-substance, the excess, if any, of the loan over the fair market value of the assets received, less estimated selling costs, is charged to the allowance for credit losses and any subsequent valuation write-downs are charged to other expense. In connection with the determination of the allowance for credit losses and the valuation of other real estate owned, management obtains appraisals for properties. Operating costs associated with the properties are charged to expense as incurred. Gains on the sale of other real estate owned are included in income when title has passed and the sale has met the minimum down payment requirements prescribed by GAAP. The balance of other real estate owned was \$0 and \$3.0 million at December 31, 2021 and 2020, respectively.

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

(j.) Company Owned Life Insurance

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

(k.) Premises and Equipment

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

(l.) Goodwill and Other Intangible Assets

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

Goodwill is not amortized but, instead, is subject to impairment tests on at least an annual basis, and more frequently if an event occurs or circumstances change that would more likely than not reduce the fair value of a reporting unit below its carrying amount. The impairment testing process is conducted by assigning net assets and goodwill to each reporting unit. An initial qualitative evaluation is made to assess the likelihood of impairment and determine whether further quantitative testing to calculate the fair value is necessary. When the qualitative evaluation indicates that impairment is more likely than not, quantitative testing is required whereby the fair value of each reporting unit is calculated and compared to the recorded book value. If the calculated fair value of the reporting unit exceeds its carrying value, then goodwill is not considered impaired. However, if the carrying value of a reporting unit exceeds its calculated fair value, a goodwill impairment charge is recognized. See Note 8 for additional information on goodwill and other intangible assets.

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

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

As a member of the FHLB system, the Company is required to maintain a specified investment in FHLB of New York ("FHLB NY") stock in proportion to its volume of certain transactions with the FHLB. FHLB NY stock totaled \$4.4 million and \$2.6 million as of December 31, 2021 and 2020, respectively.

As a member of the FRB system, the Company is required to maintain a specified investment in FRB stock based on a ratio relative to the Company's capital. FRB stock totaled \$6.4 million and \$6.1 million as of December 31, 2021 and 2020, respectively.

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

(n.) Equity Method Investments

The Company has investments in limited partnerships, primarily Small Business Investment Companies, and accounts for these investments under the equity method. These investments are included in other assets in the consolidated statements of financial condition and totaled \$9.9 million and \$7.9 million as of December 31, 2021 and 2020, respectively.

(o.) Derivative Instruments and Hedging Activities

Financial Accounting Standards Board (“FASB”) Accounting Standards Codification (“ASC”) Topic 815, Derivatives and Hedging (“ASC 815”), provides the disclosure requirements for derivatives and hedging activities with the intent to provide users of financial statements with an enhanced understanding of: (a) how and why an entity uses derivative instruments, (b) how the entity accounts for derivative instruments and related hedged items, and (c) how derivative instruments and related hedged items affect an entity’s financial position, financial performance, and cash flows. Further, qualitative disclosures are required that explain the Company’s objectives and strategies for using derivatives, as well as quantitative disclosures about the fair value of and gains and losses on derivative instruments, and disclosures about credit-risk-related contingent features in derivative instruments.

As required by ASC 815, the Company records all derivatives on the balance sheet at fair value. The accounting for changes in the fair value of derivatives depends on the intended use of the derivative. Changes in fair value of the Company’s derivatives designated in a qualifying hedging relationship are recorded in accumulated other comprehensive income (loss). Changes in fair value of the Company’s derivatives not designated in a qualifying hedging relationship are recognized directly in earnings.

In accordance with the FASB’s fair value measurement guidance, the Company made an accounting policy election to measure the credit risk of its derivative financial instruments that are subject to master netting agreements on a net basis by counterparty portfolio.

(p.) Treasury Stock

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

(q.) Transfers of Financial Assets

Transfers of financial assets are accounted for as sales, when control over the assets has been surrendered. Control over financial assets is deemed surrendered when the assets have been isolated from the Company, the transferee obtains the right (free of conditions that constrain it from taking advantage of the right) to pledge or exchange the transferred assets and the Company does not maintain effective control over the transferred assets through an agreement to repurchase them before their maturity.

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

(r.) Revenue Recognition

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

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

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

(s.) Employee Benefits

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

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

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

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

(t.) Share-Based Compensation Plans

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

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

FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES
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December 31, 2021, 2020 and 2019

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

(u.) Income Taxes

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

The Company has investments directly and indirectly in several limited partnerships formed by third parties that generate investment tax credits related to rehabilitation of certified real property and qualified affordable housing projects. As a limited partner in the partnerships, we have determined that we are not the primary beneficiary of these investments because the general partners have the power to direct the activities that most significantly influence the economic performance of their respective partnerships and have the obligation to absorb expected losses and the right to receive residual returns. As we are not the primary beneficiary of these investments, we do not consolidate them.

For limited partnerships that generate tax credits related to the rehabilitation of certified real property, at the time that a structure is placed into service, the limited partnership is eligible for federal and New York State tax credits. The federal tax credit impact is recorded as a reduction of income tax expense. For a New York State tax credit generated after January 1, 2015, the amount not used in the current tax year is treated as a refund or overpayment of tax to be credited to next year's tax. Since the realization of the tax credit does not depend on the Company's generation of future taxable income or the Company's ongoing tax status or tax position, the credit is not considered an element of income tax accounting (ASC 740). The Company includes the tax credit in non-interest income as opposed to a reduction of income tax expense. At the time that a structure is placed into service, the Company records a loss on tax credit investments in noninterest income to reduce the investment to the present value of the expected cash flows from its partnership interest.

For limited partnerships that generate tax credits related to qualified affordable housing projects, the investments are accounted for using the proportional amortization method. Under this method, the Company amortizes the initial cost of the investment in proportion to the tax credits and other tax benefits received and recognizes the net amount as a reduction of income tax expense.

The tax credit investments are included in other assets in the consolidated statements of financial condition and totaled \$57.0 million and \$34.4 million as of December 31, 2021 and 2020, respectively. We do not have any loss reserves recorded related to these investments because we believe the likelihood of any loss is remote. For all legally binding unfunded equity commitments, we increase our recognized investment and recognize a liability. As of December 31, 2021 and 2020, we had liabilities of \$20.2 million and \$17.5 million, respectively, related to these investments that are included in other liabilities in the consolidated statements of financial condition. We continue to invest in these limited partnerships.

(v.) Comprehensive Income (Loss)

Comprehensive income (loss) includes all changes in shareholders' equity during a period, except those resulting from transactions with shareholders. In addition to net income, other components of the Company's comprehensive income (loss) include the after-tax effect of changes in net unrealized gain / loss on securities available for sale, changes in unrealized gain / loss on hedging derivative instruments and changes in net actuarial gain / loss on defined benefit post-retirement plans. Comprehensive income (loss) is reported in the accompanying consolidated statements of changes in shareholders' equity and consolidated statements of comprehensive income (loss). See Note 17 - Accumulated Other Comprehensive Income (Loss) for additional information.

(w.) Earnings Per Common Share

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

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

Basic EPS is computed by dividing distributed and undistributed earnings available to common shareholders by the weighted average number of common shares outstanding for the period. Distributed and undistributed earnings available to common shareholders represent net income reduced by preferred stock dividends and distributed and undistributed earnings available to participating securities. Common shares outstanding include common stock and vested restricted stock awards. Diluted EPS reflects the assumed conversion of all potential dilutive securities. A reconciliation of the weighted-average shares used in calculating basic earnings per common share and the weighted average common shares used in calculating diluted earnings per common share for the reported periods is provided in Note 20 - Earnings Per Common Share.

(x.) Reclassifications

Certain items in prior financial statements have been reclassified to conform to the current presentation. These reclassifications did not result in any changes to previously reported net income or shareholders' equity.

(y.) Recent Accounting Pronouncements

In 2017, the United Kingdom's Financial Conduct Authority ("FCA"), who is responsible for regulating the London Interbank Offered Rate ("LIBOR"), announced its intention that it would no longer be necessary to persuade or compel its panel banks to submit LIBOR rates after December 31, 2021. On March 5, 2021, the ICE Benchmark Administration ("IBA"), the administrator of LIBOR, released the results of its consultation on the cessation timeline for certain LIBOR tenors. In coordination with the IBA, the FCA also confirmed when certain LIBOR tenors will cease to exist. The results of the consultation indicated that certain LIBOR tenors (overnight, one-month, three-month, six-month, and twelve-month USD LIBOR) will be extended to June 30, 2023 to allow some legacy contracts that cannot be easily amended to mature on their current terms. Notwithstanding the extension of certain LIBOR tenors to 2023, banks may no longer offer new LIBOR-based contracts after December 31, 2021. Given that LIBOR is a widely used pricing index for loan and derivative contracts, a Company-wide initiative was introduced to assess all LIBOR exposures through the Company's loan, deposit, borrowing and derivative categories, while developing a plan for the ultimate cessation of the index. In developing the transition plan, the Company has followed best practice recommendations from the Federal Reserve's Alternative Reference Rate Committee, our third-party derivative advisor and the Internal Swaps and Derivatives Association. To date, the Company has identified the portion of loan notes that reference LIBOR, which are primarily representative of commercial relationships. Additionally, the Company has one designated derivative instrument that is utilized to hedge the LIBOR characteristic of a future dated borrowing (i.e. Federal Home Loan Bank Advance). In 2015, the Company issued \$40 million in fixed to floating rate subordinated notes that currently bear a fixed rate of interest at 6.00% until April 2025, when the rate converts to a floating rate equal to three-month LIBOR plus 3.944%; the indenture under which the notes were issued includes language allowing an alternate index to be applied in the event that LIBOR becomes unavailable at the floating rate determination date. At this time, no other borrowing or deposit relationships have been identified that utilize LIBOR as an index.

In March 2020, the FASB issued ASU No. 2020-04, *Reference Rate Reform (Topic 848): Facilitation of the Effects of Reference Rate Reform on Financial Reporting*. The ASU provides temporary optional expedients and exceptions to GAAP guidance on contract modifications and hedge accounting to ease the financial reporting burdens of the expected market transition from LIBOR and other interbank offered rates to alternative rates, such as SOFR. ASU 2020-04 became effective during the first quarter of 2020 and applies to contract modifications and amendments made as of the beginning of the reporting period including the ASU's issuance date, March 12, 2020, through December 31, 2022. The adoption of this guidance in 2020 resulted in the application of certain practical expedients, which did not have a material effect on the Company's consolidated financial statements.

In January 2021, the FASB issued ASU No. 2021-01, *Reference Rate Reform (Topic 848): Scope*. The ASU clarifies that certain optional expedients and exceptions in ASC 848 for contract modifications and hedge accounting apply to derivatives that are affected by the discounting transition. The ASU also amends the expedients and exceptions in ASC 848 to capture the incremental consequences of the scope clarification and to tailor the existing guidance to derivative instruments affected by the discounting transition. ASU 2021-01 was effective upon issuance and applies through December 31, 2022. The adoption of this guidance resulted in the application of certain practical expedients, which did not have a material effect on the Company's consolidated financial statements.

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(2.) BUSINESS COMBINATIONS

On February 1, 2021, SDN completed the acquisition of the assets of Landmark Group (“Landmark”), an independent insurance brokerage firm. Consideration for the acquisition included common shares of Company stock and cash. As a result of the acquisition, SDN recorded goodwill of \$611 thousand and other intangible assets of \$399 thousand. The goodwill and other intangible assets are expected to be deductible for income tax purposes. The allocation of acquisition cost to the assets acquired and liabilities assumed and pro forma results of operations for this acquisition have not been presented because the effect of this acquisition was not material to the Company’s consolidated financial statements.

On August 2, 2021, SDN completed the acquisition of the assets of North Woods Capital Benefits LLC ("North Woods"), an employee benefits and human resources advisory firm. As a result of the acquisition, SDN recorded goodwill of \$399 thousand and other intangible assets of \$263 thousand. The goodwill and other intangible assets are expected to be deductible for income tax purposes. The allocation of acquisition cost to the assets acquired and liabilities assumed and pro forma results of operations for this acquisition have not been presented because the effect of this acquisition was not material to the Company’s consolidated financial statements.

There were no business combinations during 2020 or 2019.

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(3.) RESTRUCTURING CHARGES

On July 17, 2020, the Bank announced management's decision to adopt a full-service branch model that streamlines retail branches to better align with shifting customer needs and preferences. The transformation resulted in six branch closures and a reduction in staffing. The announcement was the result of a nine-month comprehensive assessment of all lines of business and functional areas, conducted in partnership with a leading process improvement organization. The data-driven analysis identified, among other things, overlapping service areas, automation opportunities and streamlining of processes and operations that would enhance customer experiences and facilitate the long-term sustainability of current and future branches. The announced consolidations represented about ten percent of the branch network and impacted approximately six percent of the total Company workforce. Where possible, those impacted were offered alternative roles or the opportunity to apply for open positions in other areas of the Company. Separated associates received a comprehensive severance package based on tenure.

In October 2020, the Company announced the planned closure of one additional branch in January 2021. This location was not included in the branch consolidations announced in July 2020, as alternative options were being considered and consolidation was not possible given its significant distance from other Bank branches.

The Company incurred total pre-tax expense related to the branch closures of approximately \$1.7 million, including approximately \$0.2 million in employee severance, \$0.5 million in lease termination costs and \$1.0 million in valuation adjustments on branch facilities during 2020. Additional related restructuring charges of \$111 thousand were incurred in 2021 as a result of property valuation adjustments. The Company expects approximately \$0.4 million of total costs will result in future cash expenditures. The Company anticipates annual expense savings of approximately \$2.7 million as a result of these branch closures.

The following table represents the consolidated statements of income classification of the Company's restructuring charges (in thousands):

	Income Statement Location	2021	2020	2019
Severance costs	Salaries and employee benefits	\$ -	\$ 242	\$ -
Lease termination costs	Restructuring charges	-	454	-
Valuation adjustments	Restructuring charges	111	1,038	-
Valuation adjustments	Net loss (gain) on sale of other assets	11	-	-
Total		<u>\$ 122</u>	<u>\$ 1,734</u>	<u>\$ -</u>

The following table represents the changes in the restructuring reserve (in thousands):

Balance, January 1, 2019	\$ -
No activity during the period	-
Balance, December 31, 2019	-
Restructuring charges	1,734
Cash payments	(287)
Charges against assets	(202)
Balance, December 31, 2020	1,245
Restructuring charges	122
Cash payments	(192)
Charges against assets	(730)
Balance, December 31, 2021	<u>\$ 445</u>

In contemplation of the transactions noted above, certain long-lived assets had met the held for sale criteria as of December 31, 2021. Long lived assets held for sale totaled \$3.2 million as of December 31, 2021 and is included in other assets on the Company's consolidated statement of financial position. No long-lived assets had met the held for sale criteria as of December 31, 2020. For the year ended December 31, 2021 the Company recognized a gain of \$111 thousand on the sale of certain long-lived assets held for sale.

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(4.) INVESTMENT SECURITIES

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

	<u>Amortized Cost</u>	<u>Unrealized Gains</u>	<u>Unrealized Losses</u>	<u>Fair Value</u>
December 31, 2021				
Securities available for sale:				
U.S. Government agencies and government sponsored enterprises	\$ 15,793	\$ 195	\$ 97	\$ 15,891
Mortgage-backed securities:				
Federal National Mortgage Association	576,163	6,565	5,242	577,486
Federal Home Loan Mortgage Corporation	430,010	952	6,435	424,527
Government National Mortgage Association	122,266	298	2,082	120,482
Collateralized mortgage obligations:				
Federal National Mortgage Association	15,346	26	433	14,939
Federal Home Loan Mortgage Corporation	25,257	-	477	24,780
Privately issued	-	410	-	410
Total mortgage-backed securities	<u>1,169,042</u>	<u>8,251</u>	<u>14,669</u>	<u>1,162,624</u>
Total available for sale securities	<u>\$ 1,184,835</u>	<u>\$ 8,446</u>	<u>\$ 14,766</u>	<u>\$ 1,178,515</u>
Securities held to maturity:				
State and political subdivisions	\$ 111,399	\$ 2,412	\$ 300	\$ 113,511
Mortgage-backed securities:				
Federal National Mortgage Association	9,275	411	-	9,686
Federal Home Loan Mortgage Corporation	8,706	137	144	8,699
Government National Mortgage Association	27,400	706	2	28,104
Collateralized mortgage obligations:				
Federal National Mortgage Association	19,485	368	3	19,850
Federal Home Loan Mortgage Corporation	23,840	565	-	24,405
Government National Mortgage Association	5,481	84	-	5,565
Total mortgage-backed securities	<u>94,187</u>	<u>2,271</u>	<u>149</u>	<u>96,309</u>
Total held to maturity securities	<u>205,586</u>	<u>\$ 4,683</u>	<u>\$ 449</u>	<u>\$ 209,820</u>
Allowance for credit losses - securities	(5)			
Total held to maturity securities, net	<u>\$ 205,581</u>			
December 31, 2020				
Securities available for sale:				
U.S. Government agencies and government sponsored enterprises	\$ 6,239	\$ 396	\$ -	\$ 6,635
Mortgage-backed securities:				
Federal National Mortgage Association	350,627	15,549	44	366,132
Federal Home Loan Mortgage Corporation	225,645	3,155	24	228,776
Government National Mortgage Association	22,107	830	-	22,937
Collateralized mortgage obligations:				
Federal National Mortgage Association	3,047	97	-	3,144
Federal Home Loan Mortgage Corporation	-	-	-	-
Privately issued	-	435	-	435
Total mortgage-backed securities	<u>601,426</u>	<u>20,066</u>	<u>68</u>	<u>621,424</u>
Total available for sale securities	<u>\$ 607,665</u>	<u>\$ 20,462</u>	<u>\$ 68</u>	<u>\$ 628,059</u>

FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
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(4.) INVESTMENT SECURITIES (Continued)

	Amortized Cost	Unrealized Gains	Unrealized Losses	Fair Value
December 31, 2020 (continued)				
Securities held to maturity:				
State and political subdivisions	\$ 144,506	\$ 4,478	\$ -	\$ 148,984
Mortgage-backed securities:				
Federal National Mortgage Association	10,776	703	-	11,479
Federal Home Loan Mortgage Corporation	5,858	382	-	6,240
Government National Mortgage Association	37,084	1,578	-	38,662
Collateralized mortgage obligations:				
Federal National Mortgage Association	29,988	1,075	-	31,063
Federal Home Loan Mortgage Corporation	35,897	1,581	-	37,478
Government National Mortgage Association	7,864	265	-	8,129
Total mortgage-backed securities	127,467	5,584	-	133,051
Total held to maturity securities	\$ 271,973	\$ 10,062	\$ -	\$ 282,035
Allowance for credit losses - securities	(7)			
Total held to maturity securities, net	\$ 271,966			

The Company elected to exclude accrued interest receivable (“AIR”) from the amortized cost basis of debt securities disclosed throughout this footnote. For AFS debt securities, AIR totaled \$2.1 million and \$1.2 million as of December 31, 2021 and December 31, 2020, respectively. For HTM debt securities, AIR totaled \$696 thousand and \$905 thousand as of December 31, 2021 and December 31, 2020, respectively. AIR is included in other assets on the Company’s consolidated statements of financial condition.

For the years ended December 31, 2021 and 2020, credit loss (credit) expense for HTM investment securities was \$(5) thousand and \$(7) thousand, respectively.

Investment securities with a total fair value of \$637.6 million and \$567.4 million at December 31, 2021 and 2020, respectively, were pledged as collateral to secure public deposits and for other purposes required or permitted by law.

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

	2021	2020	2019
Taxable interest and dividends	\$ 16,736	\$ 14,186	\$ 14,382
Tax-exempt interest and dividends	2,355	3,278	4,150
Total interest and dividends on securities	\$ 19,091	\$ 17,464	\$ 18,532

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

	2021	2020	2019
Proceeds from sales	\$ 51,891	\$ 107,098	\$ 178,059
Gross realized gains	251	1,642	2,391
Gross realized losses	180	43	714

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

The scheduled maturities of securities available for sale and securities held to maturity at December 31, 2021 are shown below (in thousands). Actual expected maturities may differ from contractual maturities because issuers may have the right to call or prepay obligations.

	Amortized Cost	Fair Value
Debt securities available for sale:		
Due in one year or less	\$ 1,469	\$ 1,479
Due from one to five years	64,526	66,843
Due after five years through ten years	178,918	182,096
Due after ten years	939,922	928,097
Total available for sale securities	<u>\$ 1,184,835</u>	<u>\$ 1,178,515</u>
Debt securities held to maturity:		
Due in one year or less	\$ 35,419	\$ 35,700
Due from one to five years	68,054	70,227
Due after five years through ten years	19,209	19,414
Due after ten years	82,904	84,479
Total held to maturity securities	<u>\$ 205,586</u>	<u>\$ 209,820</u>

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

Unrealized losses on investment securities for which an allowance for credit losses has not been recorded and the fair value of the related securities, aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position as of December 31 are summarized as follows (in thousands):

	Less than 12 months		12 months or longer		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
December 31, 2021						
Securities available for sale:						
U.S. Government agencies and government sponsored enterprises	\$ 9,438	\$ 97	\$ -	\$ -	\$ 9,438	\$ 97
Mortgage-backed securities:						
Federal National Mortgage Association	333,489	3,597	61,249	1,645	394,738	5,242
Federal Home Loan Mortgage Corporation	283,965	3,353	110,931	3,082	394,896	6,435
Government National Mortgage Association	108,448	2,082	-	-	108,448	2,082
Collateralized mortgage obligations:						
Federal National Mortgage Association	13,364	433	-	-	13,364	433
Federal Home Loan Mortgage Corporation	24,780	477	-	-	24,780	477
Total mortgage-backed securities	764,046	9,942	172,180	4,727	936,226	14,669
Total available for sale securities	773,484	10,039	172,180	4,727	945,664	14,766
Total temporarily impaired securities	<u>\$ 773,484</u>	<u>\$ 10,039</u>	<u>\$ 172,180</u>	<u>\$ 4,727</u>	<u>\$ 945,664</u>	<u>\$ 14,766</u>
December 31, 2020						
Securities available for sale:						
U.S. Government agencies and government sponsored enterprises	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -
Mortgage-backed securities:						
Federal National Mortgage Association	18,155	44	-	-	18,155	44
Federal Home Loan Mortgage Corporation	10,932	24	-	-	10,932	24
Government National Mortgage Association	-	-	-	-	-	-
Collateralized mortgage obligations:						
Federal National Mortgage Association	-	-	8	-	8	-
Federal Home Loan Mortgage Corporation	-	-	-	-	-	-
Privately issued	-	-	-	-	-	-
Total mortgage-backed securities	29,087	68	8	-	29,095	68
Total available for sale securities	29,087	68	8	-	29,095	68
Total temporarily impaired securities	<u>\$ 29,087</u>	<u>\$ 68</u>	<u>\$ 8</u>	<u>\$ -</u>	<u>\$ 29,095</u>	<u>\$ 68</u>

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

The total number of security positions, for which an allowance for credit losses has not been recorded, in the investment portfolio in an unrealized loss position at December 31, 2021 was 116 compared to eight at December 31, 2020. At December 31, 2021, the Company had a position in 28 investment securities with a fair value of \$172.2 million dollars and a total unrealized loss of \$4.7 million dollars that has been in a continuous unrealized loss position for more than 12 months. At December 31, 2021, there were a total of 88 securities positions in the Company's investment portfolio with a fair value of \$773.5 million and a total unrealized loss of \$10.0 million that had been in a continuous unrealized loss position for less than 12 months. At December 31, 2020, the Company had a position in one investment security with a fair value of eight thousand dollars and a total unrealized loss of less than one thousand dollars that has been in a continuous unrealized loss position for more than 12 months. At December 31, 2020, there were a total of seven securities positions in the Company's investment portfolio with a fair value of \$29.1 million and a total unrealized loss of \$68 thousand that had been in a continuous unrealized loss position for less than 12 months. The unrealized loss on investment securities was predominantly caused by changes in market interest rates subsequent to purchase. The fair value of most of the investment securities in the Company's portfolio fluctuates as market interest rates change.

Securities Available for Sale

As of December 31, 2021, no allowance for credit losses has been recognized on available for sale securities in an unrealized loss position as management does not believe any of the securities are impaired due to reasons of credit quality. This is based upon our analysis of the underlying risk characteristics, including credit ratings, and other qualitative factors related to our available for sale securities and in consideration of our historical credit loss experience and internal forecasts. The issuers of these securities continue to make timely principal and interest payments under the contractual terms of the securities. Furthermore, management does not have the intent to sell any of the securities classified as available for sale in the table above and believes that it is more likely than not that we will not have to sell any such securities before a recovery of cost. The unrealized losses are 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 securities approach their maturity date or repricing date or if market yields for such investments decline.

Securities Held to Maturity

The Company's HTM investment securities include debt securities that are issued by U.S. government agencies or U.S. government-sponsored enterprises. These securities carry the explicit and/or implicit guarantee of the U.S. government, are widely recognized as "risk free," and have a long history of zero credit loss. In addition, the Company's HTM investment securities include debt securities that are issued by state and local government agencies, or municipal bonds.

The Company monitors the credit quality of our municipal bonds through the use of a credit rating agency or by ratings that are derived by an internal scoring model. The scoring methodology for the internally derived ratings is based on a series of financial ratios for the municipality being reviewed as compared to typical industry figures. This information is used to determine the financial strengths and weaknesses of the municipality, which is indicated with a numeric rating. This number is then converted into a letter rating to better match the system used by the credit rating agencies. As of December 31, 2021, \$105.6 million of our municipal bonds were rated as an equivalent to Standard & Poor's A/AA/AAA, with \$5.8 million internally rated to be the equivalent of Standard & Poor's A/AA/AAA rating. Additionally, no municipal bonds were rated below investment grade. As of December 31, 2020, \$135.7 million of our municipal bonds were rated as an equivalent to Standard & Poor's A/AA/AAA, with \$8.5 million internally rated to be the equivalent of Standard & Poor's A/AA/AAA rating. Additionally, as of December 31, 2020, one municipal bond was rated below investment grade, with a BB+ Standard & Poor's equivalent rating. The below investment grade bond represented exposure of \$279 thousand, or 0.19% of the municipal bond portfolio and had been closely monitored for repayment.

As of December 31, 2021, the Company had no past due or nonaccrual held to maturity investment securities.

FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES
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(5.) LOANS HELD FOR SALE AND LOAN SERVICING RIGHTS

Loans held for sale were entirely comprised of residential real estate loans and totaled \$6.2 million and \$4.3 million as of December 31, 2021 and 2020, respectively.

The Company sells certain qualifying newly originated or refinanced residential real estate loans on the secondary market. Residential real estate loans serviced for others, which are not included in the consolidated statements of financial condition, amounted to \$272.7 million and \$241.7 million as of December 31, 2021 and 2020, respectively. In connection with these mortgage-servicing activities, the Company administered escrow and other custodial funds which amounted to approximately \$4.9 million and \$4.5 million as of December 31, 2021 and 2020, respectively.

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

	2021	2020	2019
Mortgage servicing assets, beginning of year	\$ 1,376	\$ 1,129	\$ 1,022
Originations	520	601	349
Amortization	(378)	(354)	(242)
Mortgage servicing assets, end of year	1,518	1,376	1,129
Valuation allowance	(1)	(56)	-
Mortgage servicing assets, net, end of year	<u>\$ 1,517</u>	<u>\$ 1,320</u>	<u>\$ 1,129</u>

(6.) LOANS

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

	Principal Amount Outstanding	Net Deferred Loan (Fees) Costs	Loans, Net
2021			
Commercial business	\$ 639,368	\$ (1,075)	\$ 638,293
Commercial mortgage	1,415,486	(2,698)	1,412,788
Residential real estate loans	563,579	13,720	577,299
Residential real estate lines	75,515	3,016	78,531
Consumer indirect	923,052	34,996	958,048
Other consumer	14,355	122	14,477
Total	<u>\$ 3,631,355</u>	<u>\$ 48,081</u>	3,679,436
Allowance for credit losses - loans			(39,676)
Total loans, net			<u>\$ 3,639,760</u>
2020			
Commercial business	\$ 798,409	\$ (4,261)	\$ 794,148
Commercial mortgage	1,256,525	(2,624)	1,253,901
Residential real estate loans	586,537	13,263	599,800
Residential real estate lines	86,708	3,097	89,805
Consumer indirect	812,816	27,605	840,421
Other consumer	16,913	150	17,063
Total	<u>\$ 3,557,908</u>	<u>\$ 37,230</u>	3,595,138
Allowance for credit losses - loans			(52,420)
Total loans, net			<u>\$ 3,542,718</u>

FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
December 31, 2021, 2020 and 2019

(6.) LOANS (Continued)

The CARES Act was passed by Congress and signed into law on March 27, 2020. The CARES Act established the PPP, an expansion of the SBA's 7(a) loan program and the EIDL, administered directly by the SBA. The Company had \$57.5 million and \$253.1 million of PPP loans, principal amount outstanding (included in Commercial business above) as of December 31, 2021 and 2020, respectively. In addition, the CARES Act provides that a financial institution may elect to suspend (1) the application of GAAP for certain loan modifications related to COVID-19 that would otherwise be categorized as a TDR and (2) any determination that such loan modifications would be considered a TDR, including the related impairment for accounting purposes. Accordingly, the Company had \$532.4 million of loans with modifications related to COVID-19 during 2020, with \$46.2 million and \$113.0 million still on deferral as of December 31, 2021 and 2020, respectively.

The Company elected to exclude AIR from the amortized cost basis of loans disclosed throughout this footnote. As of December 31, 2021 and December 31, 2020, AIR for loans totaled \$12.7 million and \$13.6 million, respectively, and is included in other assets on the Company's consolidated statements of financial condition.

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

Certain executive officers, directors and their business interests are customers of the Company. Transactions with these parties are based on the same terms as similar transactions with unrelated third parties and do not carry more than normal credit risk. Borrowings by these related parties amounted to \$44.7 million and \$32.8 million at December 31, 2021 and 2020, respectively. During 2021, new borrowings amounted to \$19.0 million (including borrowings of executive officers and directors that were outstanding at the time of their appointment), and repayments and other reductions were \$7.1 million.

Past Due Loans Aging

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

	30-59 Days Past Due	60-89 Days Past Due	Greater Than 90 Days	Total Past Due	Nonaccrual	Current	Total Loans	Nonaccrual with no allowance
2021								
Commercial business	\$ 659	\$ 34	\$ 797	\$ 1,490	\$ 602	\$ 637,276	\$ 639,368	\$ 477
Commercial mortgage	69	-	-	69	6,414	1,409,003	1,415,486	781
Residential real estate loans	1,148	141	-	1,289	2,373	559,917	563,579	2,373
Residential real estate lines	18	3	-	21	200	75,294	75,515	200
Consumer indirect	5,706	770	-	6,476	1,780	914,796	923,052	1,780
Other consumer	121	1	-	122	-	14,233	14,355	-
Total loans, gross	<u>\$ 7,721</u>	<u>\$ 949</u>	<u>\$ 797</u>	<u>\$ 9,467</u>	<u>\$ 11,369</u>	<u>\$ 3,610,519</u>	<u>\$ 3,631,355</u>	<u>\$ 5,611</u>
2020								
Commercial business	\$ 264	\$ 87	\$ -	\$ 351	\$ 1,975	\$ 796,083	\$ 798,409	\$ 1,502
Commercial mortgage	822	26	-	848	2,906	1,252,771	1,256,525	2,709
Residential real estate loans	984	60	-	1,044	2,587	582,906	586,537	2,587
Residential real estate lines	40	15	-	55	323	86,330	86,708	323
Consumer indirect	3,966	1,348	-	5,314	1,495	806,007	812,816	1,495
Other consumer	133	18	231	382	-	16,531	16,913	-
Total loans, gross	<u>\$ 6,209</u>	<u>\$ 1,554</u>	<u>\$ 231</u>	<u>\$ 7,994</u>	<u>\$ 9,286</u>	<u>\$ 3,540,628</u>	<u>\$ 3,557,908</u>	<u>\$ 8,616</u>

The Company had \$797 thousand of PPP loans greater than 90 days past due and still accruing interest (included in Commercial business above) as of December 31, 2021. Repayment of PPP loans is guaranteed by the SBA.

There were no loans past due greater than 90 days and still accruing interest as of December 31, 2020. There was less than one thousand dollars and \$231 thousand in consumer overdrafts which were past due greater than 90 days as of December 31, 2021 and 2020, respectively. Consumer overdrafts are overdrawn deposit accounts which have been reclassified as loans but by their terms do not accrue interest.

FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES
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(6.) LOANS (Continued)

Interest income on nonaccrual loans, if recognized, is recorded using the cash basis method of accounting. There was no interest income recognized on nonaccrual loans during the years ended December 31, 2021, 2020 and 2019. For the years ended December 31, 2021, 2020 and 2019, estimated interest income of \$211 thousand, \$430 thousand, and \$508 thousand, respectively, would have been recorded if all such loans had been accruing interest according to their original contractual terms.

Troubled Debt Restructurings

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

There were no loans modified as a TDR during the years ended December 31, 2021 and 2020. There were no loans modified as a TDR during the years ended December 31, 2021 and 2020 that defaulted during the year ended December 31, 2021. For purposes of this disclosure, a loan modified as a TDR is considered to have defaulted when the borrower becomes 90 days past due.

Collateral Dependent Loans

Management has determined that specific commercial loans on nonaccrual status, all loans that have had their terms restructured in a troubled debt restructuring and other loans deemed appropriate by management where repayment is expected to be provided substantially through the operation or sale of the collateral to be collateral dependent loans. Collateral dependent loans at December 31, 2021 and 2020 included certain criticized COVID-19 bridge loans not otherwise classified as nonaccrual. The amortized cost basis of collateral dependent loans categorized by collateral type are set forth as of the dates indicated (in thousands):

	<u>Collateral Type</u>			Specific Reserve
	Business Assets	Real Property	Total	
December 31, 2021				
Commercial business	\$ 326	\$ 993	\$ 1,319	\$ 1,055
Commercial mortgage	-	37,936	37,936	4,716
Total	<u>\$ 326</u>	<u>\$ 38,929</u>	<u>\$ 39,255</u>	<u>\$ 5,771</u>
December 31, 2020				
Commercial business	\$ 2,379	-	\$ 2,379	\$ 1,383
Commercial mortgage	-	36,625	36,625	8,187
Total	<u>\$ 2,379</u>	<u>\$ 36,625</u>	<u>\$ 39,004</u>	<u>\$ 9,570</u>

FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES
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(6.) LOANS (Continued)

Credit Quality Indicators

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

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

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

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

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

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(6.) LOANS (Continued)

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

Term Loans Amortized Cost Basis by Origination Year							Revolving Loans Amortized Cost Basis	Revolving Loans Converted to Term	Total
2021	2020	2019	2018	2017	Prior				
December 31, 2021									
Commercial Business									
Uncriticized	\$ 141,925	\$ 91,338	\$ 68,433	\$ 42,631	\$ 24,847	\$ 12,033	\$ 248,338	\$ -	\$ 629,545
Special mention	-	132	166	44	180	1,344	1,993	-	3,859
Substandard	45	256	169	745	415	49	3,210	-	4,889
Doubtful	-	-	-	-	-	-	-	-	-
Total	\$ 141,970	\$ 91,726	\$ 68,768	\$ 43,420	\$ 25,442	\$ 13,426	\$ 253,541	\$ -	\$ 638,293
Commercial Mortgage									
Uncriticized	\$ 342,483	\$ 339,988	\$ 176,753	\$ 147,247	\$ 128,381	\$ 167,739	\$ 3,712	\$ -	\$ 1,306,303
Special mention	11,184	2,450	29,759	2,344	8,269	27,635	-	-	81,641
Substandard	1,001	77	2,950	11,607	3,209	6,000	-	-	24,844
Doubtful	-	-	-	-	-	-	-	-	-
Total	\$ 354,668	\$ 342,515	\$ 209,462	\$ 161,198	\$ 139,859	\$ 201,374	\$ 3,712	\$ -	\$ 1,412,788

Term Loans Amortized Cost Basis by Origination Year							Revolving Loans Amortized Cost Basis	Revolving Loans Converted to Term	Total
2020	2019	2018	2017	2016	Prior				
December 31, 2020									
Commercial Business									
Uncriticized	\$ 350,992	\$ 112,469	\$ 82,029	\$ 31,990	\$ 8,195	\$ 16,600	\$ 179,770	\$ -	\$ 782,045
Special mention	-	360	21	709	41	1,025	2,995	-	5,151
Substandard	193	211	1,183	464	202	309	4,390	-	6,952
Doubtful	-	-	-	-	-	-	-	-	-
Total	\$ 351,185	\$ 113,040	\$ 83,233	\$ 33,163	\$ 8,438	\$ 17,934	\$ 187,155	\$ -	\$ 794,148
Commercial Mortgage									
Uncriticized	\$ 310,364	\$ 227,406	\$ 163,839	\$ 161,771	\$ 74,915	\$ 154,399	\$ 731	\$ -	\$ 1,093,425
Special mention	14,299	42,305	19,505	27,530	12,256	28,744	43	-	144,682
Substandard	189	2,521	1,890	1,648	3	9,344	199	-	15,794
Doubtful	-	-	-	-	-	-	-	-	-
Total	\$ 324,852	\$ 272,232	\$ 185,234	\$ 190,949	\$ 87,174	\$ 192,487	\$ 973	\$ -	\$ 1,253,901

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(6.) LOANS (Continued)

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

	<u>Term Loans Amortized Cost Basis by Origination Year</u>						Revolving Loans Amortized Cost Basis	Revolving Loans Converted to Term	Total
	2021	2020	2019	2018	2017	Prior			
December 31, 2021									
Residential Real Estate Loans									
Performing	\$ 92,620	\$ 129,240	\$ 85,876	\$ 65,866	\$ 50,932	\$ 150,392	\$ -	\$ -	\$ 574,926
Nonperforming	79	55	225	557	899	558	-	-	2,373
Total	\$ 92,699	\$ 129,295	\$ 86,101	\$ 66,423	\$ 51,831	\$ 150,950	\$ -	\$ -	\$ 577,299
Residential Real Estate Lines									
Performing	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ 70,521	\$ 7,810	\$ 78,331
Nonperforming	-	-	-	-	-	-	39	161	200
Total	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ 70,560	\$ 7,971	\$ 78,531
Consumer Indirect									
Performing	\$ 452,601	\$ 206,472	\$ 122,849	\$ 90,998	\$ 51,598	\$ 31,750	\$ -	\$ -	\$ 956,268
Nonperforming	417	515	436	230	136	46	-	-	1,780
Total	\$ 453,018	\$ 206,987	\$ 123,285	\$ 91,228	\$ 51,734	\$ 31,796	\$ -	\$ -	\$ 958,048
Other Consumer									
Performing	\$ 4,422	\$ 3,738	\$ 1,681	\$ 763	\$ 280	\$ 1,044	\$ 2,549	\$ -	\$ 14,477
Nonperforming	-	-	-	-	-	-	-	-	-
Total	\$ 4,422	\$ 3,738	\$ 1,681	\$ 763	\$ 280	\$ 1,044	\$ 2,549	\$ -	\$ 14,477

	<u>Term Loans Amortized Cost Basis by Origination Year</u>						Revolving Loans Amortized Cost Basis	Revolving Loans Converted to Term	Total
	2020	2019	2018	2017	2016	Prior			
December 31, 2020									
Residential Real Estate Loans									
Performing	\$ 137,926	\$ 103,923	\$ 87,153	\$ 66,446	\$ 67,473	\$ 134,292	\$ -	\$ -	\$ 597,213
Nonperforming	-	199	765	665	233	725	-	-	2,587
Total	\$ 137,926	\$ 104,122	\$ 87,918	\$ 67,111	\$ 67,706	\$ 135,017	\$ -	\$ -	\$ 599,800
Residential Real Estate Lines									
Performing	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ 79,257	\$ 10,225	\$ 89,482
Nonperforming	-	-	-	-	-	-	65	258	323
Total	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ 79,322	\$ 10,483	\$ 89,805
Consumer Indirect									
Performing	\$ 295,216	\$ 202,187	\$ 166,773	\$ 111,008	\$ 47,793	\$ 15,949	\$ -	\$ -	\$ 838,926
Nonperforming	70	652	319	287	132	35	-	-	1,495
Total	\$ 295,286	\$ 202,839	\$ 167,092	\$ 111,295	\$ 47,925	\$ 15,984	\$ -	\$ -	\$ 840,421
Other Consumer									
Performing	\$ 6,774	\$ 3,177	\$ 1,765	\$ 907	\$ 369	\$ 508	\$ 3,563	\$ -	\$ 17,063
Nonperforming	-	-	-	-	-	-	-	-	-
Total	\$ 6,774	\$ 3,177	\$ 1,765	\$ 907	\$ 369	\$ 508	\$ 3,563	\$ -	\$ 17,063

FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES
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(6.) LOANS (Continued)

Allowance for Credit Losses - Loans

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

	Commercial Business	Commercial Mortgage	Residential Real Estate Loans	Residential Real Estate Lines	Consumer Indirect	Other Consumer	Total
2021							
Allowance for credit losses - loans:							
Beginning balance	13,580	21,763	3,924	674	12,165	314	\$ 52,420
Charge-offs	(669)	(3,999)	(148)	(141)	(7,236)	(1,026)	(13,219)
Recoveries	881	185	92	-	5,980	321	7,459
Provision (benefit)	(2,693)	(3,172)	(2,264)	(154)	702	597	(6,984)
Ending balance	<u>\$ 11,099</u>	<u>\$ 14,777</u>	<u>\$ 1,604</u>	<u>\$ 379</u>	<u>\$ 11,611</u>	<u>\$ 206</u>	<u>\$ 39,676</u>

2020							
Allowance for credit losses - loans:							
Beginning balance, prior to adoption of ASC 326	\$ 11,358	\$ 5,681	\$ 1,059	\$ 118	\$ 11,852	\$ 414	\$ 30,482
Impact of adopting ASC 326	(246)	7,310	3,290	607	(1,234)	(133)	\$ 9,594
Beginning balance, after adoption of ASC 326	11,112	12,991	4,349	725	10,618	281	40,076
Charge-offs	(9,093)	(1,792)	(100)	-	(9,959)	(681)	(21,625)
Recoveries	1,709	37	28	3	5,681	352	7,810
Provision (benefit)	9,852	10,527	(353)	(54)	5,825	362	26,159
Ending balance	<u>\$ 13,580</u>	<u>\$ 21,763</u>	<u>\$ 3,924</u>	<u>\$ 674</u>	<u>\$ 12,165</u>	<u>\$ 314</u>	<u>\$ 52,420</u>

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(6.) LOANS (Continued)

	Commercial Business	Commercial Mortgage	Residential Real Estate Loans	Residential Real Estate Lines	Consumer Indirect	Other Consumer	Total
2019							
Allowance for loan losses:							
Beginning balance	\$ 14,312	\$ 5,219	\$ 1,112	\$ 210	\$ 12,572	\$ 489	33,914
Charge-offs	(2,481)	(2,997)	(340)	(13)	(10,810)	(1,170)	(17,811)
Recoveries	492	17	43	6	5,390	387	6,335
Provision (benefit)	(965)	3,442	244	(85)	4,700	708	8,044
Ending balance	<u>\$ 11,358</u>	<u>\$ 5,681</u>	<u>\$ 1,059</u>	<u>\$ 118</u>	<u>\$ 11,852</u>	<u>\$ 414</u>	<u>\$ 30,482</u>
Evaluated for impairment:							
Individually	<u>\$ 214</u>	<u>\$ 479</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ 693</u>
Collectively	<u>\$ 11,144</u>	<u>\$ 5,202</u>	<u>\$ 1,059</u>	<u>\$ 118</u>	<u>\$ 11,852</u>	<u>\$ 414</u>	<u>\$ 29,789</u>
Loans:							
Ending balance	<u>\$ 571,222</u>	<u>\$ 1,108,315</u>	<u>\$ 560,717</u>	<u>\$ 101,048</u>	<u>\$ 822,179</u>	<u>\$ 15,984</u>	<u>\$3,179,465</u>
Evaluated for impairment:							
Individually	<u>\$ 1,177</u>	<u>\$ 3,146</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ 4,323</u>
Collectively	<u>\$ 570,045</u>	<u>\$ 1,105,169</u>	<u>\$ 560,717</u>	<u>\$ 101,048</u>	<u>\$ 822,179</u>	<u>\$ 15,984</u>	<u>\$3,175,142</u>

Risk Characteristics

Commercial business loans primarily consist of loans to small to mid-sized businesses in our market area in a diverse range of industries. These loans are of higher risk and typically are made on the basis of the borrower's ability to make repayment from the cash flow of the borrower's business. Further, the collateral securing the loans may depreciate over time, may be difficult to appraise and may fluctuate in value. The credit risk related to commercial loans is largely influenced by general economic conditions, including the impact of the COVID-19 pandemic on small to mid-sized business in our market area, inflation and the resulting impact on a borrower's operations or on the value of underlying collateral, if any.

Commercial mortgage loans generally have larger balances and involve a greater degree of risk than residential mortgage loans, potentially resulting in higher potential losses on an individual customer basis. Loan repayment is often dependent on the successful operation and management of the properties, as well as on the collateral securing the loan. Economic events, including the impact of the COVID-19 pandemic on the ability of the tenants to pay rent at these properties, inflation or conditions in the real estate market could have an adverse impact on the cash flows generated by properties securing the Company's commercial real estate loans and on the value of such properties.

Residential real estate loans (comprised of conventional mortgages and home equity loans) and residential real estate lines (comprised of home equity lines) are generally made based on the borrower's ability to make repayment from his or her employment and other income but are secured by real property whose value tends to be more easily ascertainable. Credit risk for these types of loans is generally influenced by general economic conditions, including the impact of the COVID-19 pandemic on the employment income of these borrowers, inflation, the characteristics of individual borrowers, and the nature of the loan collateral.

Consumer indirect and other consumer loans may entail greater credit risk than residential mortgage loans and home equities, particularly in the case of other consumer loans which are unsecured or, in the case of indirect consumer loans, secured by depreciable assets, such as automobiles. In such cases, any repossessed collateral for a defaulted consumer loan may not provide an adequate source of repayment of the outstanding loan balance. In addition, consumer loan collections are dependent on the borrower's continuing financial stability, and thus are more likely to be affected by adverse personal circumstances such as job loss, illness or personal bankruptcy, including the heightened risk that such circumstances may arise as a result of the COVID-19 pandemic including inflation. Furthermore, the application of various federal and state laws, including bankruptcy and insolvency laws, may limit the amount which can be recovered on such loans.

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(7.) PREMISES AND EQUIPMENT, NET

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

	2021⁽¹⁾	2020
Land and land improvements	\$ 5,019	\$ 6,022
Buildings and leasehold improvements	50,253	56,842
Furniture, fixtures, equipment and vehicles	39,759	40,996
Premises and equipment	95,031	103,860
Accumulated depreciation and amortization	(54,920)	(63,250)
Premises and equipment, net	<u>\$ 40,111</u>	<u>\$ 40,610</u>

⁽¹⁾ The premises and equipment balance at December 31, 2021, excludes amounts reclassified to assets held for sale. See Note 3 - Restructuring Charges for additional information.

Depreciation and amortization expense included in occupancy and equipment expense on the consolidated statements of income for the years ended December 31 was as follows (in thousands):

	2021	2020	2019
Occupancy and equipment expense	\$ 3,905	\$ 4,109	\$ 4,382
Computer and data processing expense	659	637	599
Total depreciation and amortization expense	<u>\$ 4,564</u>	<u>\$ 4,746</u>	<u>\$ 4,981</u>

(8.) GOODWILL AND OTHER INTANGIBLE ASSETS

Goodwill

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

The Company completed qualitative assessments for the Banking, Courier Capital and HNP Capital reporting units and a quantitative assessment for the SDN reporting unit during 2021. The results of the 2021 annual impairment tests for the Company's reporting units indicated no goodwill impairment.

Based on volatility in the capital markets and overall economic conditions as a result of the COVID-19 pandemic accompanied by a decline in the Company's stock price, a quantitative assessment was performed for the Banking reporting unit in the third quarter of 2020. Based on this quantitative assessment, the Company concluded that goodwill was not impaired.

The Company completed a quantitative assessment in relation to the SDN reporting unit as of its 2020 annual test date and determined that goodwill was not impaired.

The Company completed qualitative assessments in relation to the Courier Capital and the HNP Capital reporting units as of their 2020 annual test date and determined it was not more likely than not that the fair value of these reporting units were less than their carrying values.

The results of the 2019 annual impairment tests for the Company's reporting units indicated no goodwill impairment.

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

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(8.) GOODWILL AND OTHER INTANGIBLE ASSETS (Continued)

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

	Banking	All Other⁽¹⁾	Total
Balance, January 1, 2020	\$ 48,536	\$ 17,526	\$ 66,062
No activity during the period	-	-	-
Balance, December 31, 2020	48,536	17,526	66,062
Acquisitions	-	1,009	1,009
Balance, December 31, 2021	<u>\$ 48,536</u>	<u>\$ 18,535</u>	<u>\$ 67,071</u>

⁽¹⁾ All Other includes the SDN, Courier Capital and HNP Capital reporting units. The amounts are reported net of \$4.7 million accumulated impairment related to the SDN reporting unit.

Other Intangible Assets

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

	2021	2020
Core deposit intangibles:		
Gross carrying amount	\$ 2,042	\$ 2,042
Accumulated amortization	(2,039)	(2,014)
Net book value	<u>\$ 3</u>	<u>\$ 28</u>
Other intangibles:		
Gross carrying amount	\$ 14,545	\$ 13,883
Accumulated amortization	(7,219)	(6,184)
Net book value	<u>\$ 7,326</u>	<u>\$ 7,699</u>

Core deposit intangibles and other intangibles amortization expense was \$25 thousand and \$1.0 million, respectively, for the year ended December 31, 2021. Core deposit intangibles and other intangibles amortization expense was \$70 thousand and \$1.1 million, respectively, for the year ended December 31, 2020. Core deposit intangibles and other intangibles amortization expense was \$115 thousand and \$1.1 million, respectively, for the year ended December 31, 2019. Estimated amortization expense of other intangible assets for each of the next five years is as follows (in thousands):

2022	\$ 985
2023	910
2024	838
2025	766
2026	694

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(9.) LEASES

Accounting Standards Codification (“ASC”) 842, Leases (“ASC 842”), establishes a right of use model that requires a lessee to record a right of use asset and a lease liability for all leases with terms longer than 12 months. The Company is obligated under a number of non-cancellable operating lease agreements for land, buildings and equipment with terms, including renewal options reasonably certain to be exercised, extending through 2061. One building lease was subleased with terms that extended through June 30, 2021.

The following table represents the consolidated statements of financial condition classification of the Company’s right of use assets and lease liabilities as of December 31 (in thousands):

		2021	2020
Balance Sheet Location			
Operating Lease Right of Use Assets:			
Gross carrying amount	Other assets	\$ 27,063	\$ 23,697
Accumulated amortization	Other assets	(4,993)	(3,741)
Net book value		\$ 22,070	\$ 19,956
Operating Lease Liabilities:			
Right of use lease obligations	Other liabilities	\$ 23,867	\$ 21,507

The weighted average remaining lease term for operating leases was 24.0 years at December 31, 2021 and the weighted-average discount rate used in the measurement of operating lease liabilities was 3.71%. The Company utilizes its incremental borrowing rate at lease inception, on a collateralized basis, over a similar term for the discount rate.

The following table represents lease costs and other lease information for the years ended December 31 (in thousands):

	2021	2020	2019
Lease Costs:			
Operating lease costs	\$ 2,830	\$ 2,673	\$ 2,758
Variable lease costs ⁽¹⁾	427	410	428
Sublease income	(23)	(46)	(46)
Net lease costs	\$ 3,234	\$ 3,037	\$ 3,140

Other information:

Cash paid for amounts included in the measurement of lease liabilities:

Operating cash flows from operating leases	\$ 2,647	\$ 2,599	\$ 2,641
Initial recognition of operating lease right of use assets	\$ -	\$ -	\$ 23,275
Initial recognition of operating lease liabilities	\$ -	\$ -	\$ 23,985
Right of use assets obtained in exchange for new operating lease liabilities	\$ 4,251	\$ 477	\$ 620

⁽¹⁾ Variable lease costs primarily represent variable payments such as common area maintenance, insurance, taxes and utilities.

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(9.) LEASES (Continued)

Future minimum payments under non-cancellable operating leases with initial or remaining terms of one year or more are as follows at December 31, 2021 (in thousands):

Year ended December 31 ⁽¹⁾ ,		
2022	\$	2,215
2023		1,766
2024		1,452
2025		1,378
2026		1,299
Thereafter		29,575
Total future minimum operating lease payments		37,685
Amounts representing interest		(13,818)
Present value of net future minimum operating lease payments	\$	<u>23,867</u>

⁽¹⁾ Operating lease payments exclude \$13.8 million of future minimum lease payments for leases signed but not yet commenced.

(10.) OTHER ASSETS

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

	2021	2020
Operating lease right of use assets	\$ 22,070	\$ 19,956
Tax credit investments	57,010	34,370
Derivative instruments	16,504	20,120
Collateral on derivative instruments	4,640	19,630
Other	72,976	62,010
Total other assets	<u>\$ 173,200</u>	<u>\$ 156,086</u>

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(11.) DEPOSITS

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

	2021	2020
Noninterest-bearing demand	\$ 1,107,561	\$ 1,018,549
Interest-bearing demand	864,528	731,885
Savings and money market	1,933,047	1,642,340
Time deposits, due:		
Within one year	880,892	841,581
One to two years	23,572	30,847
Two to three years	9,881	5,186
Three to four years	6,485	5,417
Four to five years	1,124	2,562
Thereafter	-	-
Total time deposits	921,954	885,593
Total deposits	<u>\$ 4,827,090</u>	<u>\$ 4,278,367</u>

Time deposits in denominations of \$250,000 or more at December 31, 2021 and 2020 amounted to \$220.8 million and \$200.7 million, respectively.

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

	2021	2020	2019
Interest-bearing demand	\$ 1,156	\$ 1,091	\$ 1,372
Savings and money market	3,363	4,788	4,365
Time deposits	3,599	11,943	22,757
Total interest expense on deposits	<u>\$ 8,118</u>	<u>\$ 17,822</u>	<u>\$ 28,494</u>

(12.) BORROWINGS

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

	2021	2020
Short-term borrowings:		
Short-term FHLB borrowings	\$ 30,000	\$ 5,300
Long-term borrowings:		
Subordinated notes, net	73,911	73,623
Total borrowings	<u>\$ 103,911</u>	<u>\$ 78,923</u>

Short-term borrowings

Short-term FHLB borrowings have original maturities of less than one year and include overnight borrowings which we typically utilize to address short term funding needs as they arise. Short-term FHLB borrowings at December 31, 2021 and 2020 consisted of \$30 million and \$5.3 million, respectively, in short-term borrowings. The FHLB borrowings are collateralized by securities from the Company's investment portfolio and certain qualifying loans. At December 31, 2021 and 2020, the Company's borrowings had a weighted average rate of 0.34% and 1.70%, respectively.

The Parent has a revolving line of credit with a commercial bank allowing borrowings up to \$20.0 million in total as an additional source of working capital. At December 31, 2021 and 2020, no amounts have been drawn on the line of credit.

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(12.) BORROWINGS (Continued)

Long-term borrowings

On October 7, 2020, the Company completed a private placement of \$35.0 million in aggregate principal amount of fixed-to-floating rate subordinated notes due 2030 to qualified institutional buyers and accredited institutional investors that were subsequently exchanged for subordinated notes with substantially the same terms (the “2020 Notes”) registered under the Securities Act of 1933, as amended. The 2020 Notes have a maturity date of October 15, 2030 and bear interest, payable semi-annually, at the rate of 4.375% per annum, until October 15, 2025. Commencing on that date, the interest rate will reset quarterly to an interest rate per annum equal to the then current three-month secured overnight financing rate (“SOFR”) plus 4.265%, payable quarterly until maturity. Proceeds, net of debt issuance costs of \$779 thousand, were \$34.2 million. The net proceeds from this offering were used for general corporate purposes, including but not limited to, contribution of capital to the Bank to support both organic growth and regulatory capital ratios. The 2020 Notes qualify as Tier 2 capital for regulatory purposes.

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

The Company adopted ASU 2015-03 that requires debt issuance costs to be reported as a direct deduction from the face value of the 2015 Notes and the 2020 Notes, and not as a deferred charge. The debt issuance costs will be amortized as an adjustment to interest expense through April 15, 2025 for the 2015 Notes and through October 15, 2025 for the 2020 Notes.

(13.) DERIVATIVE INSTRUMENT AND HEDGING ACTIVITIES

Risk Management Objective of Using Derivatives

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

Cash Flow Hedges of Interest Rate Risk

The Company’s objectives in using interest rate derivatives are to add stability to interest expense and to manage its exposure to interest rate movements. To accomplish this objective, the Company primarily uses interest rate caps and interest rate swaps as part of its interest rate risk management strategy. Interest rate caps designated as cash flow hedges involve the receipt of variable amounts from a counterparty if interest rates rise above the strike rate on the contract in exchange for an up-front premium. During 2021, such derivatives were used to hedge the variable cash flows associated with short-term borrowings. Interest rate swaps designated as cash flow hedges involve the receipt of variable amounts from a counterparty in exchange for the Company making fixed-rate payments over the life of the agreements without exchange of the underlying notional amount. The Company is hedging its exposure to the variability in future cash flows for forecasted transactions over a period of approximately 60 months. As of December 31, 2021, the Company had one outstanding forward interest rate derivative with a notional value of \$50.0 million that was designated as a cash flow hedge of interest rate risk. The derivative becomes effective in April 2022.

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

For derivatives designated and that qualify as cash flow hedges of interest rate risk, the gain or loss on the derivative is recorded in accumulated other comprehensive income (loss) and subsequently reclassified into interest expense in the same period(s) during which the hedged transaction affects earnings. Amounts reported in accumulated other comprehensive income (loss) related to derivatives will be reclassified to interest expense as interest payments are made on the Company's borrowings. During the next twelve months, the Company estimates that \$53 thousand will be reclassified as an increase to interest expense.

Interest Rate Swaps

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

Credit-risk-related Contingent Features

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

Mortgage Banking Derivatives

The Company extends rate lock agreements to borrowers related to the origination of residential mortgage loans. To mitigate the interest rate risk inherent in these rate lock agreements when the Company intends to sell the related loan, once originated, as well as closed residential mortgage loans held for sale, the Company enters into forward commitments to sell individual residential mortgages. Rate lock agreements and forward commitments are considered derivatives and are recorded at fair value.

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

Fair Values of Derivative Instruments on the Balance Sheet

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

	Gross notional amount		Asset derivatives		Liability derivatives			
			Balance sheet line item	Fair value		Balance sheet line item	Fair value	
	2021	2020		2021	2020		2021	2020
Derivatives designated as hedging instruments								
Cash flow hedges	\$ 50,000	\$ 50,000	Other assets	\$ 1,559	\$ -	Other liabilities	\$ -	\$ 311
Total derivatives	<u>\$ 50,000</u>	<u>\$ 50,000</u>		<u>\$ 1,559</u>	<u>\$ -</u>		<u>\$ -</u>	<u>\$ 311</u>
Derivatives not designated as hedging instruments								
Cash flow hedges	\$ -	\$ 100,000	Other assets	\$ -	\$ -	Other liabilities	\$ -	\$ -
Interest rate swaps ⁽¹⁾	853,445	631,907	Other assets	14,702	19,626	Other liabilities	14,708	19,837
Credit contracts	113,833	113,434	Other assets	-	23	Other liabilities	1	86
Mortgage banking	18,199	28,225	Other assets	243	471	Other liabilities	4	1
Total derivatives	<u>\$ 985,477</u>	<u>\$ 873,566</u>		<u>\$ 14,945</u>	<u>\$ 20,120</u>		<u>\$ 14,713</u>	<u>\$ 19,924</u>

⁽¹⁾ The Company secured its obligations under these contracts with \$4.6 million and \$19.6 million in cash at December 31, 2021 and 2020, respectively.

Effect of Derivative Instruments on the Income Statement

The table below presents the effect of the Company's derivative financial instruments on the income statement for the years ended December 31 (in thousands):

Undesignated derivatives	Line item of gain (loss) recognized in income	Gain (loss) recognized in income		
		2021	2020	2019
Cash flow hedges	Income from derivative instruments, net	\$ -	\$ -	\$ -
Interest rate swaps	Income from derivative instruments, net	2,852	4,707	2,189
Credit contracts	Income from derivative instruments, net	74	455	29
Mortgage banking	Income from derivative instruments, net	(231)	359	56
Total undesignated		<u>\$ 2,695</u>	<u>\$ 5,521</u>	<u>\$ 2,274</u>

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(14.) COMMITMENTS AND CONTINGENCIES

Financial Instruments with Off-Balance Sheet Risk

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

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

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

	2021	2020
Commitments to extend credit	\$ 936,298	\$ 1,012,810
Standby letters of credit	24,913	22,393

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

Unfunded Commitments

At December 31, 2021 and December 31, 2020, the allowance for credit losses for unfunded commitments totaled \$1.8 million and \$3.1 million, respectively, and was included in other liabilities on the Company's consolidated statements of financial condition. For the years ended December 31, 2021 and 2020, credit loss (benefit) expense for unfunded commitments was \$(1.3) million and \$1.0 million, respectively, and was included in provision (benefit) for credit losses on the Company's consolidated statements of income.

Contingent Liabilities and Litigation

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

We are party to an action filed against us on May 16, 2017 by Matthew L. Chipego, Charlene Mowry, Constance C. Churchill and Joseph W. Ewing in the Court of Common Pleas in Philadelphia, Pennsylvania. Plaintiffs sought and were granted class certification to represent classes of consumers in New York and Pennsylvania seeking to recover statutory damages, interest and declaratory relief. The plaintiffs allege that they obtained direct or indirect financing from us for the purchase of vehicles that we later repossessed. The plaintiffs specifically claim that the notices the Bank sent to defaulting consumers after their vehicles were repossessed did not comply with the relevant portions of the Uniform Commercial Code in New York and Pennsylvania. We dispute and believe we have meritorious defenses against these claims and plan to continue to vigorously defend ourselves.

On September 30, 2021, the Court granted plaintiffs' motion for class certification and certified four different classes (two classes of New York consumers and two classes of Pennsylvania consumers). There are approximately 5,200 members in the New York classes and approximately 300 members in the Pennsylvania classes. Our motion seeking permission to appeal the class certification ruling and a stay of proceedings pending any such appeal was denied. We are currently awaiting a ruling from the Superior Court of Pennsylvania on our motion seeking permission to appeal the denial of our motion to dismiss the action for lack of standing. On February 8, 2022, plaintiffs filed a motion for partial summary judgment for most of the relief they seek. The Company intends to oppose and file cross motions for partial summary judgment. The parties agreed that the Company's opposition and cross motion papers will be filed by March 21, 2022. Through a Case Management Order dated February 10, 2022, the trial court directed, among other things, that discovery be completed by October 3, 2022, pre-trial motions be submitted by November 21, 2022, and that the case be ready for trial on March 6, 2023. We have not accrued a contingent liability for this matter at this time because, given our defenses, we are unable to conclude whether a liability is reasonably probable to occur nor are we able to currently reasonably estimate the amount of potential loss.

FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES
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(14.) COMMITMENTS AND CONTINGENCIES (Continued)

If we settle these claims or the action is not resolved in our favor, we may suffer reputational damage and incur legal costs, settlements or judgments that exceed the amounts covered by our existing insurance policies. We can provide no assurances that our insurer will insure the legal costs, settlements or judgments we incur in excess of our deductible. If we are unsuccessful in defending ourselves from these claims or if our insurer does not insure us against legal costs we incur in excess of our deductible, the result may materially adversely affect our business, results of operations and financial condition.

(15.) REGULATORY MATTERS

General

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

Capital

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

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

The Economic Growth Act provided for a potential exception from the Basel III Rules for community banks that maintain a Community Bank Leverage Ratio ("CBLR") of at least 8.0% to 10.0%. The CBLR is calculated by dividing Tier 1 capital by the bank's average total consolidated assets. In the final rules approved by the FDIC in September 2019, qualifying community banking organizations that opt in to using the CBLR are considered to be in compliance with the Basel III Rules as long as the bank maintains a CBLR of greater than 9.0%. If a bank is not a qualifying community banking organization, does not opt in to using the CBLR, or cannot maintain a CBLR of greater than 9.0%, the bank would have to comply with the Basel III Rules. We determined to comply with the Basel III Rules instead of using the CBLR framework.

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

Tier 1 capital includes Common Equity Tier 1 capital and additional Tier 1 capital. For the Company, additional Tier 1 capital at December 31, 2021 includes, subject to limitation, \$17.3 million of preferred stock.

Total capital includes Tier 1 capital and Tier 2 capital. Tier 2 capital for both the Company and the Bank includes a permissible portion of the allowance for credit losses. Tier 2 capital for the Company also includes qualified subordinated debt. At December 31, 2021, the Company's Tier 2 capital included \$73.9 million of Subordinated Notes.

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

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(15.) REGULATORY MATTERS (Continued)

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

The Basel III Capital Rules also provide for a “countercyclical capital buffer” that is applicable to only certain covered institutions and does not have any current applicability to the Company or the Bank. The capital conservation buffer is designed to absorb losses during periods of economic stress and effectively increases the minimum required risk-weighted capital ratios. Banking institutions with a ratio of Common Equity Tier 1 capital to risk-weighted assets below the effective minimum will face constraints on dividends, equity repurchases and compensation based on the amount of the shortfall.

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(15.) REGULATORY MATTERS (Continued)

The following table presents actual and required capital ratios as of December 31, 2021 and 2020 for the Company and the Bank under the Basel III Capital Rules. Capital levels required to be considered well capitalized are based upon prompt corrective action regulations, as amended to reflect the changes under the Basel III Capital Rules (in thousands):

	Actual		Minimum Capital Required – Basel III		Required to be Considered Well Capitalized	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
2021						
Tier 1 leverage:						
Company	\$ 455,138	8.23%	\$ 221,319	4.00%	\$ 276,649	5.00%
Bank	496,337	8.98	220,963	4.00	276,204	5.00
CET1 capital:						
Company	437,846	10.28	298,207	7.00	276,907	6.50
Bank	496,337	11.68	297,489	7.00	276,240	6.50
Tier 1 capital:						
Company	455,138	10.68	362,109	8.50	340,808	8.00
Bank	496,337	11.68	361,237	8.50	339,987	8.00
Total capital:						
Company	558,987	13.12	447,311	10.50	426,010	10.00
Bank	526,274	12.38	446,233	10.50	424,984	10.00
2020						
Tier 1 leverage:						
Company	\$ 407,061	8.25%	\$ 197,344	4.00%	\$ 246,680	5.00%
Bank	441,929	8.97	197,064	4.00	246,330	5.00
CET1 capital:						
Company	389,733	10.14	269,107	7.00	249,885	6.50
Bank	441,929	11.52	268,483	7.00	249,306	6.50
Tier 1 capital:						
Company	407,061	10.59	326,772	8.50	307,550	8.00
Bank	441,929	11.52	326,015	8.50	306,838	8.00
Total capital:						
Company	521,193	13.56	403,660	10.50	384,438	10.00
Bank	482,439	12.58	402,725	10.50	383,547	10.00

As of December 31, 2021 and 2020, the Company and Bank were considered “well capitalized” under all regulatory capital guidelines. Such determination has been made based on the Tier 1 leverage, CET1 capital, Tier 1 capital and total capital ratios.

Federal Reserve Requirements

The Bank is typically required to maintain cash on hand or on deposit at the FRB of New York according to the reserve requirements set by the FRB. In March 2020, the FRB reduced the required reserve to 0%. Accordingly, as of December 31, 2021 and 2020, the Bank was not required to maintain a reserve balance at the FRB of New York. The reserve requirement for the Bank totaled \$6.4 million as of December 31, 2019.

Dividend Restrictions

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

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(16.) SHAREHOLDERS' EQUITY

The Company's authorized capital stock consists of 50,210,000 shares of capital stock, 50,000,000 of which are common stock, par value \$0.01 per share, and 210,000 of which are preferred stock, par value \$100 per share, which is designated into two classes, Class A of which 10,000 shares are authorized, and Class B of which 200,000 shares are authorized. There are two series of Class A preferred stock: Series A 3% preferred stock and the Series A preferred stock. There is one series of Class B preferred stock: Series B-1 8.48% preferred stock. There were 172,921 and 173,282 shares of preferred stock issued and outstanding as of December 31, 2021 and 2020, respectively.

Common Stock

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

	Outstanding	Treasury	Issued
2021			
Shares outstanding at beginning of year	16,041,926	57,630	16,099,556
Shares issued for Landmark Group acquisition	12,831	(12,831)	-
Restricted stock awards issued	9,350	(9,350)	-
Restricted stock units released	24,069	(24,069)	-
Stock awards	5,972	(5,972)	-
Treasury stock purchases	(348,695)	348,695	-
Shares outstanding at end of year	<u>15,745,453</u>	<u>354,103</u>	<u>16,099,556</u>
2020			
Shares outstanding at beginning of year	16,002,899	96,657	16,099,556
Restricted stock awards issued	12,798	(12,798)	-
Restricted stock units released	24,921	(24,921)	-
Stock awards	8,439	(8,439)	-
Treasury stock purchases	(7,131)	7,131	-
Shares outstanding at end of year	<u>16,041,926</u>	<u>57,630</u>	<u>16,099,556</u>

Share Repurchases

In November 2020, the Company's Board of Directors authorized a share repurchase program of common stock for up to 801,879 shares of common stock. Repurchased shares are recorded in treasury stock, at cost, which includes any applicable transaction costs. 340,688 shares were repurchased at an average price of \$26.44 during the year ended December 31, 2021. No shares were repurchased under this program during the year ended December 31, 2020. As of December 31, 2021, the remaining number of shares authorized for repurchase under the repurchase program was 461,191.

Preferred Stock

Series A 3% Preferred Stock. There were 1,435 shares of Series A 3% preferred stock issued and outstanding as of December 31, 2021 and 2020. Holders of Series A 3% preferred stock are entitled to receive an annual dividend of \$3.00 per share, which is cumulative and payable quarterly. Holders of Series A 3% preferred stock have no pre-emptive right in, or right to purchase or subscribe for, any additional shares of the Company's capital stock and have no voting rights. Dividend or dissolution payments to the Class A shareholders must be declared and paid, or set apart for payment, before any dividends or dissolution payments can be declared and paid, or set apart for payment, to the holders of Class B preferred stock or common stock. The Series A 3% preferred stock is not convertible into any other of the Company's securities.

Series B-1 8.48% Preferred Stock. There were 171,486 shares and 171,847 shares of Series B-1 8.48% preferred stock issued and outstanding as of December 31, 2021 and 2020. Holders of Series B-1 8.48% preferred stock are entitled to receive an annual dividend of \$8.48 per share, which is cumulative and payable quarterly. Holders of Series B-1 8.48% preferred stock have no pre-emptive right in, or right to purchase or subscribe for, any additional shares of the Company's common stock and have no voting rights. Accumulated dividends on the Series B-1 8.48% preferred stock do not bear interest, and the Series B-1 8.48% preferred stock is not subject to redemption. Dividend or dissolution payments to the Class B shareholders must be declared and paid, or set apart for payment, before any dividends or dissolution payments are declared and paid, or set apart for payment, to the holders of common stock. The Series B-1 8.48% preferred stock is not convertible into any other of the Company's securities.

FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES
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(17.) ACCUMULATED OTHER COMPREHENSIVE INCOME (LOSS)

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

	Pre-tax Amount	Tax Effect	Net-of-tax Amount
2021			
Securities available for sale and transferred securities:			
Change in unrealized gain (loss) during the year	\$ (26,643)	\$ (6,826)	\$ (19,817)
Reclassification adjustment for net gains included in net income ⁽¹⁾	139	36	103
Total securities available for sale and transferred securities	<u>(26,504)</u>	<u>(6,790)</u>	<u>(19,714)</u>
Hedging derivative instruments:			
Change in unrealized gain (loss) during the year	1,984	508	1,476
Pension and post-retirement obligations:			
Net actuarial gain (loss) arising during the year	3,162	810	2,352
Amortization of net actuarial loss and prior service cost included in income	741	190	551
Total pension and post-retirement obligations	<u>3,903</u>	<u>1,000</u>	<u>2,903</u>
Other comprehensive loss	<u>\$ (20,617)</u>	<u>\$ (5,282)</u>	<u>\$ (15,335)</u>
2020			
Securities available for sale and transferred securities:			
Change in unrealized gain (loss) during the year	\$ 19,928	\$ 5,106	\$ 14,822
Reclassification adjustment for net gains included in net income ⁽¹⁾	(1,281)	(329)	(952)
Total securities available for sale and transferred securities	<u>18,647</u>	<u>4,777</u>	<u>13,870</u>
Hedging derivative instruments:			
Change in unrealized gain (loss) during the year	271	69	202
Pension and post-retirement obligations:			
Net actuarial gain (loss) arising during the year	2,201	565	1,636
Amortization of net actuarial loss and prior service cost included in income	1,254	321	933
Total pension and post-retirement obligations	<u>3,455</u>	<u>886</u>	<u>2,569</u>
Other comprehensive income	<u>\$ 22,373</u>	<u>\$ 5,732</u>	<u>\$ 16,641</u>
2019			
Securities available for sale and transferred securities:			
Change in unrealized gain (loss) during the year	\$ 13,648	\$ 3,456	\$ 10,192
Reclassification adjustment for net gains included in net income ⁽¹⁾	(1,176)	(307)	(869)
Total securities available for sale and transferred securities	<u>12,472</u>	<u>3,149</u>	<u>9,323</u>
Hedging derivative instruments:			
Change in unrealized gain (loss) during the year	(327)	(85)	(242)
Pension and post-retirement obligations:			
Net actuarial gain (loss) arising during the year	(879)	(303)	(576)
Amortization of net actuarial loss and prior service cost included in income	1,398	352	1,046
Total pension and post-retirement obligations	<u>519</u>	<u>49</u>	<u>470</u>
Other comprehensive income	<u>\$ 12,664</u>	<u>\$ 3,113</u>	<u>\$ 9,551</u>

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

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

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

	Hedging Derivative Instruments	Securities Available for Sale and Transferred Securities	Pension and Post- retirement Obligations	Accumulated Other Comprehensive Income (Loss)
Balance at January 1, 2021	\$ (316)	\$ 14,743	\$ (12,299)	\$ 2,128
Other comprehensive income (loss) before reclassifications	1,476	(19,817)	2,352	(15,989)
Amounts reclassified from accumulated other comprehensive income (loss)	-	103	551	654
Net current period other comprehensive income (loss)	1,476	(19,714)	2,903	(15,335)
Balance at December 31, 2021	<u>\$ 1,160</u>	<u>\$ (4,971)</u>	<u>\$ (9,396)</u>	<u>\$ (13,207)</u>
Balance at January 1, 2020	\$ (518)	\$ 873	\$ (14,868)	\$ (14,513)
Other comprehensive income (loss) before reclassifications	202	14,822	1,636	16,660
Amounts reclassified from accumulated other comprehensive income (loss)	-	(952)	933	(19)
Net current period other comprehensive income	202	13,870	2,569	16,641
Balance at December 31, 2020	<u>\$ (316)</u>	<u>\$ 14,743</u>	<u>\$ (12,299)</u>	<u>\$ 2,128</u>
Balance at January 1, 2019	\$ (276)	\$ (7,769)	\$ (13,236)	\$ (21,281)
Reclassification adjustment for net gains included in net income	-	(681)	(2,102)	(2,783)
Other comprehensive income (loss) before reclassifications	(242)	10,192	(576)	9,374
Amounts reclassified from accumulated other comprehensive income (loss)	-	(869)	1,046	177
Net current period other comprehensive (loss) income	(242)	9,323	470	9,551
Balance at December 31, 2019	<u>\$ (518)</u>	<u>\$ 873</u>	<u>\$ (14,868)</u>	<u>\$ (14,513)</u>

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

The following table presents the amounts reclassified out of each component of accumulated other comprehensive income (loss) for the years ended December 31 (in thousands):

Details About Accumulated Other Comprehensive Income (Loss) Components	Amount Reclassified from Accumulated Other Comprehensive Income (Loss)		Affected Line Item in the Consolidated Statement of Income
	2021	2020	
		\$	
Realized gain (loss) on sale of investment securities	71	1,599	Net gain on investment securities
Amortization of unrealized holding gains (losses) on investment securities transferred from available for sale to held to maturity	(210)	(318)	Interest income
	(139)	1,281	Total before tax
	36	(329)	Income tax benefit (expense)
	(103)	952	Net of tax
Amortization of pension and post-retirement items:			
Prior service credit ⁽¹⁾	3	34	Salaries and employee benefits
Net actuarial losses ⁽¹⁾	(744)	(1,288)	Salaries and employee benefits
	(741)	(1,254)	Total before tax
	190	321	Income tax benefit
	(551)	(933)	Net of tax
Total reclassified for the period	\$ (654)	\$ 19	

⁽¹⁾ These items are included in the computation of net periodic pension expense. See Note 21 – Employee Benefit Plans for additional information.

(18.) SHARE-BASED COMPENSATION

The Company maintains certain stock-based compensation plans, approved by the Company’s shareholders, that are administered by the Management Development and Compensation Committee (the “Compensation Committee”) of the Board. In May 2015, the Company’s shareholders approved the 2015 Long-Term Incentive Plan (the “2015 Plan”) to replace the 2009 Management Stock Incentive Plan and the 2009 Directors’ Stock Incentive Plan (collectively, the “2009 Plans”). A total of 438,076 shares transferred from the 2009 Plans were available for grant pursuant to the 2015 Plan. In addition, any shares subject to outstanding awards under the 2009 Plans that are canceled, expired, forfeited or otherwise not issued or are settled in cash will become available for future award grants under the 2015 Plan. In June 2021, the Company’s shareholders approved the Amended and Restated 2015 Long-Term Incentive Plan (the “Plan”), which increased the total number of shares available for grant under the Plan by 734,000 shares. As of December 31, 2021, there were approximately 816,000 shares available for grant under the 2015 Plan.

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

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

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(18.) SHARE-BASED COMPENSATION (Continued)

The Plan uses metrics that measure the Company's performance on a relative basis against a peer group, which was defined as the SNL Small Cap Bank & Thrift Index. The SNL Small Cap Bank & Thrift Index was discontinued August 7, 2021 and was replaced with the S&P U.S. SmallCap Banks Index. As the award agreements do not contain successor language pertaining to the removal or modification of an index, the Compensation Committee approved the application of the survivorship peer group with the S&P U.S. SmallCap Banks Index used as the basis for measuring relative performance of existing awards.

The Company awarded grants of restricted stock units to certain members of management during the year ended December 31, 2021. Fifty percent of the shares subject to each grant that ultimately vest are contingent on achieving specified return on average equity ("ROAE") targets relative to the market index the Compensation Committee has selected as a peer group for this purpose. These shares will be earned based on the Company's achievement of a relative ROAE performance requirement, on a percentile basis, compared to the market index over a three-year performance period ending December 31, 2023. The shares earned based on the achievement of the ROAE performance requirement, if any, will vest on the third anniversary of the grant date assuming the recipient's continuous service to the Company. The remaining fifty percent of the PSUs that ultimately vest are contingent upon achievement of an average return on average assets ("ROAA") performance requirement over a three-year performance period ending December 31, 2023. The shares earned based on the achievement of the ROAA performance requirement, if any, will vest on the third anniversary of the grant date assuming the recipient's continuous service to the Company. If earned at target level, members of management will receive up to 22,178 shares of our common stock in the aggregate.

The grant-date fair values for both the ROAE and the ROAA portions of PSUs granted during the year ended December 31, 2021 are equal to the closing market price of our common stock on the date of grant reduced by the present value of the dividends expected to be paid on the underlying shares.

The Company granted additional restricted stock units to management during the year ended December 31, 2021. These awards will vest after completion of a three-year service requirement. If earned, members of management will receive up to 63,998 shares of our common stock, in the aggregate. The average market price of the restricted stock units on the date of grant was \$27.55.

During the year ended December 31, 2021, the Company granted a total of 9,350 restricted shares of common stock to non-employee directors, of which 4,670 shares vested immediately and 4,680 shares will vest after completion of a one-year service requirement. The weighted average market price of the restricted stock on the date of grant was \$32.06. In addition, the Company issued a total of 5,972 shares of common stock in-lieu of cash for the annual retainer of seven non-employee directors during the year ended December 31, 2021. The weighted average market price of the stock on the date of grant was \$32.03.

The Company awarded grants of restricted stock units to certain members of management during the year ended December 31, 2020. Fifty percent of the shares subject to each grant will be earned based on the Company's achievement of a relative ROAE performance requirement, on a percentile basis, compared to the market index over a three-year performance period ending December 31, 2022. The shares earned based on the achievement of the ROAE performance requirement, if any, will vest on the third anniversary of the grant date assuming the recipient's continuous service to the Company. The remaining fifty percent of the PSUs that ultimately vest are contingent upon achievement of an average return on average assets ("ROAA") performance requirement over a three-year performance period ending December 31, 2022. The shares earned based on the achievement of the ROAA performance requirement, if any, will vest on the third anniversary of the grant date assuming the recipient's continuous service to the Company. If earned at target level, members of management will receive up to 23,302 shares of our common stock in the aggregate.

The grant-date fair values for both the ROAE and the ROAA portions of PSUs granted during the year ended December 31, 2020 are equal to the closing market price of our common stock on the date of grant reduced by the present value of the dividends expected to be paid on the underlying shares.

The Company granted additional restricted stock units to management during the year ended December 31, 2020. These awards will vest after completion of a three-year service requirement. If earned, members of management will receive up to 58,806 shares of our common stock, in the aggregate. The average market price of the restricted stock units on the date of grant was \$25.02.

During the year ended December 31, 2020, the Company granted a total of 12,798 restricted shares of common stock to non-employee directors, of which 6,399 shares vested immediately and 6,399 shares will vest after completion of a one-year service requirement. The weighted average market price of the restricted stock on the date of grant was \$17.57. In addition, the Company issued a total of 8,439 shares of common stock in-lieu of cash for the annual retainer of four non-employee directors during the year ended December 31, 2020. The weighted average market price of the stock on the date of grant was \$19.54.

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(18.) SHARE-BASED COMPENSATION (Continued)

The Company awarded grants of restricted stock units to certain members of management during the year ended December 31, 2019. Fifty percent of the shares subject to each grant will be earned upon achievement of an ROAA performance requirement for the Company's fiscal year ending December 31, 2021. The remaining fifty percent of the shares will be earned based on the Company's achievement of a relative total shareholder return ("TSR") performance requirement, on a percentile basis, compared to the market index over a three-year performance period ending December 31, 2021. If earned at target level, members of management will receive up to 21,970 shares of our common stock in the aggregate, which will vest on February 26, 2022 assuming the recipient's continuous service to the Company.

The grant-date fair value of the TSR performance award granted on February 26, 2019 was determined using the Monte Carlo simulation model on the date of grant, assuming the following (i) expected term of 2.84 years, (ii) risk free interest rate of 2.43%, (iii) expected dividend yield of 3.20% and (iv) expected stock price volatility over the expected term of the TSR performance award of 21.3%. The grant-date fair value of the TSR performance award granted on May 22, 2019 was determined using the Monte Carlo simulation model on the date of grant, assuming the following (i) expected term of 2.61 years, (ii) risk free interest rate of 2.18%, (iii) expected dividend yield of 3.60% and (iv) expected stock price volatility over the expected term of the TSR performance award of 22.0%. The grant-date fair value of all other restricted stock awards is equal to the closing market price of the Company's common stock on the date of grant.

The Company granted additional restricted stock units to management during the year ended December 31, 2019. These awards will vest after completion of a three-year service requirement. If earned, members of management will receive up to 54,476 shares of our common stock, in the aggregate. The average market price of the restricted stock units on the date of grant was \$25.60.

During the year ended December 31, 2019, the Company granted a total of 8,226 restricted shares of common stock to non-employee directors, of which 4,113 shares vested immediately and 4,113 shares will vest after completion of a one-year service requirement. The weighted average market price of the restricted stock on the date of grant was \$27.33. In addition, the Company issued a total of 4,192 shares of common stock in -lieu of cash for the annual retainer of three non-employee directors during the year ended December 31, 2019. The weighted average market price of the stock on the date of grant was \$29.78.

The restricted stock awards granted to the directors and the restricted stock units granted to management in 2021, 2020 and 2019 do not have rights to dividends or dividend equivalents.

The Company uses the Black-Scholes valuation method to estimate the fair value of its stock option awards. There were no stock options awarded during 2021, 2020 or 2019. There was no unrecognized compensation expense related to unvested stock options as of December 31, 2021. There was no stock option activity for the year ended December 31, 2021.

The following is a summary of restricted stock award and restricted stock units activity for the year ended December 31, 2021:

	Number of Shares	Weighted Average Market Price at Grant Date
Outstanding at beginning of year	168,513	\$ 25.65
Granted	95,526	28.00
Vested	(35,138)	26.13
Forfeited	(32,911)	26.56
Outstanding at end of period	<u>195,990</u>	<u>\$ 26.56</u>

As of December 31, 2021, there was \$2.4 million of unrecognized compensation expense related to unvested restricted stock awards and restricted stock units that is expected to be recognized over a weighted average period of 1.8 years.

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(18.) SHARE-BASED COMPENSATION (Continued)

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

	2021	2020	2019
Salaries and employee benefits	\$ 1,460	\$ 1,107	\$ 1,175
Other noninterest expense	283	226	231
Total share-based compensation expense	<u>\$ 1,743</u>	<u>\$ 1,333</u>	<u>\$ 1,406</u>

(19.) INCOME TAXES

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

	2021	2020	2019
Current tax expense:			
Federal	\$ 11,453	\$ 10,041	\$ 8,882
State	2,854	1,873	1,308
Total current tax expense	<u>14,307</u>	<u>11,914</u>	<u>10,190</u>
Deferred tax expense (benefit):			
Federal	4,384	(3,306)	280
State	834	(1,217)	89
Total deferred tax expense (benefit)	<u>5,218</u>	<u>(4,523)</u>	<u>369</u>
Total income tax expense	<u>\$ 19,525</u>	<u>\$ 7,391</u>	<u>\$ 10,559</u>

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

	2021	2020	2019
Statutory federal tax rate	21.0%	21.0%	21.0%
Increase (decrease) resulting from:			
Tax exempt interest income	(0.7)	(2.0)	(1.9)
Tax credits and adjustments	(2.6)	(3.4)	(3.0)
Non-taxable earnings on company owned life insurance	(0.6)	(0.9)	(0.6)
State taxes, net of federal tax benefit	3.0	1.1	1.9
Nondeductible expenses	-	0.1	0.2
Goodwill and contingent consideration adjustments	-	-	-
Other, net	-	0.3	0.2
Effective tax rate	<u>20.1%</u>	<u>16.2%</u>	<u>17.8%</u>

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

	2021	2020	2019
Income tax expense	\$ 19,525	\$ 7,391	\$ 10,559
Shareholder's equity	(5,282)	5,732	3,113

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(19.) INCOME TAXES (Continued)

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

In 2021 and 2020, the Company recognized the impact of its investments in limited partnerships that generated qualifying tax credits resulting in a \$2.6 million and \$1.5 million reduction in income tax expense, respectively, and a \$431 thousand and \$275 thousand net loss recorded in noninterest income, respectively. See Note 1 for the Company's accounting policy for income taxes and these tax credit investments.

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

	2021	2020
Deferred tax assets:		
Allowance for credit losses	\$ 10,627	\$ 14,239
Leases - right of use obligations	5,993	5,510
Deferred compensation	1,365	1,149
Investment in limited partnerships	-	1,418
SERP agreements	262	323
Share-based compensation	759	602
Tax attribute carryforward benefits	446	-
Net unrealized loss on securities available for sale	1,712	-
Other	579	236
Gross deferred tax assets	<u>21,743</u>	<u>23,477</u>
Deferred tax liabilities:		
Leases - right of use assets	5,533	5,113
Investments in limited partnerships	126	-
Prepaid expenses	662	635
Prepaid pension costs	1,677	1,183
Intangible assets	2,418	2,286
Depreciation and amortization	3,471	2,046
Net unrealized gain on securities available for sale	-	5,079
Loan servicing assets	389	338
Deferred loan origination costs	830	623
Other	403	4
Gross deferred tax liabilities	<u>15,509</u>	<u>17,307</u>
Net deferred tax asset	<u>\$ 6,234</u>	<u>\$ 6,170</u>

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(19.) INCOME TAXES (Continued)

Based upon the Company's historical and projected future levels of pre-tax and taxable income, the scheduled reversals of taxable temporary differences to offset future deductible amounts, and prudent and feasible tax planning strategies, management believes it is more likely than not that the deferred tax assets will be realized. As such, no valuation allowance has been recorded as of December 31, 2021 or 2020.

The Company and its subsidiaries are primarily subject to federal and New York income taxes. The federal income tax years currently open for audits are 2018 through 2021. The New York income tax years currently open for audits are 2019 through 2021.

At December 31, 2021, the Company had no federal or New York net operating loss or tax credit carryforwards. The Company has a capital loss carryforward totaling \$1.7 million as of December 31, 2021 that was generated in the 2020 tax year. A portion of the capital loss will be carried back to prior years and the remainder, if unused, will expire in 2025. Realization of this tax benefit is dependent on the ability to generate sufficient capital gains in an appropriate tax year to offset the remaining capital loss carryforward. Management has determined it is more likely than not to be realized, therefore we have not established a valuation allowance on this tax benefit.

The Company's unrecognized tax benefits and changes in unrecognized tax benefits were not significant as of or for the years ended December 31, 2021, 2020 and 2019. There were no material interest or penalties recorded in the income statement in income tax expense for the years ended December 31, 2021, 2020 and 2019. As of December 31, 2021 and 2020, there were no amounts accrued for interest or penalties related to uncertain tax positions.

(20.) EARNINGS PER COMMON SHARE

The following table presents a reconciliation of the earnings and shares used in calculating basic and diluted EPS for each of the years ended December 31 (in thousands, except per share amounts). All outstanding unvested share-based payment awards that contain rights to non-forfeitable dividends are considered participating securities.

	2021	2020	2019
Net income available to common shareholders	\$ 76,237	\$ 36,871	\$ 47,401
Weighted average common shares outstanding:			
Total shares issued	16,100	16,100	16,086
Unvested restricted stock awards	(5)	(5)	(4)
Treasury shares	(254)	(73)	(110)
Total basic weighted average common shares outstanding	15,841	16,022	15,972
Incremental shares from assumed:			
Exercise of stock options	-	-	-
Vesting of restricted stock awards	96	41	59
Total diluted weighted average common shares outstanding	15,937	16,063	16,031
Basic earnings per common share	\$ 4.81	\$ 2.30	\$ 2.97
Diluted earnings per common share	\$ 4.78	\$ 2.30	\$ 2.96

For each of the periods presented, average shares subject to the following instruments were excluded from the computation of diluted EPS because the effect would be antidilutive:

Stock options	-	-	-
Restricted stock awards	3	54	4
Total	3	54	4

There were no participating securities outstanding for the years ended December 2021, 2020 and 2019; therefore, the two-class method of calculating basic and diluted EPS was not applicable for the years presented.

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(21.) EMPLOYEE BENEFIT PLANS

Supplemental Executive Retirement Agreements

The Company has non-qualified Supplemental Executive Retirement Agreements (“SERPs”) covering certain former executives. The unfunded liability related to the SERPs was \$1.0 million and \$1.3 million at December 31, 2021 and 2020, respectively. SERP expense was \$39 thousand, \$51 thousand and \$366 thousand for 2021, 2020 and 2019, respectively.

Defined Contribution Plan

Employees that meet specified eligibility conditions are eligible to participate in the Company sponsored 401(k) plan. Under the plan, participants may make contributions, in the form of salary deferrals, up to the maximum Internal Revenue Code limit. The Company is also permitted to make additional discretionary contributions, although no such additional discretionary contributions were made in 2021, 2020 or 2019.

Defined Benefit Pension Plan

The Company participates in The New York State Bankers Retirement System (the “Plan”), a defined benefit pension plan covering substantially all employees. For employees hired prior to December 31, 2006, who met participation requirements on or before January 1, 2008 (“Tier 1 Participant”), the benefits are generally based on years of service and the employee’s highest average compensation during five consecutive years of employment.

Effective January 1, 2016, the Plan was amended to open the Plan to eligible employees who were hired on and after January 1, 2007 (“Tier 2 Participant”) and provide these eligible participants with a cash balance benefit formula.

The following table provides a reconciliation of the Company’s changes in the Plan’s benefit obligations, fair value of assets and a statement of the funded status as of and for the year ended December 31 (in thousands):

	2021	2020
Change in projected benefit obligation:		
Projected benefit obligation at beginning of period	\$ 97,560	\$ 84,328
Service cost	4,196	3,693
Interest cost	2,202	2,537
Actuarial (gain) loss	(1,945)	11,154
Benefits paid and plan expenses	(4,331)	(4,152)
Projected benefit obligation at end of period	<u>97,682</u>	<u>97,560</u>
Change in plan assets:		
Fair value of plan assets at beginning of period	102,176	87,827
Actual return on plan assets	6,382	18,501
Employer contributions	-	-
Benefits paid and plan expenses	(4,331)	(4,152)
Fair value of plan assets at end of period	<u>104,227</u>	<u>102,176</u>
Funded status at end of period	<u>\$ 6,545</u>	<u>\$ 4,616</u>

The accumulated benefit obligation was \$90.1 million and \$88.9 million at December 31, 2021 and 2020, respectively.

The Company’s funding policy is to contribute, at a minimum, an actuarially determined amount that will satisfy the minimum funding requirements determined under the appropriate sections of Internal Revenue Code. The Company has no minimum required contribution for the 2022 fiscal year.

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(21.) EMPLOYEE BENEFIT PLANS (Continued)

Estimated benefit payments under the Plan over the next ten years at December 31, 2021 are as follows (in thousands):

2022	\$	3,731
2023		3,935
2024		4,199
2025		4,425
2026		4,663
2027 - 2031		25,686

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

	2021	2020	2019
Service cost	\$ 4,196	\$ 3,693	\$ 3,207
Interest cost on projected benefit obligation	2,202	2,537	2,777
Expected return on plan assets	(5,225)	(5,136)	(4,736)
Amortization of unrecognized loss	724	1,270	1,445
Net periodic pension cost	<u>\$ 1,897</u>	<u>\$ 2,364</u>	<u>\$ 2,693</u>

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

	2021	2020	2019
Weighted average discount rate	2.32%	3.09%	4.13%
Rate of compensation increase	3.00%	3.00%	3.00%
Expected long-term rate of return	5.25%	6.00%	6.50%

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

	2021	2020	2019
Weighted average discount rate	2.70%	2.32%	3.09%
Rate of compensation increase	3.00%	3.00%	3.00%

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

The Plan's overall investment strategy is to invest in a diversified portfolio while managing the variability between the assets and projected liabilities of underfunded pension plans. The Plan's Board Members approved a migration (the "Migration") of substantially all of the Plan's assets to one fund, Commingled Pensions Trust Fund (LDI Diversified Balanced) of JPMorgan Chase Bank, N.A. ("JPMCB LDI Diversified Balanced Fund" or the "Fund"). The Fund is a collective investment fund managed by the Plan's trustee (the "Trustee") under the Declaration of Trust. The Trustee is the Fund's manager and makes day-to-day investment decisions for the Fund. The Fund is a group trust within the meaning of Internal Revenue Service Revenue Ruling 81-100, as amended. In reliance upon exemptions from the registration requirements of the federal securities laws, neither the Fund nor the Fund's Units are registered with the SEC or any state securities commission. Because the Fund is not subject to registration under federal or state securities laws, certain protections that might otherwise be provided to investors in registered funds are not available to investors in the Fund. However, as a bank-sponsored collective investment trust holding qualified retirement plan assets, the Fund is required to comply with applicable provisions of the Employee Retirement Income Security Act of 1974, as amended ("ERISA"), and the Trustee is subject to supervision and regulation by the Office of the Comptroller of the Currency and the Department of Labor.

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(21.) EMPLOYEE BENEFIT PLANS (Continued)

Prior to the Migration, the Plan’s overall investment strategy was to achieve a mix of approximately 97% of investments for long-term growth and 3% for near-term benefit payments with a wide diversification of asset types, fund strategies, and fund managers. The Board made the election in their December 2018 meeting and the Migration had an effective trade date of February 28, 2019. The Fund employs a liability driven investing (“LDI”) strategy for pension plans that are seeking a solution that is balanced between growth and hedging. The Bloomberg Barclays Long A U.S. Corporate Index, the Fund’s primary liability-performance benchmark, is used as a proxy for plan projected liabilities. The growth-oriented portion of the Fund invests in a mix of asset classes that the Fund’s Trustee believes will collectively maximize total risk-adjusted return through a combination of capital appreciation and income. This portion of the Fund will comprise between 35% and 90% of the portfolio and will invest directly or indirectly via underlying funds in a broad mix of global equity, credit, global fixed income, real estate and cash-plus strategies. The remaining portion of the Fund, between 10% and 65% of the portfolio, provides exposure to U.S. long duration fixed income and is used to minimize volatility relative to a plan’s projected liabilities. This portion of the Fund will invest directly or indirectly via underlying funds in investment grade corporate bonds and securities issued by the U.S. Treasury and its agencies or instrumentalities.

The following table represents the Plan’s target asset allocation and actual asset allocation, respectively, as of December 31, 2021 and 2020:

	2021		2020	
	Target Allocation	Actual Allocation	Target Allocation	Actual Allocation
Asset category:				
Cash and cash equivalents	0.00%	0.00%	0.00%	0.00%
Equity securities	30.00	35.65	28.25	31.56
Fixed income securities	15.00	34.98	59.75	62.60
Alternative investments	55.00	29.37	12.00	5.84

Cash equivalents include repurchase agreements, banker’s acceptances, commercial paper, negotiable certificates of deposit, U.S. government securities with less than one year to maturity and funds (including the Commingled Pension Trust Fund (Liquidity) of JPMorgan Chase Bank, N.A. (“JPMorgan”)) established to invest in these types of highly liquid, high quality instruments. Equity securities primarily include investments in common stocks, depository receipts, preferred stocks, commingled pension trust funds, exchange traded funds and real estate investment trusts. Fixed income securities include corporate bonds, government issues, credit card receivables, mortgage backed securities, municipals, commingled pension trust funds and other asset backed securities. Alternative investments are real estate interests and related investments held within a commingled pension trust fund.

The Fund is valued utilizing the valuation policies set forth by JP Morgan’s asset management committee. Underlying investments for which market quotations are readily available are valued at their market value. Underlying investments for which market quotations are not readily available are fair valued by approved affiliated and/or unaffiliated pricing vendors, third-party broker-dealers or methodologies as approved by the asset management committee. Fixed income instruments are valued based on prices received from approved affiliated and unaffiliated pricing vendors or third-party broker-dealers (collectively referred to as “Pricing Services”). The Pricing Services use multiple valuation techniques to determine the valuation of fixed income instruments. In instances where sufficient market activity exists, the Pricing Services may utilize a market-based approach through which trades or quotes from market makers are used to determine the valuation of these instruments. In instances where sufficient market activity may not exist, the Pricing Services also utilize proprietary valuation models which may consider market transactions in comparable securities and the various relationships between securities in determining fair value and/or market characteristics in order to estimate the relevant cash flows, which are then discounted to calculate the fair values. Equities and other exchange-traded instruments are valued at the last sales price or official market closing price on the primary exchange on which the instrument is traded before the net asset values (“NAV”) of the Funds are calculated on a valuation date. Futures contracts are generally valued on the basis of available market quotations. Forward foreign currency exchange contracts are valued utilizing market quotations from approved Pricing Services. The Fund invests in the Commingled Pension Trust Fund (“Strategic Property Fund”) of JPMorgan (the “SPF”), which holds significant amounts of investments which have been fair valued at December 31, 2021 and 2020.

During the years ended December 31, 2021 and 2020, there were no transfers in or out of Levels 1, 2 or 3. In addition, there were no changes in valuation methodologies during the years ended December 31, 2021 and 2020.

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(21.) EMPLOYEE BENEFIT PLANS (Continued)

The major categories of Plan assets measured at fair value on a recurring basis as of December 31 are presented in the following tables (in thousands).

	Level 1 Inputs	Level 2 Inputs	Level 3 Inputs	Total Fair Value
2021				
Cash equivalents:				
Cash (including foreign currencies)	\$ -	\$ -	\$ -	\$ -
Short term investment funds	-	-	-	-
Total cash equivalents	-	-	-	-
Equity securities:				
Commingled pension trust funds	-	37,157	-	37,157
Total equity securities	-	37,157	-	37,157
Fixed income securities:				
Commingled pension trust funds	-	36,459	-	36,459
Corporate bonds	-	-	-	-
Total fixed income securities	-	36,459	-	36,459
Other investments:				
Commingled pension trust funds	-	30,611	-	30,611
Total Plan investments	\$ -	\$ 104,227	\$ -	\$ 104,227

At December 31, 2021, the portfolio was substantially managed by one investment firm, with control of approximately 100% of the Plan's assets. A portfolio concentration of 100% in the JPMCB LDI Diversified Balanced Fund, a CPTF, existed at December 31, 2021.

	Level 1 Inputs	Level 2 Inputs	Level 3 Inputs	Total Fair Value
2020				
Cash equivalents:				
Cash (including foreign currencies)	\$ 6	\$ -	\$ -	\$ 6
Short term investment funds	-	1,253	-	1,253
Total cash equivalents	6	1,253	-	1,259
Equity securities:				
Commingled pension trust funds	-	31,848	-	31,848
Total equity securities	-	31,848	-	31,848
Fixed income securities:				
Commingled pension trust funds	-	63,171	-	63,171
Corporate bonds	-	5	-	5
Total fixed income securities	-	63,176	-	63,176
Other investments:				
Commingled pension trust funds	-	5,893	-	5,893
Total Plan investments	\$ 6	\$ 102,170	\$ -	\$ 102,176

At December 31, 2020, the portfolio was substantially managed by one investment firm, with control of approximately 99% of the Plan's assets with the remaining 1% under the direct control of the Plan. A portfolio concentration of 99% in the JPMCB LDI Diversified Balanced Fund, a CPTF, existed at December 31, 2020.

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(21.) EMPLOYEE BENEFIT PLANS (Continued)

Postretirement Benefit Plan

An entity acquired by the Company provided health and dental care benefits to retired employees who met specified age and service requirements through a postretirement health and dental care plan in which both the acquired entity and the retirees shared the cost. The plan provided for substantially the same medical insurance coverage as for active employees until their death and was integrated with Medicare for those retirees aged 65 or older. In 2001, the plan's eligibility requirements were amended to curtail eligible benefit payments to only retired employees and active employees who had already met the then-applicable age and service requirements under the Plan. In 2003, retirees under age 65 began contributing to health coverage at the same cost-sharing level as that of active employees. Retirees ages 65 or older were offered new Medicare supplemental plans as alternatives to the plan historically offered. The cost sharing of medical coverage was standardized throughout the group of retirees aged 65 or older. In addition, to be consistent with the administration of the Company's dental plan for active employees, all retirees who continued dental coverage began paying the full monthly premium. The accrued liability included in other liabilities in the consolidated statements of financial condition related to this plan amounted to \$33 thousand and \$108 thousand as of December 31, 2021 and 2020, respectively. The postretirement expense for the plan that was included in salaries and employee benefits in the consolidated statements of income was not significant for the years ended December 31, 2021, 2020 and 2019. The plan is not funded.

The components of accumulated other comprehensive loss related to the defined benefit plan and postretirement benefit plan as of December 31 are summarized below (in thousands):

	2021	2020
Defined benefit plan:		
Net actuarial loss	\$ (12,587)	\$ (16,412)
Prior service credit (cost)	-	-
	(12,587)	(16,412)
Postretirement benefit plan:		
Net actuarial loss	(46)	(127)
Prior service credit	-	3
	(46)	(124)
Total	(12,633)	(16,536)
Deferred tax benefit	3,237	4,237
Amounts included in accumulated other comprehensive loss	\$ (9,396)	\$ (12,299)

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

	2021	2020
Defined benefit plan:		
Net actuarial gain	\$ 3,101	\$ 2,212
Amortization of net loss	724	1,270
Amortization of prior service credit	-	-
	3,825	3,482
Postretirement benefit plan:		
Net actuarial gain (loss)	61	(12)
Amortization of net loss	20	18
Amortization of prior service credit	(3)	(34)
	78	(28)
Total recognized in other comprehensive income	\$ 3,903	\$ 3,454

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(22.) FAIR VALUE MEASUREMENTS

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

Valuation Hierarchy

The fair value of an asset or liability is the price that would be received to sell that asset or paid to transfer that liability in an orderly transaction occurring in the principal market (or most advantageous market in the absence of a principal market) for such asset or liability. ASC Topic 820, “Fair Value Measurements and Disclosures,” establishes a fair value hierarchy for valuation inputs that gives the highest priority to quoted prices in active markets for identical assets or liabilities and the lowest priority to unobservable inputs. There have been no changes in the valuation techniques used during the current period. The fair value hierarchy is as follows:

- **Level 1** - Unadjusted quoted prices in active markets for identical assets or liabilities that the reporting entity has the ability to access at the measurement date.
- **Level 2** - Inputs other than quoted prices included in Level 1 that are observable for the asset or liability, either directly or indirectly. These might include quoted prices for similar assets or liabilities in active markets, quoted prices for identical or similar assets or liabilities in markets that are not active, inputs other than quoted prices that are observable for the asset or liability (such as interest rates, volatilities, prepayment speeds, credit risks, etc.) or inputs that are derived principally from or corroborated by market data by correlation or other means.
- **Level 3** - Unobservable inputs for determining the fair values of assets or liabilities that reflect an entity’s own assumptions about the assumptions that market participants would use in pricing the assets or liabilities.

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

In general, fair value is based upon quoted market prices, where available. If such quoted market prices are not available, fair value is based upon internally developed models that primarily use, as inputs, observable market-based parameters. Valuation adjustments may be made to ensure that financial instruments are recorded at fair value. These adjustments may include amounts to reflect counterparty credit quality and the company’s creditworthiness, among other things, as well as unobservable parameters. Any such valuation adjustments are applied consistently over time. The Company’s valuation methodologies may produce a fair value calculation that may not be indicative of net realizable value or reflective of future fair values. While management believes the Company’s valuation methodologies are appropriate and consistent with other market participants, the use of different methodologies or assumptions to determine the fair value of certain financial instruments could result in a different estimate of fair value at the reporting date. Furthermore, the reported fair value amounts have not been comprehensively revalued since the presentation dates, and therefore, estimates of fair value after the balance sheet date may differ significantly from the amounts presented herein. A more detailed description of the valuation methodologies used for assets and liabilities measured at fair value, as well as the general classification of such instruments pursuant to the valuation hierarchy, is set forth below.

Securities available for sale: Securities classified as available for sale are reported at fair value utilizing Level 2 inputs. For these securities, the Company obtains fair value measurements from an independent pricing service. The fair value measurements consider observable data that may include dealer quotes, market spreads, cash flows, the U.S. Treasury yield curve, live trading levels, trade execution data, market consensus prepayment speeds, credit information and the bond’s terms and conditions, among other things.

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

Loans held for sale: The fair value of loans held for sale is determined using quoted secondary market prices and investor commitments. Loans held for sale are classified as Level 2 in the fair value hierarchy.

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

Collateral dependent loans: Fair value of collateral dependent loans with specific allocations of the allowance for credit losses - loans is measured based on the value of the collateral securing these loans and is classified as Level 3 in the fair value hierarchy. Collateral may be real estate and/or business assets including equipment, inventory and/or accounts receivable and collateral value is determined based on appraisals performed by qualified licensed appraisers hired by the Company. These appraisals may utilize a single valuation approach or a combination of approaches including comparable sales and the income approach. Appraised and reported values may be discounted based on management's historical knowledge, changes in market conditions from the time of valuation, and/or management's expertise and knowledge of the client and the client's business. Such discounts are typically significant and result in a Level 3 classification of the inputs for determining fair value. Collateral dependent loans are reviewed and evaluated on at least a quarterly basis for additional impairment and adjusted accordingly, based on the same factors identified above.

Long-lived assets held for sale: The fair value of the long-lived assets held for sale was based on estimated market prices from independently prepared current appraisals, adjusted for expected costs to sell, and are classified as Level 3 in the fair value hierarchy.

Loan servicing rights: Loan servicing rights do not trade in an active market with readily observable market data. As a result, the Company estimates the fair value of loan servicing rights by using a discounted cash flow model to calculate the present value of estimated future net servicing income. The assumptions used in the discounted cash flow model are those that we believe market participants would use in estimating future net servicing income, including estimates of loan prepayment rates, servicing costs, ancillary income, impound account balances, and discount rates. The significant unobservable inputs used in the fair value measurement of the Company's loan servicing rights are the constant prepayment rates and weighted average discount rate. Significant increases (decreases) in any of those inputs in isolation could result in a significantly lower (higher) fair value measurement. Although the constant prepayment rate and the discount rate are not directly interrelated, they will generally move in opposite directions. Loan servicing rights are classified as Level 3 measurements due to the use of significant unobservable inputs, as well as significant management judgment and estimation.

Other real estate owned (foreclosed assets): Nonrecurring adjustments to certain commercial and residential real estate properties classified as other real estate owned are measured at the lower of carrying amount or fair value, less costs to sell. Fair values are generally based on third party appraisals of the property, resulting in a Level 3 classification. The appraisals are sometimes further discounted based on management's historical knowledge, changes in market conditions from the time of valuation, and/or management's expertise and knowledge of the client and client's business. Such discounts are typically significant and result in a Level 3 classification of the inputs for determining fair value. In cases where the carrying amount exceeds the fair value, less costs to sell, an impairment loss is recognized.

Commitments to extend credit and letters of credit: Commitments to extend credit and fund letters of credit are principally at current interest rates, and, therefore, the carrying amount approximates fair value. The fair value of commitments is not material.

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

Assets Measured at Fair Value

The following tables present for each of the fair-value hierarchy levels the Company's assets that are measured at fair value on a recurring and non-recurring basis as of December 31 (in thousands):

	Quoted Prices in Active Markets for Identical Assets or Liabilities (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Total
2021				
Measured on a recurring basis:				
Securities available for sale:				
U.S. Government agencies and government sponsored enterprises	\$ -	\$ 15,891	\$ -	\$ 15,891
Mortgage-backed securities	-	1,162,624	-	1,162,624
Other assets:				
Hedging derivative instruments	-	1,559	-	1,559
Fair value adjusted through comprehensive income	\$ -	\$ 1,180,074	\$ -	\$ 1,180,074
Other assets:				
Derivative instruments – interest rate products	\$ -	\$ 14,702	\$ -	\$ 14,702
Derivative instruments – credit contracts	-	-	-	-
Derivative instruments – mortgage banking	-	243	-	243
Other liabilities:				
Derivative instruments – interest rate products	-	(14,708)	-	(14,708)
Derivative instruments – credit contracts	-	(1)	-	(1)
Derivative instruments – mortgage banking	-	(4)	-	(4)
Fair value adjusted through net income	\$ -	\$ 232	\$ -	\$ 232
Measured on a nonrecurring basis:				
Loans:				
Loans held for sale	\$ -	\$ 6,202	\$ -	\$ 6,202
Collateral dependent loans	-	-	33,484	33,484
Other assets:				
Long-lived assets held for sale	-	-	2,560	2,560
Loan servicing rights	-	-	1,517	1,517
Total	\$ -	\$ 6,202	\$ 37,561	\$ 43,763

There were no transfers between Levels 1 and 2 during the years ended December 31, 2021 and 2020. There were no liabilities measured at fair value on a nonrecurring basis during the years ended December 31, 2021 and 2020.

FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
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(22.) FAIR VALUE MEASUREMENTS (Continued)

	Quoted Prices in Active Markets for Identical Assets or Liabilities (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Total
2020				
Measured on a recurring basis:				
Securities available for sale:				
U.S. Government agencies and government sponsored enterprises	\$ -	\$ 6,635	\$ -	\$ 6,635
Mortgage-backed securities	-	621,424	-	621,424
Other liabilities:				
Hedging derivative instruments	-	(311)	-	(311)
Fair value adjusted through comprehensive income	\$ -	\$ 627,748	\$ -	\$ 627,748
Other assets:				
Derivative instruments – interest rate products	\$ -	\$ 19,626	\$ -	\$ 19,626
Derivative instruments – credit contracts	-	23	-	23
Derivative instruments – mortgage banking	-	471	-	471
Other liabilities:				
Derivative instruments – interest rate products	-	(19,837)	-	(19,837)
Derivative instruments – credit contracts	-	(86)	-	(86)
Derivative instruments – mortgage banking	-	(1)	-	(1)
Fair value adjusted through net income	\$ -	\$ 196	\$ -	\$ 196
Measured on a nonrecurring basis:				
Loans:				
Loans held for sale	\$ -	\$ 4,305	\$ -	\$ 4,305
Collateral dependent loans	-	-	29,434	29,434
Other assets:				
Loan servicing rights	-	-	1,320	1,320
Other real estate owned	-	-	2,966	2,966
Total	\$ -	\$ 4,305	\$ 33,720	\$ 38,025

There were no transfers between Levels 1 and 2 during the years ended December 31, 2020 and 2019. There were no liabilities measured at fair value on a nonrecurring basis during the years ended December 31, 2020 and 2019.

The following table presents additional quantitative information about assets measured at fair value on a recurring and nonrecurring basis for which the Company has utilized Level 3 inputs to determine fair value (dollars in thousands).

Asset	Fair Value	Valuation Technique	Unobservable Input	Unobservable Input Value / Range
Collateral dependent loans	\$ 33,484	Appraisal of collateral ⁽¹⁾	Appraisal adjustments ⁽²⁾	24.7% ⁽³⁾ / 0 - 45%
Loan servicing rights	\$ 1,517	Discounted cash flow	Discount rate	10.2% ⁽³⁾
			Constant prepayment rate	14.4% ⁽³⁾
Long-lived assets held for sale	\$ 2,560	Appraisal of collateral ⁽¹⁾	Appraisal adjustments ⁽²⁾	11-40%

⁽¹⁾ Fair value is generally determined through independent appraisals of the underlying collateral, which generally include various Level 3 inputs which are not identifiable.

⁽²⁾ Appraisals may be adjusted by management for qualitative factors such as economic conditions and estimated liquidation expenses.

⁽³⁾ Weighted averages.

FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
December 31, 2021, 2020 and 2019

(22.) FAIR VALUE MEASUREMENTS (Continued)

Changes in Level 3 Fair Value Measurements

There were no assets measured at fair value on a recurring basis using significant unobservable inputs (Level 3) as of or during the years ended December 31, 2021 and 2020.

Disclosures about Fair Value of Financial Instruments

The assumptions used below are expected to approximate those that market participants would use in valuing these financial instruments.

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

The estimated fair value approximates carrying value for cash and cash equivalents, FHLB and FRB stock, accrued interest receivable, non-maturity deposits, short-term borrowings and accrued interest payable. Fair value estimates for other financial instruments not included elsewhere in this disclosure are discussed below.

Securities held to maturity: The fair value of the Company's investment securities held to maturity is primarily measured using information from a third-party pricing service. The fair value measurements consider observable data that may include dealer quotes, market spreads, cash flows, the U.S. Treasury yield curve, live trading levels, trade execution data, market consensus prepayment speeds, credit information and the bond's terms and conditions, among other things.

Loans: The fair value of the Company's loans was estimated by discounting the expected future cash flows using the current interest rates at which similar loans would be made for the same remaining maturities. Loans were first segregated by type such as commercial, residential mortgage, and consumer, and were then further segmented into fixed and variable rate and loan quality categories. Expected future cash flows were projected based on contractual cash flows, adjusted for estimated prepayments.

Time deposits: The fair value of time deposits was estimated using a discounted cash flow approach that applies prevailing market interest rates for similar maturity instruments. The fair values of the Company's time deposit liabilities do not take into consideration the value of the Company's long-term relationships with depositors, which may have significant value.

Long-term borrowings: Long-term borrowings consist of \$75 million of subordinated notes. The subordinated notes are publicly traded and are valued based on market prices, which are characterized as Level 2 liabilities in the fair value hierarchy.

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

The following presents the carrying amount, estimated fair value, and placement in the fair value measurement hierarchy of the Company's financial instruments as of December 31(in thousands):

	Level in Fair Value Measurement Hierarchy	2021		2020	
		Carrying Amount	Estimated Fair Value	Carrying Amount	Estimated Fair Value
Financial assets:					
Cash and cash equivalents	Level 1	\$ 79,112	\$ 79,112	\$ 93,878	\$ 93,878
Securities available for sale	Level 2	1,178,515	1,178,515	628,059	628,059
Securities held to maturity, net	Level 2	205,581	209,820	271,973	282,035
Loans held for sale	Level 2	6,202	6,202	4,305	4,305
Loans	Level 2	3,606,276	3,642,351	3,513,284	3,549,770
Loans ⁽¹⁾	Level 3	33,484	33,484	29,434	29,434
Long-lived assets held for sale	Level 3	2,560	2,560	-	-
Accrued interest receivable	Level 1	15,482	15,482	15,635	15,635
Derivative instruments – cash flow hedge	Level 2	1,559	1,559	-	-
Derivative instruments – interest rate products	Level 2	14,702	14,702	19,626	19,626
Derivative instruments – credit contracts	Level 2	-	-	23	23
Derivative instruments – mortgage banking	Level 2	243	243	471	471
FHLB and FRB stock	Level 2	10,770	10,770	8,619	8,619
Financial liabilities:					
Non-maturity deposits	Level 1	3,905,136	3,905,136	3,392,774	3,392,774
Time deposits	Level 2	921,954	920,699	885,593	887,113
Short-term borrowings	Level 1	30,000	30,000	5,300	5,300
Long-term borrowings	Level 2	73,911	77,792	73,623	83,953
Accrued interest payable	Level 1	2,147	2,147	4,381	4,381
Derivative instruments – cash flow hedges	Level 2	-	-	311	311
Derivative instruments – interest rate products	Level 2	14,708	14,708	19,837	19,837
Derivative instruments – credit contracts	Level 2	1	1	86	86
Derivative instruments – mortgage banking	Level 2	4	4	1	1

(1) Comprised of collateral dependent loans.

FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES
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December 31, 2021, 2020 and 2019

(23.) PARENT COMPANY FINANCIAL INFORMATION

Condensed financial statements pertaining only to the Parent are presented below (in thousands).

Condensed Statements of Financial Condition	December 31,	
	2021	2020
Assets:		
Cash and due from subsidiary	\$ 23,318	\$ 31,848
Investment in and receivables due from subsidiary	555,310	511,572
Other assets	5,998	4,136
Total assets	\$ 584,626	\$ 547,556
Liabilities and shareholders' equity:		
Long-term borrowings, net of issuance costs of \$1,089 and \$1,377, respectively	\$ 73,911	\$ 73,623
Other liabilities	5,573	5,570
Shareholders' equity	505,142	468,363
Total liabilities and shareholders' equity	\$ 584,626	\$ 547,556

Condensed Statements of Income	Years ended December 31,		
	2021	2020	2019
Dividends from subsidiary and associated companies	\$ 24,000	\$ 23,000	\$ 20,000
Management and service fees from subsidiaries	147	146	146
Other income	93	121	97
Total income	24,240	23,267	20,243
Interest expense	4,237	2,888	2,471
Operating expenses	3,379	3,171	3,073
Total expense	7,616	6,059	5,544
Income before income tax benefit and equity in undistributed earnings of subsidiary	16,624	17,208	14,699
Income tax benefit	1,999	1,399	596
Income before equity in undistributed earnings of subsidiary	18,623	18,607	15,295
Equity in undistributed earnings of subsidiary	59,074	19,725	33,567
Net income	\$ 77,697	\$ 38,332	\$ 48,862

FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
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(23.) PARENT COMPANY FINANCIAL INFORMATION (Continued)

Condensed Statements of Cash Flows	Years ended December 31,		
	2021	2020	2019
Cash flows from operating activities:			
Net income	\$ 77,697	\$ 38,332	\$ 48,862
Adjustments to reconcile net income to net cash provided by operating activities:			
Equity in undistributed earnings of subsidiary	(59,074)	(19,725)	(33,567)
Depreciation and amortization	367	209	153
Share-based compensation	1,743	1,333	1,406
(Increase) decrease in other assets	(1,448)	(48)	2,243
(Decrease) increase in other liabilities	(86)	497	(1,407)
Net cash provided by operating activities	19,199	20,598	17,690
Cash flows from investing activities:			
Capital investment in subsidiaries	-	(11,966)	(350)
Purchase of premises and equipment	-	(11)	8
Net cash paid for acquisition	-	-	-
Net cash used in investing activities	-	(11,977)	(342)
Cash flows from financing activities:			
Issuance of long-term debt, net of issuance costs	-	34,221	-
Purchase of preferred and common shares	(9,235)	(209)	(293)
Proceeds from issuance of preferred and common shares	(43)	-	-
Dividends paid	(18,451)	(17,957)	(17,260)
Net cash (used in) provided by financing activities	(27,729)	16,055	(17,553)
Net (decrease) increase in cash and cash equivalents	(8,530)	24,676	(205)
Cash and cash equivalents as of beginning of year	31,848	7,172	7,377
Cash and cash equivalents as of end of the year	\$ 23,318	\$ 31,848	\$ 7,172

(24.) SEGMENT REPORTING

The Company has one reportable segment, Banking, which includes all of the Company's retail and commercial banking operations. This reportable segment has been identified and organized based on the nature of the underlying products and services applicable to the segment, the type of customers to whom those products and services are offered and the distribution channel through which those products and services are made available.

All other segments that do not meet the quantitative threshold for separate reporting have been grouped as "All Other." This "All Other" grouping includes the activities of SDN, a full service insurance agency that provides a broad range of insurance services to both personal and business clients, Courier Capital and HNP Capital, our investment advisor and wealth management firms that provide customized investment management, investment consulting and retirement plan services to individuals, businesses, institutions, foundations and retirement plans, CHIL, which oversees the Company's Banking as a Service and Fintech relationships, and Holding Company amounts, which are the primary differences between segment amounts and consolidated totals, along with amounts to eliminate balances and transactions between segments.

FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
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(24.) SEGMENT REPORTING (Continued)

The following table presents information regarding the Company's business segments as of the dates indicated (in thousands).

	Banking	All Other	Consolidated Totals
December 31, 2021			
Goodwill	\$ 48,536	\$ 18,535	\$ 67,071
Other intangible assets, net	3	7,326	7,329
Total assets	5,481,889	38,890	5,520,779
December 31, 2020			
Goodwill	\$ 48,536	\$ 17,526	\$ 66,062
Other intangible assets, net	28	7,699	7,727
Total assets	4,875,673	36,633	4,912,306

The following table presents information regarding the Company's business segments for the periods indicated (in thousands).

	Banking	All Other ⁽¹⁾	Consolidated Totals
Year ended December 31, 2021			
Net interest income (expense)	\$ 158,967	\$ (4,237)	\$ 154,730
Benefit for credit losses - loans	8,336	-	8,336
Noninterest income	31,340	15,566	46,906
Noninterest expense	(95,882)	(16,868)	(112,750)
Income (loss) before income taxes	102,761	(5,539)	97,222
Income tax (expense) benefit	(21,038)	1,513	(19,525)
Net income (loss)	<u>\$ 81,723</u>	<u>\$ (4,026)</u>	<u>\$ 77,697</u>
Year ended December 31, 2020			
Net interest income (expense)	\$ 141,873	\$ (2,888)	\$ 138,985
Provision for credit losses - loans	(27,184)	-	(27,184)
Noninterest income	31,232	11,944	43,176
Noninterest expense	(94,988)	(14,266)	(109,254)
Income (loss) before income taxes	50,933	(5,210)	45,723
Income tax (expense) benefit	(8,630)	1,239	(7,391)
Net income (loss)	<u>\$ 42,303</u>	<u>\$ (3,971)</u>	<u>\$ 38,332</u>
Year ended December 31, 2019			
Net interest income (expense)	\$ 132,383	\$ (2,471)	\$ 129,912
Provision for loan losses	(8,044)	-	(8,044)
Noninterest income	29,390	10,991	40,381
Noninterest expense	(88,801)	(14,027)	(102,828)
Income (loss) before income taxes	64,928	(5,507)	59,421
Income tax (expense) benefit	(11,190)	631	(10,559)
Net income (loss)	<u>\$ 53,738</u>	<u>\$ (4,876)</u>	<u>\$ 48,862</u>

⁽¹⁾ Reflects activity from the acquisitions of assets of Landmark since February 1, 2021 (the date of acquisition) and North Woods since August 2, 2021 (date of acquisition).

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

None.

ITEM 9A. CONTROLS AND PROCEDURES

Effectiveness of Controls and Procedures

As of the end of the period covered by this report, the Company carried out an evaluation, under the supervision and with the participation of the Company's management, including the Company's Chief Executive Officer (Principal Executive Officer) and Chief Financial Officer (Principal Financial Officer), of the effectiveness of the design and operation of the Company's disclosure controls and procedures pursuant to Rule 13a-15(b), as adopted by the Securities and Exchange Commission ("SEC") under the Securities Exchange Act of 1934 ("Exchange Act"). Based upon that evaluation, the Chief Executive Officer and Chief Financial Officer concluded that the Company's disclosure controls and procedures were effective as of the end of the period covered by this Annual Report on Form 10-K.

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

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

Management of the Company is responsible for establishing and maintaining adequate internal control over financial reporting. Management assessed the Company's internal control over financial reporting based on criteria established in the *Internal Control—Integrated Framework (2013)* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). Based on this assessment, management has concluded that, as of December 31, 2021, the Company maintained effective internal control over financial reporting. Management's Report on Internal Control over Financial Reporting is included under Item 8 "Financial Statements and Supplementary Data" in Part II of this Form 10-K.

RSM US LLP, an independent registered public accounting firm, has audited the consolidated financial statements as of and for the year ended December 31, 2021 which are included in this Annual Report on Form 10-K, and has issued a report on the effectiveness of the Company's internal control over financial reporting as of December 31, 2021. The Report of the Independent Registered Public Accounting Firm that attests the effectiveness of internal control over financial reporting is included under Item 8 "Financial Statements and Supplementary Data" in Part II of this Form 10-K.

Changes in Internal Control over Financial Reporting

There were no changes in the Company's internal control over financial reporting that occurred during the quarter ended December 31, 2021 that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

ITEM 9B. OTHER INFORMATION

Not applicable.

ITEM 9C. DISCLOSURE REGARDING FOREIGN JURISDICTIONS THAT PREVENT INSPECTIONS

Not applicable.

PART III

ITEM 10. DIRECTORS, EXECUTIVE OFFICERS AND CORPORATE GOVERNANCE

In response to this Item, the information set forth in the Company’s Proxy Statement for its 2022 Annual Meeting of Shareholders (the “2022 Proxy Statement”) to be filed within 120 days following the end of the Company’s fiscal year, under the headings “Proposal 1 - Election of Directors,” “Business Experience and Qualification of Directors,” “Our Executive Officers” and “Delinquent Section 16(a) Reports” is incorporated herein by reference.

Information concerning the Company’s Audit Committee and the Audit Committee’s financial expert is set forth under the caption “Committees of the Board” in the 2022 Proxy Statement and is incorporated herein by reference.

Information concerning the Company’s Code of Business Conduct and Ethics is set forth under the caption “ESG and Corporate Responsibility” in the 2022 Proxy Statement and is incorporated herein by reference.

ITEM 11. EXECUTIVE COMPENSATION

In response to this Item, the information set forth in the 2022 Proxy Statement under the headings “Compensation Discussion and Analysis,” “Executive Compensation Tables,” “Management Development and Compensation Committee Interlocks and Insider Participation,” “Director Compensation,” and “Management Development and Compensation Committee Report” is incorporated herein by reference.

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

In response to this Item, the information set forth in the 2022 Proxy Statement under the heading “Security Ownership of Certain Beneficial Owners and Management” is incorporated herein by reference.

Equity Compensation Plan Information

The following table sets forth, as of December 31, 2021, 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 (a)	Weighted average exercise price of outstanding options, warrants and rights (b) ⁽¹⁾	Number of securities remaining for future issuance under equity compensation plans (excluding securities reflected in column (a)) (c)
Equity compensation plans approved by shareholders	191,310 ⁽¹⁾	\$ -	815,769
Equity compensation plans not approved by shareholders	-	\$ -	-

⁽¹⁾ Comprised of restricted stock units granted under our 2015 Plan. See Note 18, Share-Based Compensation, to the Consolidated Financial Statements included in Item 8 of this Annual Report on Form 10-K for further details. All restricted stock units are excluded from the weighted average exercise price column.

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

In response to this Item, the information set forth in the 2022 Proxy Statement under the headings “Certain Relationships and Related Party Transactions” and “Director Independence and Qualifications” is incorporated herein by reference.

ITEM 14. PRINCIPAL ACCOUNTING FEES AND SERVICES

In response to this Item, the information set forth in the 2022 Proxy Statement under the heading “Proposal 3 – Ratification of Appointment of Independent Registered Public Accounting Firm” is incorporated herein by reference.

PART IV

ITEM 15. EXHIBITS AND FINANCIAL STATEMENT SCHEDULES

(a) FINANCIAL STATEMENTS

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

(b) EXHIBITS

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

Exhibit Number	Description	Location
3.1	Amended and Restated Certificate of Incorporation of the Company	Incorporated by reference to Exhibits 3.1, 3.2 and 3.3 of the Form 10-K for the year ended December 31, 2008, dated March 12, 2009
3.2	Amended and Restated Bylaws of Financial Institutions, Inc.	Incorporated by reference to Exhibit 3.1 of the Form 8-K, dated June 25, 2019
4.1	Subordinated Indenture, dated as of April 15, 2015, between Financial Institutions, Inc. and Wilmington Trust, National Association, as Trustee	Incorporated by reference to Exhibit 4.1 of the Form 8-K, dated April 15, 2015
4.2	First Supplemental Indenture, dated as of April 15, 2015, between Financial Institutions, Inc. and Wilmington Trust, National Association, as Trustee	Incorporated by reference to Exhibit 4.2 of the Form 8-K, dated April 15, 2015
4.3	Form of Global Note to represent the 6.00% Fixed-to-Floating Rate Subordinated Notes due April 15, 2030	Incorporated by reference to Exhibit A of Exhibit 4.2 of the Form 8-K, dated April 15, 2015
4.4	Subordinated Indenture, dated as of October 7, 2020, between Financial Institutions, Inc. and Wilmington Trust, National Association, as Trustee	Incorporated by reference to Exhibit 4.1 of the Form 8-K, dated October 7, 2020.
4.5	Form of 4.375% Fixed-to-Floating Rate Subordinated Note due October 15, 2030	Included in Exhibit 4.4.
4.6	Description of the Company’s Securities	Incorporated by reference to Exhibit 4.4 of the Form 10-K for the year ended December 31, 2019, dated March 4, 2020.
10.1	Supplemental Executive Retirement Agreement between Financial Institutions, Inc. and Peter G. Humphrey	Incorporated by reference to Exhibit 10.3 of the Form 10-Q for the quarterly period ended September 30, 2012, dated November 6, 2012
10.2	Supplemental Executive Retirement Agreement between Financial Institutions, Inc. and Richard J. Harrison	Incorporated by reference to Exhibit 10.1 of the Form 10-Q for the quarterly period ended June 30, 2014, dated August 5, 2014
10.3	Financial Institutions, Inc. Amended and Restated 2015 Long-Term Incentive Plan	Incorporated by reference to Exhibit 10.1 of the Form 10-Q for the quarterly period ended June 30, 2021, dated August 9, 2021
10.4	Form of Director Annual Restricted Stock Award Agreement Pursuant to the Financial Institutions, Inc. 2015 Long-Term Incentive Plan	Filed Herewith
10.5	Form of Director “In Lieu of Cash Fees” Stock Award Agreement Pursuant to the Financial Institutions, Inc. 2015 Long-Term Incentive Plan	Incorporated by reference to Exhibit 10.3 of the Form 10-Q for the quarterly period ended June 30, 2015, dated August 5, 2015
10.6	Form of Restricted Stock Unit Award Agreement Pursuant to the Financial Institutions, Inc. 2015 Long-Term Incentive Plan	Filed Herewith
10.7	Form of Restricted Stock Unit Award Agreement Pursuant to the Financial Institutions, Inc. Amended and Restated 2015 Long-Term Incentive Plan	Filed Herewith
10.8	Form of Indemnification Agreement	Incorporated by reference to Exhibit 10.1 of the Form 8-K, dated December 30, 2016

10.9	Amended and Restated Executive Agreement, dated May 3, 2017, by and between Financial Institutions, Inc. and Martin K. Birmingham	Incorporated by reference to Exhibit 10.1 of the Form 8-K, dated May 4, 2017
10.10	Supplemental Executive Retirement Agreement between Financial Institutions, Inc. and Kevin B. Klotzbach dated June 26, 2018	Incorporated by reference to Exhibit 10.1 of the Form 10-Q for the quarterly period ended June 30, 2018, dated August 8, 2018
10.11	Form of Executive Agreement	Incorporated by reference to Exhibit 10.15 of the Form 10-K for the year ended December 31, 2020, dated March 15, 2021
10.12	Form of Performance Stock Unit Award Agreement Pursuant to the Financial Institutions, Inc. 2015 Long-Term Incentive Plan	Incorporated by reference to Exhibit 10.2 of the Form 10-Q for the quarterly period ended March 31, 2021, dated May 10, 2021
10.13	Financial Institutions, Inc. Executive Incentive Plan, effective as of January 1, 2021	Filed Herewith
21	Subsidiaries of Financial Institutions, Inc.	Filed Herewith
23.1	Consent of Independent Registered Public Accounting Firm, RSM US LLP	Filed Herewith
31.1	Certification pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 - Principal Executive Officer	Filed Herewith
31.2	Certification pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 - Principal Financial Officer	Filed Herewith
32	Certification pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002	Filed Herewith
101.INS	Inline XBRL Instance Document	
101.SCH	Inline XBRL Taxonomy Extension Schema Document	
101.CAL	Inline XBRL Taxonomy Extension Calculation Linkbase Document	
101.LAB	Inline XBRL Taxonomy Extension Label Linkbase Document	
101.PRE	Inline XBRL Taxonomy Extension Presentation Linkbase Document	
101.DEF	Inline XBRL Taxonomy Extension Definition Linkbase Document	
104	Cover Page Interactive Data File (embedded within the Inline XBRL document)	

All material agreements consist of management contracts, compensatory plans or arrangements.

ITEM 16. FORM 10-K SUMMARY

None.

SIGNATURES

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

FINANCIAL INSTITUTIONS, INC.

March 10, 2022

By: /s/ Martin K. Birmingham
Martin K. Birmingham
President and Chief Executive Officer

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the registrant and in the capacities and on the dates indicated.

<u>Signatures</u>	<u>Title</u>	<u>Date</u>
<u>/s/ Martin K. Birmingham</u> Martin K. Birmingham	Director, President and Chief Executive Officer (Principal Executive Officer)	March 10, 2022
<u>/s/ W. Jack Plants, II</u> W. Jack Plants, II	Senior Vice President, Chief Financial Officer and Treasurer (Principal Financial Officer)	March 10, 2022
<u>/s/ Sonia M. Dumbleton</u> Sonia M. Dumbleton	Senior Vice President and Controller (Principal Accounting Officer)	March 10, 2022
<u>/s/ Donald K. Boswell</u> Donald K. Boswell	Director	March 10, 2022
<u>/s/ Dawn H. Burlew</u> Dawn H. Burlew	Director	March 10, 2022
<u>/s/ Andrew W. Dorn, Jr.</u> Andrew W. Dorn, Jr.	Director	March 10, 2022
<u>/s/ Robert M. Glaser</u> Robert M. Glaser	Director	March 10, 2022
<u>/s/ Samuel M. Gullo</u> Samuel M. Gullo	Director	March 10, 2022
<u>/s/ Susan R. Holliday</u> Susan R. Holliday	Director, Chair	March 10, 2022
<u>/s/ Robert N. Latella</u> Robert N. Latella	Director	March 10, 2022
<u>/s/ Mauricio F. Riveros</u> Mauricio F. Riveros	Director	March 10, 2022
<u>/s/ Kim E. VanGelder</u> Kim E. VanGelder	Director	March 10, 2022
<u>/s/ Mark A. Zupan</u> Mark A. Zupan	Director	March 10, 2022

Five Year Financial Highlights

(Dollars in thousands, except per share data)

	At or for the year ended December 31,				
	2021	2020	2019	2018	2017
Selected Financial Condition Data:					
Total assets	\$5,520,779	\$4,912,306	\$4,384,178	\$4,311,698	\$4,105,210
Shareholders' equity	505,142	468,363	438,947	396,293	381,177
Selected Operations Data:					
Interest income	\$167,205	\$161,299	\$168,800	\$152,732	\$130,110
Interest expense	12,475	22,314	38,888	29,868	17,495
Net interest income	154,730	138,985	129,912	122,864	112,615
(Benefit) provision for credit losses	(8,336)	27,184	8,044	8,934	13,361
Net interest income after provision for credit losses	163,066	111,801	121,868	113,930	99,254
Noninterest income	46,906	43,176	40,381	36,478	34,730
Noninterest expense	112,750	109,254	102,828	100,876	90,513
Income before income taxes	97,222	45,723	59,421	49,532	43,471
Income tax expense	19,525	7,391	10,559	10,006	9,945
Net income	\$77,697	\$38,332	\$48,862	\$39,526	\$33,526
Preferred stock dividends	1,460	1,461	1,461	1,461	1,462
Net income available to common shareholders	\$76,237	\$36,871	\$47,401	\$38,065	\$32,064
Stock and Related Per Share Data:					
Earnings per common share:					
Basic	\$4.81	\$2.30	\$2.97	\$2.39	\$2.13
Diluted	\$4.78	\$2.30	\$2.96	\$2.39	\$2.13
Cash dividends declared per common share	\$1.08	\$1.04	\$1.00	\$0.96	\$0.85
Common book value per share	\$30.98	\$28.12	\$26.35	\$23.79	\$22.85
Market price (Nasdaq: FISL):					
High	\$33.65	\$32.70	\$33.28	\$34.35	\$35.40
Low	\$21.76	\$12.78	\$25.50	\$24.49	\$25.65
Close	\$31.80	\$22.50	\$32.10	\$25.70	\$31.10
Performance and Capital Ratios:					
Net income, returns on:					
Average assets	1.46%	0.82%	1.14%	0.95%	0.86%
Average equity	16.01%	8.49%	11.61%	10.18%	9.62%
Common dividend payout ratio	22.45%	45.22%	33.67%	40.17%	39.91%
Net interest margin (fully tax-equivalent)	3.14%	3.22%	3.28%	3.18%	3.21%
Effective tax rate	20.1%	16.2%	17.8%	20.2%	22.9%
Efficiency ratio ¹	55.76%	60.22%	60.59%	62.73%	60.65%
Common equity to assets	8.84%	9.18%	9.62%	8.79%	8.86%
Reconciliations to Non-GAAP Financial Measures					
Pre-tax pre-provision income:					
Net income	\$77,697	\$38,332	\$48,862	\$39,526	\$33,526
Add: Income tax expense	19,525	7,391	10,559	10,006	9,945
Add: (Benefit) provision for credit losses	(8,336)	27,184	8,044	8,934	13,361
Pre-tax pre-provision income	\$88,886	\$72,907	\$67,465	\$58,466	\$56,832
Tangible common book value per share:					
Common shareholders' equity	\$487,850	\$451,035	\$421,619	\$378,965	\$363,848
Less: Goodwill and other intangible assets, net	74,400	73,789	74,923	76,173	74,703
Tangible common equity	\$413,450	\$377,246	\$346,696	\$302,792	\$289,145
Common shares outstanding	15,747	16,042	16,003	15,929	15,925
Tangible common book value per share ²	\$26.26	\$23.52	\$21.66	\$19.01	\$18.16
Other data:					
Number of branches	48	47	53	53	53
Number of employees	625	613	722	725	656

1: Efficiency ratio provides a ratio of operating expenses to operating income. Efficiency ratio is calculated by dividing noninterest expense by net revenue, which is defined as the sum of tax-equivalent net interest income and noninterest income before net gains on investment securities. The efficiency ratio is not a financial measurement required by GAAP. However, the efficiency ratio is used by management in its assessment of financial performance specifically as it relates to noninterest expense control. Management also believes such information is useful to investors in evaluating Company performance.

2: Tangible common equity divided by common shares outstanding.

Investor Information

Corporate Headquarters

220 Liberty Street
Warsaw, New York 14569

Corporate Website

Financial results, corporate announcements, dividend news and corporate governance information is available on the Company's website: www.fiiwarsaw.com

Annual Meeting

The 2022 Annual Meeting of Shareholders will be held at 10:00 a.m. EDT on June 14, 2022. The meeting will be held solely by means of remote communication via the virtual meeting at www.virtualshareholdermeeting.com/FISI2022.

Transfer Agent

Our transfer agent, American Stock Transfer & Trust Co., maintains the records for our registered shareholders and can assist you with a variety of shareholder services including address changes, certificate replacement and other inquiries regarding your account.

American Stock Transfer & Trust Company, LLC
6201 15th Avenue
Brooklyn, New York 11219

Phone: 800.937.5449

Teletypewriter for the hearing impaired: 866.703.9077
help@astfinancial.com

Website: www.astfinancial.com

Stock Exchange Information

NASDAQ Global Select Market
Ticker Symbol: FISI

Form 10-K and Other Reports

This Annual Report includes the Financial Institutions, Inc. Annual Report on Form 10-K. The Form 10-K Report filed with the U.S. Securities and Exchange Commission in March 2022 also contains additional information including exhibits.

The Form 10-K can be viewed at www.fiiwarsaw.com, Financials/SEC Filings, and is also available without charge upon request to Samuel J. Burruano, Jr., Chief Legal Officer and Corporate Secretary, 220 Liberty Street, Warsaw, New York 14569.

Investor Relations Contacts

Shelly J. Doran – Director of Investor and External Relations

SJDoran@five-starbank.com

or

W. Jack Plants II – Chief Financial Officer and Treasurer
WJPlants@five-starbank.com

Legal Counsel

Harter Secrest & Emery LLP

Independent Auditors

RSM US LLP
Chicago, IL

Affiliates

Five Star Bank
SDN Insurance Agency, LLC
Courier Capital, LLC
HNP Capital, LLC

Five Star Bank Rochester Regional Administrative Center

Five Star Bank Plaza
100 Chestnut Street
Rochester, NY 14604

Five Star Bank Buffalo Regional Administrative Center

300 Spindrift Drive
Amherst, New York 14221

New Address Effective Summer 2022:
6215 Sheridan Drive
Amherst, NY 14221

SDN Insurance Agency, LLC

300 Spindrift Drive
Amherst, New York 14221

New Address Effective Summer 2022:
6215 Sheridan Drive
Amherst, NY 14221

Courier Capital, LLC

1114 Delaware Avenue
Buffalo, NY 14209

HNP Capital, LLC

Five Star Bank Plaza
100 Chestnut Street
Rochester, NY 14604





**Financial
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