FINANCIAL INSTITUTIONS INC
Form 10-Q
November 08, 2006

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UNITED STATES SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549
FORM 10-Q

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

FOR THE QUARTERLY PERIOD ENDED September 30, 2006

Commission File Number 0-26481

(Exact Name of Registrant as specified in its charter)

NEW YORK	16-0816610
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification Number)
220 Liberty Street Warsaw, NY	14569
(Address of Principal Executive Offices)	(Zip Code)

Registrant s Telephone Number Including Area Code:
(585) 786-1100

Indicate by check mark whether the Registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding twelve months (or for such shorter period that the Registrant was required to file reports) and (2) has been subject to such requirements for at least the past 90 days. YES þ NO o

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act. (Check One):

Large Accelerated filer o Accelerated filer þ Non-accelerated filer o

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

Indicate the number of shares outstanding of each of the issuer s classes of common stock, as of the latest practicable date.

CLASS	OUTSTANDING AT NOVEMBER 1, 2006
Common Stock, $0.01 par value	11,348,122 shares

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Item 1. Financial Statements (Unaudited)

FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF FINANCIAL CONDITION
(Unaudited)

(Dollars in thousands, except per share amounts)	September 30, 2006	December 31, 2005
Assets		
Cash, due from banks and interest-bearing deposits	$ 52,910	$ 47,258
Federal funds sold	80,223	44,682
Securities available for sale, at fair value	737,776	790,855
Securities held to maturity fair value of $41,929 at September 30, 2006 and $42,898 at December 31, 2005	41,927	42,593
Loans held for sale	721	1,253
Loans, net	923,330	972,090
Premises and equipment, net	34,472	36,471
Goodwill	37,369	37,369
Other assets	43,401	49,821
Total assets	$ 1,952,129	$ 2,022,392
Liabilities And Shareholders Equity		
Liabilities:		
Deposits:		
Demand	$ 270,671	$ 284,958
Savings, money market and interest-bearing checking	714,141	755,229
Certificates of deposit	654,807	677,074
Total deposits	1,639,619	1,717,261
Short-term borrowings	40,549	35,106
Long-term borrowings	54,342	63,391
Junior subordinated debentures issued to unconsolidated subsidiary trust (Junior subordinated debentures)	16,702	16,702
Accrued expenses and other liabilities	18,919	18,175
Total liabilities	1,770,131	1,850,635
Shareholders equity:		
3% cumulative preferred stock, $100 par value, authorized 10,000 shares, issued and outstanding 1,586 shares at September 30, 2006 and December 31, 2005	159	159
	17,464	17,475

8.48% cumulative preferred stock, $100 par value, authorized 200,000 shares, issued and outstanding 174,639 shares at September 30, 2006 and 174,747 shares at December 31, 2005		
Common stock, $0.01 par value, authorized 50,000,000 shares, issued 11,347,375 shares at September 30, 2006 and 11,334,874 shares at December 31, 2005	113	113
Additional paid-in capital	24,314	23,278
Retained earnings	147,092	136,925
Accumulated other comprehensive loss	(7,144)	(6,178)
Treasury stock, at cost 1,000 shares at December 31, 2005		(15)
Total shareholders equity	181,998	171,757
Total liabilities and shareholders equity	$ 1,952,129	$ 2,022,392

See Accompanying Notes to Unaudited Consolidated Financial Statements.

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FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF INCOME (LOSS)
(Unaudited)

(Dollars in thousands, except per share amounts)	Three Months Ended September 30, 2006	Three Months Ended September 30, 2005	Nine Months Ended September 30, 2006	Nine Months Ended September 30, 2005
Interest income:				
Interest and fees on loans	$ 17,291	$ 17,402	$ 50,944	$ 54,610
Interest and dividends on securities	8,001	7,698	24,597	22,319
Other interest income	531	395	1,307	804
Total interest income	25,823	25,495	76,848	77,733
Interest expense:				
Deposits	9,491	7,712	26,833	21,691
Short-term borrowings	245	181	734	472
Long-term borrowings	973	913	2,812	2,790
Junior subordinated debentures issued to unconsolidated subsidiary trust	432	432	1,296	1,296
Total interest expense	11,141	9,238	31,675	26,249
Net interest income	14,682	16,257	45,173	51,484
(Credit) provision for loan losses	(491)	1,529	(1,842)	27,110
Net interest income after (credit) provision for loan losses	15,173	14,728	47,015	24,374
Noninterest income:				
Service charges on deposits	3,054	3,076	8,559	8,605
ATM and debit card income	558	426	1,645	1,233
Financial services group fees and commissions	491	678	1,559	2,059
Mortgage banking revenues	284	384	898	1,248
Income from corporate owned life insurance	14	15	466	52
Net gain on sale of securities				14
Net gain on sale of student loans held for sale	427	162	604	209
Net gain on sale of commercial-related loans held for sale		9,212	82	9,212
Net gain (loss) on sale of premises and equipment	(12)	(6)	2	(103)
Net gain (loss) on sale of other real estate and repossessed assets	(44)	(19)	63	(24)
Gain on sale of trust relationships	1,365		1,365	
Other	842	821	1,873	1,942

Total noninterest income	6,979	14,749	17,116	24,447
Noninterest expense:				
Salaries and employee benefits	8,510	8,808	25,294	26,881
Occupancy and equipment	2,293	2,252	7,083	6,754
Supplies and postage	442	530	1,452	1,663
Amortization of intangible assets	108	108	323	323
Computer and data processing	469	412	1,312	1,359
Professional fees	660	1,344	2,090	3,534
Other	2,111	2,858	6,895	8,808
Total noninterest expense	14,593	16,312	44,449	49,322
Income (loss) from continuing operations before income taxes	7,559	13,165	19,682	(501)
Income tax provision (benefit) from continuing operations	2,314	4,205	5,324	(2,278)
Income from continuing operations	5,245	8,960	14,358	1,777
Discontinued operation (note 7):				
Loss from operation of discontinued subsidiary		(84)		(340)
Gain (loss) on sale of discontinued subsidiary		88		(1,112)
Income tax (benefit) expense		(7)		1,030
Income (loss) from discontinued operation		11		(2,482)
Net income (loss)	$ 5,245	$ 8,971	$ 14,358	$ (705)
Earnings (loss) per common share (note 3):				
Basic:				
Income from continuing operations	$ 0.43	$ 0.76	$ 1.17	$ 0.06
Net income (loss)	$ 0.43	$ 0.76	$ 1.17	$ (0.16)
Diluted:				
Income from continuing operations	$ 0.43	$ 0.76	$ 1.17	$ 0.06
Net income (loss)	$ 0.43	$ 0.76	$ 1.17	$ (0.16)

See Accompanying Notes to Unaudited Consolidated Financial Statements.

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FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENT OF CHANGES IN
SHAREHOLDERS EQUITY AND COMPREHENSIVE INCOME
(Unaudited)

(Dollars in thousands, except per share amounts)	3% Preferred Stock	8.48% Preferred Stock	Common Stock	Additional Paid-in Capital	Retained Earnings	Accumulated Other Comprehensive Loss	Treasury Stock	Total Shareholders Equity
Balance December 31, 2005	$ 159	$ 17,475	$ 113	$ 23,278	$ 136,925	$ (6,178)	$ (15)	$ 171,757
Purchase 108 shares of preferred stock		(11)						(11)
Purchase 15,000 shares of common stock director repurchase agreements							(222)	(222)
Issue 5,693 shares of common stock director retainers				28			84	112
Issue 9,608 shares of common stock exercised stock options				161			23	184
Excess tax benefit from stock options exercised				15				15
Issue 13,200 shares of common stock restricted stock awards				131	(261)		130	
Amortization of unvested stock options				701				701
Amortization of unvested restricted stock awards					18			18
Comprehensive income:								
Net income					14,358			14,358
Unrealized loss on securities available for sale (net of tax of $(641))						(966)		(966)
Total comprehensive income								13,392
Cash dividends declared:								

3% Preferred $2.25 per share					(4)			(4)
8.48% Preferred $6.36 per share					(1,111)			(1,111)
Common $0.25 per share					(2,833)			(2,833)
Balance September 30, 2006	$ 159	$ 17,464	$ 113	$ 24,314	$ 147,092	$ (7,144)	$	$ 181,998

See Accompanying Notes to Unaudited Consolidated Financial Statements.

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FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOWS
(Unaudited)

(Dollars in thousands)	Nine Months Ended September 30, 2006	Nine Months Ended September 30, 2005
Cash flows from operating activities:		
Net income (loss)	$ 14,358	$ (705)
Adjustments to reconcile net income (loss) to net cash provided by operating activities:		
Depreciation and amortization	3,131	3,314
Net amortization of premiums and discounts on securities	507	802
(Credit) provision for loan losses	(1,842)	27,110
Amortization of unvested stock options	701	
Amortization of unvested restricted stock awards	18	
Deferred income tax (benefit) expense	(583)	8,923
Proceeds from sale of loans held for sale	59,145	64,034
Originations of loans held for sale	(58,357)	(62,737)
Net gain on sale of securities		(14)
Net gain on sale of loans held for sale	(833)	(676)
Net gain on sale of commercial-related loans held for sale	(82)	(9,212)
Net (gain) loss on sale and disposal of other assets	(65)	127
Loss on sale of discontinued subsidiary		1,112
Gain on sale of trust relationships	(1,365)	
Decrease in other assets	8,154	1,063
Increase in accrued expenses and other liabilities	631	76
Net cash provided by operating activities	23,518	33,217
Cash flows from investing activities:		
Purchase of securities:		
Available for sale	(35,126)	(229,327)
Held to maturity	(25,498)	(20,600)
Proceeds from maturity and call of securities:		
Available for sale	86,096	120,965
Held to maturity	26,160	21,998
Proceeds from sale of securities available for sale		2,445
Net loan collections	48,522	52,493
Proceeds from sale of commercial-related loans	659	139,220
Proceeds from sale of discontinued subsidiary		4,552
Proceeds from sale of other assets	1,379	46
Proceeds from sale of trust relationships	1,365	
Purchase of premises and equipment	(878)	(3,949)
Net cash provided by investing activities	102,679	87,843
Cash flows from financing activities:		
Net decrease in deposits	(77,642)	(37,884)

Net decrease in short-term borrowings	(3,557)	(10,067)
Repayment of long-term borrowings	(50)	(1,950)
Purchase of preferred and common shares	(233)	(161)
Issuance of common shares	112	57
Stock options exercised	184	919
Excess tax benefit from stock options exercised	15	
Dividends paid	(3,833)	(5,624)
Net cash used in financing activities	(85,004)	(54,710)
Net increase in cash and cash equivalents	41,193	66,350
Cash and cash equivalents at the beginning of the period	91,940	46,055
Cash and cash equivalents at the end of the period	$ 133,133	$ 112,405
Supplemental information:		
Cash paid (received) during period for:		
Interest	$ 31,217	$ 25,866
Income taxes paid	2,493	
Income taxes received	(6,300)	
Noncash investing and financing activities:		
Real estate and other assets acquired in settlement of loans	$ 2,080	$ 1,374
Issuance of common stock for Burke Group, Inc. earnout		425
Transfer of loans to loans held for sale		131,749
Transfer of borrowings from long-term to short-term	9,000	11,000

See Accompanying Notes to Unaudited Consolidated Financial Statements.

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FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES
NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS
(1) Basis of Presentation

Financial Institutions, Inc. (FII), a bank holding company organized under the laws of New York State, and its subsidiaries (collectively the Company) provide deposit, lending and other financial services to individuals and businesses in Central and Western New York State. The Company is subject to regulation by certain federal and state agencies.

The Company for many years operated under a decentralized, Super Community Bank business model, with separate and largely autonomous subsidiary banks whose Boards and management had the authority to operate within guidelines set forth in broad corporate policies established at the holding company level. During 2005, FII s Board of Directors decided to implement changes to the Company s business model and governance structure. Effective December 3, 2005, the Company merged Wyoming County Bank (100% owned) (WCB), National Bank of Geneva (100% owned) (NBG) and Bath National Bank (100% owned) (BNB) into the New York State-chartered First Tier Bank & Trust (100% owned) (FTB), which was then renamed Five Star Bank (100% owned) (FSB or the Bank). The merger was accounted for at historical cost as a combination of entities under common control.

The Company formerly qualified as a financial holding company under the Gramm-Leach-Bliley Act, which allowed FII to expand business operations to include financial services businesses. The Company had two financial services subsidiaries: Five Star Investment Services, Inc. (100% owned) (FSIS) (formerly known as The FI Group, Inc.) and Burke Group, Inc. (formerly 100% owned) (BGI), collectively referred to as the Financial Services Group (FSG). FSIS is a brokerage subsidiary that commenced operations as a start-up company in March 2000. BGI was an employee benefits and compensation consulting firm acquired by the Company in October 2001. During 2005, the Company sold the stock of BGI and its results have been reported separately as a discontinued operation in the consolidated statements of income (loss). Since the sale of BGI occurred during 2005, there are no assets or liabilities associated with the discontinued operation recorded at September 30, 2006 or December 31, 2005. BGI cash flows are shown in the consolidated statements of cash flows by activity (operating, investing and financing) consistent with the applicable source of cash flow.

During 2003, the Company terminated its financial holding company status and now operates as a bank holding company. The change in status did not affect the non-financial subsidiaries or activities being conducted by the Company, although future acquisitions or expansions of non-financial activities may require prior Federal Reserve Bank (FRB) approval and will be limited to those that are permissible for bank holding companies.

In February 2001, the Company formed FISI Statutory Trust I (100% owned) (FISI or the Trust) and capitalized the trust with a $502,000 investment in FISI s common securities. The Trust was formed to facilitate the private placement of $16.2 million in capital securities (trust preferred securities). Effective December 31, 2003, the provisions of Financial Accounting Standards Board (FASB) Interpretation No. 46, Consolidation of Variable Interest Entities, resulted in the deconsolidation of the Trust. The deconsolidation resulted in the derecognition of the $16.2 million in trust preferred securities and the recognition of $16.7 million in junior subordinated debentures and a $502,000 investment in the trust recorded in other assets in the Company s consolidated statements of financial position.

In management s opinion, the interim consolidated financial statements reflect all adjustments necessary for a fair presentation. The results of operations for the interim periods are not necessarily indicative of the results of operation to be expected for the full year ended December 31, 2006. The interim consolidated financial statements should be read in conjunction with the Company s 2005 Annual Report on Form 10-K. The consolidated financial information included herein combines the results of operations, the assets, liabilities and shareholders equity of the Company and its subsidiaries. All significant inter-company transactions and balances have been eliminated in consolidation. Amounts in the prior periods consolidated financial statements are reclassified when necessary to conform to the current period s presentation.

The interim consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America and prevailing practices in the banking industry. In preparing the financial statements, management is required to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities, and the reported revenues and expenses for the period.

Actual results could differ from those estimates. A material estimate that is particularly susceptible to near-term change is the allowance for loan losses.

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For purposes of the consolidated statements of cash flows, short-term interest-bearing deposits, federal funds sold and commercial paper due in less than 90 days are considered cash equivalents.

(2) Stock Compensation Plans

The Company has a Management Stock Incentive Plan and a Director s Stock Incentive Plan (the Plans). Under the Plans, the Company may grant stock options to purchase shares of common stock, shares of restricted stock or stock appreciation rights to its directors and key employees. The Company had previously only granted stock options to purchase shares of common stock under the Plans, but during the third quarter of 2006, restricted stock awards were granted to certain Executives and Senior Officers of the Management team. Grants under the plans may be made up to 10% of the number of shares of common stock issued, including treasury shares. The exercise price of each option equals the market price of the Company s stock on the date of the grant. The maximum term of each option is ten years and the vesting period generally ranges between three and five years.

Prior to January 1, 2006, the Company applied Accounting Principles Board (APB) Opinion No. 25, Accounting for Stock Issued to Employees , and related interpretations in accounting for stock-based compensation. No stock-based compensation expense was recognized in the consolidated statements of income prior to 2006 for stock options, as the exercise price was equal to the market price of the common stock on the date of all grants made by the Company. Effective January 1, 2006, the Company adopted Statement of Financial Accounting Standards (SFAS) No. 123R, Share-Based Payment , requiring the Company to recognize expense related to the fair value of the stock-based compensation awards. The Company elected the modified prospective transition method as permitted by SFAS No. 123R; accordingly, results from prior periods have not been restated. Under the transition method, stock-based compensation expense for the three and nine months ended September 30, 2006 includes:

(a) compensation expense for all stock-based compensation awards granted prior to, but not yet vested as of December 31, 2005, based on the grant date fair value estimated in accordance with the original provisions of SFAS No. 123, Accounting for Stock-Based Compensation ; and

(b) compensation expense for all stock-based compensation awards granted subsequent to December 31, 2005, based on the grant-date fair value estimated in accordance with the provisions of SFAS No. 123R.

Historically, SFAS No. 123 required pro forma disclosure of stock-based compensation expense and the Company has recognized pro forma compensation expense for stock option awards on a straight-line basis over the applicable vesting periods. This policy differs from the policy required to be applied to awards granted after the adoption of SFAS No. 123R, which requires that compensation expense be recognized for awards over the requisite service period of the award or to an employee s eligible retirement date, if earlier. The Company will continue to recognize compensation expense over the vesting periods for awards granted prior to adoption of SFAS No. 123R, but for all awards after December 31, 2005, compensation expense will be recognized over the requisite service period of the award or over a period ending with an employee s eligible retirement date, if earlier.

The expense associated with the amortization of unvested stock compensation included in the consolidated statements of income for the three and nine months ended September 30, 2006 is as follows:

(Dollars in thousands)	Three Months Ended Sept 30, 2006	Nine Months Ended Sept 30, 2006
Stock options:		
Management Stock Incentive Plan*	$ 230	$ 428
Director Stock Incentive Plan**	29	273
Total amortization of unvested stock options	259	701
Restricted stock awards:		

Management Stock Incentive Plan*		18		18
Total amortization of unvested restricted stock awards		18		18
Total amortization of unvested stock compensation	$	277	$	719

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* Included in salaries and employee benefits in the consolidated statements of income.

** Included in other expense in the consolidated statements of income.

The following table illustrates the effect on net earnings and earnings per share as if the Company had applied the fair value recognition provision of SFAS No. 123 to stock-based compensation during the three and nine months ended September 30, 2005:

(Dollars in thousands, except per share amounts)	Three Months Ended Sept 30, 2005	Nine Months Ended Sept 30, 2005
Reported net income (loss)	$ 8,971	$ (705)
Less: Total stock-based compensation expense determined under fair value based method for all awards, net of related tax effects (1)	147	456
Pro forma net income (loss)	8,824	(1,161)
Less: Preferred stock dividends	372	1,116
Pro forma net income (loss) available to common shareholders	$ 8,452	$ (2,277)
Basic income (loss) per share:		
Reported	$ 0.76	$ (0.16)
Pro forma	0.75	(0.20)
Diluted income (loss) per share:		
Reported	$ 0.76	$ (0.16)
Pro forma	0.74	(0.20)

(1) For purposes of this pro forma disclosure, the value of the

stock-based compensation is amortized to expense on a straight-line basis over the vesting periods.

The following table summarizes the stock option activity for the nine months ended September 30, 2006:

(Dollars in thousands, except per share amounts)	Options	Weighted-Average Exercise Price Per Share	Weighted-Average Remaining Contractual Term (in years)	Aggregate Intrinsic Value
Outstanding at December 31, 2005	426,238	$ 19.58		
Granted	97,797	19.73		
Exercised	(10,208)	18.87		
Forfeited	(5,028)	21.24		
Expired	(10,440)	22.84		
Outstanding at September 30, 2006	498,359	$ 19.55	6.50	$ 2,094
Vested and expected to vest at September 30, 2006	468,688	$ 19.51	6.33	$ 2,000
Exercisable at September 30, 2006	307,553	$ 18.93	4.98	$ 1,547

As of September 30, 2006, there was $839,000 of unrecognized compensation expense related to unvested stock options that is expected to be recognized over a weighted average period of 2.74 years.

The aggregate intrinsic value of options (the amount by which the market price of the stock on the date of exercise exceeded the market price of the stock on the date of grant) exercised during the nine months ended September 30, 2006 and 2005 was $54,000 and $315,000, respectively.

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The weighted average grant date fair value and Black-Scholes option valuation assumptions used for the stock option grants totaling 97,797 and 142,896 for the nine months ended September 30, 2006 and 2005, respectively were as follows:

	Nine Months Ended September 30,	
	2006	2005
Fair value of stock options granted	$ 8.14	$ 6.41
Risk-free interest rate	4.96%(1)	4.17%
Expected dividend yield	1.65%	1.94%
Expected stock price volatility	41.75%(2)	26.64%
Expected term of stock options (in years)	6.19 years(3)	6.22 years

(1) Based on the average of the five and seven year Treasury constant maturity (TCM) interest rates to be consistent with the expected term of the stock options.

(2) Expected stock price volatility is based on actual experience using a historical period that is consistent with the expected term of the stock options.

(3) The Company estimated the expected term of the stock options using the simplified method prescribed by SEC Staff

Accounting
Bulletin (SAB)
No. 107.

The following table summarizes the restricted stock award activity for the nine months ended September 30, 2006:

	Shares	Weighted-Average Exercise Price Per Share
Outstanding at December 31, 2005		$
Awarded	13,200	19.75
Vested		
Forfeited		
Outstanding at September 30, 2006	13,200	$ 19.75

As of September 30, 2006, there was $243,000 of unrecognized compensation expense related to unvested restricted stock awards that is expected to be recognized over a weighted average period of 2.66 years.

(3) Earnings (Loss) Per Common Share

Basic earnings (loss) per common share, after giving effect to preferred stock dividends, has been computed using weighted average common shares outstanding adjusted to exclude unvested restricted stock shares. Diluted earnings (loss) per common share reflects the effects of common stock equivalent shares, which are incremental shares (computed using the treasury stock method) that would have been outstanding if all potentially dilutive stock options and unvested restricted stock awards were exercised or became vested during the periods.

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Earnings (loss) per common share have been computed based on the following:

(Dollars and shares in thousands, except per share amounts)	Three Months Ended September 30, 2006	Three Months Ended September 30, 2005	Nine Months Ended September 30, 2006	Nine Months Ended September 30, 2005
Income from continuing operations	$ 5,245	$ 8,960	$ 14,358	$ 1,777
Less: Preferred stock dividends	371	372	1,115	1,116
Income from continuing operations available to common shareholders	4,874	8,588	13,243	661
Income (loss) on discontinued operation, net of tax		11		(2,482)
Net income (loss) available to common shareholders	$ 4,874	$ 8,599	$ 13,243	$ (1,821)
Weighted average number of common shares outstanding used to calculate basic earnings (loss) per common share	11,327	11,333	11,326	11,293
Add: Effect of common stock equivalents	45	20	31	32
Weighted average number of common shares used to calculate diluted earnings (loss) per common share	11,372	11,353	11,357	11,325
Earnings (loss) per common share:				
Basic:				
Income from continuing operations	$ 0.43	$ 0.76	$ 1.17	$ 0.06
Loss on discontinued operation	$	$	$	$ (0.22)
Net income (loss)	$ 0.43	$ 0.76	$ 1.17	$ (0.16)
Diluted:				
Income from continuing operations	$ 0.43	$ 0.76	$ 1.17	$ 0.06
Loss on discontinued operation	$	$	$	$ (0.22)
Net income (loss)	$ 0.43	$ 0.76	$ 1.17	$ (0.16)

There were approximately 258,000 and 277,000 weighted average common stock equivalents from outstanding stock options and restricted stock awards for the quarter and nine months ended September 30, 2006, respectively, that were not considered in the calculation of diluted earnings per share since their effect would have been anti-dilutive. There were approximately 351,000 and 373,000 weighted average common stock equivalents from outstanding stock options for the quarter and nine months ended September 30, 2005, respectively, that were not considered in the calculation of diluted earnings per share since their effect would have been anti-dilutive.

(4) Retirement Plans and Postretirement Benefits

The Company participates in The New York Bankers Retirement System, which is a defined benefit pension plan covering substantially all employees. The benefits are based on years of service and the employee s highest average compensation during five consecutive years of employment. The Company s funding policy is to contribute at least the

minimum-funding requirement as determined actuarially to cover current service cost plus amortization of prior service costs.

Net periodic pension cost consists of the following components:

	Three Months Ended September 30,		Nine Months Ended September 30,	
(Dollars in thousands)	2006	2005	2006	2005
Service cost	$ 431	$ 395	$ 1,294	$ 1,185
Interest cost on projected benefit obligation	335	321	1,006	963
Expected return on plan assets	(467)	(408)	(1,400)	(1,224)
Amortization of net transition asset	(6)	(10)	(20)	(30)
Amortization of unrecognized loss	56	55	167	165
Amortization of unrecognized prior service cost	4	4	11	12
Net periodic pension cost	$ 353	$ 357	$ 1,058	$ 1,071

The Company contributed approximately $1.6 million to the pension plan during February 2006. No additional contributions are expected in 2006.

Prior to December 31, 2001, BNB 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 BNB and the retiree shared the cost. The plan was amended in 2001 to curtail eligible benefit payments to only retired employees and active participants who were fully vested under the plan.

(5) Commitments and Contingencies

In the normal course of business, the Company has outstanding commitments to extend credit not reflected in the Company s consolidated financial statements. These commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. The Company uses the same credit policy to make such commitments as it uses for on-balance-sheet items. Unused lines of credit and loan commitments totaling $253.8 million and $231.5 million were contractually available at September 30, 2006 and December 31, 2005, respectively, and are not reflected in the consolidated statements of financial condition. Since commitments to extend credit and unused lines of credit may expire without being fully drawn upon, the amount does not necessarily represent future cash commitments.

The Company guarantees the obligations or performance of customers by issuing stand-by letters of credit to third parties. The risk involved in issuing stand-by letters of credit is essentially the same as the credit risk involved in extending loan facilities to customers, and they are subject to the same credit origination, portfolio maintenance and management procedures in effect to monitor other credit and off-balance-sheet products. Typically, these instruments have terms of five years or less and expire unused; therefore, the amount does not necessarily represent future cash requirements. Stand-by letters of credit totaled $6.1 million and $9.5 million at September 30, 2006 and December 31, 2005, respectively. As of September 30, 2006, the fair value of the standby letters of credit was not material to the Company s consolidated financial statements.

(6) Supervision and Regulation

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

The Company is also subject to varying regulatory capital requirements administered by the Federal banking agencies. Failure to meet minimum capital requirements can initiate certain mandatory, and possibly additional discretionary, actions by regulators that, if undertaken, could have a direct material impact on the Company s consolidated financial statements. For evaluating regulatory capital adequacy, companies are required to determine capital and assets under regulatory accounting practices. Quantitative measures established by regulation to ensure capital adequacy require the Company to maintain minimum amounts and ratios. The leverage ratio requirement is based on period-end capital to average adjusted total assets during the previous three months. Compliance with risk-based capital requirements is determined by dividing regulatory capital by the sum of a company s weighted asset values. Risk weightings are established by the regulators for each asset category according to the perceived degree of risk. As of September 30, 2006 and December 31, 2005, the Company and FSB met all capital adequacy requirements to which they are subject. At December 31, 2005, the most recent notification from the Federal Deposit Insurance Corporation (FDIC) categorized the Bank as well-capitalized under the regulatory framework for prompt corrective action. For purposes of determining the annual deposit insurance assessment rate for insured depository institutions, each insured institution is assigned an assessment risk classification. Each institution s assigned risk classification is composed of a group and subgroup assignment based on capital group and supervisory subgroup. Prior to the Company s restructuring in December 2005, the Company s former bank subsidiaries NBG and BNB remained assigned to the well-capitalized capital group, but were placed in lower supervisory subgroups based on the formal agreements that were in place with the Office of the Comptroller of the Currency (OCC). Because of the downgrades, the Company s FDIC insurance premiums increased in 2005. As a result of the merger of the Company s subsidiary banks and the FDIC risk classification for FSB, the Company s 2006 premiums are lower.

Payments of dividends by FSB to FII are limited or restricted in certain circumstances under banking regulations. During September 2006, FII requested approval from the NYS Banking Department to pay a one time $25.0 million

cash dividend from FSB to FII. Regulatory approval was necessary as the requested dividend amount exceeded the amount allowable under regulatory restrictions. During October 2006, FSB received regulatory approval and paid

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the $25.0 million dividend to FII. FSB will be required to obtain approval from the NYS Banking Department for any future dividend that exceeds the sum of the current year s net income plus the retained profits for the preceding two years. FII used the dividend proceeds to repay a $25.0 million term loan with another commercial bank during October 2006. See also Note 10 Subsequent Events.

(7) Discontinued Operation

In 2005, the Company decided to dispose of its BGI subsidiary. The results of BGI have been reported separately as a discontinued operation in the consolidated statements of income (loss). The Company recorded a loss on discontinued operation of $84,000, a gain on the sale of discontinued operation of $88,000 and income tax benefit associated with the discontinued operation of $7,000 for the three months ended September 30, 2005. The Company recorded a loss on discontinued operation of $340,000, a loss on sale of discontinued operation of $1.1 million and income tax expense associated with the discontinued operation of $1.0 million for the nine months ended September 30, 2005. Since the sale occurred during 2005, there are no assets or liabilities associated with the discontinued operation recorded at September 30, 2006 or December 31, 2005. Cash flows from BGI are shown in the consolidated statements of cash flows by activity (operating, investing and financing) consistent with the applicable source of the cash flow.

(8) Loans Held for Sale

During the year ended December 31, 2005, the Company transferred $169.0 million in commercial-related loans to held for sale, at an estimated fair value less costs to sell of $132.3 million. As a result, $36.7 million in commercial-related charge-offs were recorded from the classification of the loans to held for sale. In the second half of 2005, the Company realized a net gain of $9.4 million on the ultimate sale or settlement of these commercial-related loans held for sale.

A summary of loans held for sale is as follows:

(Dollars in thousands)	September 30, 2006	December 31, 2005
Commercial and agricultural *	$	$ 577
Residential real estate	721	676
Total loans held for sale	$ 721	$ 1,253

* All commercial and agricultural loans held for sale were in nonaccrual status.

The Company originates and sells certain residential mortgage loans in the secondary market. The Company typically retains the right to service the mortgages upon sale. The Company makes the determination of whether or not to identify the mortgage as a loan held for sale at the time the application is received from the borrower. The Company also originates student loans and has a forward commitment to sell the student loans to a third-party at a fixed premium on the day of origination. The volume of student loans originated and sold increased beginning in the third quarter of 2005.

Proceeds from the sale of residential mortgage and student loans held for sale were $15.6 million and $43.7 million for the three months ended September 30, 2006 and 2005, respectively. These proceeds included proceeds from the sale of student loans totaling $11.5million and $31.2 million for the three months ended September 30, 2006 and 2005, respectively. The net gain on sale of residential mortgage and student loans held for sale was $503,000 and $314,000 for the three months ended September 30, 2006 and 2005, respectively.

Proceeds from the sale of residential mortgage and student loans held for sale were $59.1 million and $64.0 million for the nine months ended September 30, 2006 and 2005, respectively. These proceeds included proceeds from the sale of student loans totaling $43.0 million and $32.7 million for the nine months ended September 30, 2006 and 2005, respectively. The net gain on sale of residential mortgage and student loans held for sale was $833,000 and $676,000 for the nine months ended September 30, 2006 and 2005, respectively.

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(9) New Accounting Pronouncements

In February 2006, the Financial Accounting Standards Board (FASB) issued SFAS No. 155, Accounting for Certain Hybrid Financial Instruments. SFAS No. 155 amends SFAS No. 133 and SFAS No. 140, and improves the financial reporting of certain hybrid financial instruments by requiring more consistent accounting that eliminates exemptions and provides a means to simplify the accounting for these instruments. Specifically, SFAS No. 155 allows financial instruments that have embedded derivatives to be accounted for as a whole (eliminating the need to bifurcate the derivative from its host) if the holder elects to account for the whole instrument on a fair value basis. SFAS No. 155 is effective for all financial instruments acquired or issued in fiscal years beginning after September 15, 2006. The Company plans to adopt this statement on January 1, 2007 and is currently assessing the impact that the adoption will have on its consolidated financial position, consolidated results of operations, or liquidity.

In March 2006, the FASB issued SFAS No. 156, Accounting for Servicing of Financial Assets, an amendment of SFAS No. 140, which requires that all separately recognized servicing assets and servicing liabilities be initially measured at fair value, if practicable and permits the entities to elect either fair value measurement with changes in fair value reflected in earnings or the amortization and impairment requirements of SFAS No. 140 for subsequent measurement. SFAS No. 156 is effective for fiscal years beginning after September 15, 2006. Earlier adoption is permitted as of the beginning of an entity s fiscal year, provided the entity has not yet issued financial statements, including interim financial statements for any period of that fiscal year. The Company did not elect for early adoption and plans to adopt this statement on January 1, 2007 and does not expect adoption to have a material effect on its consolidated financial position, consolidated results of operations, or liquidity.

In June 2006, FASB issued FASB Interpretation No. 48, Accounting for Uncertainty in Income Taxes an interpretation of FASB Statement No. 109 (FIN 48). FIN 48 prescribes a recognition threshold and measurement attribute for financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return, and also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure, and transition. FIN 48 is effective for fiscal years beginning after December 15, 2006. The Company plans to adopt this statement on January 1, 2007 and is currently assessing the impact that the adoption will have on its consolidated financial position, consolidated results of operations, or liquidity.

In September 2006, the SEC issued Staff Accounting Bulletin (SAB) No. 108, Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements. SAB No. 108 addresses how the effects of prior year uncorrected misstatements should be considered when quantifying misstatements in current year financial statements. SAB No. 108 requires companies to quantify misstatements using a balance sheet and income statement approach and to evaluate whether either approach results in quantifying an error that is material in light of relevant quantitative and qualitative factors. SAB No. 108 is effective for fiscal years ending after November 15, 2006. The Company plans to adopt this SAB for the fiscal year ended December 31, 2006 and is currently assessing the impact that the adoption will have on its consolidated financial position, consolidated results of operations, or liquidity.

In September 2006, the FASB issued SFAS No. 157, Fair Value Measurements. SFAS No. 157 defines fair value, establishes a framework for measuring fair value under generally accepted accounting principles, and expands disclosures about fair value measurements. SFAS No. 157 emphasizes that fair value is a market-based measurement, not an entity-specific measurement, and states that a fair value measurement should be determined based on assumptions that market participants would use in pricing the asset or liability. The Company is required to adopt SFAS No. 157 for fiscal years beginning after November 15, 2007. The Company plans to adopt this statement on January 1, 2008 and is currently assessing the impact that the adoption will have on its consolidated financial position, consolidated results of operations, or liquidity.

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

No. 158 also requires companies to measure the funded status of a plan as of the date of the company s fiscal year-end, with limited exceptions. The Company is required and plans to adopt this provision for the fiscal year ending December 31, 2008. The Company is currently assessing the impact that the adoption of these provisions will have on its consolidated financial position, consolidated results of operations, or liquidity.

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(10) Subsequent Events

In October 2006, FII repaid a $25.0 million term loan with another commercial bank. The debt was scheduled for repayment in equal annual installments of $6.25 million beginning in December 2007 and is reflected in long-term debt on the consolidated statements of financial condition.

In October 2006, the Company s Board of Directors approved a one-year, $5.0 million common stock repurchase program. Under the program, stock repurchases may be made either in the open market or through privately negotiated transactions in amounts and at times and prices as determined by the Company.

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

FORWARD LOOKING STATEMENTS

This report contains certain forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended (the Securities Act), and Section 21E of the Securities Exchange Act of 1934, as amended (the Exchange Act), that involve substantial risks and uncertainties. When used in this report, or in the documents incorporated by reference herein, the words anticipate , believe , estimate , expect , intend , may , project , pl similar expressions identify such forward-looking statements. Actual results, performance or achievements could differ materially from those contemplated, expressed or implied by the forward-looking statements contained herein. There are a number of important factors that could affect the Company s forward-looking statements which include the quality of collateral associated with nonperforming loans, the ability of customers to continue to make payments on criticized or substandard loans, the impact of rising interest rates on customer cash flows, the speed or cost of resolving bad loans, the ability to hire and train personnel, the economic conditions in the area in which the Company operates, customer preferences, the competition and other factors discussed in the Company s filings with the Securities and Exchange Commission. Many of these factors are beyond the Company s control.

GENERAL

The principal objective of this discussion is to provide an overview of the financial condition and results of operations of the Company for the periods covered in this quarterly report. This discussion and tabular presentations should be read in conjunction with the accompanying consolidated financial statements and accompanying notes.

The Company s revenue is primarily dependent on net interest income, which is the difference between the income earned on loans and securities and the cost of funds, consisting of the interest paid on deposits and borrowings. Results of operations are also affected by the provision for loan losses, service charges on deposits, financial services group fees and commissions, mortgage banking activities, gain or loss on the sale of securities, gain or loss on sale of loans, other miscellaneous income and noninterest expense. Noninterest expense primarily consists of salaries and employee benefits, occupancy and equipment, supplies and postage, amortization of intangible assets, computer and data processing, professional fees, other miscellaneous expense and income taxes. The results of operations are also significantly affected by general economic and competitive conditions, particularly changes in interest rates, government policies and the actions of regulatory authorities.

OVERVIEW

Net income for the quarter was $5.2 million, or $0.43 per diluted share, compared with net income of $9.0 million, or $0.76 per diluted share, for the third quarter of 2005. Included in income for the third quarter of 2005 was a net gain of $9.2 million related to the sale or settlement of lower quality commercial-related loans. This year s third quarter included a $1.4 million gain on the sale of the Company s trust relationships, which closed September 29, 2006. Excluding these impacts, the primary contributors to the 2006 third quarter results were a $0.5 million credit for loan losses compared with a $1.5 million provision for loan losses last year and a $1.7 million reduction in noninterest expense compared with the same quarter last year. The improved risk profile of the Company s loan portfolio contributed to the credit for loan losses, while lower noninterest expenses are the result of improved operating efficiencies and the reduction of costs associated with asset quality issues and regulatory matters.

Net income for the first nine-months of 2006 was $14.4 million, or $1.17 per diluted share, compared with a net loss of $0.7 million, or $0.16 net loss per diluted share from the same period last year. The first nine months of 2005

results reflects a higher provision for loan losses as a result of write-downs associated with the decision to sell approximately $169.0 million of commercial-related loans in 2005.

The Company recorded a credit for loan losses of $0.5 million and $1.8 million for the third quarter and the first nine months of 2006, respectively. Net loan charge-offs were $0.4 million for the third quarter and $0.7 million for the first nine months of 2006. Nonperforming loans at September 30, 2006 were $12.8 million, a reduction of $5.2 million from December 31, 2005. The improved risk rating profile of the loan portfolio, the lower level of net loan charge-offs, and a smaller loan portfolio all contributed to the credit for loan losses for the quarter and year-to-date periods. The allowance for loan losses was $17.7 million and $20.2 million at September 30, 2006 and December 31, 2005, respectively.

Effective December 3, 2005, the Company merged its commercial subsidiary banks into the New York State-chartered First Tier Bank & Trust (FTB), which was then renamed Five Star Bank (FSB). The consolidation activities have improved operational efficiencies and have contributed to lower non-interest expense in both the third quarter of 2006 and the first nine months of 2006 when compared with the same periods in 2005. The Company also sold its Burke Group, Inc. (BGI) subsidiary during 2005 in order to focus on its core community banking business. The results of BGI have been reported separately as a discontinued operation in the consolidated statements of income (loss). Income on discontinued operation for the third quarter of 2005 totaled $11,000, compared with a loss on discontinued operation of $2.5 million for the nine months ended September 30, 2005.

CRITICAL ACCOUNTING POLICIES

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

The Company has numerous accounting policies, of which the most significant are presented in Note 1 of the Notes to Consolidated Financial Statements included in the Company s Annual Report on Form 10-K as of December 31, 2005, dated March 15, 2006, as filed with the Securities and Exchange Commission. 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 financial statements and how those reported amounts are determined. Based on the sensitivity of financial statement amounts to the methods, assumptions, and estimates underlying those amounts, management has determined that the accounting policies with respect to the allowance for loan losses and goodwill require particularly subjective or complex judgments important to the Company s consolidated financial statements, results of operations or liquidity, and are therefore considered to be critical accounting policies as discussed below.

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

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

Loans, including impaired loans, are generally classified as nonaccrual if they are past due as to maturity or payment of principal or interest for a period of more than 90 days (120 days for consumer loans), unless such loans are well-

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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 nonaccrual if repayment in full of principal and/or interest is uncertain.

For additional discussion related to the Company s accounting policies for the allowance for loan losses, see the section titled Analysis of the Allowance for Loan Losses.

Goodwill: Statement of Financial Accounting Standards (SFAS) No. 142, Goodwill and Other Intangible Assets prescribes the accounting for goodwill and intangible assets subsequent to initial recognition. The provisions of SFAS No. 142 discontinue the amortization of goodwill and intangible assets with indefinite lives. Instead, these assets are subject to at least an annual impairment review, and more frequently if certain impairment indicators are in evidence. Changes in the estimates and assumptions used to evaluate impairment may have a material impact on the Company s consolidated financial statements, results of operations or liquidity. During the fourth quarter of 2005, the Company evaluated goodwill for impairment using a discounted cash flow analysis and determined no impairment existed. There were no material events or transactions that occurred subsequent to that evaluation that indicates any impairment at the current period end.

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SELECTED FINANCIAL DATA

The following tables present certain information and ratios that management of the Company considers important in evaluating performance:

	At or For the Three Months Ended September 30,			
(Dollars and shares in thousands, except per share amounts)	2006	2005	$ Change	% Change
Per common share data:				
Basic:				
Income from continuing operations	$ 0.43	$ 0.76	$ (0.33)	(43)%
Net income	$ 0.43	$ 0.76	$ (0.33)	(43)%
Diluted:				
Income from continuing operations	$ 0.43	$ 0.76	$ (0.33)	(43)%
Net income	$ 0.43	$ 0.76	$ (0.33)	(43)%
Cash dividends declared	$ 0.09	$ 0.08	$ 0.01	&nb