ARROW FINANCIAL CORP
Form 10-Q
May 09, 2013

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

[X] QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d)
OF THE SECURITIES EXCHANGE ACT OF 1934

For the Quarterly Period Ended March 31, 2013

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

Commission File Number: 0-12507

ARROW FINANCIAL CORPORATION

(Exact name of registrant as specified in its charter)

| | |
|---|---|
| New York<br>(State or other jurisdiction of incorporation or organization) | 22-2448962<br>(I.R.S. Employer Identification No.) |

250 GLEN STREET, GLENS FALLS, NEW YORK 12801
(Address of principal executive offices) (Zip Code)
Registrant's telephone number, including area code: (518) 745-1000

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. x Yes No

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

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See definition of "large accelerated filer," "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act.
Large accelerated filer Accelerated filer x Non-accelerated filer Smaller reporting company

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

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

| Class | Outstanding as of April 30, 2013 |
|---|---|
| Common Stock, par value $1.00 per share | 12,107,397 |

ARROW FINANCIAL CORPORATION
FORM 10-Q
TABLE OF CONTENTS

PART I - Financial Information

ARROW FINANCIAL CORPORATION AND SUBSIDIARIES
CONSOLIDATED BALANCE SHEETS
(In Thousands, Except Share and Per Share Amounts)
(Unaudited)

| | March 31, 2013 | December 31, 2012 | March 31, 2012 |
|---|---|---|---|
| ASSETS | | | |
| Cash and Due From Banks | $23,943 | $37,076 | $31,128 |
| Interest-Bearing Deposits at Banks | 113,231 | 11,756 | 106,380 |
| Investment Securities: | | | |
| Available-for-Sale | 478,775 | 478,698 | 466,785 |
| Held-to-Maturity (Approximate Fair Value of $259,562 at March 31, 2013, $248,252 at December 31, 2012, and $207,779 at March 31, 2012) | 251,456 | 239,803 | 200,607 |
| Federal Home Loan Bank and Federal Reserve Bank Stock | 4,493 | 5,792 | 4,382 |
| Loans | 1,164,759 | 1,172,341 | 1,137,547 |
| Allowance for Loan Losses | (14,603) | (15,298) | (15,053) |
| Net Loans | 1,150,156 | 1,157,043 | 1,122,494 |
| Premises and Equipment, Net | 29,363 | 28,897 | 23,217 |
| Other Real Estate and Repossessed Assets, Net | 1,194 | 1,034 | 555 |
| Goodwill | 22,003 | 22,003 | 22,003 |
| Other Intangible Assets, Net | 4,457 | 4,492 | 4,650 |
| Accrued Interest Receivable | 6,481 | 5,486 | 6,380 |
| Other Assets | 30,410 | 30,716 | 31,788 |
| Total Assets | $2,115,962 | $2,022,796 | $2,020,369 |
| LIABILITIES | | | |
| Noninterest-Bearing Deposits | $254,308 | $247,232 | $230,289 |
| NOW Accounts | 845,531 | 758,287 | 758,114 |
| Savings Deposits | 476,115 | 442,363 | 432,854 |
| Time Deposits of $100,000 or More | 89,797 | 93,375 | 115,161 |
| Other Time Deposits | 185,455 | 189,898 | 224,460 |
| Total Deposits | 1,851,206 | 1,731,155 | 1,760,878 |
| Federal Funds Purchased and Securities Sold Under Agreements to Repurchase | 12,166 | 12,678 | 16,652 |
| Federal Home Loan Bank Overnight Advances | — | 29,000 | — |
| Federal Home Loan Bank Term Advances | 30,000 | 30,000 | 30,000 |
| Junior Subordinated Obligations Issued to Unconsolidated Subsidiary Trusts | 20,000 | 20,000 | 20,000 |
| Accrued Interest Payable | 523 | 584 | 974 |
| Other Liabilities | 24,264 | 23,554 | 23,399 |
| Total Liabilities | 1,938,159 | 1,846,971 | 1,851,903 |
| STOCKHOLDERS' EQUITY | | | |
| Preferred Stock, $5 Par Value; 1,000,000 Shares Authorized | — | — | — |
| Common Stock, $1 Par Value; 20,000,000 Shares Authorized (16,416,163 Shares Issued at March 31, 2013 and December 31, 2012 and | 16,416 | 16,416 | 16,094 |

| | | | |
|---|---|---|---|
| 16,094,277 Shares Issued at March 31, 2012) | | | |
| Additional Paid-in Capital | 219,178 | 218,650 | 208,808 |
| Retained Earnings | 28,423 | 26,251 | 26,291 |
| Unallocated ESOP Shares (95,172 Shares at March 31, 2013, 102,890 Shares at December 31, 2012 and 109,939 Shares at March 31, 2012) | (2,000) | (2,150) | (2,350) |
| Accumulated Other Comprehensive Loss | (8,324) | (8,462) | (6,872) |
| Treasury Stock, at Cost (4,310,578 Shares at March 31, 2013, 4,288,617 Shares at December 31, 2012, and 4,223,687 Shares at March 31, 2012) | (75,890) | (74,880) | (73,505) |
| Total Stockholders' Equity | 177,803 | 175,825 | 168,466 |
| Total Liabilities and Stockholders' Equity | $2,115,962 | $2,022,796 | $2,020,369 |

See Notes to Unaudited Interim Consolidated Financial Statements.

ARROW FINANCIAL CORPORATION AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF INCOME
(In Thousands, Except Per Share Amounts)
(Unaudited)

| | Three Months Ended March 31, | |
|---|---|---|
| | 2013 | 2012 |
| INTEREST AND DIVIDEND INCOME | | |
| Interest and Fees on Loans | $12,783 | $13,958 |
| Interest on Deposits at Banks | 27 | 21 |
| Interest and Dividends on Investment Securities: | | |
| Fully Taxable | 1,796 | 2,638 |
| Exempt from Federal Taxes | 1,390 | 1,321 |
| Total Interest and Dividend Income | 15,996 | 17,938 |
| INTEREST EXPENSE | | |
| NOW Accounts | 778 | 1,059 |
| Savings Deposits | 268 | 357 |
| Time Deposits of $100,000 or More | 319 | 608 |
| Other Time Deposits | 554 | 1,146 |
| Federal Funds Purchased and Securities Sold Under Agreements to Repurchase | 3 | 6 |
| Federal Home Loan Bank Advances | 173 | 197 |
| Junior Subordinated Obligations Issued to Unconsolidated Subsidiary Trusts | 144 | 159 |
| Total Interest Expense | 2,239 | 3,532 |
| NET INTEREST INCOME | 13,757 | 14,406 |
| Provision for Loan Losses | 100 | 280 |
| NET INTEREST INCOME AFTER PROVISION FOR LOAN LOSSES | 13,657 | 14,126 |
| NONINTEREST INCOME | | |
| Income From Fiduciary Activities | 1,574 | 1,622 |
| Fees for Other Services to Customers | 2,282 | 1,960 |
| Insurance Commissions | 2,028 | 1,889 |
| Gain on Securities Transactions | 527 | 502 |
| Net Gain on Sales of Loans | 607 | 357 |
| Other Operating Income | 156 | 229 |
| Total Noninterest Income | 7,174 | 6,559 |
| NONINTEREST EXPENSE | | |
| Salaries and Employee Benefits | 7,621 | 7,903 |
| Occupancy Expenses, Net | 2,276 | 2,024 |
| FDIC Assessments | 264 | 255 |
| Other Operating Expense | 3,250 | 2,964 |
| Total Noninterest Expense | 13,411 | 13,146 |
| INCOME BEFORE PROVISION FOR INCOME TAXES | 7,420 | 7,539 |
| Provision for Income Taxes | 2,239 | 2,251 |
| NET INCOME | $5,181 | $5,288 |
| Average Shares Outstanding: | | |
| Basic | 12,031 | 12,005 |

| | | |
|---|---|---|
| Diluted | 12,049 | 12,030 |
| Per Common Share: | | |
| Basic Earnings | $0.43 | $0.44 |
| Diluted Earnings | 0.43 | 0.44 |

Share and Per Share Amounts have been restated for the September 2012 2% stock dividend.
See Notes to Unaudited Interim Consolidated Financial Statements.

# 4

ARROW FINANCIAL CORPORATION AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME
(In Thousands)
(Unaudited)

| | Three Months Ended March 31, | |
|---|---|---|
| | 2013 | 2012 |
| Net Income | $5,181 | $5,288 |
| Other Comprehensive Income (Loss), Net of Tax: | | |
| Net Unrealized Securities Holding Gains Arising During the Period | 220 | (98) |
| Reclassification Adjustment for Securities Gains Included in Net Income | (318) | (303) |
| Amortization of Net Retirement Plan Actuarial Loss | 236 | 228 |
| Accretion of Net Retirement Plan Prior Service Credit | — | (4) |
| Other Comprehensive Income (Loss) | 138 | (177) |
| Comprehensive Income | $5,319 | $5,111 |

See Notes to Unaudited Interim Consolidated Financial Statements.

# 5

ARROW FINANCIAL CORPORATION AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY
(In Thousands, Except Share and Per Share Amounts)
(Unaudited)

| | Common Stock | Additional Paid-In Capital | Retained Earnings | Unallo-cated ESOP Shares | Accumu-lated Other Com-prehensive Income (Loss) | Treasury Stock | Total |
|---|---|---|---|---|---|---|---|
| Balance at December 31, 2012 | $16,416 | $218,650 | $26,251 | $ (2,150) | $ (8,462) | $(74,880) | $175,825 |
| Net Income | — | — | 5,181 | — | — | — | 5,181 |
| Other Comprehensive (Loss) Income | — | — | — | — | 138 | — | 138 |
| Cash Dividends Paid, $.25 per Share [1] | — | — | (3,009) | — | — | — | (3,009) |
| Stock Options Exercised (23,434 Shares) | — | 259 | — | — | — | 231 | 490 |
| Shares Issued Under the Directors' Stock Plan (396 Shares) | — | 6 | — | — | — | 4 | 10 |
| Shares Issued Under the Employee Stock Purchase Plan (4,683 Shares) | — | 64 | — | — | — | 46 | 110 |
| Stock-Based Compensation Expense | — | 97 | — | — | — | — | 97 |
| Tax Benefit for Disposition of Stock Options | — | 8 | — | — | — | — | 8 |
| Purchase of Treasury Stock (54,231 Shares) | — | — | — | — | — | (1,328) | (1,328) |
| Acquisition of Subsidiaries (3,757 Shares) | — | 54 | — | — | — | 37 | 91 |
| Allocation of ESOP Stock (7,718 Shares) | — | 40 | — | 150 | — | — | 190 |
| Balance at March 31, 2013 | $16,416 | $219,178 | $28,423 | $ (2,000) | $ (8,324) | $(75,890) | $177,803 |
| | | | | | | | |
| Balance at December 31, 2011 | $16,094 | $207,600 | $23,947 | $ (2,500) | $ (6,695) | $(72,061) | $166,385 |
| Net Income | — | — | 5,288 | — | — | — | 5,288 |
| Other Comprehensive (Loss) Income | — | — | — | — | (177) | — | (177) |
| Cash Dividends Paid, $.245 per Share [1] | — | — | (2,944) | — | — | — | (2,944) |
| Stock Options Exercised (52,502 Shares) | — | 627 | — | — | — | 522 | 1,149 |
| Shares Issued Under the Employee Stock Purchase Plan (4,542 Shares) | — | 62 | — | — | — | 45 | 107 |

| | | | | | | | |
|---|---|---|---|---|---|---|---|
| Shares Issued for Dividend Reinvestment Plans (19,032 Shares) | — | 275 | — | — | — | 189 | 464 |
| Stock-Based Compensation Expense | — | 99 | — | — | — | — | 99 |
| Tax Benefit for Disposition of Stock Options | — | 53 | — | — | — | — | 53 |
| Purchase of Treasury Stock (90,017 Shares) | — | — | — | — | — | (2,237 ) | (2,237 ) |
| Acquisition of Subsidiaries (3,724 Shares) | — | 54 | — | — | — | 37 | 91 |
| Allocation of ESOP Stock (7,563 Shares) | — | 38 | — | 150 | — | — | 188 |
| Balance at March 31, 2012 | $16,094 | $208,808 | $26,291 | $ (2,350 ) | $ (6,872 ) | $(73,505 ) | $168,466 |

[1] Cash dividends paid per share have been adjusted for the September 2012 2% stock dividend.

See Notes to Unaudited Interim Consolidated Financial Statements.

# 6

ARROW FINANCIAL CORPORATION AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOWS
(Dollars in Thousands)
(Unaudited)

| | Three Months Ended March 31, | |
|---|---|---|
| Cash Flows from Operating Activities: | 2013 | 2012 |
| Net Income | $5,181 | $5,288 |
| Adjustments to Reconcile Net Income to Net Cash Provided by Operating Activities: | | |
| Provision for Loan Losses | 100 | 280 |
| Depreciation and Amortization | 2,373 | 2,043 |
| Allocation of ESOP Stock | 190 | 188 |
| Gains on the Sale of Securities Available-for-Sale | (527) | (502) |
| Loans Originated and Held-for-Sale | (18,842) | (10,469) |
| Proceeds from the Sale of Loans Held-for-Sale | 21,385 | 10,630 |
| Net Gains on the Sale of Loans | (607) | (357) |
| Net Gains on the Sale of Premises and Equipment, Other Real Estate Owned and Repossessed Assets | 105 | 30 |
| Contributions to Pension Plans | (111) | (80) |
| Deferred Income Tax Expense (Benefit) | 358 | (288) |
| Shares Issued Under the Directors’ Stock Plan | 10 | — |
| Stock-Based Compensation Expense | 97 | 99 |
| Net (Increase) Decrease in Other Assets | (991) | 1,064 |
| Net Increase in Other Liabilities | 926 | 659 |
| Net Cash Provided By Operating Activities | 9,647 | 8,585 |
| Cash Flows from Investing Activities: | | |
| Proceeds from the Sale of Securities Available-for-Sale | 16,261 | 10,851 |
| Proceeds from the Maturities and Calls of Securities Available-for-Sale | 22,846 | 77,782 |
| Purchases of Securities Available-for-Sale | (39,928) | (288) |
| Proceeds from the Maturities and Calls of Securities Held-to-Maturity | 6,815 | 8,987 |
| Purchases of Securities Held-to-Maturity | (18,930) | (59,043) |
| Net Decrease (Increase) in Loans | 4,247 | (6,355) |
| Proceeds from the Sales of Premises and Equipment, Other Real Estate Owned and Repossessed Assets | 341 | 230 |
| Purchase of Premises and Equipment | (991) | (1,025) |
| Cash Paid for Subsidiaries, Net | (75) | (75) |
| Net Decrease in Other Investments | 1,299 | 2,340 |
| Net Cash (Used In) Provided By Investing Activities | (8,115) | 33,404 |
| Cash Flows from Financing Activities: | | |
| Net Increase in Deposits | 120,051 | 116,832 |
| Net Decrease in Short-Term Borrowings | (29,512) | (51,641) |
| Repayments of Federal Home Loan Bank Term Advances | — | (10,000) |
| Purchase of Treasury Stock | (1,328) | (2,237) |
| Stock Options Exercised | 490 | 1,149 |
| Shares Issued Under the Employee Stock Purchase Plan | 110 | 107 |
| Tax Benefit from Exercise of Stock Options | 8 | 53 |
| Shares Issued for Dividend Reinvestment Plans | — | 464 |
| Cash Dividends Paid | (3,009) | (2,944) |
| Net Cash Provided By Financing Activities | 86,810 | 51,783 |

| | | |
|---|---|---|
| Net Increase in Cash and Cash Equivalents | 88,342 | 93,772 |
| Cash and Cash Equivalents at Beginning of Period | 48,832 | 43,736 |
| Cash and Cash Equivalents at End of Period | $137,174 | $137,508 |
| | | |
| Supplemental Disclosures to Statements of Cash Flow Information: | | |
| Interest on Deposits and Borrowings | $2,299 | $3,704 |
| Income Taxes | 511 | 191 |
| Non-cash Investing and Financing Activity: | | |
| Transfer of Loans to Other Real Estate Owned and Repossessed Assets | 604 | 232 |
| Acquisition of Subsidiaries | 91 | 91 |

See Notes to Unaudited Interim Consolidated Financial Statements.

# 7

NOTES TO INTERIM CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

Note 1. ACCOUNTING POLICIES

In the opinion of the management of Arrow Financial Corporation (Arrow), the accompanying unaudited consolidated interim financial statements contain all of the adjustments necessary to present fairly the financial position as of March 31, 2013, December 31, 2012 and March 31, 2012; the results of operations for the three-month periods ended March 31, 2013 and 2012; the consolidated statements of comprehensive income for the three-month periods ended March 31, 2013 and 2012; the changes in stockholders' equity for the three-month periods ended March 31, 2013 and 2012; and the cash flows for the three-month periods ended March 31, 2013 and 2012. All such adjustments are of a normal recurring nature. The preparation of financial statements requires the use of management estimates. The unaudited consolidated interim financial statements should be read in conjunction with the audited annual consolidated financial statements of Arrow for the year ended December 31, 2012, included in Arrow's 2012 Form 10-K.

New Accounting Standards Updates (ASU): During 2013, through the date of this report, the FASB issued five accounting standards updates. Four did not apply to Arrow. ASU 2013-02 "Comprehensive Income" requires additional disclosures relating to reclassifications out of accumulated other comprehensive income. Since the ASU was effective for this Form 10-Q, the new disclosures are included in the Consolidating Statements of Income and Note 5 - Comprehensive Income.

Note 2. INVESTMENT SECURITIES (In Thousands)

The following table is the schedule of Available-For-Sale Securities at March 31, 2013, December 31, 2012 and March 31, 2012:
Available-For-Sale Securities

| | U.S. Agency Obligations | State and Municipal Obligations | Mortgage-Backed Securities - Residential | Corporate and Other Debt Securities | Mutual Funds and Equity Securities | Total Available-For-Sale Securities |
|---|---|---|---|---|---|---|
| March 31, 2013 | | | | | | |
| Available-For-Sale Securities, at Amortized Cost | $132,217 | $104,304 | $219,067 | $12,913 | $1,120 | $469,621 |
| Available-For-Sale Securities, at Fair Value | 132,153 | 104,469 | 228,323 | 12,691 | 1,139 | 478,775 |
| Gross Unrealized Gains | 23 | 228 | 9,256 | 2 | 19 | 9,528 |
| Gross Unrealized Losses | 87 | 63 | — | 224 | — | 374 |
| Available-For-Sale Securities, Pledged as Collateral | | | | | | 274,433 |
| | | | | | | |
| Maturities of Debt Securities, at Amortized Cost: | | | | | | |
| Within One Year | — | 29,880 | 14,955 | — | | 44,835 |
| From 1 - 5 Years | 132,217 | 69,269 | 193,002 | 11,913 | | 406,401 |
| From 5 - 10 Years | — | 4,235 | 11,110 | — | | 15,345 |
| Over 10 Years | — | 920 | — | 1,000 | | 1,920 |

| | | | | | | |
|---|---|---|---|---|---|---|
| Maturities of Debt Securities, at Fair Value: | | | | | | |
| Within One Year | — | 29,925 | 15,367 | — | | 45,292 |
| From 1 - 5 Years | 132,153 | 69,340 | 200,956 | 11,891 | | 414,340 |
| From 5 - 10 Years | — | 4,284 | 12,000 | — | | 16,284 |
| Over 10 Years | — | 920 | — | 800 | | 1,720 |
| | | | | | | |
| Securities in a Continuous Loss Position, at Fair Value: | | | | | | |
| Less than 12 Months | $94,909 | $31,325 | $3 | $8,452 | $— | $134,689 |
| 12 Months or Longer | — | 1,481 | — | — | — | 1,481 |
| Total | $94,909 | $32,806 | $3 | $8,452 | $— | $136,170 |
| Number of Securities in a Continuous Loss Position | 28 | 154 | 1 | 11 | — | 194 |
| | | | | | | |
| Unrealized Losses on Securities in a Continuous Loss Position: | | | | | | |
| Less than 12 Months | $87 | $61 | $— | $224 | $— | $372 |

# 8

| Available-For-Sale Securities | U.S. Agency Obligations | State and Municipal Obligations | Mortgage-Backed Securities - Residential | Corporate and Other Debt Securities | Mutual Funds and Equity Securities | Total Available-For-Sale Securities |
|---|---|---|---|---|---|---|
| 12 Months or Longer | — | 2 | — | — | — | 2 |
| Total | $87 | $63 | $— | $224 | $— | $374 |
| December 31, 2012 | | | | | | |
| Available-For-Sale Securities, at Amortized Cost | $122,297 | $84,798 | $252,480 | $8,689 | $1,120 | $469,384 |
| Available-For-Sale Securities, at Fair Value | 122,457 | 84,838 | 261,804 | 8,451 | 1,148 | 478,698 |
| Gross Unrealized Gains | 204 | 206 | 9,405 | — | 28 | 9,843 |
| Gross Unrealized Losses | 44 | 166 | 81 | 238 | — | 529 |
| Available-For-Sale Securities, Pledged as Collateral | | | | | | 260,292 |
| Securities in a Continuous Loss Position, at Fair Value: | | | | | | |
| Less than 12 Months | $72,531 | $46,627 | $10,230 | $8,451 | $— | $137,839 |
| 12 Months or Longer | — | 2,149 | 4,968 | — | — | 7,117 |
| Total | $72,531 | $48,776 | $15,198 | $8,451 | $— | $144,956 |
| Number of Securities in a Continuous Loss Position | 22 | 198 | 7 | 11 | — | 238 |
| Unrealized Losses on Securities in a Continuous Loss Position: | | | | | | |
| Less than 12 Months | $44 | $160 | $50 | $238 | $— | $492 |
| 12 Months or Longer | — | 6 | 31 | — | — | 37 |
| Total | $44 | $166 | $81 | $238 | $— | $529 |
| March 31, 2012 | | | | | | |
| Available-For-Sale Securities, at Amortized Cost | $65,303 | $43,186 | $345,294 | $1,028 | $1,365 | $456,176 |
| Available-For-Sale Securities, at Fair Value | 65,660 | 43,482 | 355,382 | 828 | 1,433 | 466,785 |
| Gross Unrealized Gains | 357 | 308 | 10,240 | — | 74 | 10,979 |
| Gross Unrealized Losses | — | 12 | 152 | 200 | 6 | 370 |
| Available-For-Sale Securities, Pledged as Collateral | | | | | | 304,303 |
| Securities in a Continuous Loss Position, at Fair Value: | | | | | | |
| Less than 12 Months | $— | $2,831 | $14,205 | $800 | $39 | $17,875 |
| 12 Months or Longer | — | — | — | — | — | — |
| Total | $— | $2,831 | $14,205 | $800 | $39 | $17,875 |
| Number of Securities in a Continuous Loss Position | — | 7 | 4 | 1 | 1 | 13 |

| | | | | | | |
|---|---|---|---|---|---|---|
| Unrealized Losses on Securities in a Continuous Loss Position: | | | | | | |
| Less than 12 Months | $— | $12 | $152 | $200 | $6 | $370 |
| 12 Months or Longer | — | — | — | — | — | — |
| Total | $— | $12 | $152 | $200 | $6 | $370 |

# 9

The following table is the schedule of Held-To-Maturity Securities at March 31, 2013, December 31, 2011 and March 31, 2012:
Held-To-Maturity Securities

| | State and Municipal Obligations | Mortgage-Backed Securities - Residential | Corporate and Other Debt Securities | Total Held-To Maturity Securities |
|---|---|---|---|---|
| March 31, 2013 | | | | |
| Held-To-Maturity Securities, at Amortized Cost | $198,858 | $51,598 | $1,000 | $251,456 |
| Held-To-Maturity Securities, at Fair Value | 206,141 | 52,421 | 1,000 | 259,562 |
| Gross Unrealized Gains | 7,317 | 823 | — | 8,140 |
| Gross Unrealized Losses | 34 | — | — | 34 |
| Held-To-Maturity Securities, Pledged as Collateral | | | | 250,456 |
| | | | | |
| Maturities of Debt Securities, at Amortized Cost: | | | | |
| Within One Year | 46,701 | — | — | 46,701 |
| From 1 - 5 Years | 71,562 | 51,598 | — | 123,160 |
| From 5 - 10 Years | 75,122 | — | — | 75,122 |
| Over 10 Years | 5,473 | — | 1,000 | 6,473 |
| | | | | |
| Maturities of Debt Securities, at Fair Value: | | | | |
| Within One Year | 46,740 | — | — | 46,740 |
| From 1 - 5 Years | 72,640 | 52,421 | — | 125,061 |
| From 5 - 10 Years | 80,919 | — | — | 80,919 |
| Over 10 Years | 5,842 | — | 1,000 | 6,842 |
| | | | | |
| Securities in a Continuous Loss Position, at Fair Value: | | | | |
| Less than 12 Months | $8,794 | $— | $— | $8,794 |
| 12 Months or Longer | 173 | — | — | 173 |
| Total | $8,967 | $— | $— | $8,967 |
| Number of Securities in a Continuous Loss Position | 33 | — | — | 33 |
| | | | | |
| Unrealized Losses on Securities in a Continuous Loss Position: | | | | |
| Less than 12 Months | $34 | $— | $— | $34 |
| 12 Months or Longer | — | — | — | — |
| Total | $34 | $— | $— | $34 |

# 10

Held-To-Maturity Securities

| | State and Municipal Obligations | Mortgage-Backed Securities - Residential | Corporate and Other Debt Securities | Total Held-To Maturity Securities |
|---|---|---|---|---|
| December 31, 2012 | | | | |
| Held-To-Maturity Securities, at Amortized Cost | $183,373 | $55,430 | $1,000 | $239,803 |
| Held-To-Maturity Securities, at Fair Value | 191,196 | 56,056 | 1,000 | 248,252 |
| Gross Unrealized Gains | 7,886 | 626 | — | 8,512 |
| Gross Unrealized Losses | 63 | — | — | 63 |
| Held-To-Maturity Securities, Pledged as Collateral | | | | 238,803 |
| | | | | |
| Securities in a Continuous Loss Position, at Fair Value: | | | | |
| Less than 12 Months | $21,583 | $— | $— | $21,583 |
| 12 Months or Longer | 503 | — | — | 503 |
| Total | $22,086 | $— | $— | $22,086 |
| Number of Securities in a Continuous Loss Position | 61 | — | — | 61 |
| | | | | |
| Unrealized Losses on Securities in a Continuous Loss Position: | | | | |
| Less than 12 Months | $62 | $— | $— | $62 |
| 12 Months or Longer | 1 | — | — | 1 |
| Total | $63 | $— | $— | $63 |
| | | | | |
| March 31, 2012 | | | | |
| Held-To-Maturity Securities, at Amortized Cost | $159,790 | $39,817 | $1,000 | $200,607 |
| Held-To-Maturity Securities, at Fair Value | 167,109 | 39,670 | 1,000 | 207,779 |
| Gross Unrealized Gains | 7,415 | 17 | — | 7,432 |
| Gross Unrealized Losses | 96 | 164 | — | 260 |
| Held-To-Maturity Securities, Pledged as Collateral | | | | 199,607 |
| | | | | |
| Securities in a Continuous Loss Position, at Fair Value: | | | | |
| Less than 12 Months | $11,719 | $33,704 | $— | $45,423 |
| 12 Months or Longer | — | — | — | — |
| Total | $11,719 | $33,704 | $— | $45,423 |
| Number of Securities in a Continuous Loss Position | 33 | 18 | — | 51 |
| | | | | |
| Unrealized Losses on | | | | |

| | | | | |
|---|---|---|---|---|
| Securities in a Continuous Loss Position: | | | | |
| Less than 12 Months | $96 | $164 | $— | $260 |
| 12 Months or Longer | — | — | — | — |
| Total | $96 | $164 | $— | $260 |

In the tables above, maturities of mortgage-backed-securities - residential are included based on their expected average lives. Actual maturities will differ from the table below because issuers may have the right to call or prepay obligations with or without prepayment penalties.

# 11

In the available-for-sale category at March 31, 2013, U.S. agency obligations consisted solely of U.S. Government Agency securities with an amortized cost of $132.2 million and a fair value of $132.2 million. Mortgage-backed securities-residential consisted of U.S. Government Agency securities with an amortized cost of $35.3 million and a fair value of $37.2 million and GSE securities with an amortized cost of $183.8 million and a fair value of $191.1 million. In the held-to-maturity category at March 31, 2013, mortgage-backed securities-residential consisted of GSEs with an amortized cost of $51.6 million and a fair value of $52.4 million.

In the available-for-sale category at March 31, 2012, U.S. agency obligations consisted solely of U.S. Government Agency securities with an amortized cost of $65.3 million and a fair value of $65.7 million. Mortgage-backed securities-residential consisted of US Government Agency securities with an amortized cost of $44.4 million and a fair value of $45.9 million and GSEs with an amortized cost of $300.9 million and a fair value of $309.5 million. In the held-to-maturity category at March 31, 2012, mortgage-backed securities-residential consisted of GSEs with an amortized cost of $39.8 million and a fair value of $39.7 million.

Securities in a continuous loss position, in the tables above for March 31, 2013, December 31, 2012 and March 31, 2012 do not reflect any deterioration of the credit worthiness of the issuing entities. U.S. Agency issues, including agency-backed collateralized mortgage obligations and mortgage-backed securities, are all rated Aaa by Moody's and AA+ by Standard and Poor's. The state and municipal obligations are general obligations supported by the general taxing authority of the issuer, and in some cases are insured. Obligations issued by school districts are supported by state aid. For any non-rated municipal securities, credit analysis is performed in-house based upon data that has been submitted by the issuers to the NY State Comptroller. That analysis shows no deterioration in the credit worthiness of the municipalities. Subsequent to March 31, 2013, there were no securities downgraded below investment grade.

The unrealized losses on these temporarily impaired securities are primarily the result of changes in interest rates for fixed rate securities where the interest rate received is less than the current rate available for new offerings of similar securities, changes in market spreads as a result of shifts in supply and demand, and/or changes in the level of prepayments for mortgage related securities. Because we do not currently intend to sell any of our temporarily impaired securities, and because it is not more likely-than-not that we would be required to sell the securities prior to recovery, the impairment is considered temporary.

Note 3. LOANS (In Thousands)

Loan Categories and Past Due Loans

The following table presents loan balances outstanding as of March 31, 2013, December 31, 2012 and March 31, 2012 and an analysis of the recorded investment in loans that are past due at these dates. Generally, Arrow considers a loan past due 30 or more days if the borrower is two or more payments past due. Loans held-for-sale of $864, $2,801 and $1,089 as of March 31, 2013, December 31, 2012 and March 31, 2012, respectively, are included in the residential real estate loan balances.

Past Due Loans

| | Commercial | Commercial Construction | Commercial Real Estate | Other Consumer | Automobile | Residential | Total |
|---|---|---|---|---|---|---|---|
| March 31, 2013 | | | | | | | |
| Loans Past Due 30-59 Days | $428 | $— | $1,351 | $26 | $1,986 | $1,481 | $5,272 |
| Loans Past Due 60-89 Days | 421 | — | 200 | 10 | 375 | 1,058 | 2,064 |
| Loans Past Due 90 or more Days | 130 | — | 1,886 | — | 98 | 1,302 | 3,416 |
| Total Loans Past Due | 979 | — | 3,437 | 36 | 2,459 | 3,841 | 10,752 |
| Current Loans | 88,188 | 27,380 | 251,805 | 6,995 | 351,542 | 428,097 | 1,154,007 |
| Total Loans | $89,167 | $27,380 | $255,242 | $7,031 | $354,001 | $431,938 | $1,164,759 |
| | | | | | | | |
| Loans 90 or More Days Past Due and Still Accruing Interest | $— | $— | $— | $— | $— | $259 | $259 |
| Nonaccrual Loans | $253 | $— | $1,953 | $4 | $334 | $2,674 | $5,218 |
| | | | | | | | |
| December 31, 2012 | | | | | | | |
| Loans Past Due 30-59 Days | $1,045 | $— | $534 | $43 | $2,427 | $407 | $4,456 |
| Loans Past Due 60-89 Days | 1,588 | — | 1,332 | 17 | 793 | 2,466 | 6,196 |
| Loans Past Due 90 or more Days | 494 | — | 1,871 | — | 185 | 1,462 | 4,012 |
| Total Loans Past Due | 3,127 | — | 3,737 | 60 | 3,405 | 4,335 | 14,664 |
| Current Loans | 102,409 | 29,149 | 241,440 | 6,624 | 345,695 | 432,360 | 1,157,677 |
| Total Loans | $105,536 | $29,149 | $245,177 | $6,684 | $349,100 | $436,695 | $1,172,341 |
| | | | | | | | |
| Loans 90 or More Days Past Due and Still Accruing Interest | $126 | $— | $378 | $— | $42 | $374 | $920 |
| Nonaccrual Loans | $1,787 | $— | $2,026 | $1 | $419 | $2,400 | $6,633 |
| | | | | | | | |
| March 31, 2012 | | | | | | | |
| Loans Past Due 30-59 Days | $368 | $— | $427 | $21 | $1,930 | $1,089 | $3,835 |
| Loans Past Due 60-89 Days | 44 | — | 117 | 20 | 256 | 943 | 1,380 |
| Loans Past Due 90 or more Days | 9 | — | 1,073 | 15 | 158 | 2,704 | 3,959 |
| Total Loans Past Due | 421 | — | 1,617 | 56 | 2,344 | 4,736 | 9,174 |
| Current Loans | 101,732 | 10,814 | 232,700 | 6,414 | 326,332 | 450,381 | 1,128,373 |
| Total Loans | $102,153 | $10,814 | $234,317 | $6,470 | $328,676 | $455,117 | $1,137,547 |
| | | | | | | | |
| Loans 90 or More Days Past Due and Still Accruing Interest | $9 | $— | $— | $— | $— | $112 | $121 |
| Nonaccrual Loans | $35 | $— | $1,925 | $15 | $500 | $3,001 | $5,476 |

Allowance for Loan Losses

The following table presents a roll-forward of the allowance for loan losses and other information pertaining to the allowance for loan losses:

Allowance for Loan Losses

| | Commercial | Commercial Construction | Commercial Real Estate | Other Consumer | Automobile | Residential | Unallocated | Total |
|---|---|---|---|---|---|---|---|---|
| Roll-forward of the Allowance for Loan Losses for the Year-to-Date Periods: | | | | | | | | |
| December 31, 2012 | $2,344 | $601 | $3,050 | $304 | $4,536 | $3,405 | $1,058 | $15,298 |
| Charge-offs | (773) | — | (11) | (8) | (98) | — | — | (890) |
| Recoveries | 4 | — | — | — | 91 | — | — | 95 |
| Provision | 44 | 11 | 340 | 12 | (235) | (13) | (59) | 100 |
| March 31, 2013 | $1,619 | $612 | $3,379 | $308 | $4,294 | $3,392 | $999 | $14,603 |
| | | | | | | | | |
| December 31, 2011 | $1,927 | $602 | $3,136 | $350 | $4,496 | $3,414 | $1,078 | $15,003 |
| Charge-offs | (5) | — | (167) | (19) | (106) | — | — | (297) |
| Recoveries | 2 | — | — | 6 | 59 | — | — | 67 |
| Provision | (90) | 59 | 328 | 15 | 81 | (114) | 1 | 280 |
| March 31, 2012 | $1,834 | $661 | $3,297 | $352 | $4,530 | $3,300 | $1,079 | $15,053 |
| | | | | | | | | |
| March 31, 2013 | | | | | | | | |
| Allowance for loan losses - Loans Individually Evaluated for Impairment | $— | $— | $— | $— | $— | $— | $— | $— |
| Allowance for loan losses - Loans Collectively Evaluated for Impairment | $1,619 | $612 | $3,379 | $308 | $4,294 | $3,392 | $999 | $14,603 |
| Ending Loan Balance - Individually Evaluated for Impairment | $37 | $— | $1,505 | $— | $182 | $1,085 | $— | $2,809 |
| Ending Loan Balance - Collectively Evaluated for | $89,130 | $27,380 | $253,737 | $7,031 | $353,819 | $430,853 | $— | $1,161,950 |

Impairment

# 14

---

Allowance for Loan Losses

| | Commercial | Commercial Construction | Commercial Real Estate | Other Consumer | Automobile | Residential | Unallocated | Total |
|---|---|---|---|---|---|---|---|---|
| December 31, 2012 | | | | | | | | |
| Allowance for loan losses - Loans Individually Evaluated for Impairment | $ 853 | $ — | $— | $— | $— | $— | $— | $853 |
| Allowance for loan losses - Loans Collectively Evaluated for Impairment | $ 1,491 | $ 601 | $3,050 | $304 | $4,536 | $3,405 | $1,058 | $14,445 |
| Ending Loan Balance - Individually Evaluated for Impairment | $ 1,432 | $ — | $2,528 | $— | $203 | $1,090 | $— | $5,253 |
| Ending Loan Balance - Collectively Evaluated for Impairment | $ 104,104 | $ 29,149 | $242,649 | $6,684 | $348,897 | $435,605 | $— | $1,167,088 |
| March 31, 2012 | | | | | | | | |
| Allowance for loan losses - Loans Collectively Evaluated for Impairment | $ 1,834 | $ 661 | $3,297 | $352 | $4,530 | $3,300 | $1,079 | $15,053 |
| Ending Loan Balance - Individually Evaluated for Impairment | $ 62 | $ — | $1,454 | $— | $240 | $2,108 | $— | $3,864 |
| Ending Loan Balance - Collectively Evaluated for Impairment | $ 102,091 | $ 10,814 | $232,863 | $6,470 | $328,436 | $453,009 | $— | $1,133,683 |

Through the provision for loan losses, an allowance is maintained that reflects our best estimate of losses related to specifically identified loans and the inherent risk of probable losses for categories of loans in the remaining portfolio. Actual loan losses are charged against this allowance when loans are deemed uncollectible.

We use a two-step process to determine the provision for loans losses and the amount of the allowance for loan losses. We evaluate nonaccrual loans over $250 thousand and all troubled debt restructured loans individually for impairment, while we evaluate the remainder of the portfolio on a pooled basis as described below.

Quantitative Analysis: Quantitatively, we determine the historical loss rate for each homogeneous loan pool. During the previous five years we have had little charge-off activity on loans secured by residential real estate. Indirect consumer lending (principally automobile loans) represents a significant component of our total loan portfolio and contains the majority of our total loan charge-offs. We have had only two small losses on commercial real estate loans in the previous five years. Prior to this most recent quarter, losses on commercial loans (other than those secured by real estate) were also historically low, but can vary widely from year-to-year; this is the most complex category of loans in our loss analysis. For the whole portfolio, our net charge-offs for the previous five years have been at or near historical lows for our Company. Annualized net charge-offs for the entire loan portfolio has ranged from .04% to .09% of average loans during this period, although we may exceed that range for all of 2013, due to one large commercial charge-off in the first quarter of 2013.

Qualitative Analysis: While historical loss experience provides a reasonable starting point for our analysis, historical losses, or even recent trends in losses, do not by themselves form a sufficient basis to determine the appropriate level for the allowance. Therefore, we also consider and adjust historical loss factors for qualitative and environmental factors that are likely to impact the inherent risk of loss associated with our existing portfolio. These included:

- Changes in the volume and severity of past due, nonaccrual and adversely classified loans
- Changes in the nature and volume of the portfolio and in the terms of loans
- Changes in the value of the underlying collateral for collateral dependent loans
- Changes in lending policies and procedures, including changes in underwriting standards and collection, charge-off, and recovery practices not considered elsewhere in estimating credit losses

# 15

- Changes in the quality of the loan review system
- Changes in the experience, ability, and depth of lending management and other relevant staff
- Changes in international, national, regional, and local economic and business conditions and developments that affect the collectibility of the portfolio
- The existence and effect of any concentrations of credit, and changes in the level of such concentrations
- The effect of other external factors such as competition and legal and regulatory requirements on the level of estimated credit losses in the existing portfolio or pool

For each homogeneous loan pool, we estimate a loss factor expressed in basis points for each of the qualitative factors above, and for historical net credit losses. We update and change, if necessary, the loss-rates assigned to various pools based on the analysis of loss trends and the change in qualitative and environmental factors on a quarterly basis.

Due to the imprecise nature of the loan loss estimation process and ever changing economic conditions, the risk attributes of our portfolio may not be adequately captured in data related to the formula-based loan loss components used to determine allocations in our analysis of the adequacy of the allowance for loan losses. Management, therefore, has established and held an unallocated portion within the allowance for loan losses reflecting the uncertainty of economic conditions within our market area.

Credit Quality Indicators

The following table presents the credit quality indicators by loan category at March 31, 2013, December 31, 2012 and March 31, 2012:

Loan Credit Quality Indicators

| | Commercial | Commercial Construction | Commercial Real Estate | Other Consumer | Automobile | Residential | Total |
|---|---|---|---|---|---|---|---|
| March 31, 2013 | | | | | | | |
| Credit Risk Profile by Creditworthiness Category: | | | | | | | |
| Satisfactory | $82,063 | $26,180 | $234,609 | | | | $342,852 |
| Special Mention | 183 | — | 1,385 | | | | 1,568 |
| Substandard | 6,921 | 1,200 | 19,248 | | | | 27,369 |
| Doubtful | — | — | — | | | | — |
| Credit Risk Profile Based on Payment Activity: | | | | | | | |
| Performing | | | | $7,027 | $353,667 | $429,004 | 789,698 |
| Nonperforming | | | | 4 | 334 | 2,934 | 3,272 |
| | | | | | | | |
| December 31, 2012 | | | | | | | |
| Credit Risk Profile by Creditworthiness Category: | | | | | | | |
| Satisfactory | 97,085 | 27,913 | 225,312 | | | | 350,310 |
| Special Mention | 192 | — | 1,419 | | | | 1,611 |
| Substandard | 6,872 | 1,236 | 18,446 | | | | 26,554 |
| Doubtful | 1,387 | — | — | | | | 1,387 |
| Credit Risk Profile Based on Payment Activity: | | | | | | | |
| Performing | | | | 6,683 | 348,676 | 433,922 | 789,281 |
| Nonperforming | | | | 1 | 424 | 2,773 | 3,198 |

| | | | | | | | |
|---|---|---|---|---|---|---|---|
| March 31, 2012 | | | | | | | |
| Credit Risk Profile by Creditworthiness Category: | | | | | | | |
| Satisfactory | 95,385 | 8,969 | 213,429 | | | | 317,783 |
| Special Mention | 2,066 | — | 2,545 | | | | 4,611 |
| Substandard | 4,702 | 1,845 | 18,343 | | | | 24,890 |
| Doubtful | — | — | — | | | | — |
| Credit Risk Profile Based on Payment Activity: | | | | | | | |
| Performing | | | | 6,455 | 328,176 | 452,004 | 786,635 |
| Nonperforming | | | | $15 | $500 | $3,113 | $3,628 |

We use an internally developed system of five credit quality indicators to rate the credit worthiness of each commercial loan defined as follows: 1) Satisfactory - "Satisfactory" borrowers have acceptable financial condition with satisfactory record of earnings and sufficient

# 16

historical and projected cash flow to service the debt. Borrowers have satisfactory repayment histories and primary and secondary sources of repayment can be clearly identified; 2) Special Mention - Loans in this category have potential weaknesses that deserve management's close attention. If left uncorrected, these potential weaknesses may result in deterioration of the repayment prospects for the asset or in the institution's credit position at some future date. "Special mention" assets are not adversely classified and do not expose an institution to sufficient risk to warrant adverse classification. Loans which might be assigned this risk rating include loans to borrowers with deteriorating financial strength and/or earnings record and loans with potential for problems due to weakening economic or market conditions; 3) Substandard - Loans classified as "substandard" are inadequately protected by the current sound net worth or paying capacity of the borrower or the collateral pledged, if any. Loans in this category have well defined weaknesses that jeopardize the repayment. They are characterized by the distinct possibility that the bank will sustain some loss if the deficiencies are not corrected. "Substandard" loans may include loans which are likely to require liquidation of collateral to effect repayment, and other loans where character or ability to repay has become suspect. Loss potential, while existing in the aggregate amount of substandard assets, does not have to exist in individual assets classified substandard; 4) Doubtful - Loans classified as "doubtful" have all of 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 current existing facts, conditions, and values highly questionable and improbable. Although possibility of loss is extremely high, classification of these loans as "loss" has been deferred due to specific pending factors or events which may strengthen the value (i.e. possibility of additional collateral, injection of capital, collateral liquidation, debt restructure, economic recovery, etc). Loans classified as "doubtful" need to be placed on non-accrual; and 5) Loss - Loans classified as "loss" are considered uncollectible and of such little value that their continuance as bankable assets is not warranted. As of the date of the balance sheet, all loans in this category have been charged-off to the allowance for loan losses. Commercial loans are evaluated on an annual basis, unless the credit quality indicator falls to a level of "substandard" or below, when the loan is evaluated quarterly. The credit quality indicator is one of the factors used to determine any loss, as further described in this footnote.

For the purposes of the table above, nonperforming consumer loans are those loans on nonaccrual status or are 90 days or more past due and still accruing interest.

Impaired Loans

The following table presents information on impaired loans based on whether the impaired loan has a recorded related allowance or has no recorded related allowance:

Impaired Loans

| | Commercial | Commercial Construction | Commercial Real Estate | Other Consumer | Automobile | Residential | Total |
|---|---|---|---|---|---|---|---|
| March 31, 2013 | | | | | | | |
| Recorded Investment: | | | | | | | |
| With No Related Allowance | $37 | $— | $1,505 | $— | $182 | $1,085 | $2,809 |
| With a Related Allowance | — | — | — | — | — | — | — |
| Unpaid Principal Balance: | | | | | | | |
| With No Related Allowance | 37 | — | 1,505 | — | 182 | 1,085 | 2,809 |
| With a Related Allowance | — | — | — | — | — | — | — |
| December 31, 2012 | | | | | | | |
| Recorded Investment: | | | | | | | |
| With No Related Allowance | $45 | $— | $2,528 | $— | $203 | $1,090 | $3,866 |
| With a Related Allowance | 1,387 | — | — | — | — | — | 1,387 |
| Unpaid Principal Balance: | | | | | | | |
| With No Related Allowance | 45 | — | 2,695 | — | 203 | 1,090 | 4,033 |
| With a Related Allowance | 1,387 | — | — | — | — | — | 1,387 |
| March 31, 2012 | | | | | | | |
| Recorded Investment: | | | | | | | |
| With No Related Allowance | $62 | $— | $1,454 | $— | $240 | $2,108 | $3,864 |
| Unpaid Principal Balance: | | | | | | | |
| With No Related Allowance | 62 | — | 1,621 | — | 240 | 2,108 | 4,031 |
| For the Year-To-Date Period Ended: | | | | | | | |
| March 31, 2013 | | | | | | | |
| Average Recorded Balance: | | | | | | | |
| With No Related Allowance | $41 | $— | $2,017 | $— | $193 | $1,088 | $3,339 |
| With a Related Allowance | 694 | — | — | — | — | — | 694 |
| Interest Income Recognized: | | | | | | | |
| With No Related Allowance | 1 | — | — | — | 2 | 4 | 7 |
| With a Related Allowance | 72 | — | — | — | — | — | 72 |
| Cash Basis Income: | | | | | | | |
| With No Related Allowance | — | — | — | — | — | — | — |
| With a Related Allowance | 72 | — | — | — | — | — | 72 |
| March 31, 2012 | | | | | | | |
| Average Recorded Balance: | | | | | | | |
| With No Related Allowance | $65 | $— | $1,584 | $— | $172 | $2,108 | $3,929 |
| Interest Income Recognized: | | | | | | | |
| With No Related Allowance | 2 | — | 38 | — | 2 | 1 | 43 |
| Cash Basis Income: | | | | | | | |
| With No Related Allowance | — | — | 38 | — | — | — | 38 |

At March 31, 2013, December 31, 2012 and March 31, 2012, all impaired loans were considered to be collateral dependent and were therefore evaluated for impairment based on the fair value of collateral less estimated cost to sell. There was no allowance for loan losses allocated to impaired loans at March 31, 2013 and March 31, 2012. Interest income recognized in the table above, represents income earned after the loans became impaired and includes restructured loans in compliance with their modified terms and nonaccrual loans where we have recognized interest income on a cash basis.

Loans Modified in Trouble Debt Restructurings

The following table presents information on loans modified in trouble debt restructurings during the periods indicated:
Loans Modified in Trouble Debt Restructurings During the Period

| | Commercial | Commercial Construction | Commercial Real Estate | Other Consumer | Automobile | Residential | Total |
|---|---|---|---|---|---|---|---|
| For the Year-To-Date Period Ended: | | | | | | | |
| March 31, 2013 | | | | | | | |
| Number of Loans | — | — | — | — | 2 | — | 2 |
| Pre-Modification Outstanding Recorded Investment | $— | $— | $— | $— | $11 | $— | $11 |
| Post-Modification Outstanding Recorded Investment | $— | $— | $— | $— | $11 | $— | $11 |
| March 31, 2012 | | | | | | | |
| Number of Loans | — | — | — | — | 5 | — | 5 |
| Pre-Modification Outstanding Recorded Investment | $— | $— | $— | $— | $44 | $— | $44 |
| Post-Modification Outstanding Recorded Investment | $— | $— | $— | $— | $44 | $— | $44 |

In general, loans requiring modification are restructured to accommodate the projected cash-flows of the borrower. As indicated in the table above, no loans modified during the preceding twelve months subsequently defaulted as of March 31, 2013.

Note 4. GUARANTEES (In Thousands)

The following table presents the balance for standby letters of credit for the periods ended March 31, 2013, December 31, 2012 and March 31, 2012:

Loan Commitments and Letters of Credit

| | 03/31/2013 | 12/31/2012 | 03/31/2012 |
|---|---|---|---|
| Notional Amount: | | | |
| Commitments to Extend Credit | $215,498 | $198,405 | $201,742 |
| Standby Letters of Credit | 3,562 | 10,929 | 11,641 |
| Fair Value: | | | |
| Commitments to Extend Credit | $— | $— | $— |
| Standby Letters of Credit | 52 | 118 | 86 |

Arrow is party to financial instruments with off-balance sheet risk 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. Commitments to extend credit include home equity lines of credit, commitments for residential and commercial construction loans and other personal and commercial lines of credit. Those instruments involve, to varying degrees, elements of credit and interest rate risk in excess of the amount recognized in the consolidated balance sheets. The contract or notional amounts of those instruments reflect the extent of the involvement Arrow has in particular classes of financial instruments.

Arrow'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 represented by the contractual notional amount of those instruments. Arrow uses the same credit policies in making commitments and conditional obligations as it does for on-balance sheet instruments.

Commitments to extend credit are agreements to lend to a customer as long as there is no violation of any condition established in the contract. Commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. Since many of the commitments are expected to expire without being drawn upon, the total commitment amounts do not necessarily represent future cash requirements. Arrow evaluates each customer's creditworthiness on a case-by-case basis. Home equity lines of credit are secured by residential real estate. Construction lines of credit are secured by underlying real estate. For other lines of credit, the amount of collateral obtained, if deemed necessary by Arrow upon extension of credit, is based on management's credit evaluation of the counterparty. Collateral held varies, but may include accounts receivable, inventory, property, plant and equipment, and income-producing commercial properties. Most of the commitments are variable rate instruments.

Arrow has issued conditional commitments in the form of standby letters of credit to guarantee payment on behalf of a customer and guarantee the performance of a customer to a third party. Standby letters of credit generally arise in connection with lending relationships. The credit risk involved in issuing these instruments is essentially the same as that involved in extending loans to customers. Contingent obligations under standby letters of credit at March 31, 2013, December 31, 2012 and March 31, 2012 represent the maximum potential future payments Arrow could be required to make. Typically, these instruments have terms of 12 months or less and expire unused; therefore, the total amounts do not necessarily represent future cash requirements. Each customer is evaluated individually for creditworthiness under the same underwriting standards used for commitments to extend credit and on-balance sheet instruments. Company policies governing loan collateral apply to standby letters of credit at the time of credit extension. Loan-to-value ratios will generally range from 50% for movable assets, such as inventory, to 100% for liquid assets, such as bank CD's. Fees for standby letters of credit range from 1% to 3% of the notional amount. Fees are collected upfront and amortized over the life of the commitment. The fair values of Arrow's standby letters of credit at March 31, 2013, December 31, 2012 and March 31, 2012, in the table above, were the same as the carrying amounts. The fair value of standby letters of credit is based on the fees currently charged for similar agreements or the cost to terminate the arrangement with the counterparties.

The fair value of commitments to extend credit is determined by estimating the fees to enter into similar agreements, taking into account the remaining terms and present creditworthiness of the counterparties, and for fixed rate loan commitments, the difference between the current and committed interest rates.  Arrow provides several types of commercial lines of credit and standby letters of credit to its commercial customers.  The pricing of these services is not isolated as Arrow considers the customer's complete deposit and borrowing relationship in pricing individual products and services.  The commitments to extend credit also include commitments under home equity lines of credit, for which Arrow charges no fee.  The carrying value and fair value of commitments to extend credit are not material and Arrow does not expect to incur any material loss as a result of these commitments.

# 20

Note 5. COMPREHENSIVE INCOME (In Thousands)

The following table presents the components of other comprehensive income for the three months ended March 31, 2013 and 2012 :
Schedule of Comprehensive Income

| | Three Months Ended March 31, | | |
|---|---|---|---|
| | Before-Tax Amount | Tax (Expense) Benefit | Net-of-Tax Amount |
| 2013 | | | |
| Net Unrealized Securities Holding Gains Arising During the Period | $367 | $(147) | $220 |
| Reclassification Adjustment for Securities Gains Included in Net Income | (527) | 209 | (318) |
| Amortization of Net Retirement Plan Actuarial Loss | 391 | (155) | 236 |
| Accretion of Net Retirement Plan Prior Service Credit | — | — | — |
| Other Comprehensive Income | $231 | $(93) | $138 |
| 2012 | | | |
| Net Unrealized Securities Holding Gains Arising During the Period | $(162) | $64 | $(98) |
| Reclassification Adjustment for Securities Gains Included in Net Income | (502) | 199 | (303) |
| Amortization of Net Retirement Plan Actuarial Loss | 378 | (150) | 228 |
| Accretion of Net Retirement Plan Prior Service Credit | (7) | 3 | (4) |
| Other Comprehensive Income | $(293) | $116 | $(177) |

# 21

The following table presents the changes in accumulated other comprehensive income by component:

Changes in Accumulated Other Comprehensive Income by Component [1]

| | Unrealized Gains and Losses on Available-for-Sale Securities | Defined Benefit Plan Items | | |
|---|---|---|---|---|
| | | Net Gain (Loss) | Net Prior Service (Cost ) Credit | Total |
| For the Year-to-date periods: | | | | |
| December 31, 2012 | $5,625 | $(14,036) | $(51) | $(8,462) |
| Other comprehensive income before reclassifications | 220 | — | — | 220 |
| Amounts reclassified from accumulated other comprehensive income | (318) | 236 | — | (82) |
| Net current-period other comprehensive income | (98) | 236 | — | 138 |
| March 31, 2013 | $5,527 | $(13,800) | $(51) | $(8,324) |
| December 31, 2011 | $6,808 | $(13,709) | $206 | $(6,695) |
| Other comprehensive income before reclassifications | (98) | — | — | (98) |
| Amounts reclassified from accumulated other comprehensive income | (303) | 228 | (4) | (79) |
| Net current-period other comprehensive income | (401) | 228 | (4) | (177) |
| March 31, 2012 | $6,407 | $(13,481) | $202 | $(6,872) |

(1) All amounts are net of tax. Amounts in parentheses indicate debits.

# 22

The following table presents the reclassifications out of accumulated other comprehensive income:

Reclassifications Out of Accumulated Other Comprehensive Income [1]

| Details about Accumulated Other Comprehensive Income Components | Amounts Reclassified from Accumulated Other Comprehensive Income | | Affected Line Item in the Statement Where Net Income Is Presented |
|---|---|---|---|
| For the Year-to-date periods: | | | |
| March 31, 2013 | | | |
| Unrealized gains and losses on available-for-sale securities | | | |
| | $527 | | Gain on Securities Transactions |
| | 527 | | Total before tax |
| | (209 | ) | Provision for Income Taxes |
| | $318 | | Net of tax |
| Amortization of defined benefit pension items | | | |
| Prior-service costs | $— | [2] | Salaries and Employee Benefits |
| Actuarial gains/(losses) | (391 | ) [2] | Salaries and Employee Benefits |
| | (391 | ) | Total before tax |
| | 155 | | Provision for Income Taxes |
| | $(236 | ) | Net of tax |
| Total reclassifications for the period | $82 | | Net of tax |
| March 31, 2012 | | | |
| Unrealized gains and losses on available-for-sale securities | | | |
| | $502 | | Gain on Securities Transactions |
| | 502 | | Total before tax |
| | (199 | ) | Provision for Income Taxes |
| | $303 | | Net of tax |
| Amortization of defined benefit pension items | | | |
| Prior-service costs | $7 | [2] | Salaries and Employee Benefits |
| Actuarial gains/(losses) | (378 | ) [2] | Salaries and Employee Benefits |
| | (371 | ) | Total before tax |
| | 147 | | Provision for Income Taxes |
| | $(224 | ) | Net of tax |
| Total reclassifications for the period | $79 | | Net of tax |

(1) Amounts in parentheses indicate debits to profit/loss.
(2) These accumulated other comprehensive income components are included in the computation of net periodic pension cost (see pension footnote for additional details.).

# 23

Note 6. STOCK BASED COMPENSATION PLANS

Under our 2008 Long-Term Incentive Plan, we granted options in the first quarter of 2013 to purchase shares of our common stock. The fair values of the options were estimated on the date of grant using the Black-Scholes option-pricing model. The fair value of our grants is expensed over the four year vesting period. Share and per share amounts have been restated for the September 2012 2% stock dividend.

The following table presents a roll-forward of our stock option plans and grants issued during 2013:
.

Schedule of Share-based Compensation Arrangements

| | Stock Option Plans | |
|---|---|---|
| Roll-Forward of Shares Outstanding: | | |
| Outstanding at January 1, 2013 | 442,385 | |
| Granted | 10,000 | |
| Exercised | (23,434 | ) |
| Forfeited | — | |
| Outstanding at March 31, 2013 | 428,951 | |
| Exercisable at Period End | 308,470 | |
| Vested and Expected to Vest | 428,951 | |
| | | |
| Roll-Forward of Shares Outstanding - Weighted Average Exercise Price: | | |
| Outstanding at January 1, 2013 | $23.03 | |
| Granted | 24.28 | |
| Exercised | 20.92 | |
| Forfeited | — | |
| Outstanding at March 31, 2013 | 23.17 | |
| Exercisable at Period End | 22.72 | |
| Vested and Expected to Vest | 23.17 | |
| | | |
| Grants Issued During 2013 - Weighted Average Information: | | |
| Fair Value | 5.57 | |
| Fair Value Assumptions: | | |
| Dividend Yield | 4.20 | % |
| Expected Volatility | 36.57 | % |
| Risk Free Interest Rate | 1.31 | % |
| Expected Lives (in years) | 6.71 | |

The following table presents information on the amounts expensed and remaining amounts to be expensed for the periods ended March 31, 2013 and 2012:

Share-Based Compensation Expense

| | For the Three Months Ended March 31, | |
|---|---|---|
| | 2013 | 2012 |
| Share-Based Compensation Expense | $97 | $99 |

Arrow also sponsors an Employee Stock Purchase Plan under which employees purchase Arrow's common stock at a 5% discount below market price. Under current accounting guidance, a stock purchase plan with a discount of 5% or less is not considered a compensatory plan.

# 24

Note 7. RETIREMENT PLANS (Dollars in Thousands)

The following tables provide the components of net periodic benefit costs for the three-month periods ended March 31:

| | Employees' Pension Plan | Select Executive Retirement Plan | Postretirement Benefit Plans |
|---|---|---|---|
| Net Periodic Benefit Cost | | | |
| 2013 | | | |
| Service Cost | $367 | $22 | $51 |
| Interest Cost | 353 | 38 | 81 |
| Expected Return on Plan Assets | (716) | — | — |
| Amortization of Prior Service Cost (Credit) | 9 | 20 | (29) |
| Amortization of Net Loss | 312 | 38 | 41 |
| Net Periodic Benefit Cost | 325 | 118 | 144 |
| | | | |
| Plan Contributions During the Period | $— | $111 | $81 |
| | | | |
| Estimated Future Contributions in the Current Fiscal Year | $— | $346 | $413 |
| | | | |
| 2012 | | | |
| Service Cost | $340 | $19 | $45 |
| Interest Cost | 404 | 51 | 88 |
| Expected Return on Plan Assets | (755) | — | — |
| Amortization of Prior Service (Credit) Cost | 10 | 11 | (28) |
| Amortization of Net Loss | 310 | 35 | 33 |
| Net Periodic Benefit Cost | $309 | $116 | $138 |
| | | | |
| Plan Contributions During the Period | $— | $80 | $74 |

We are not required to make a contribution to our qualified pension plan in 2013, we currently do not expect to make a contribution in 2013. Arrow makes contributions to its other post-retirement benefit plans in an amount equal to actual expenses for the year.

Note 8. EARNINGS PER COMMON SHARE (In Thousands, Except Per Share Amounts)

The following table presents a reconciliation of the numerator and denominator used in the calculation of basic and diluted earnings per common share (“EPS”) for periods ended March 31, 2013 and 2012. All share and per share amounts have been adjusted for the September 2012 2% stock dividend.

Earnings Per Share

| | Year-to-Date Period Ended: | |
|---|---|---|
| | 3/31/2013 | 3/31/2012 |
| Earnings Per Share - Basic: | | |
| Net Income | $5,181 | $5,288 |
| Weighted Average Shares - Basic | 12,031 | 12,005 |
| Earnings Per Share - Basic | $0.43 | $0.44 |

| | | |
|---|---|---|
| Earnings Per Share - Diluted: | | |
| Net Income | $5,181 | $5,288 |
| Weighted Average Shares - Basic | 12,031 | 12,005 |
| Dilutive Average Shares Attributable to Stock Options | 18 | 25 |
| Weighted Average Shares - Diluted | 12,049 | 12,030 |
| Earnings Per Share - Diluted | $0.43 | $0.44 |
| Antidilutive Shares Excluded from the Calculation of Earnings Per Share | 129 | 132 |

# 25

Note 9. FAIR VALUE OF FINANCIAL INSTRUMENTS (In Thousands)

FASB ASC Subtopic 820-10 defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles (GAAP) and requires certain disclosures about fair value measurements. We do not have any nonfinancial assets or liabilities measured at fair value on a recurring basis. The only assets or liabilities that Arrow measured at fair value on a recurring basis at March 31, 2013, December 31, 2012 and March 31, 2012 were securities available-for-sale. Arrow held no securities or liabilities for trading on such date.

The table below presents the financial instrument's fair value and the amounts within the fair value hierarchy based on the lowest level of input that is significant to the fair value measurement:
Fair Value of Assets and Liabilities Measured on a Recurring and Nonrecurring Basis

| | | Fair Value Measurements at Reporting Date Using: | | |
|---|---|---|---|---|
| | Fair Value | Quoted Prices In Active Markets for Identical Assets (Level 1) | Significant Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) |
| Fair Value of Assets and Liabilities Measured on a Recurring Basis: | | | | |
| March 31, 2013 | | | | |
| Securities Available-for Sale: | | | | |
| U.S. Agency Obligations | $132,153 | $— | $132,153 | $— |
| State and Municipal Obligations | 104,469 | — | 104,469 | — |
| Mortgage-Backed Securities - Residential | 228,323 | — | 228,323 | — |
| Corporate and Other Debt Securities | 12,691 | — | 12,691 | — |
| Mutual Funds and Equity Securities | 1,139 | — | 1,139 | — |
| Total Securities Available-for-Sale | $478,775 | $— | $478,775 | $— |
| December 31, 2012 | | | | |
| Securities Available-for Sale: | | | | |
| U.S. Agency Obligations | $122,457 | $— | $122,457 | $— |
| State and Municipal Obligations | 84,838 | — | 84,838 | — |
| Mortgage-Backed Securities - Residential | 261,804 | — | 261,804 | — |
| Corporate and Other Debt Securities | 8,451 | — | 8,451 | — |
| Mutual Funds and Equity Securities | 1,148 | — | 1,148 | — |
| Total Securities Available-for Sale | $478,698 | $— | $478,698 | $— |
| March 31, 2012 | | | | |
| Securities Available-for Sale: | | | | |
| U.S. Agency Obligations | $65,660 | $— | $65,660 | $— |
| State and Municipal Obligations | 43,482 | — | 43,482 | — |
| Mortgage-Backed Securities - Residential | 355,382 | — | 355,382 | — |
| Corporate and Other Debt Securities | 828 | — | 828 | — |
| Mutual Funds and Equity Securities | 1,433 | 281 | 1,152 | — |
| Total Securities Available-for Sale | $466,785 | $281 | $466,504 | $— |
| | | | | |
| Fair Value of Assets and Liabilities Measured on a Nonrecurring Basis: | | | | |
| March 31, 2013 | | | | |

| | | | | |
|---|---|---|---|---|
| Collateral Dependent Impaired Loans | $— | $— | $— | $— |
| Other Real Estate Owned and Repossessed Assets, Net | $1,194 | $— | $— | $1,194 |
| December 31, 2012 | | | | |
| Collateral Dependent Impaired Loans | $1,020 | $— | $— | $1,020 |
| Other Real Estate Owned and Repossessed Assets, Net | $1,034 | $— | $— | $1,034 |
| March 31, 2012 | | | | |
| Collateral Dependent Impaired Loans | $486 | $— | $— | $486 |
| Other Real Estate Owned and Repossessed Assets, Net | $555 | $— | $— | $555 |

We determine the fair value of financial instruments under the following hierarchy:

- Level 1 - Unadjusted quoted prices in active markets that are accessible at the measurement date for identical, unrestricted assets or liabilities;
- Level 2 - 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, or inputs that are observable, either directly or indirectly, for substantially the full term of the asset or liability;
- Level 3 - Prices or valuation techniques that require inputs that are both significant to the fair value measurement and unobservable (i.e., supported by little or no market activity).

Fair Value Methodology for Assets and Liabilities Measured on a Recurring Basis

The fair value of level 1 securities available-for-sale are based on unadjusted, quoted market prices from exchanges in active markets. The fair value of level 2 securities available-for-sale are based on an independent bond and equity pricing service for identical assets or significantly similar securities and an independent equity pricing service for equity securities not actively traded. The pricing services use a variety of techniques to arrive at fair value including market maker bids, quotes and pricing models. Inputs to the pricing models include recent trades, benchmark interest rates, spreads and actual and projected cash flows.

Fair Value Methodology for Assets and Liabilities Measured on a Nonrecurring Basis

The fair value of collateral dependent impaired loans was based on third-party appraisals of the collateral.

The fair value of other real estate owned was based on third-party appraisals.

Other assets which might have been included in this table include mortgage servicing rights, goodwill and other intangible assets. Arrow evaluates each of these assets for impairment on an annual basis, with no impairment recognized for these assets at March 31, 2013, December 31, 2012 and March 31, 2012.

Fair Value by Balance Sheet Grouping

The following table presents a summary of the carrying amount, the fair value or an amount approximating fair value and the fair value hierarchy of Arrow's financial instruments:

Schedule of Fair Values by Balance Sheet Grouping

| | | | Fair Value Hierarchy | | |
|---|---|---|---|---|---|
| | Carrying Amount | Fair Value | Level 1 | Level 2 | Level 3 |
| March 31, 2013 | | | | | |
| Cash and Cash Equivalents | $137,174 | $137,174 | $137,174 | $— | $— |
| Securities Available-for-Sale | 478,775 | 478,775 | — | 478,775 | — |
| Securities Held-to-Maturity | 251,456 | 259,562 | — | 259,562 | — |
| Federal Home Loan Bank and Federal Reserve Bank Stock | 4,493 | 4,493 | 4,493 | — | — |
| Net Loans | 1,150,156 | 1,167,063 | — | — | 1,167,063 |
| Accrued Interest Receivable | 6,481 | 6,481 | 6,481 | — | — |
| Deposits | 1,851,206 | 1,850,614 | 1,575,954 | 274,660 | — |
| Federal Funds Purchased and Securities Sold Under Agreements to Repurchase | 12,166 | 12,166 | 12,166 | — | — |
| Federal Home Loan Bank Term Advances | 30,000 | 31,263 | — | 31,263 | — |
| Junior Subordinated Obligations Issued to Unconsolidated Subsidiary Trusts | 20,000 | 20,000 | 20,000 | — | — |
| Accrued Interest Payable | 523 | 523 | 523 | — | — |
| | | | | | |
| December 31, 2012 | | | | | |
| Cash and Cash Equivalents | $48,832 | $48,832 | $48,832 | $— | $— |
| Securities Available-for-Sale | 478,698 | 478,698 | — | 478,698 | — |
| Securities Held-to-Maturity | 239,803 | 248,252 | — | 248,252 | — |
| Federal Home Loan Bank and Federal Reserve Bank Stock | 5,792 | 5,792 | 5,792 | — | — |
| Net Loans | 1,157,043 | 1,192,628 | — | — | 1,192,628 |
| Accrued Interest Receivable | 5,486 | 5,486 | 5,486 | — | — |
| Deposits | 1,731,155 | 1,732,894 | 1,447,882 | 285,012 | — |
| Federal Funds Purchased and Securities Sold Under Agreements to Repurchase | 12,678 | 12,678 | 12,678 | — | — |
| Federal Home Loan Bank Term Advances | 59,000 | 60,312 | 29,000 | 31,312 | — |
| Junior Subordinated Obligations Issued to Unconsolidated Subsidiary Trusts | 20,000 | 20,000 | — | 20,000 | — |
| Accrued Interest Payable | 584 | 584 | 584 | — | — |
| | | | | | |
| March 31, 2012 | | | | | |
| Cash and Cash Equivalents | $137,508 | $137,508 | $137,508 | $— | $— |
| Securities Available-for-Sale | 466,785 | 466,785 | 281 | 466,504 | — |
| Securities Held-to-Maturity | 200,607 | 207,779 | — | 207,779 | — |
| Federal Home Loan Bank and Federal Reserve Bank Stock | 4,382 | 4,382 | 4,382 | — | — |

| | | | | | |
|---|---|---|---|---|---|
| Net Loans | 1,122,494 | 1,147,014 | — | — | 1,147,014 |
| Accrued Interest Receivable | 6,380 | 6,380 | 6,380 | — | — |
| Deposits | 1,760,878 | 1,766,258 | 1,421,257 | 345,001 | — |
| Federal Funds Purchased and Securities Sold Under Agreements to Repurchase | 16,652 | 16,652 | 16,652 | — | — |
| Federal Home Loan Bank Term Advances | 30,000 | 31,310 | — | 31,310 | — |
| Junior Subordinated Obligations Issued to Unconsolidated Subsidiary Trusts | 20,000 | 20,000 | 20,000 | — | — |
| Accrued Interest Payable | 974 | 974 | 974 | — | — |

# 28

Fair Value Methodology for Financial Instruments Not Measured on a Recurring or Nonrecurring Basis

Securities held-to-maturity are fair valued utilizing an independent bond pricing service for identical assets or significantly similar securities. The pricing service uses a variety of techniques to arrive at fair value including market maker bids, quotes and pricing models. Inputs to the pricing models include recent trades, benchmark interest rates, spreads and actual and projected cash flows.

Fair values for loans are estimated for portfolios of loans with similar financial characteristics. Loans are segregated by type such as commercial, commercial real estate, residential mortgage, indirect and other consumer loans. Each loan category is further segmented into fixed and adjustable interest rate terms and by performing and nonperforming categories. The fair value of performing loans is calculated by discounting scheduled cash flows through the estimated maturity using estimated market discount rates that reflect the credit and interest rate risk inherent in the loan. The estimate of maturity is based on historical experience with repayments for each loan classification, modified, as required, by an estimate of the effect of current economic and lending conditions. Fair value for nonperforming loans is generally based on recent external appraisals. If appraisals are not available, estimated cash flows are discounted using a rate commensurate with the risk associated with the estimated cash flows. Assumptions regarding credit risk, cash flows and discount rates are judgmentally determined using available market information and specific borrower information.

The fair value of time deposits is based on the discounted value of contractual cash flows, except that the fair value is limited to the extent that the customer could redeem the certificate after imposition of a premature withdrawal penalty. The discount rates are estimated using the FHLBNY yield curve, which is considered representative of Arrow’s time deposit rates. The fair value of all other deposits is equal to the carrying value.

The fair value of FHLBNY advances is estimated based on the discounted value of contractual cash flows. The discount rate is estimated using current rates on FHLBNY advances with similar maturities and call features.

Based on Arrow’s capital adequacy, the book value of the outstanding trust preferred securities (Junior Subordinated Obligations Issued to Unconsolidated Subsidiary Trusts) are considered to approximate fair value since the interest rates are variable (indexed to LIBOR) and Arrow is well-capitalized.

Report of Independent Registered Public Accounting Firm
The Board of Directors and Stockholders
Arrow Financial Corporation:

We have reviewed the consolidated balance sheets of Arrow Financial Corporation and subsidiaries (the Company) as of March 31, 2013 and 2012, and the related consolidated statements of income and comprehensive income for the three-month periods ended March 31, 2013 and 2012, and the related consolidated statements of changes in stockholders' equity and cash flows for the three-month periods ended March 31, 2013 and 2012. These consolidated financial statements are the responsibility of the Company's management.

We conducted our reviews in accordance with the standards of the Public Company Accounting Oversight Board (United States). A review of interim financial information consists principally of applying analytical procedures and making inquiries of persons responsible for financial and accounting matters. It is substantially less in scope than an audit conducted in accordance with the standards of the Public Company Accounting Oversight Board (United States), the objective of which is the expression of an opinion regarding the financial statements taken as a whole. Accordingly, we do not express such an opinion.

Based on our reviews, we are not aware of any material modifications that should be made to the consolidated financial statements referred to above for them to be in conformity with U.S. generally accepted accounting principles.

We have previously audited, in accordance with standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheet of Arrow Financial Corporation and subsidiaries as of December 31, 2012, and the related consolidated statements of income, comprehensive income, changes in stockholders' equity, and cash flows for the year then ended (not presented herein); and in our report dated March 15, 2013, we expressed an unqualified opinion on those consolidated financial statements. In our opinion, the information set forth in the accompanying consolidated balance sheet as of December 31, 2012, is fairly stated, in all material respects, in relation to the consolidated balance sheet from which it has been derived.

/s/ KPMG LLP
Albany, New York
May 9, 2013

ARROW FINANCIAL CORPORATION AND SUBSIDIARIES
MANAGEMENT'S DISCUSSION AND ANALYSIS OF
FINANCIAL CONDITION AND RESULTS OF OPERATIONS
March 31, 2013

Note on Terminology - In this Quarterly Report on Form 10-Q, the terms “Arrow,” “the registrant,” “the company,” “we,” “us,” and “our” generally refer to Arrow Financial Corporation and its subsidiaries as a group, except where the context indicates otherwise. Arrow is a two-bank holding company headquartered in Glens Falls, New York. Our banking subsidiaries are Glens Falls National Bank and Trust Company (Glens Falls National) whose main office is located in Glens Falls, New York, and Saratoga National Bank and Trust Company (Saratoga National) whose main office is located in Saratoga Springs, New York. Our non-bank subsidiaries include Capital Financial Group, Inc. (an insurance agency specializing in selling and servicing group health care policies); three property and casualty insurance agencies: Loomis & LaPann, Inc., Upstate Agency LLC, and McPhillips Agency which is a division of Glens Falls National Insurance Agencies LLC; North Country Investment Advisers, Inc. (a registered investment adviser that provides investment advice to our proprietary mutual funds); Glens Falls National Community Development Corporation (which invests in qualifying community development projects); and Arrow Properties, Inc. (a real estate investment trust, or REIT). All of these are wholly owned or majority owned subsidiaries of Glens Falls National.
At certain points in this Report, our performance is compared with that of our “peer group” of financial institutions. Unless otherwise specifically stated, this peer group is comprised of the group of 351 domestic bank holding companies with $1 to $3 billion in total consolidated assets as identified in the Federal Reserve Board’s “Bank Holding Company Performance Report” for December 31, 2012 (the most recent such Report currently available), and peer group data has been derived from such Report.
Forward Looking Statements - The information contained in this Quarterly Report on Form 10-Q contains statements that are not historical in nature but rather are based on our beliefs, assumptions, expectations, estimates and projections about the future. These statements are “forward-looking statements” within the meaning of Section 21E of the Securities Exchange Act of 1934, as amended, and involve a degree of uncertainty and attendant risk. Words such as “expects,” “believes,” “anticipates,” “estimates” and variations of such words and similar expressions are intended to identify such forward-looking statements. Some of these statements, such as those included in the interest rate sensitivity analysis in Part I, Item 3, entitled “Quantitative and Qualitative Disclosures About Market Risk,” are merely presentations of what future performance or changes in future performance would look like based on hypothetical assumptions and on simulation models. Other forward-looking statements are based on our general perceptions of market conditions and trends in business activity, both our own and in the banking industry generally, as well as current management strategies for future operations and development.
Examples of Forward-Looking Statements

| Topic | Page | Location |
|---|---|---|
| Impact of Heath Care Reform | 35 | "Health care reform" |
| Impact of market rate structure on net interest margin, loan yields and deposit rates | 39 | 2nd paragraph under "Recent Pressure on Our Net Interest Margin" |
| | 40 | 2nd paragraph under "Potential Inflation; Effect on Interest Rates and Margin" |
| | 42 | Last 2 paragraphs under "Quarterly Taxable Equivalent Yield on Loans" |
| Provision for loan losses | 45 | 1st paragraph in section |
| Future level of nonperforming assets | 46 | Last 3 paragraphs under "Risk Elements" |
| Future level of residential real estate loans | 41 | |

| | | |
|---|---|---|
| | | "Maintenance of High Quality in the Loan Portfolio" |
| Future level of indirect consumer loans | 41 | Last paragraph under "Automobile Loans" |
| Future level of commercial loans | 42 | 3rd paragraph under "Commercial, Commercial Real Estate and Construction and Land Development Loans |
| Impact of changing capital standards and legislative developments | 35 | "Dodd-Frank Act" |
| | 46 | "Important Proposed Changes to Regulatory Capital Standards" |
| Liquidity | 49 | 5th paragraph |
| Fees for other services to customers | 51 | 3rd paragraph under "Noninterest Income" |
| Insurance commissions | 51 | 4th paragraph under "Noninterest Income) |

These statements are not guarantees of future performance and involve certain risks and uncertainties that are difficult to quantify or, in some cases, to identify. In the case of all forward-looking statements, actual outcomes and results may differ materially from what the statements predict or forecast. Factors that could cause or contribute to such differences include, but are not limited to:

# 31

a. rapid and dramatic changes in economic and market conditions, such as the U.S. economy experienced in the early stages of the "financial crisis" particularly, 2008-2009;
b. sharp fluctuations in interest rates, economic activity, and consumer spending patterns;
c. sudden changes in the market for products we provide, such as real estate loans;
d. significant new banking laws and regulations, including the wide array of new banking regulations still to be issued under the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2011 (the Dodd-Frank Act or Dodd-Frank);
e. unexpected or enhanced competition from new or unforeseen sources; and
f. similar uncertainties inherent in banking operations or business generally.

Readers are cautioned not to place undue reliance on these forward-looking statements, which speak only as of the date hereof. We undertake no obligation to revise or update these forward-looking statements to reflect the occurrence of unanticipated events. This Quarterly Report should be read in conjunction with our Annual Report on Form 10-K for the year ended December 31, 2012.

USE OF NON-GAAP FINANCIAL MEASURES

The Securities and Exchange Commission (SEC) has adopted Regulation G, which applies to all public disclosures, including earnings releases, made by registered companies that contain “non-GAAP financial measures.” GAAP is generally accepted accounting principles in the United States of America. Under Regulation G, companies making public disclosures containing non-GAAP financial measures must also disclose, along with each non-GAAP financial measure, certain additional information, including a reconciliation of the non-GAAP financial measure to the closest comparable GAAP financial measure and a statement of the Company’s reasons for utilizing the non-GAAP financial measure as part of its financial disclosures. The SEC has exempted from the definition of “non-GAAP financial measures” certain commonly used financial measures that are not based on GAAP. When these exempted measures are included in public disclosures, supplemental information is not required. The following measures used in this Report, which are commonly utilized by financial institutions, have not been specifically exempted by the SEC and may constitute "non-GAAP financial measures" within the meaning of the SEC's new rules, although we are unable to state with certainty that the SEC would so regard them.

Tax-Equivalent Net Interest Income and Net Interest Margin: Net interest income, as a component of the tabular presentation by financial institutions of Selected Financial Information regarding their recently completed operations, is commonly presented on a tax-equivalent basis. That is, to the extent that some component of the institution's net interest income, which is presented on a before-tax basis, is exempt from taxation (e.g., is received by the institution as a result of its holdings of state or municipal obligations), an amount equal to the tax benefit derived from that component is added to the actual before-tax net interest income total. This adjustment is considered helpful in comparing one financial institution's net interest income to that of other institutions or in analyzing any institution’s net interest income trend line over time, to correct any analytical distortion that might otherwise arise from the fact that financial institutions vary widely in the proportions of their portfolios that are invested in tax-exempt securities, and that even a single institution may significantly alter over time the proportion of its own portfolio that is invested in tax-exempt obligations. Moreover, net interest income is itself a component of a second financial measure commonly used by financial institutions, net interest margin, which is the ratio of net interest income to average earning assets. For purposes of this measure as well, tax-equivalent net interest income is generally used by financial institutions, as opposed to actual net interest income, again to provide a better basis of comparison from institution to institution and to better demonstrate a single institution’s performance over time. We follow these practices.

The Efficiency Ratio: Financial institutions often use an "efficiency ratio" as a measure of expense control. The efficiency ratio typically is defined as the ratio of noninterest expense to net interest income and noninterest income. Net interest income as utilized in calculating the efficiency ratio is, once again, typically expressed on a tax-equivalent basis (see preceding paragraph). Moreover, most financial institutions, in calculating the efficiency ratio, also adjust both noninterest expense and noninterest income to exclude from these items (as calculated under GAAP) certain recurring component elements of income and expense, such as intangible asset amortization (deducted from noninterest expense) and securities gains or losses (excluded from noninterest income). We follow these practices.

Tangible Book Value per Share: Tangible equity is total stockholders' equity less intangible assets. Tangible book value per share is tangible equity divided by total shares issued and outstanding. Tangible book value per share is often regarded as a more meaningful comparative ratio than book value per share as calculated under GAAP, that is, total stockholders' equity including intangible assets divided by total shares issued and outstanding. Intangible assets includes many items, but essentially represents goodwill for Arrow.

Adjustments for Certain Items of Income or Expense: In addition to our disclosures of certain GAAP financial measures, including net income, earnings per share (i.e. EPS), return on average assets (i.e. ROA), return on average equity (i.e. ROE), we may also provide comparative disclosures that adjust these GAAP financial measures for a particular period by removing from the calculation thereof the impact of certain transactions or other material items of income or expense occurring during the period, including certain nonrecurring items. We believe that the resulting non-GAAP financial measures may improve an understanding of our results of operations by separating out such items that have a disproportionate positive or negative impact during the particular period in question. Additionally, we believe that the adjustment for certain items allows a better comparison from period to period in our results of operations with respect to our fundamental lines of business including the commercial banking business. In our presentation of any such non-GAAP (adjusted) financial measures not specifically discussed in the preceding paragraphs, we supply the supplemental financial information and explanations required under Regulation G.

We believe that the non-GAAP financial measures disclosed by us from time-to-time are useful in evaluating our performance and that such information should be considered as supplemental in nature and not as a substitute for or superior to the related financial information prepared in accordance with GAAP. Our non-GAAP financial measures may differ from similar measures presented by other companies.

| Selected Quarterly Information - Unaudited (dollars in thousands) | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|
| Quarter Ended | 03/31/2013 | | 12/31/2012 | | 09/30/2012 | | 06/30/2012 | | 03/31/2012 | |
| Net Income | $5,181 | | $5,549 | | $5,748 | | $5,594 | | $5,288 | |
| Transactions Recorded in Net Income (Net of Tax): | | | | | | | | | | |
| Net Gain on Securities Transactions | 318 | | 94 | | 39 | | 86 | | 303 | |
| Net Gain on Sales of Loans | 367 | | 476 | | 362 | | 324 | | 216 | |
| Reversal of the VISA Litigation Reserve | — | | — | | — | | 178 | | — | |
| Share and Per Share Data:[1] | | | | | | | | | | |
| Period End Shares Outstanding | 12,010 | | 12,025 | | 12,034 | | 12,001 | | 11,996 | |
| Basic Average Shares Outstanding | 12,031 | | 12,014 | | 12,012 | | 11,994 | | 12,005 | |
| Diluted Average Shares Outstanding | 12,049 | | 12,032 | | 12,032 | | 12,009 | | 12,030 | |
| Basic Earnings Per Share | $0.43 | | $0.46 | | $0.48 | | $0.47 | | $0.44 | |
| Diluted Earnings Per Share | 0.43 | | 0.46 | | 0.48 | | 0.47 | | 0.44 | |
| Cash Dividend Per Share | 0.25 | | 0.25 | | 0.25 | | 0.25 | | 0.25 | |
| Selected Quarterly Average Balances: | | | | | | | | | | |
| Interest-Bearing Deposits at Banks | $41,145 | | $40,065 | | $33,332 | | $55,023 | | $30,780 | |
| Investment Securities | 711,848 | | 745,150 | | 670,328 | | 682,589 | | 678,474 | |
| Loans | 1,169,870 | | 1,160,226 | | 1,148,771 | | 1,143,666 | | 1,136,322 | |
| Deposits | 1,773,126 | | 1,781,778 | | 1,701,599 | | 1,733,320 | | 1,683,781 | |
| Other Borrowed Funds | 64,622 | | 80,357 | | 68,667 | | 66,022 | | 83,055 | |
| Shareholders’ Equity | 176,874 | | 176,514 | | 174,069 | | 170,199 | | 167,849 | |
| Total Assets | 2,039,314 | | 2,064,602 | | 1,971,215 | | 1,994,883 | | 1,959,741 | |
| Return on Average Assets | 1.03 | % | 1.07 | % | 1.16 | % | 1.13 | % | 1.09 | % |
| Return on Average Equity | 11.88 | % | 12.51 | % | 13.14 | % | 13.22 | % | 12.67 | % |
| Return on Tangible Equity[2] | 13.97 | % | 14.72 | % | 15.50 | % | 15.67 | % | 15.07 | % |
| Average Earning Assets | $1,922,863 | | $1,945,441 | | $1,852,431 | | $1,881,278 | | $1,845,576 | |
| Average Interest-Bearing Liabilities | 1,590,401 | | 1,612,959 | | 1,511,634 | | 1,565,692 | | 1,545,098 | |
| Interest Income, Tax-Equivalent | 17,059 | | 17,787 | | 18,168 | | 18,508 | | 18,810 | |
| Interest Expense | 2,239 | | 2,503 | | 2,643 | | 3,279 | | 3,532 | |
| Net Interest Income, Tax-Equivalent | 14,820 | | 15,284 | | 15,525 | | 15,229 | | 15,278 | |
| Tax-Equivalent Adjustment | 1,063 | | 1,047 | | 1,000 | | 975 | | 872 | |
| Net Interest Margin [3] | 3.13 | % | 3.13 | % | 3.33 | % | 3.26 | % | 3.33 | % |
| Efficiency Ratio Calculation: | | | | | | | | | | |
| Noninterest Expense | $13,411 | | $13,117 | | $12,922 | | $12,651 | | $13,146 | |
| Less: Intangible Asset Amortization | (124 | ) | (126 | ) | (126 | ) | (127 | ) | (138 | ) |
| Net Noninterest Expense | $13,287 | | $12,991 | | $12,796 | | $12,524 | | $13,008 | |
| Net Interest Income, Tax-Equivalent | $14,820 | | $15,284 | | $15,525 | | $15,229 | | $15,278 | |
| Noninterest Income | 7,174 | | 6,897 | | 6,835 | | 6,808 | | 6,559 | |
| Less: Net Securities Gains | (527 | ) | (156 | ) | (64 | ) | (143 | ) | (502 | ) |
| Net Gross Income | $21,467 | | $22,025 | | $22,296 | | $21,894 | | $21,335 | |
| Efficiency Ratio | 61.90 | % | 58.98 | % | 57.39 | % | 57.20 | % | 60.97 | % |
| Period-End Capital Information: | | | | | | | | | | |
| Total Stockholders’ Equity (i.e. Book Value) | $177,803 | | $175,825 | | $176,314 | | $171,940 | | $168,466 | |
| Book Value per Share | 14.80 | | 14.62 | | 14.65 | | 14.33 | | 14.04 | |
| Intangible Assets | 26,460 | | 26,495 | | 26,546 | | 26,611 | | 26,653 | |
| Tangible Book Value per Share [2] | 12.60 | | 12.42 | | 12.45 | | 12.11 | | 11.82 | |
| Capital Ratios: | | | | | | | | | | |
| Tier 1 Leverage Ratio | 9.30 | % | 9.10 | % | 9.41 | % | 9.09 | % | 9.10 | % |

| | | | | | |
|---|---|---|---|---|---|
| Tier 1 Risk-Based Capital Ratio | 15.15 % | 15.02 % | 15.20 % | 15.08 % | 14.84 % |
| Total Risk-Based Capital Ratio | 16.34 % | 16.26 % | 16.45 % | 16.34 % | 16.10 % |
| Assets Under Trust Administration and Investment Management | $1,094,708 | $1,045,972 | $1,051,176 | $1,019,702 | $1,038,186 |

[1]Share and Per Share Data have been restated for the September 27, 2012 2% stock dividend.
[2]Tangible Book Value and Tangible Equity exclude intangible assets from total equity. These are non-GAAP financial measures which we believe provide investors with information that is useful in understanding our financial performance (see page 32).
[3]Net Interest Margin is the ratio of our annualized tax-equivalent net interest income to average earning assets. This is also a non-GAAP financial measure which we believe provides investors with information that is useful in understanding our financial performance (see page 32).

Average Consolidated Balance Sheets and Net Interest Income Analysis
(see “Use of Non-GAAP Financial Measures” on page 32)
(Fully Taxable Basis using a marginal tax rate of 35%)
(Dollars In Thousands)

| Three-Month Period Ended March 31: | 2013 | | | 2012 | | |
|---|---|---|---|---|---|---|
| | Average Balance | Interest Income/ Expense | Rate Earned/ Paid | Average Balance | Interest Income/ Expense | Rate Earned/ Paid |
| Interest-Bearing Deposits at Banks | $41,145 | $27 | 0.27 % | $30,780 | $21 | 0.27 % |
| Investment Securities: | | | | | | |
| Fully Taxable | 442,671 | 1,800 | 1.65 | 482,424 | 2,643 | 2.20 |
| Exempt from Federal Taxes | 269,177 | 2,381 | 3.59 | 196,050 | 2,114 | 4.34 |
| Loans | 1,169,870 | 12,851 | 4.46 | 1,136,322 | 14,032 | 4.97 |
| Total Earning Assets | 1,922,863 | 17,059 | 3.60 | 1,845,576 | 18,810 | 4.10 |
| Allowance for Loan Losses | (15,307) | | | (15,008) | | |
| Cash and Due From Banks | 30,635 | | | 29,772 | | |
| Other Assets | 101,123 | | | 99,401 | | |
| Total Assets | $2,039,314 | | | $1,959,741 | | |
| Deposits: | | | | | | |
| NOW Accounts | $791,669 | 778 | 0.40 | $688,982 | 1,059 | 0.62 |
| Savings Deposits | 455,311 | 268 | 0.24 | 425,247 | 357 | 0.34 |
| Time Deposits of $100,000 or More | 91,322 | 319 | 1.42 | 121,112 | 608 | 2.02 |
| Other Time Deposits | 187,477 | 554 | 1.20 | 226,702 | 1,146 | 2.03 |
| Total Interest-Bearing Deposits | 1,525,779 | 1,919 | 0.51 | 1,462,043 | 3,170 | 0.87 |
| Short-Term Borrowings | 14,622 | 3 | 0.08 | 31,846 | 6 | 0.08 |
| FHLBNY Term Advances and Other Long-Term Debt | 50,000 | 317 | 2.57 | 51,209 | 356 | 2.80 |
| Total Interest-Bearing Liabilities | 1,590,401 | 2,239 | 0.57 | 1,545,098 | 3,532 | 0.92 |
| Demand Deposits | 247,347 | | | 221,738 | | |
| Other Liabilities | 24,692 | | | 25,056 | | |
| Total Liabilities | 1,862,440 | | | 1,791,892 | | |
| Stockholders’ Equity | 176,874 | | | 167,849 | | |
| Total Liabilities and Stockholders’ Equity | $2,039,314 | | | $1,959,741 | | |
| Net Interest Income (Tax-equivalent Basis) | | 14,820 | | | 15,278 | |
| Reversal of Tax Equivalent Adjustment | | (1,063) | 0.22 % | | (872) | 0.19 % |
| Net Interest Income | | $13,757 | | | $14,406 | |
| Net Interest Spread | | | 3.03 % | | | 3.18 % |
| Net Interest Margin | | | 3.13 % | | | 3.33 % |

OVERVIEW

We reported net income for the first quarter of 2013 of $5.2 million, representing diluted earnings per share (EPS) of $0.43. This EPS result was a decrease of one cent, or 2.3%, from the 0.44 reported for the first quarter of 2012. Return on average equity (ROE) for the 2013 quarter continued to be strong at 11.88%, although a decrease from the ROE of 12.67% for the quarter ended March 31, 2012. Return on average assets (ROA) for the 2013 quarter also continued to be strong at 1.03%, a decrease from ROA of 1.09% for the quarter ended March 31, 2012. The decrease in our 2013

results was primarily attributable to a decrease in net interest income, which itself was a direct result of the narrowing of our net interest margin between the two periods. Net interest income was $14.8 million on a tax-equivalent basis, a decrease of $458 thousand, or 3.0%, from net interest income of $15.3 million from the quarter ended March 31, 2012. Total assets were $2.116 billion at March 31, 2013, which represented an increase of $93.2 million, or 4.6%, above the level at December 31, 2012, and an increase of $95.6 million, or 4.7%, from the March 31, 2012 level.
The changes in net income, net interest income and net interest margin between the three-month periods are more fully described under the heading "RESULTS OF OPERATIONS," beginning on page 50. See also, "CHANGE IN FINANCIAL CONDITIONS - Impact of Interest Rate Changes," on page 39.
Stockholders’ equity was $177.8 million at March 31, 2013, an increase of $9.3 million, or 5.5%, from the year earlier level. Stockholders' equity was also up $2.0 million, or 1.1%, from the December 31, 2012 level of $175.8 million. The components of the change in stockholders’ equity since year-end 2012 are presented in the Consolidated Statement of Changes in Stockholders’ Equity on page 6, and are discussed in more detail in the last section of this Overview on page 36 entitled, “Increase in Stockholder Equity.”

Regulatory capital: At period-end, we continued to exceed all current regulatory minimum capital requirements at both the holding company and bank levels, by a substantial amount. As of March 31, 2013 both of our banks, as well as our holding company, qualified as "well-capitalized" under federal bank regulatory guidelines. Our regulatory capital levels have consistently remained well in excess of required minimums during recent years, despite the economic downturn, because of our continued profitability and strong asset quality. Even if the new enhanced capital requirements as set forth in the June 2012 joint bank regulatory release "Basel III Notices of Proposed Rulemaking" were to go into effect as they were proposed, Arrow and its banks would meet all of these enhanced standards. See the discussions of "Current Capital Standards" under the “CURRENT REGULATORY CAPITAL STANDARDS" section beginning on page 47, and “Important Proposed Changes to Regulatory Capital Standards” under the "CAPITAL RESOURCES" section beginning on page 46.

Economic recession and loan quality: During the early stages of the financial crisis in late 2008 and early 2009, our market area of northeastern New York State was relatively sheltered from the widespread collapse in real estate values and general surge in unemployment. This may have been due, in part, to the fact that our market area was less affected by the preceding real estate “bubble” than other areas of the U.S. As the recession became stronger and deeper through late 2009, even northeastern New York began to feel the impact of the worsening national economy including a slow-down in regional real estate sales and increasing unemployment rates. From year-end 2009 and through most of 2010, we experienced a very modest decline in the credit quality of our loan portfolio, although by standard measures our portfolio continued to be significantly stronger than the average for our peer group of U.S. bank holding companies with $1 billion to $3 billion in total assets (see page 31 for peer group information).

By year-end 2010, our loan quality, to the limited extent it had declined at all, began to stabilize, a trend that continued through 2011 and 2012. During this period, although nonperforming loans increased slightly, net charge-offs decreased. However, in the first quarter of 2013, we charged-off one commercial loan for $753 thousand, which had been fully provisioned at December 31, 2012. Our net charge-offs for the first quarter of 2013 were $795 thousand as compared to $230 thousand for the 2012 quarter. Our ratio of net charge-offs to average loans (annualized) was 0.28% for the first quarter of 2013 and 0.08% for the first quarter of 2012, compared with our peer group's ratio of 0.30% for all of 2012. At March 31, 2013, the allowance for loan losses was $14.6 million representing 1.25% of total loans, down five basis points from the December 31, 2012 ratio.

Nonperforming loans were $6.0 million at March 31, 2013, representing 0.51% of period-end loans. By way of comparison, this ratio for our peer group was 2.18% at December 31, 2012, which was a significant improvement from the peer group's ratio of 3.60% at year-end 2010, but still very high when compared to the group's ratio of 1.09% at December 31, 2007.

Since the onset of the financial crisis in 2008, we have not experienced significant deterioration in any of our three major loan portfolio segments:

Commercial Loans: These loans comprise approximately 32% of our loan portfolio. Current unemployment rates in our region are higher than in the past few years and the total number of jobs has decreased, but these trends are largely attributable to a scaling back of local operations on the part of a few large corporations having operations in our service area. Commercial property values have not shown significant deterioration. We update the appraisals on our nonperforming and watched commercial loan properties as deemed necessary, usually when the loan is downgraded or when we perceive significant market deterioration since our last appraisal.

Residential Real Estate Loans: These loans, including home equity loans, make up approximately 37% of our portfolio. We have not experienced a notable increase in our foreclosure rates, primarily due to the fact that we never have originated or participated in underwriting high-risk mortgage loans, such as so called “Alt A,” “negative amortization,” “option ARM's” or “negative equity” loans. We originated all of the residential real estate loans currently held in our portfolio and apply conservative underwriting standards to all of our originations.

Automobile Loans (Primarily Through Indirect Lending): These loans comprise approximately 30% of our loan portfolio. Throughout 2010, 2011, 2012 and the first three months of 2013, we did not experience any significant change in our delinquency rate or level of charge-offs on these loans, although both delinquencies and charge-offs did increase modestly during 2009.

Recent legislative developments:

(i) Dodd-Frank Act: As a result of the 2008-2009 financial crisis, the U.S. Congress passed and the President signed the Dodd-Frank Act on July 21, 2010. While many of the Act's provisions have not had and likely will not have any direct impact on Arrow, other provisions have impacted or likely will impact our business operations and financial results in a significant way. These include the establishment of a new regulatory body known as the Bureau of Consumer Financial Protection. (See the discussion on p. 9 under "The Dodd-Frank Act" regarding the likely impact on Arrow of the Bureau of Consumer Financial Protection.) Dodd-Frank also directs the federal banking authorities to issue new capital requirements for banks and holding companies that must be at least as strict as the pre-existing capital requirements for depository institutions and may be much more onerous. See the discussion under "Important Proposed Changes to Regulatory Capital Standards" on page 46 of this Report. Dodd-Frank also provided that any new issuances of trust preferred securities ("TRUPs") by bank holding companies having between $500 million and $15 billion in assets (such as Arrow) will no longer be able to qualify as Tier 1 capital, although previously issued and outstanding TRUPs of such bank holding companies, including Arrow's $20 million of TRUPs that are currently outstanding, will continue to qualify as Tier 1 capital. However, if the proposed new capital rules jointly issued by the federal bank regulatory agencies in June 2012 were to be implemented as proposed, even these "grandfathered" TRUPs previously issued by small- to mid-sized financial institutions like Arrow would be phased out from qualifying as Tier 1 capital, at a rate of 10% per year beginning in 2013. We as well as other community and regional banks would be adversely affected by this particular treatment, which is more severe in its impact on the capital of affected banks like ours than is required under Dodd-Frank. In any event, TRUPs, which have been an important financing tool for community banks such as ours, can no longer be counted on as a viable source of new capital.

(ii) Health care reform: In March 2010, comprehensive healthcare reform legislation was passed under the Patient Protection and Affordable Care Act, as amended by the Health Care and Education Reconciliation Act of 2010 (collectively, the "Health Reform Act"). Included among the major provisions of the Health Reform Act is a change in tax treatment of the federal drug subsidy paid with respect to eligible retirees. The statute also contains provisions that may impact the Company's accounting for some of its benefit plans in future periods. The exact extent of the Health Reform Act's impact, if any, cannot be determined until final regulations are promulgated and interpretations of the Health Reform Act become available.

Liquidity and access to credit markets: We have not experienced any liquidity problems or special concerns during 2013, nor did we during 2012 or 2011. The terms of our lines of credit with our correspondent banks, the FHLBNY and the Federal Reserve Bank have not changed. In general, we rely on asset-based liquidity (i.e., funds in overnight investments and cash flow from maturing investments and loans) with liability-based liquidity as a secondary source (our main liability-based sources are overnight borrowing arrangements with our correspondent banks, term credit arrangement advances from the FHLBNY and the Federal Reserve Bank discount window). During the recent financial crisis, many financial institutions, small and large, relied extensively on the Fed's discount window to support their liquidity positions, but we did not. We maintain, and periodically test, a contingent liquidity plan to ensure that we can generate an adequate amount of available funds to meet a wide variety of potential liquidity crises, including a severe crisis.

FDIC Shift From Deposit-Based to Asset-Based Insurance Premiums; Reduction in Our Premiums: The Dodd-Frank Act changed the basis on which insured banks would be assessed deposit insurance premiums, which has had a beneficial effect on the rates community banks like us pay and our overall premiums. Beginning with the second quarter of 2011, the calculation of regular FDIC insurance premiums for insured institutions changed so as to be based on adjusted assets (as defined) rather than deposits. This had the effect of imposing FDIC insurance fees not only on deposits but on other sources of funding as well, including short-term borrowings and repurchase agreements (even though these other sources are not FDIC-insured). The rate, however, given the significantly larger base on which premiums would be assessed (total assets versus insured deposits), was set at a lower percentage than the rate applicable under the old formula. Because our banks, like most community banks, have a much higher ratio of deposits to total assets than the large banks maintain, the new substantially lower rate even applied to a somewhat larger base of assets has resulted in a significant decrease in our FDIC premiums, whereas the large banks, even with the lower rates, have such vastly greater asset totals than deposit totals that their premiums have generally increased.

VISA Transactions - Reversal of the Litigation Reserve: On March 28, 2008, VISA Inc. redeemed, for cash, from its member banks, including Glens Falls National, 38.7% of the Visa Class B shares held by the member banks, using some of the proceeds realized by Visa from the initial public offering and sale of its Class A shares just then completed. With another portion of the IPO proceeds, Visa established a $3 billion escrow fund to cover certain, but not necessarily all, of its continuing litigation liabilities under various antitrust claims, which its member banks would otherwise be required to bear; the deposits into the escrow account reduced the value of the member banks' remaining Class B shares on a dollar-for-dollar basis. We maintained at year-end 2008 a $294 thousand accrual for our estimated proportional share of future Visa litigation costs, beyond the implicit reserve reflected in Visa's book valuation of our B shares. In 2008, we did not recognize on our books any dollar value for our remaining Class B Visa shares, in accordance with SEC guidance, in view of the fact that any future deposits by Visa into the escrow fund for covered litigation, while simultaneously reducing our proportionate exposure as a Visa member for the litigation, would also directly reduce the dollar value of our Class B shares.

Since the first quarter of 2008, Visa has settled several claims falling within the category of covered litigation, and from time-to-time has deposited substantial additional amounts into the escrow fund for covered litigation. Such deposits have reduced Visa's book value of its outstanding Class B shares proportionately. We did not recognize any income or expense after 2008 resulting from such additional deposits by Visa into the escrow fund as it was not determinable with an appropriate level of certainty what the impact of such funding was on the Company's contingent obligation beyond its Class B Visa shares.

Most recently, in July 2012, Visa and MasterCard entered into a Memorandum of Understanding ("MOU") with a class of plaintiffs to settle certain additional antitrust claims involving merchant discounts. Visa's share of this settlement also will be paid out of its escrow fund. In light of the current state of covered litigation at Visa, which is winding down, as well as the remaining dollar amounts in Visa's escrow fund, we determined in the second quarter 2012 to reverse the entire amount of our remaining VISA litigation-related accrual, which was $294 thousand pre-tax. This reversal reduced our other operating expenses for the year ending December 31, 2012. We believed then, and continue to believe, that the multi-billion dollar balance that Visa maintains in its escrow fund is substantially sufficient to satisfy the Company's contingent liability for the remaining covered litigation. The Company continues not to recognize any economic value for its remaining shares of Visa Class B common stock.

Increase in Stockholders' Equity:  At March 31, 2013, our tangible book value per share (calculated based on stockholders' equity reduced by goodwill and other intangible assets) amounted to $12.60, an increase of $0.18, or 1.5%, from December 31, 2012 and an increase of $0.78, or 6.6%, from the level as of March 31, 2012. Our total stockholders' equity at March 31, 2013 increased 5.5% over the year-earlier level, and our total book value per share increased by 5.4%, over the year earlier level. This increase in stockholders' equity over the first three months of 2013 principally reflected the following factors: i) $5.2 million net income for the period; ii) issuance of $610 thousand of common stock through our employee benefit and dividend reinvestment plans; offset in part by iii) cash dividends of $3.0 million; and (iv) repurchases of our own common stock of $1.3 million. As of March 31, 2013, our closing stock price was $24.64, representing a trading multiple of 1.96 to our tangible book value. From a regulatory capital standpoint, the Company and each of its subsidiary banks also continued to remain classified as “well-capitalized” at quarter end. The Board of Directors declared and the Company paid quarterly cash dividends of $.245 per share for the first three quarters of 2012, as adjusted for a 2% stock dividend distributed September 27, 2012, and cash dividends of $.25 per share for the last quarter of 2012 and the first quarter of 2013.

CHANGE IN FINANCIAL CONDITION

Summary of Selected Consolidated Balance Sheet Data
(Dollars in Thousands)

| | At Period-End | | | $ Change From Dec | $ Change From Mar | % Change From Dec | % Change From Mar |
|---|---|---|---|---|---|---|---|
| | 3/31/2013 | 12/31/2012 | 3/31/2012 | | | | |
| Interest-Bearing Bank Balances | $113,231 | $11,756 | $106,380 | $101,475 | $6,851 | 863.2 % | 6.4 % |
| Securities Available-for-Sale | 478,775 | 478,698 | 466,785 | 77 | 11,990 | — % | 2.6 % |
| Securities Held-to-Maturity | 251,456 | 239,803 | 200,607 | 11,653 | 50,849 | 4.9 % | 25.3 % |
| Loans (1) | 1,164,759 | 1,172,341 | 1,137,547 | (7,582) | 27,212 | (0.6)% | 2.4 % |
| Allowance for Loan Losses | 14,603 | 15,298 | 15,053 | (695) | (450) | (4.5)% | (3.0)% |
| Earning Assets (1) | 2,012,714 | 1,908,390 | 1,915,701 | 104,324 | 97,013 | 5.5 % | 5.1 % |
| Total Assets | 2,115,962 | 2,022,796 | 2,020,369 | 93,166 | 95,593 | 4.6 % | 4.7 % |
| Demand Deposits | 254,308 | 247,232 | 230,289 | 7,076 | 24,019 | 2.9 % | 10.4 % |
| NOW Accounts | 845,531 | 758,287 | 758,114 | 87,244 | 87,417 | 11.5 % | 11.5 % |
| Savings Deposits | 476,115 | 442,363 | 432,854 | 33,752 | 43,261 | 7.6 % | 10.0 % |
| Time Deposits of $100,000 or More | 89,797 | 93,375 | 115,161 | (3,578) | (25,364) | (3.8)% | (22.0)% |
| Other Time Deposits | 185,455 | 189,898 | 224,460 | (4,443) | (39,005) | (2.3)% | (17.4)% |
| Total Deposits | $1,851,206 | $1,731,155 | $1,760,878 | $120,051 | $90,328 | 6.9 % | 5.1 % |
| Federal Funds Purchased and Securities Sold Under Agreements to Repurchase | $12,166 | $12,678 | $16,652 | $(512) | $(4,486) | (4.0)% | (26.9)% |
| FHLB Advances | 30,000 | 59,000 | 30,000 | (29,000) | — | (49.2)% | — % |
| Stockholders' Equity | 177,803 | 175,825 | 168,466 | 1,978 | 9,337 | 1.1 % | 5.5 % |

(1) Includes Nonaccrual Loans

Municipal Deposits: Fluctuations in balances of our NOW accounts and time deposits of $100,000 or more are largely the result of municipal deposit seasonality factors. In recent years, municipal deposits on average have represented from 24% to over 32% of our total deposits. As of March 31, 2013, municipal deposits were at a relatively high level, representing approximately 32.3% of total deposits. Municipal deposits typically are invested in NOW accounts and time deposits of short duration. Many of our municipal deposit relationships are subject to annual renewal, by formal or informal agreement.

In general, there is a seasonal pattern to municipal deposits starting with a low point during July and August. Account balances tend to increase throughout the fall and remain elevated during the winter months, due to tax deposits, and generally receive an additional boost at the end of March from the electronic deposit of state aid to school districts. In addition to these seasonal fluctuations within accounts, the overall level of municipal deposit balances fluctuates from year-to-year as some municipalities move their accounts in and out of our banks due to competitive factors. Often, the balances of municipal deposits at the end of a quarter are not representative of the average balances for that quarter.

The recent and continuing financial crisis has had a significant negative impact on municipal tax revenues in many regions, and consequently on municipal funds available for deposit. To date, this has not resulted in either a sustained

decrease in municipal deposit levels at our banks, adjusted for seasonal fluctuations (in fact, we have experienced an increase in such deposits in 2013 - see following paragraph), or an overall increase in the average rate we pay on such deposits (despite the heightened competition for such deposits). However, if the regional economy weakens or the competition for municipal deposits becomes even more intense, we may experience either or both of these adverse developments in the future.
Changes in Sources of Funds: In recent periods, for cost reasons and because of the sustained growth of customer deposits even at very low rates, we have lessened our reliance on wholesale funding sources and increased our reliance on customer deposits as a source of day-to-day funding. Our total deposits increased $120.1 million, or 6.9%, from December 31, 2012 to March 31, 2013, mainly due to both an increase in the number of municipal deposit relationships and a seasonal increase in balances at the end of the first quarter of 2013. Another factor contributing to the increase was a widespread flight to safety on the part of many individual savers during the crisis, who continue to increase their deposits in banks, even in the face of historically-low deposit rates. From December 31, 2012 to March 31, 2013, we experienced an increase in municipal deposit balances of $97.0 million, or 19.3% (a sizable portion of this large increase was seasonable; see the preceding section, "Municipal Deposits"). Non-municipal deposits increased by $23.0 million, or 1.9%, with the increases spread among all categories of non-maturity products, except for money market checking, which decreased by 2.3%. At March 31, 2013 securities sold under agreements to repurchase were essentially unchanged from year-end 2012 balances and $4.5 million below year-earlier levels.
Changes in Earning Assets: Our loan portfolio decreased by $7.6 million, or 0.6%, from December 31, 2012 to March 31, 2013. We experienced the following trends in our three largest segments:

1. Commercial and commercial real estate loans – period-end balances for this segment were down $8.1 million, or 2.1%, from the December 31, 2012 total, principally due to the repayment of one large commercial loan, while demand generally continued to be moderate.

2. Residential real estate loans – the period-end balance decreased by $4.8 million, or 1.1% from the December 31, 2012 total, as we continued to sell most of our residential mortgage originations during the period, even though demand remained average.
3. Automobile loans – the balance of these loans at March 31, 2013, increased by $4.9 million, or 1.4% from the December 31, 2012 balance, reflecting a modest resurgence of automobile sales region-wide.

Most of our incoming cash flows for the first three months of 2013 came from maturing investments and the increase in deposit balances. During that period, we purchased $58.9 million of securities to replace maturing securities in the held-to-maturity and available-for-sale portfolios. The remaining cash flows were held in overnight funds at period-end pending reinvestment as suitable opportunities arise.

Generally, we pursued a strategy in 2012 and first quarter 2013 of increasing our holding of liquid assets, with a view to redeploying these funds into longer term earning assets when prevailing interest rates begin to rise, whenever that may be.

Deposit Trends

The following two tables provide information on trends in the balance and mix of our deposit portfolio by presenting, for each of the last five quarters, the quarterly average balances by deposit type and the percentage of total deposits represented by each deposit type.

Quarterly Average Deposit Balances
(Dollars in Thousands)

| | Quarter Ended | | | | |
|---|---|---|---|---|---|
| | 3/31/2013 | 12/31/2012 | 9/30/2012 | 6/30/2012 | 3/31/2012 |
| Demand Deposits | $247,347 | $249,176 | $258,632 | $233,650 | $221,738 |
| NOW Accounts | 791,669 | 798,513 | 685,212 | 733,600 | 688,982 |
| Savings Deposits | 455,311 | 444,603 | 446,450 | 431,896 | 425,247 |
| Time Deposits of $100,000 or More | 91,322 | 95,742 | 102,230 | 111,766 | 121,112 |
| Other Time Deposits | 187,477 | 193,744 | 209,075 | 222,408 | 226,702 |
| Total Deposits | $1,773,126 | $1,781,778 | $1,701,599 | $1,733,320 | $1,683,781 |

Percentage of Total Quarterly Average Deposits

| | Quarter Ended | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| | 3/31/2013 | | 12/31/2012 | | 09/30/2012 | | 06/30/2012 | | 03/31/2012 | |
| Demand Deposits | 13.9 | % | 14.0 | % | 15.2 | % | 13.5 | % | 13.2 | % |
| NOW Accounts | 44.6 | | 44.8 | | 40.3 | | 42.3 | | 40.9 | |
| Savings Deposits | 25.7 | | 24.9 | | 26.2 | | 24.9 | | 25.3 | |
| Time Deposits of $100,000 or More | 5.2 | | 5.4 | | 6.0 | | 6.5 | | 7.2 | |
| Other Time Deposits | 10.6 | | 10.9 | | 12.3 | | 12.8 | | 13.4 | |
| Total Deposits | 100.0 | % | 100.0 | % | 100.0 | % | 100.0 | % | 100.0 | % |

For a variety of reasons, we typically experience little growth in average deposit balances in the first quarter of each calendar year (even though municipal balances tend to grow sharply at the very end of first quarter), little net growth or a small contraction in the second and third quarters of the year (when municipal deposits normally drop off), and significant growth in the fourth quarter (when municipal deposits usually increase substantially to and through year-end). This pattern has held true in recent quarters, except for the second quarter of 2012, when average deposits actually increased somewhat over the average balance for the first quarter of 2012, with a large gain in NOW accounts. This modest overall increase in deposits was due to a significant increase in municipal deposits in the second quarter, reflecting the addition of several new municipal relationships. However, as expected, average balances fell from the second quarter to the third quarter of 2012.

Quarterly Cost of Deposits

| | Quarter Ended | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| | 3/31/2013 | | 12/31/2012 | | 9/30/2012 | | 6/30/2012 | | 3/31/2012 | |
| Demand Deposits | — | % | — | % | — | % | — | % | — | % |

| | | | | | |
|---|---|---|---|---|---|
| NOW Accounts | 0.40 | 0.43 | 0.39 | 0.54 | 0.62 |
| Savings Deposits | 0.24 | 0.25 | 0.28 | 0.31 | 0.34 |
| Time Deposits of $100,000 or More | 1.42 | 1.54 | 1.79 | 2.05 | 2.02 |
| Other Time Deposits | 1.20 | 1.34 | 1.63 | 1.94 | 2.03 |
| Total Deposits | 0.44 | 0.48 | 0.54 | 0.68 | 0.76 |

In keeping with industry trend lines, average rates paid by us on deposits decreased steadily over the five quarters ending March 31, 2013, for virtually all deposit categories, as did our average yield on loans for almost all loan categories (see "Quarterly Taxable Equivalent Yield on Loans," p. 43).

Impact of Interest Rate Changes

Changes in Interest Rates in Recent Years. When prevailing rates began to fall at year-end 2007, we saw an immediate impact in the reduced cost of our deposits and these costs continued to fall in 2008 and 2009 and to a lesser extent throughout 2010, 2011 and 2012. Yields on our earning assets have also fallen since 2008, but at a different pace than our cost of funds. Initially, the drop in our asset yields was not as significant as the decline in our deposit rates, but in recent periods (since the beginning of 2009) the decline in yields on our earning assets has generally exceeded the decline in the cost of our deposits. As a result of these trends, our net interest margin generally increased in late 2007 and early 2008, positively impacting our net interest income, but since mid-2008 we, like almost all banks, have experienced a fairly steady contraction in our net interest margin.

Changes in the Yield Curve in Recent Years. An additional important aspect in recent years with regard to the effect of prevailing interest rates on our profitability has been the changing shape in the yield curve. A positive (upward-sloping) yield curve, where long-term rates significantly exceed short term rates, is both a more common occurrence and generally a better situation for banks, including ours, than a flat or less upwardly-sloping yield curve. We, like many banks, typically fund longer-duration assets with shorter-maturity liabilities, and the flattening of the yield curve directly diminishes the benefit of this strategy.
As the financial crisis deepened in the 2008-2010 period, long-term rates also decreased roughly in parity with the continuing decreases in short-term rates, as both short- and long-term rates approached historically low levels, a goal explicitly sought by the Federal Reserve. In recent quarters, as short-term rates have neared zero, long-term rate decreases generally have exceeded short-term rate decreases and the yield curve has flattened somewhat. In the third quarter of 2011 and the second quarter of 2012, the Federal Reserve undertook new measures specifically designed to reduce longer-term rates as compared to short-term rates, in an attempt to stimulate the housing market and the economy generally. Thirty-year mortgage rates have subsequently fallen to levels not seen in many years, if ever.

Continuing Pressure on Credit Quality. All lending institutions, even those like us who have avoided subprime lending problems and continue to maintain high credit quality, have experienced some continuing pressure on credit quality in recent periods, and this may continue if the national or regional economies continue to be weak or suffer a new downturn. Any credit or asset quality erosion will negatively impact net interest income, and will reduce or possibly outweigh the benefit we may experience from the combination of low prevailing interest rates generally and a modestly upward-sloping yield curve. Thus, no assurances can be given on our ability to maintain or increase our net interest margin, net interest income or net income generally, in upcoming periods, particularly as residential mortgage related borrowings have diminished across the economy and the redeployment of funds from maturing loans and long-term assets into similarly high yielding asset categories has become progressively more difficult. The modest uptick in loan demand and in the U.S. economy generally experienced during 2012 and the first quarter of 2013 may prove transitory, in light of continuing economic and financial woes across the rest of the developed world and stubborn fiscal pressures in the U.S.

Recent Pressure on Our Net Interest Margin. From mid-2008 into 2009, our net interest margin held steady at around 3.90%, but the margin began to narrow in the last three quarters of 2009 and throughout 2010, 2011 and most of 2012 as the downward repricing of paying liabilities slowed while interest earning assets continued to reprice downward at a steady rate.
Currently, our net interest margin continues to be under pressure. During the last five quarters, our margin ranged from 3.33% to 3.13%. Even if new assets do not continue to price downward, our average yield on assets may continue to decline in future periods as our older, higher-priced assets continue to mature and pay off at a faster rate than our older, higher-priced liabilities. Thus, we may continue to experience additional margin compression in upcoming periods. That is, our average yield on assets may decline in upcoming periods at a slightly higher rate than our average cost of deposits. In this light, no assurances can be given that our net interest income will resume the

growth it experienced in 2010 and prior years, even if asset growth continues or increases, or that net earnings will continue to grow, if net interest income decreases more rapidly than our other sources of operating income increase.

Potential Inflation; Effect on Interest Rates and Margins.  Currently, there is considerable discussion, and some disagreement, about the possible emergence of meaningful inflation across some or all asset classes in the U.S. or other world economies. To the extent that such inflation may occur, it is likely to be the result of persistent efforts by the Federal Reserve and other central banks, including the European Central Bank, to significantly increase the money supply in the U.S. and western world economies, which in the U.S. started at the onset of the crisis in 2008 and continues. The Fed has increased the U.S. money supply by setting and maintaining the Fed funds rate at historically low levels (with consequent downward pressure on all rates), and by purchasing massive amounts of U.S. Treasuries and other debt securities through the Federal Reserve Bank (i.e., "quantitative easing"), which is intended in part to have the identical effect of lowering and reinforcing already low interest rates in addition to directly expanding the supply of credit. When the second round of quantitative easing expired on June 30, 2011, the Fed elected not to continue the program, for a variety of reasons including some concern over inflation. Instead, the Fed announced it would support economic recovery through a new series of interest rate manipulations, dubbed "Operation Twist", under which it would reinvest the proceeds from maturing short-term (and long-term) securities in its substantial U.S. Treasury and mortgage-backed securities portfolios into longer-dated securities, thereby seeking to lower long-term rates (and mortgage rates), as a priority over further reductions in short-term rates. However, in the ensuing summer months of 2012, the underlying inflation rate in the U.S., exclusive of the historically volatile categories of fuel and food purchases, remained quite low, and the U.S. economy, though slowly improving, remained sluggish. As a result, in September 2012, the Fed announced that it would resume quantitative easing, by embarking on a program of purchasing $40 billion of mortgage-backed securities on a monthly basis in the market until the economy regained suitable momentum (so-called "infinite QE"), while at the same time monitoring inflation in the economy, with a view toward taking appropriate corrective measures if inflation increased beyond acceptable levels. As the U.S. economy continued to demonstrate weakness in the second half of 2012, the Fed increased the level of its fixed monthly purchases of debt securities to $85 billion, approximately half treasury bonds and the rest in mortgage-backed securities. However, there has now emerged a certain level

of concern not only about the weak U.S. economy, but also that at some point prevailing interest rates may begin to rise, along with inflation, perhaps significant inflation, potentially damaging U.S. financial markets.
For the present, management does not anticipate near-term substantial increases in prevailing rates, short- or long-term. If modest rate increases should occur, there is some expectation that the impact on our margins, as well as on our net interest income and earnings, may be somewhat negative in the short run but possibly positive in the long run. Given the extraordinary forces currently in play in the financial markets, any speculation on the likelihood of significant inflation in the near future, or the impact of such inflation on prevailing interest rates, short- or long-term, or on the net interest margins or the net interest income of banks such as ours, must be regarded as highly subjective.
A discussion of the models we use in projecting the impact on net interest income resulting from possible changes in interest rates vis-à-vis the repricing patterns of our earning assets and interest-bearing liabilities is included later in this Report.

Non-Deposit Sources of Funds

We have several sources of funding other than deposits. Historically, we have borrowed funds from the Federal Home Loan Bank ("FHLB") under a variety of programs, including fixed and variable rate short-term borrowings and borrowings in the form of "structured advances." These structured advances typically have original maturities of 3 to 10 years and are callable by the FHLB at certain dates. If the advances are called, we may elect to receive replacement advances from the FHLB at the then prevailing FHLB rates of interest. In recent periods, we have reduced our reliance on FHLB advances as a source of funds, and in 2011 prepaid some advances, even at the cost of incurring substantial prepayment penalties. See the discussion on this in “Changes in Sources of Funds” on page 37.
We have also utilized, in the past, the issuance of trust preferred securities (or TRUPs) to supplement our funding needs. The $20 million of Junior Subordinated Obligations Issued to Unconsolidated Subsidiary Trusts (i.e., TRUPs) listed on our consolidated balance sheet as of March 31, 2013 currently qualify as Tier 1 regulatory capital under regulatory capital adequacy guidelines, as discussed under “Capital Resources” beginning on page 46 of this Report.
These trust preferred securities are subject to early redemption by us if the proceeds cease to qualify as Tier 1 capital of Arrow for any reason, or if certain other unanticipated but negative events should occur, such as any adverse change in tax laws that denies the Company the ability to deduct interest paid on these obligations for federal income tax purposes. Under Dodd-Frank, no future issuances of TRUPs by banking organizations of our size will qualify as Tier 1 regulatory capital.
Loan Trends
The following two tables present, for each of the last five quarters, the quarterly average balances by loan type and the percentage of total loans represented by each loan type.
Quarterly Average Loan Balances
(Dollars in Thousands)

| | Quarter Ended | | | | |
|---|---|---|---|---|---|
| | 3/31/2013 | 12/31/2012 | 9/30/2012 | 6/30/2012 | 3/31/2012 |
| Commercial and Commercial Real Estate | $381,281 | $366,761 | $357,148 | $354,316 | $348,472 |
| Residential Real Estate | 308,091 | 314,583 | 322,750 | 327,763 | 332,764 |
| Home Equity | 88,926 | 87,124 | 84,849 | 82,992 | 82,635 |
| Consumer Loans - Automobile | 363,120 | 361,723 | 352,597 | 346,080 | 339,409 |
| Other Consumer Loans (1) | 28,452 | 30,035 | 31,427 | 32,515 | 33,042 |
| Total Loans | $1,169,870 | $1,160,226 | $1,148,771 | $1,143,666 | $1,136,322 |

Percentage of Total Quarterly Average Loans

| | Quarter Ended | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| | 3/31/2013 | | 12/31/2012 | | 9/30/2012 | | 6/30/2012 | | 3/31/2012 | |
| Commercial and Commercial Real Estate | 32.6 | % | 31.6 | % | 31.1 | % | 31.0 | % | 30.7 | % |
| Residential Real Estate | 26.4 | | 27.1 | | 28.1 | | 28.6 | | 29.3 | |

| | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| Home Equity | 7.6 | | 7.5 | | 7.4 | | 7.3 | | 7.3 | |
| Consumer Loans - Automobile | 31.0 | | 31.2 | | 30.7 | | 30.3 | | 29.8 | |
| Other Consumer Loans (1) | 2.4 | | 2.6 | | 2.7 | | 2.8 | | 2.9 | |
| Total Loans | 100.0 | % | 100.0 | % | 100.0 | % | 100.0 | % | 100.0 | % |

(1) The category “Other Consumer Loans”, in the tables above, includes home improvement loans secured by mortgages, which are otherwise reported with residential real estate loans in tables of period-end balances.

Maintenance of High Quality in the Loan Portfolio

In late 2010 and through 2011, residential property values continued to weaken in most markets, and this trend continued for most of 2012, although during the last part of 2012 and the first quarter of 2013 the decline appeared to be slowing or even reversing itself, at least in some markets. Some analysts currently are speculating that a "bottom" may have been established in the real estate markets, both in terms of price and quantity of transactions, but the evidence is still inconclusive, particularly with respect to the markets we serve. As was true during the initial stages of the real estate collapse, indications of stability or revival in the residential and commercial real estate markets vary significantly from market-to-market.

The weakness in the asset portfolios of many financial institutions remains a serious concern, offset somewhat by the recent firming up in some real estate markets and general increase in the equity markets to levels last seen in 2007. Regardless, many lending institutions large and small continue to suffer from a lingering weakness in large portions of their existing loan portfolios as well as by limited opportunities for secure and profitable expansion of their portfolios. For many reasons, including our conservative credit underwriting standards, we largely avoided the negative impact on asset quality that other banks suffered in the years since the onset of the financial crisis. Through the date of this Report, we have not experienced a significant deterioration in our loan portfolios. In general, we underwrite our residential real estate loans to secondary market standards for prime loans. We have never engaged in subprime mortgage lending as a business line, including in residential mortgage loans, car loans or other consumer loans. We never extended or purchased any so-called "Alt-A", "negative amortization", "option ARM", or "negative equity" mortgage loans. On occasion we have made loans to borrowers having a FICO score of 650 or below or have had extensions of credit outstanding to borrowers who have developed credit problems after origination resulting in deterioration of their FICO scores.

We also on occasion have extended community development loans to borrowers whose creditworthiness is below our normal standards as part of the community support program we have developed in fulfillment of our statutorily-mandated duty to support low and moderate-income borrowers within our service area. However, we are a prime lender and apply prime lending standards and this, together with the fact that the service area in which we make most of our loans has not experienced as severe a decline in property values or economic conditions generally as other parts of the U.S., are the principal reasons that we have not to date experienced significant deterioration in our loan portfolio, including the real estate categories of our loan portfolio.

However, like all other banks we operate in an environment where identifying opportunities for secure and profitable expansion of our loan portfolio is challenging, where competition is intense, and where margins are very tight. If the U.S. economy continues to be weak, our region also will continue to experience stress from an economic and financial standpoint, and individual borrowers will also continue to experience stress, as many small businesses are operating on very narrow margins and many families are living on very tight budgets. Given our conservative underwriting standards, we may continue to experience only modest loan portfolio growth or even no growth. Moreover, if the U.S. or our regional economy worsens, which we think unlikely but possible, we may experience elevated charge-offs, higher provisions to our loan loss reserve, and increasing expense related to asset maintenance and supervision.

Residential Real Estate Loans: In recent years, residential real estate and home equity loans have represented the largest single segment of our loan portfolio (comprising approximately 37% of the entire portfolio at quarter-end 2013), eclipsing both automobile loans (30% of the portfolio) and our commercial and commercial real estate loans (32%). Our gross originations for residential real estate loans were $30.3 million for the first quarter of 2013 and were $109.1 million, $75.0 million and $94.2 million for the years 2012, 2011, and 2010, respectively. These origination totals have significantly exceeded the sum of repayments and prepayments in the portfolio, but we have also sold significant portions of these originations. During the last quarter of 2008 and the first two quarters of 2009, as prevailing mortgage rates began to decline, we sold most of our mortgage originations in the secondary market. During the second half of 2009 and the first two quarters of 2010, for a variety of reasons, we began to retain a larger percentage of the newly originated loans in our portfolio, selling only a relatively small portion of the originations to Freddie Mac (with further reductions in the portfolio as a result of normal principal amortization and prepayments on pre-existing loans).

After April 2010, rates on conventional real estate mortgages continued to fall, even as demand for such mortgages (other than refinancings) remained relatively weak. In April 2010, the national average for 30-year conventional (fixed rate) mortgage loans was 5.21%, but by the last quarter of 2011 the national average had dropped below 4.00%, a relative decline of more than 20 percent. In response, we determined to resume selling most of our originations to Freddie Mac, amounting to $48.5 million for 2011, $59.9 million for 2012 and $20.8 million for the first quarter of 2013. If the current low-rate environment for newly originated residential real estate loans persists, we may continue to sell a significant portion of our loan originations and, as a result, may even experience a decrease in our outstanding balances in this segment of our portfolio. Moreover, if our local economy or real estate market suffers further major downturns, the demand for residential real estate loans in our service area may decrease, which also may negatively impact our real estate portfolio and our financial performance.

Automobile Loans (primarily through indirect lending): At March 31, 2013, our automobile loans (primarily loans originated through dealerships located primarily in the eastern region of upstate New York) represented the third largest category of loans in our portfolio, but still a significant component of our business.
During portions of 2012, and particularly during the first quarter of 2013, there was a nation-wide resurgence in automobile sales, due in the view of many to an aging fleet and a modest resurgence in consumer optimism. Although our new loan volume for the first quarter of 2012 was very strong at $49.4 million, our first quarter originations for 2013 nearly matched that level at $46.2 million.
Net charge-offs for the first quarter of 2013 were below the net charge-offs for the first quarter of 2012. Our experienced lending staff not only utilizes credit evaluation software tools but also reviews and evaluates each loan individually. We believe our disciplined approach to evaluating risk has contributed to maintaining our strong loan quality in this portfolio. Unlike many other financial institutions, we have not extended directly or indirectly any sub-prime car loans in recent periods [nor will we in future periods]. If weakness in auto demand returns, our portfolio is likely to experience limited, if any, overall growth, either in real terms or as a percentage of the total portfolio, regardless of whether the auto company affiliates are offering highly-subsidized loans. Although recently somewhat improved, customer demand for vehicle loans is still well below pre-crisis levels and if demand does not continue to improve, neither will our financial performance in this important loan category.

Commercial, Commercial Real Estate and Construction and Land Development Loans: Over the last decade, we have experienced moderate and occasionally strong demand for commercial and commercial real estate loans. These loan balances have generally increased, both in dollar amount and as a percentage of the overall loan portfolio, and this segment of our portfolio was the segment least affected by the 2008-2009 crisis. For the first quarter of 2013, commercial loan growth was modest as outstanding balances increased by $2.5 million over the December 31, 2012 level, but that growth was restrained by the pay-off of a $10.5 million floor plan loan due to competitive reasons.

Substantially all commercial and commercial real estate loans in our portfolio were extended to businesses or borrowers located in our regional market. Many of the loans in the commercial portfolio have variable rates tied to prime, FHLBNY rates or U.S. Treasury indices. Although on a national scale the commercial real estate market suffered a major downturn in the 2008-2009 period from which it has not yet fully recovered, we have not experienced any significant weakening in the quality of our commercial loan portfolio in recent years.
It is entirely possible, however, that we may experience a reduction in the demand for such loans and/or a weakening in the quality of our commercial and commercial real estate loan portfolio in upcoming periods. Generally, however, the business sector, at least in our service area, appears to be in reasonably good financial condition at present.

The following table indicates the annualized tax-equivalent yield of each loan category for the past five quarters.
Quarterly Taxable Equivalent Yield on Loans

| | Quarter Ended | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| | 3/31/2013 | | 12/31/2012 | | 9/30/2012 | | 6/30/2012 | | 3/31/2012 | |
| Commercial and Commercial Real Estate | 4.74 | % | 4.91 | % | 5.07 | % | 5.11 | % | 5.36 | % |
| Residential Real Estate | 4.93 | | 5.00 | | 5.01 | | 5.15 | | 5.24 | |
| Home Equity | 3.03 | | 3.03 | | 3.01 | | 2.99 | | 2.98 | |
| Consumer Loans - Automobile | 3.97 | | 4.18 | | 4.38 | | 4.50 | | 4.63 | |
| Other Consumer Loans | 6.16 | | 6.24 | | 6.42 | | 6.39 | | 6.56 | |
| Total Loans | 4.46 | | 4.60 | | 4.72 | | 4.82 | | 4.97 | |

In summary, average yields in our loan portfolio have steadily declined over the last year, dropping 51 basis points or 10.3%, as a result of the historically low interest rate environment.
In the first quarter of 2013 the average yield on our loan portfolio declined by 14 basis points from the fourth quarter of 2012, from 4.60% to 4.46%. The decrease was exacerbated by extremely competitive pressures on rates for new commercial and commercial real estate loans (a 17 basis point decrease from the prior quarter), as well as on rates for automobile loans (a 21 basis point decrease from the prior quarter). The yields on new 30 year fixed-rate residential mortgage loans (the choice of most of our mortgage customers) remained very low during the quarter. As a consequence, we continued to sell most of those originations to the secondary market, specifically, to Freddie Mac.
The first quarter 2013 decrease in average yield on our loan portfolio of 14 basis points was 10 basis points more than the 4 basis point decline in our average cost of deposits during the quarter, resulting in a narrowing of our margins. We believe that our average loan yields will generally continue to decline at a somewhat higher rate than our average cost of deposits in upcoming periods.
In general, the yield (tax-equivalent interest income divided by average loans) on our loan portfolio and other earning assets has been impacted by changes in prevailing interest rates, as previously discussed in this Report beginning on page 39 under the heading "Impact of Interest Rate Changes." We expect that such will continue to be the case; that is, that loan yields will continue to rise and fall with changes in prevailing market rates, although the timing and degree of responsiveness will be influenced by a variety of other factors, including the extent of federal government and Federal Reserve participation in the home mortgage market, the makeup of our loan portfolio, the shape of the yield curve, consumer expectations and preferences, and the rate at which the portfolio expands. Additionally, there is a significant amount of cash flow from normal amortization and prepayments in all loan categories, and much of this cash flow reprices at current rates for credit, as new loans are generated at the current yields. Thus, even if prevailing rates for loans stabilize in upcoming periods, our average rate on our portfolio may continue to decline as older credits in our portfolio bearing generally higher rates continue to mature and roll over or are redeployed into lower priced loans.

Investment Portfolio Trends

The following table presents the changes in the period-end balances for the securities available-for-sale and the securities held-to-maturity investment portfolios from December 31, 2012 to March 31, 2013 (in thousands):

| | Fair Value at Period-End | | | Net Unrealized Gain (Loss) | | |
|---|---|---|---|---|---|---|
| | 03/31/2013 | 12/31/2012 | Change | 03/31/2013 | 12/31/2012 | Change |
| Securities Available-for-Sale: | | | | | | |
| U.S. Agency Securities | $132,153 | $122,457 | $9,696 | $(64) | $160 | $(224) |
| State and Municipal Obligations | 104,469 | 84,838 | 19,631 | 165 | 40 | 125 |
| Mortgage-Backed Securities-Residential | 228,323 | 261,804 | (33,481) | 9,256 | 9,324 | (68) |
| Corporate and Other Debt Securities | 12,691 | 8,451 | 4,240 | (222) | (238) | 16 |
| Mutual Funds and Equity Securities | 1,139 | 1,148 | (9) | 19 | 28 | (9) |
| Total | $478,775 | $478,698 | $77 | $9,154 | $9,314 | $(160) |
| | | | | | | |
| Securities Held-to-Maturity: | | | | | | |
| State and Municipal Obligations | $206,141 | $191,196 | $14,945 | $7,283 | $7,823 | $(540) |
| Mortgage-Backed Securities-Residential | 52,421 | 56,056 | (3,635) | 823 | 626 | 197 |
| Corporate and Other Debt Securities | 1,000 | 1,000 | — | — | — | — |
| Total | $259,562 | $248,252 | $11,310 | $8,106 | $8,449 | $(343) |

At period end, we held no investment securities in our portfolio that consisted of or included, directly or indirectly, obligations of foreign governments or governmental agencies or foreign issues of any sort.

As of both period-ends presented in the above table, all listed mortgage-backed securities and collateralized mortgage obligations (CMO's) in our portfolio were guaranteed by U.S. agency and government sponsored enterprises (GSEs), such as Fannie Mae or Freddie Mac. Mortgage-backed securities provide to the investor monthly portions of principal and interest pursuant to the contractual obligations of the underlying mortgages. In the case of most CMOs, the principal and interest payments on the pooled mortgages are separated into two or more components (tranches), with each tranche having a separate estimated life, risk profile and yield. Our practice has been to purchase only those CMOs that are guaranteed by GSEs or other federal agencies and only those tranches with shorter maturities and no more than moderate risk. Included in corporate and other debt securities are trust preferred securities which were highly rated at the time of purchase.

Other-Than-Temporary Impairment

Each quarter we evaluate all investment securities with a fair value less than amortized cost, both in the available-for-sale portfolio and the held-to-maturity portfolio, to determine if there exists other-than-temporary impairment for any such security as defined under generally accepted accounting principles. The category of mutual funds and equity securities includes this other-than-temporarily impaired security.

Investment Sales, Purchases and Maturities: Available-for-Sale Portfolio
(In Thousands)

| | Three Months Ended | |
|---|---|---|
| | 03/31/2013 | 03/31/2012 |
| Sales | | |
| Mortgage-Backed Securities-Residential | $10,666 | $10,349 |
| U.S. Agency Securities | 5,057 | — |
| Other | 11 | — |
| Net Gains on Securities Transactions | 527 | 502 |
| Proceeds on the Sales of Securities | $16,261 | $10,851 |

Historically low interest rates have increased the likelihood of greater mortgage refinancing activity. In recent periods, we have regularly reviewed our holdings of collateralized mortgage obligations for those mortgages that revealed higher credit scores and/or moderate loan-to-value ratios, i.e., where refinancing may appear to be a greater probability. We have also reviewed the underlying prepayment speed of individual issues to identify mortgage pools that were experiencing accelerating principal payments. In 2013 and 2012 we selectively sold collateralized mortgage obligations that were experiencing accelerating prepayments speeds and that were also selling at a premium, so as to capture the gain since prepayments (redemptions) of such securities typically are at par.

| | Three Months Ended | |
|---|---|---|
| | 03/31/2013 | 03/31/2012 |
| Purchases | | |
| U.S. Agency Securities | $15,000 | $— |
| State and Municipal Obligations | 20,677 | — |
| Mortgage-Backed Securities-Residential | — | 274 |
| Other | 4,251 | 14 |
| Total Purchases | $39,928 | $288 |
| | | |
| Maturities & Calls | $22,846 | $77,782 |

Investment Purchases - Held-to-Maturity Portfolio

| | Three Months Ended | |
|---|---|---|
| | 03/31/2013 | 03/31/2012 |
| Purchases | | |
| State and Municipal Obligations | $18,930 | $40,546 |
| Mortgage-Backed Securities-Residential | — | 18,497 |
| Total Purchases | $18,930 | $59,043 |
| | | |
| Maturities & Calls | $6,815 | $8,987 |

Asset Quality

The following table presents information related to our allowance and provision for loan losses for the past five quarters.

Summary of the Allowance and Provision for Loan Losses
(Dollars in Thousands, Loans Stated Net of Unearned Income)

| | 3/31/2013 | 12/31/2012 | 9/30/2012 | 6/30/2012 | 3/31/2012 |
|---|---|---|---|---|---|
| Loan Balances: | | | | | |
| Period-End Loans | $1,164,759 | $1,172,341 | $1,152,951 | $1,146,641 | $1,137,547 |
| Average Loans, Year-to-Date | 1,169,870 | 1,147,286 | 1,142,942 | 1,139,995 | 1,136,322 |
| Average Loans, Quarter-to-Date | 1,169,870 | 1,160,226 | 1,148,771 | 1,143,666 | 1,136,322 |
| Period-End Assets | 2,115,962 | 2,022,796 | 2,040,515 | 1,966,976 | 2,020,369 |
| | | | | | |
| Allowance for Loan Losses, Year-to-Date: | | | | | |
| Allowance for Loan Losses, Beginning of Period | $15,298 | $15,003 | $15,003 | $15,003 | $15,003 |
| Provision for Loan Losses, YTD | 100 | 845 | 670 | 520 | 280 |
| Loans Charged-off, YTD | (890) | (782) | (604) | (433) | (297) |
| Recoveries of Loans Previously Charged-off | 95 | 232 | 178 | 121 | 67 |
| Net Charge-offs, YTD | (795) | (550) | (426) | (312) | (230) |
| Allowance for Loan Losses, End of Period | $14,603 | $15,298 | $15,247 | $15,211 | $15,053 |
| | | | | | |
| Allowance for Loan Losses, Quarter-to-Date: | | | | | |
| Allowance for Loan Losses, Beginning of Period | $15,298 | $15,247 | $15,211 | $15,053 | $15,003 |
| Provision for Loan Losses, QTD | 100 | 175 | 150 | 240 | 280 |
| Loans Charged-off, QTD | (890) | (178) | (171) | (136) | (297) |
| Recoveries of Loans Previously Charged-off | 95 | 54 | 57 | 54 | 67 |
| Net Charge-offs, QTD | (795) | (124) | (114) | (82) | (230) |
| Allowance for Loan Losses, End of Period | $14,603 | $15,298 | $15,247 | $15,211 | $15,053 |
| | | | | | |
| Nonperforming Assets, at Period-End: | | | | | |
| Nonaccrual Loans | $5,218 | $6,633 | $6,088 | $6,822 | $5,476 |
| Restructured | 473 | 483 | 518 | 504 | 121 |
| Loans Past Due 90 or More Days and Still Accruing Interest | 259 | 920 | 150 | 510 | 511 |
| Total Nonperforming Loans | 5,950 | 8,036 | 6,756 | 7,836 | 6,108 |
| Repossessed Assets | 45 | 64 | 37 | 25 | 45 |
| Other Real Estate Owned | 1,149 | 970 | 797 | 812 | 510 |
| Total Nonperforming Assets | $7,144 | $9,070 | $7,590 | $8,673 | $6,663 |
| | | | | | |
| Asset Quality Ratios: | | | | | |
| Allowance to Nonperforming Loans | 245.43 % | 190.37 % | 225.68 % | 194.11 % | 246.45 % |
| Allowance to Period-End Loans | 1.25 | 1.30 | 1.32 | 1.33 | 1.32 |

| | | | | | |
|---|---|---|---|---|---|
| Provision to Average Loans (Quarter) [1] | 0.03 | 0.06 | 0.05 | 0.08 | 0.10 |
| Provision to Average Loans (YTD) [1] | 0.03 | 0.07 | 0.08 | 0.09 | 0.10 |
| Net Charge-offs to Average Loans (Quarter) [1] | 0.28 | 0.04 | 0.04 | 0.03 | 0.08 |
| Net Charge-offs to Average Loans (YTD) [1] | 0.28 | 0.05 | 0.05 | 0.06 | 0.08 |
| Nonperforming Loans to Total Loans | 0.51 | 0.69 | 0.59 | 0.68 | 0.54 |
| Nonperforming Assets to Total Assets | 0.34 | 0.45 | 0.37 | 0.44 | 0.33 |

[1] Annualized

Provision for Loan Losses

Through the provision for loan losses, an allowance is maintained that reflects our best estimate of probable incurred loan losses related to specifically identified loans as well as the inherent risk of loss related to the remaining portfolio. Loan charge-offs are recorded to this allowance when loans are deemed uncollectible, in whole or in part.

In the first quarter of 2013, we made a provision for loan losses of $100 thousand, a decrease of $75 thousand from the provision for the fourth quarter of 2012 and a decrease of $180 thousand from the provision for the first quarter of 2012. The decrease reflected a continued very modest level of net charge-offs (without considering the $753 thousand commercial loan charge-off in the first quarter of 2013, which was fully provided for in prior periods) combined with a general continuation of high quality across the portfolio, as indicated by other metrics, including the ratio of nonperforming loans to total loans and nonperforming assets to total assets, which continued at a very low and stable level.

# 45

We consider our accounting policy relating to the allowance for loan losses to be a critical accounting policy, given the uncertainty involved in evaluating the level of the allowance required to cover credit losses inherent in the loan portfolio, and the material effect that such judgments may have on our results of operations. Our process for determining the provision for loan losses is described in Note 3 to our Financial Statements beginning on page 12.

Risk Elements

Our nonperforming assets at March 31, 2013 amounted to $7.1 million, a decrease of $1.9 million, or 21.2%, from the December 31, 2012 total and an increase of $481 thousand or 7.2%, from the year earlier total. Our recent levels of nonperforming assets remain significantly below our peer group averages for the corresponding dates. At March 31, 2013, our ratio of loans past due 90 or more days plus nonaccrual loans plus other real estate owned to total assets was .34%, compared to our ratio at March 31, 2012 of .33%. Both ratios are well below the ratio of 2.12% for our peer group at December 31, 2012 (the latest date for which peer group information is available).

The following table presents the balance of other non-current loans at period-end as to which interest income was being accrued (i.e. loans 30 to 89 days past due, as defined in bank regulatory guidelines), which are not included in our nonperforming assets but entail heightened risk.

Loans Past Due 30-89 Days and Accruing Interest

| | 3/31/2013 | 12/31/2012 | 3/31/2012 |
|---|---|---|---|
| Commercial Loans | $849 | $1,246 | $412 |
| Commercial Real Estate Loans | 1,551 | 1,332 | 427 |
| Residential Real Estate Loans | 2,481 | 2,700 | 2,149 |
| Other Consumer Loans | 2,336 | 3,179 | 2,213 |
| Total Delinquent Loans | $7,217 | $8,457 | $5,201 |

At March 31, 2013, our loans in this category totaled $7.2 million, or 0.62% of loans then outstanding, a decrease of $1.2 million, or 14.7%, from the $8.5 million of such loans at December 31, 2012. The year-end 2012 total, in turn, equaled .72% of loans then outstanding. The decrease from December 31, 2012 is primarily attributable to one $1.4 million commercial loan that was partially charged-off ($753 thousand) with the remainder liquidated.

The number and dollar amount of our performing loans that demonstrate characteristics of potential weakness from time-to-time (potential problem loans) typically is a very small percentage of our portfolio. See the table of Credit Quality Indicators in Note 3 to the Financial Statements. We consider all accruing commercial and commercial real estate loans classified as substandard (as reported in Note 3) to be potential problem loans. The dollar amount of such loans at March 31, 2013 ($27.3 million) was up slightly from the dollar amount of such loans at December 31, 2012 and March 31, 2012. The amount of such loans depends principally on economic conditions in our geographic market area of northeastern New York State. In general, the economy in this area has been relatively strong in recent years, although we believe that a general weakening of the U.S. economy in upcoming periods would have an adverse effect on the economy in our market area as well, and on our commercial and commercial real estate portfolio.

As of March 31, 2013, we held for sale seven real estate properties in other real estate owned. As a result of our conservative underwriting standards, we do not expect to acquire a significant number of other real estate properties in the near term as a result of payment defaults or the foreclosure process, nor do we expect significant losses to be incurred generally from residential real estate borrowers who are experiencing stress due to the current economic environment.

We do not currently anticipate significant increases in our nonperforming assets, other non-current loans as to which interest income is still being accrued or potential problem loans, but can give no assurances in this regard.

CAPITAL RESOURCES

Important Proposed Changes to Regulatory Capital Standards

The Dodd-Frank Act directed U.S. bank regulators to promulgate new capital standards, which when adopted by regulators, must be at least as strict (i.e., must establish minimum capital levels that are at least as high) for banking organizations on a consolidated basis as the regulatory capital standards for U.S. insured depository financial institutions at the time Dodd-Frank was enacted in 2010.

The regulators, acting jointly, in June 2012, issued proposed new capital rules for U.S. banking organizations that aimed at implementing these Dodd-Frank capital requirements. These proposed rules were also intended to coordinate U.S. bank capital standards with the current drafts of the Basel III proposed international capital standards and would result in significantly more stringent standards upon full implementation than are now in place for U.S. financial institutions.
On November 9, 2012, the U.S. federal bank regulators announced that they would not implement their proposed new capital rules on the previously suggested effective date of January 1, 2013. Since this announcement, the regulatory authorities have been in the process of reviewing comments and concerns about the proposed new rules, which may be revised and re-issued by the regulators, perhaps in proposed form. However, no specific guidance was provided as of the end of 2012 regarding any planned revisions.
The following is a summary of the proposed new capital rules, as issued in June of 2012:

In general, the proposed new rules expand the risk-weighting categories of assets from 4 to 8 (although there are several other super-weighted categories for high-risk assets that are generally not held by community banks like us). The proposed rules also are more restrictive in their definitions of what qualify as capital components and set new, higher minimum capital ratios. Importantly, the June 2012 proposed rules require community banks like us to begin amortizing the trust preferred securities (TRUPs) held on their books as of May 19, 2010, over a 10-year period commencing in 2013, even though such TRUPs generally were accorded “grandfathered” status under Dodd-Frank itself (i.e., would be eligible in their entirety for Tier 1 capital treatment until maturity or redemption). Any such early amortization of TRUPs may present substantial additional difficulties for community banks, like us, that are and intend to remain well

capitalized but would prefer not have to seek additional capital to replace their amortized TRUPs, in what are currently very tight capital markets, as the price of continuing to grow their asset portfolios.
In addition, for all banking organizations, including ours, the proposed new rules would add a new capital ratio, a "common equity tier 1 capital ratio." The primary difference between this ratio and the current tier 1 leverage ratio is that only common equity will qualify as tier 1 capital under the new ratio. The new common equity tier 1 capital ratio also will include unrealized securities gains and losses as part of both capital and assets. In addition to setting higher minimum capital ratios, the June 2012 proposed new rules, as part of their general thrust in requiring enhanced capital for all banks, would introduce a new concept, a so-called "capital conservation buffer" (set at 2.5% under the proposed rules), which must be added to each of the proposed new minimum capital ratios (which by themselves are somewhat higher than the current minimum ratios). When, during economic downturns, an institution's capital begins to erode, the first deductions from a regulatory perspective would be taken against the conservation buffer; to the extent that buffer should erode below the required level, the bank would not necessarily be required to replace the capital deficit immediately and would face restrictions on paying dividends and other negative consequences until it did so. The following table compares the minimum capital ratios under the June 2012 proposed rules, including the 2.5% capital conservation buffer, with the current well-capitalized ratios:
Capital Ratios
Comparison of Proposed Minimum Ratios (including the buffer) to
Current Well-Capitalized Ratios

| Capital Ratio | Proposed Minimum (with 2.5% buffer) | Current Well-Capitalized |
|---|---|---|
| Common Equity Tier 1 Capital Ratio | 7.00% | N/A |
| Tier 1 Leverage Ratio | 6.50% | 5.00% |
| Tier 1 Risk-Based Capital Ratio | 8.50% | 6.00% |
| Total Risk-Based Capital Ratio | 10.50% | 10.00% |

The changes in the proposed new capital rules that would have the largest impact on our regulatory capital position, at the holding company and the bank level, include:

- the possible phase-out over 10 years of TRUPs as Tier 1 capital for mid-sized banks such as Arrow (see the discussion in the section "Recent Legislative Developments - Dodd-Frank Act" on page 35, above, and the discussion below under “Current Regulatory Capital Standards”);
- a risk-weighting scheme for residential real estate loans based on loan to value ratios;
- risk-weighting nonperforming loans at 150% of the carrying value thereof, versus 100% at present; and
- a requirement to include unrealized gains or losses on available-for-sale securities, net of tax, as a component of capital.

We note that if the proposed new capital rules issued in June 2012 had been effective on March 31, 2013, as initially planned, our capital ratios would have exceeded each of the proposed minimums, including the capital conservation buffer.

As mentioned above, the proposed new capital rules issued by the bank regulators in June 2012 are undergoing further review and consideration on their part, as of the date of this Report, and may be revised before becoming final. Because of the uncertainty surrounding these proposed new capital requirements, we are not able to predict at this time the standards that may ultimately become applicable to Arrow under these rules, or the impact they may have on Arrow. We do believe the new standards will require higher minimum levels of capital for U.S. financial institutions, maybe significantly higher, than the minimum levels required under the current standards.

Current Regulatory Capital Standards

The discussion and disclosure below on current regulatory capital standards is qualified in its entirety by reference to the fact that, as discussed above, the content and impact of the new capital standards to be implemented under the Dodd-Frank Act are currently not known.

Regulatory Capital: The following discussion of capital focuses on current regulatory capital ratios, as defined and mandated for financial institutions by federal bank regulatory authorities. Regulatory capital, although a financial measure that is not provided for or governed by GAAP, nevertheless has been exempted by the SEC from the definition of "non-GAAP financial measures" in the SEC's Regulation G governing disclosure by registered companies of non-GAAP financial measures. Thus, certain information which is generally required to be presented in connection with our disclosure of non-GAAP financial measures need not be provided, and has not been provided, for the regulatory capital measures discussed below.

Current Capital Standards: Our holding company and our subsidiary banks are currently subject to two sets of regulatory capital measures, risk-based capital guidelines and a leverage ratio test. The risk-based guidelines assign risk weightings to all assets and certain off-balance sheet items of financial institutions, which generally results in a substantial discounting of low-risk or risk-free assets, that is, a significant dollar amount of such assets disappears from the balance sheet. The guidelines then establish an 8% minimum ratio of qualified total capital to risk-weighted assets. At least half of total capital must consist of "Tier 1" capital, which comprises common equity and common equity equivalents, retained earnings, a limited amount of permanent preferred stock and (for holding companies) a limited amount of trust preferred securities (see the discussion below on these securities), less intangible assets, net of associated deferred tax liabilities. Up to half of total capital may consist of so-called "Tier 2" capital, comprising a limited amount of subordinated debt, other preferred stock, certain other instruments and a limited amount of the allowance for loan losses.

The second regulatory capital measure, the leverage ratio test, establishes minimum limits on the ratio of Tier 1 capital to total tangible assets, without risk weighting (i.e, discounting). For top-rated companies, the minimum leverage ratio currently is 4%, but lower-rated or rapidly expanding companies may be required by bank regulators to meet substantially higher minimum leverage ratios. Federal banking law mandates certain actions to be taken by banking regulators for financial institutions that are deemed undercapitalized as measured under regulatory capital guidelines. The law establishes five levels of capitalization for financial institutions ranging from "well-capitalized" (the highest ranking) to "critically undercapitalized" (the lowest ranking). Federal banking law also ties the ability of banking organizations to engage in certain types of non-banking financial activities to such organizations' continuing to qualify as "well-capitalized" under these standards.

Capital Ratios: The table below sets forth the capital ratios of our holding company and subsidiary banks, Glens Falls National and Saratoga National, as of March 31, 2013:

| | Tier 1 Leverage Ratio | | Tier 1 Risk-Based Capital Ratio | | Total Risk-Based Capital Ratio | |
|---|---|---|---|---|---|---|
| Arrow Financial Corporation | 9.30 | % | 15.15 | % | 16.34 | % |
| Glens Falls National Bank & Trust Co. | 9.03 | % | 15.06 | % | 16.23 | % |
| Saratoga National Bank & Trust Co. | 9.60 | % | 13.94 | % | 15.17 | % |
| | | | | | | |
| Regulatory Minimum | 4.00 | | 4.00 | | 8.00 | |
| FDICIA's "Well-Capitalized" Standard | 5.00 | | 6.00 | | 10.00 | |

At March 31, 2013 our holding company and both banks exceeded the minimum capital ratios established by the currently applicable regulatory guidelines, and also qualified as "well-capitalized", the highest category, in the capital classification scheme set by federal bank regulatory agencies (see the further discussion under "Supervision and Regulation" in Part I Item 1.C. of this Report).

As discussed in the preceding section of this Report, "Important Proposed Changes to Regulatory Capital Standards," there is considerable current speculation in banking and financial circles that bank regulatory capital guidelines will likely be significantly modified in forthcoming periods, based on the provisions in the Dodd-Frank Act setting new capital standards for banks and the proposed new capital rules issued in June 2012 by bank regulators, so as to require a greater degree of capital protection against sudden financial stress within banks. However, there is no certainty on what these enhanced capital standards will look like or over what period they will be imposed on the banking sectors.

Capital Components; Stock Repurchases; Dividends

Stockholders' Equity: Stockholders' equity was $177.8 million at March 31, 2013, an increase of $2.0 million, or 1.1%, from the prior year-end. The most significant contributions to stockholders' equity included net income of $5.2 million and equity received from our various stock-based compensation and dividend reinvestment plans of $610 thousand. These changes on Arrow's total shareholders' equity were offset, in part, by cash dividends of $3.0 million and purchases of our own common stock of $1.3 million.

Trust Preferred Securities Under Dodd-Frank: In each of 2003 and 2004, we issued $10 million of trust preferred securities (TRUPs) in a private placement. Under the Federal Reserve Board's pre-existing rules on regulatory capital, TRUPs typically would qualify as Tier 1 capital for bank holding companies such as ours but only in amounts up to 25% of Tier 1 capital, net of goodwill less any associated deferred tax liability. Under the Dodd-Frank Act, any trust preferred securities issued by banking organizations such as Arrow on or after the grandfathering date set forth in Dodd-Frank (May 19, 2010) will no longer qualify as Tier 1 capital under bank regulatory capital guidelines; however, our TRUPs outstanding prior to this grandfathering cutoff date may continue to qualify as Tier 1 capital until maturity or redemption. However, as stated above, the proposed new capital rules issued by bank regulators in June

2012, if adopted in the form proposed, would impose an additional restriction on such TRUPs, requiring us to "phase-out" their treatment as Tier 1 capital in equal annual installments over a 10-year period, beginning in 2013.

Stock Repurchase Program: At its regular meeting in December 2012, the Board of Directors approved a 12-month stock repurchase program (the "January 2013 program") authorizing the repurchase, at the discretion of senior management, during calendar year 2013 of up to $5 million of Arrow's common stock in open market or privately negotiated transactions. This program replaced a similar $5 million stock repurchase program which was approved in November 2011 (the "January 2012 program"), of which authorized amount a total of $3.3 million was applied to repurchases by the end of that program in December 2012. Under the January 2013 program, as under the January 2012 program, management is authorized to effect stock repurchases from time-to-time, to the extent that it believes the Company's stock is reasonably priced and such repurchases appear to be an attractive use of available capital and in the best interests of stockholders. Through March 31, 2013, 50,600 shares having an aggregate purchase price of $1.2 million had been acquired under the January 2013 program.

Dividends: Our common stock is traded on NasdaqGS® - AROW. The high and low stock prices for the past five quarters listed below represent actual sales transactions, as reported by NASDAQ. On May 1, 2013, our Board of Directors declared the 2013 second quarter cash dividend of $.25 payable on June 15, 2013. Per share amounts in the following table have been restated for our September 2012 2% stock dividend.

| | Market Price Low | High | Cash Dividends Declared |
|---|---|---|---|
| 2012 | | | |
| First Quarter | $22.80 | $26.62 | $0.245 |
| Second Quarter | 22.60 | 24.37 | 0.245 |
| Third Quarter | 23.26 | 25.68 | 0.245 |
| Fourth Quarter | 22.86 | 25.50 | 0.250 |
| 2013 | | | |
| First Quarter | $23.60 | $25.57 | $0.250 |
| Second Quarter (dividend payable June 15, 2013) | | | 0.250 |

| | Quarter Ended March 31, 2013 | 2012 |
|---|---|---|
| Cash Dividends Per Share | $0.250 | $0.245 |
| Diluted Earnings Per Share | 0.43 | 0.44 |
| Dividend Payout Ratio | 58.14 % | 55.68 % |
| Total Equity (in thousands) | $177,803 | $168,466 |
| Shares Issued and Outstanding (in thousands) | 12,010 | 11,996 |
| Book Value Per Share | $14.80 | $14.04 |
| Intangible Assets (in thousands) | $26,460 | $26,653 |
| Tangible Book Value Per Share | $12.60 | $11.82 |

LIQUIDITY

Our liquidity is measured by our ability to raise cash when we need it at a reasonable cost. We must be capable of meeting expected and unexpected obligations to our customers at any time. Given the uncertain nature of customer demands as well as the need to maximize earnings, we must have available reasonably priced sources of funds, on- and off-balance sheet, that can be accessed quickly in time of need.

Our primary sources of available liquidity are overnight investments in federal funds sold, interest bearing bank balances at the Federal Reserve Bank, and cash flow from investment securities and loans, both from normal repayment cash-flows and prepayments. Certain investment securities are selected at purchase as available-for-sale based on their marketability and collateral value, as well as their yield and maturity. Our securities available-for-sale portfolio was $478.8 million at period-end 2013, unchanged from the year-end 2012 level, resulting from the fact that maturities and our sale during the completed quarter of securities for asset and liability management purposes were redeployed in the portfolio. Due to the potential for volatility in market values, we are not always able to assume that securities may be sold on short notice at their carrying value, even to provide needed liquidity.

In addition to liquidity from short-term investments, investment securities and loans, we have supplemented available liquidity with additional off-balance sheet sources such as federal funds lines of credit and credit lines with the Federal Home Loan Bank of New York (“FHLBNY”). We have established federal funds lines of credit with three correspondent banks totaling $30 million, but did not draw on these lines during 2013.

Through our borrowing relationship with the FHLBNY, we have pledged collateral, including mortgage-backed securities and residential mortgage loans. Our unused borrowing capacity at the FHLBNY was $82.3 million at March 31, 2013.

In addition, we have identified brokered certificates of deposit as an appropriate off-balance sheet source of funding accessible in a relatively short time period. Also, our two bank subsidiaries have each established a borrowing facility with the Federal Reserve Bank of New York, pledging certain consumer loans as collateral for potential “discount window” advances. At March 31, 2013, the amount available under this facility was $269.5 million, but there were no advances then outstanding. We measure and monitor our basic liquidity as a ratio of liquid assets to short-term liabilities, both with and without the availability of borrowing arrangements. Based on the level of overnight funds investments, available liquidity from our investment securities portfolio, cash flow from our loan portfolio, our stable core deposit base and our significant borrowing capacity, we believe that our liquidity is sufficient to meet all funding needs that may arise in connection with any reasonably likely events or occurrences.

During the past several quarters, our liquidity position has been strong, as depositors and investors in the wholesale funding markets have shown no hesitations on placing or maintaining their funds with our banks. In addition, management has consciously maintained a strong liquidity position by emphasizing its short maturity asset portfolios, including cash and due from banks, as opposed to investments in longer-term assets which might generate slightly higher rates (albeit rates that are still historically low for the maturities in question) but would also represent a loss of liquidity. The financial markets have been challenging for many financial institutions, and the widely accepted view is that a lack of liquidity has been as great a problem for many troubled institution as capital shortage. As a result, liquidity premiums have widened and many banks have experienced certain liquidity constraints, including substantially increased pricing to retain deposit balances. Because of Arrow's favorable credit quality and strong balance sheet, Arrow has not experienced any significant liquidity constraints through the date of this Report and has not been forced to pay premium rates to obtain retail deposits or other funds from any source.

RESULTS OF OPERATIONS
Three Months Ended March 31, 2013 Compared With
Three Months Ended March 31, 2012

Summary of Earnings Performance
(Dollars in Thousands, Except Per Share Amounts)

| | Quarter Ended | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| | 03/31/2013 | | 03/31/2012 | | Change | | % Change | |
| Net Income | $5,181 | | $5,288 | | $(107 | ) | (2.0 | )% |
| Diluted Earnings Per Share | 0.43 | | 0.44 | | (0.01 | ) | (2.3 | ) |
| Return on Average Assets | 1.03 | % | 1.09 | % | (0.06 | )% | (5.5 | ) |
| Return on Average Equity | 11.88 | % | 12.67 | % | (0.79 | )% | (6.2 | ) |

We reported earnings (net income) of $5.2 million and diluted earnings per share (EPS) of $.43 for the first quarter of 2013, compared to net income of $5.3 million and EPS of $.44 for the first quarter of 2012.
Both quarters included net gains on the sale of securities: $318 thousand, net of tax, in the 2013 quarter, representing a positive impact on EPS of $.026; and $303 thousand, net of tax, in the 2012 quarter, representing a positive impact on EPS of $.025.

The following narrative discusses the quarter-to-quarter changes in net interest income, noninterest income, noninterest expense and income taxes.

Net Interest Income
Summary of Net Interest Income
(Taxable Equivalent Basis, Dollars in Thousands)

| | Quarter Ended | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| | 03/31/2013 | | 03/31/2012 | | Change | | % Change | |
| Interest and Dividend Income | $17,059 | | $18,810 | | $(1,751 | ) | (9.3 | )% |
| Interest Expense | 2,239 | | 3,532 | | (1,293 | ) | (36.6 | ) |
| Net Interest Income | 14,820 | | 15,278 | | (458 | ) | (3.0 | ) |
| Tax-Equivalent Adjustment | 1,063 | | 872 | | 191 | | 21.9 | |
| Average Earning Assets (1) | 1,922,863 | | 1,845,576 | | 77,287 | | 4.2 | |
| Average Interest-Bearing Liabilities | 1,590,401 | | 1,545,098 | | 45,303 | | 2.9 | |
| | | | | | | | | |
| Yield on Earning Assets (1) | 3.60 | % | 4.10 | % | (0.50 | )% | (12.2 | ) |
| Cost of Interest-Bearing Liabilities | 0.57 | | 0.92 | | (0.35 | ) | (38.0 | ) |
| Net Interest Spread | 3.03 | | 3.18 | | (0.15 | ) | (4.7 | ) |
| Net Interest Margin | 3.13 | | 3.33 | | (0.20 | ) | (6.0 | ) |

(1) Includes Nonaccrual Loans

Our net interest margin (net interest income on a tax-equivalent basis divided by average earning assets, annualized) fell by 20 bases points, from 3.33% to 3.13%, between the first quarter of 2012 and the first quarter of 2013, representing a 6% decrease in the margin. (See the discussion under “Use of Non-GAAP Financial Measures,” on page 32, regarding our net interest margin and net interest income, which are commonly used non-GAAP financial measures.) Our net interest spread (average yield on interest-earning assets minus the average rate paid on interest-bearing liabilities) dropped by 15 basis points between the respective quarters, from 3.18% to 3.03%, a decrease of 4.7%. These measures reflect a continuing trend impacting most commercial banks, i.e., the consistent pressure on margins resulting from a very low interest rate environment. In management's view, this trend of margin compression is likely to persist in the foreseeable future. Net interest income for the just completed quarter, on a taxable equivalent basis, was lower by $458 thousand, or 3.0%, from the first quarter of 2012, as the 6.0% decrease in our net interest margin between the periods was offset, in part, by the 4.2% increase in our average earning assets. The impact of recent interest rate changes on our net interest margin and net interest income are discussed above in this

Report under the sections entitled “Deposit Trends,” “Impact of Interest Rate Changes” and “Loan Trends.”
The provisions for loan losses were $100 thousand and $280 thousand for the quarters ended March 31, 2013 and 2012, respectively. The provision for loan losses was discussed previously under the heading "Asset Quality" beginning on page 45.

Noninterest Income
Summary of Noninterest Income
(Dollars in Thousands)

| | Quarter Ended | | | |
|---|---|---|---|---|
| | 03/31/2013 | 03/31/2012 | Change | % Change |
| Income From Fiduciary Activities | $1,574 | $1,622 | $(48) | (3.0)% |
| Fees for Other Services to Customers | 2,282 | 1,960 | 322 | 16.4 |
| Insurance Commissions | 2,028 | 1,889 | 139 | 7.4 |
| Net Gain on Securities Transactions | 527 | 502 | 25 | 5.0 |
| Net Gain on the Sale of Loans | 607 | 357 | 250 | 70.0 |
| Other Operating Income | 156 | 229 | (73) | (31.9) |
| Total Noninterest Income | $7,174 | $6,559 | $615 | 9.4 |

Total noninterest income in the just completed quarter was $7.2 million, an increase of $615 thousand, or 9.4%, from total noninterest income of $6.6 million for the first quarter of 2012. Although other areas of noninterest income experienced increases from last year's quarter, the greatest gains were in fees for other services to customers, net gains on the sale of loans and insurance commissions. Net gain on the sale of loans increased substantially in the 2013 quarter versus the 2012 quarter due to the fact that the volume of sales increased in the 2013 period, reflecting an increase in activity as the Fed continues to hold down longer term rates by means of their purchases of mortgage-backed securities.

For the just completed 2013 quarter, income from fiduciary activities decreased $48 thousand, or 3.0%, from the comparable 2012 quarter. At quarter-end 2013, the market value of assets under trust administration and investment management amounted to $1.095 billion, an increase of $56.5 million, or 5.4%, from quarter-end 2012. The growth in balances was generally attributable to the addition of new accounts and positive investment returns. The quarter-to-quarter decrease in income was primarily attributable to a decrease in estate administration fees, which is a more volatile source of income from fiduciary activities. In addition, period-end values of assets under administration may not necessarily reflect average values of assets during the periods in question, due to the significant fluctuations in the equity and bond markets from time-to-time. A significant portion of our fiduciary fees, however, is indexed to the dollar amount of assets under administration.

Fees for other services to customers includes service charges on deposit accounts, debit card interchange fees, revenues related to the sale of mutual funds to our customers by third party providers and servicing income on sold loans. Effective October 1, 2011 VISA announced new, reduced debit interchange rates and related modifications to comply with new debit card interchange fee rules promulgated by the Federal Reserve under the Dodd-Frank Act. This reduced rate structure has had, and will continue to have, a slight but noticeable negative impact on our fee income. However, debit card usage by our customers continues to grow which has offset, and if the trend continues, will continue to offset, at least in part, the negative effect of reduced debit interchange rates. We do not believe that Visa's new limits on interchange fees resulting from Dodd-Frank will have a material adverse impact on our financial condition or results of operations in future periods. The increase in quarter-to-quarter income in this area was primarily attributable to debit card activity.

Insurance commissions first became a significant source of noninterest income for us in the mid 2000s, following our 2004 acquisition of an insurance agency, Capital Financial Group, Inc. Capital Financial specializes in selling and servicing group health care policies as well as life insurance. During the past two years we acquired three additional insurance agencies which sell primarily property and casualty insurance to retail customers in our service area. On April 1, 2010, we acquired Loomis and LaPann, Inc., on February 1, 2011, we acquired Upstate Agency, Inc., and on August 1, 2011, we acquired the McPhillips Agencies. In each of these acquisitions, we retained all key insurance agency personnel. We have consolidated some of the insurance agency offices into our branch bank buildings. We expect that noninterest income from insurance commissions will continue to increase in upcoming periods as a result of our recent expansion of and emphasis on this line of business.

The decrease in other operating income was primarily attributable to losses on the sales of other real estate owned.

Noninterest Expense
Summary of Noninterest Expense
(Dollars in Thousands)

| | Quarter Ended | | | |
|---|---|---|---|---|
| | 03/31/2013 | 03/31/2012 | Change | % Change |
| Salaries and Employee Benefits | $7,621 | $7,903 | $(282) | (3.6)% |
| Occupancy Expense of Premises, Net | 1,210 | 1,054 | 156 | 14.8 |
| Furniture and Equipment Expense | 1,066 | 970 | 96 | 9.9 |
| FDIC and FICO Assessments | 264 | 255 | 9 | 3.5 |
| Amortization | 124 | 138 | (14) | (10.1) |
| Other Operating Expense | 3,126 | 2,826 | 300 | 10.6 |
| Total Noninterest Expense | $13,411 | $13,146 | $265 | 2.0 |
| Efficiency Ratio | 61.90% | 60.97% | 0.93% | 1.5 |

Noninterest expense for the first quarter of 2013 was $13.4 million, an increase of $265 thousand, or 2.0%, from the expense for the first quarter of 2012. For the first quarter of 2013, our efficiency ratio was 61.90%. This ratio, which is a commonly used non-GAAP financial measure in the banking industry, is a comparative measure of a financial institution's operating efficiency. The efficiency ratio (a ratio where lower is better) is the ratio of noninterest expense (excluding, under our definition, intangible asset amortization) to (i) net interest income (on a tax-equivalent basis) plus (ii) noninterest income (excluding net securities gains or losses). See the discussion on page 32 of this Report under the heading "Use of Non-GAAP Financial Measures." The efficiency ratio included by the Federal Reserve Board in its "Peer Holding Company Performance Reports" excludes net securities gains or losses from the denominator (as does our calculation), but unlike our ratio does not exclude intangible asset amortization from the numerator. Our efficiency ratios in recent periods compared favorably to the ratios of our peer group, even adjusting for the definitional differences. For the year-to-date period ended December 31, 2012 (the most recent reporting period for which peer group information is available), the peer group ratio was 70.23%, and our ratio was 59.21% (not adjusted).
Salaries and employee benefits expense were actually lower in 2013 than in 2012 due primarily to the retirement of two experienced senior officers on December 31, 2012 and decreased provisions for incentive compensation.
The increase in occupancy expense was attributable to an increase in utilities at all of our facilities and to the November 2012 opening of a newly constructed building adjacent to our main office in downtown Glens Falls, New York, housing our commercial lending activities and our trust department's sales, administration and operations.
The increase in furniture and equipment expense was primarily attributable to an increase in equipment depreciation and data processing expenses.
Other operating expense includes a variety of categories. In our case, the categories demonstrating the largest increase in cost between the periods was third party computer processing expenses and carrying costs for other real estate owned.

Income Taxes
Summary of Income Taxes
(Dollars in Thousands)

| | Quarter Ended | | | |
|---|---|---|---|---|
| | 03/31/2013 | 03/31/2012 | Change | % Change |
| Provision for Income Taxes | $2,239 | $2,251 | $(12) | (0.5)% |
| Effective Tax Rate | 30.2% | 29.9% | 0.3 | 1.0 |

The provisions for federal and state income taxes amounted to $2.2 million and $2.3 million for the respective three-month periods of 2013 and 2012. The effective tax rate was essentially unchanged.

# 52

Item 3.
QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

In addition to credit risk in our loan portfolio and liquidity risk, discussed on page 49 of this Report, our business activities also generate market risk. Market risk is the possibility that changes in future market rates (interest rates) or prices (fees for products and services) will make our position less valuable. The ongoing monitoring and management of market risk, principally interest rate risk, is an important component of our asset/liability management process, which is governed by policies that are reviewed and approved annually by the Board of Directors. The Board of Directors delegates responsibility for carrying out asset/liability oversight and control to management's Asset/Liability Committee ("ALCO"). In this capacity ALCO develops guidelines and strategies impacting our asset/liability profile based upon estimated market risk sensitivity, policy limits and overall market interest rate levels and trends. We have not made use of derivatives, such as interest rate swaps, in our risk management process.

Interest rate risk is the most significant market risk affecting us, more important to us, we believe, than credit risk or liquidity risk. Interest rate risk is the exposure of our net interest income to changes in interest rates. Interest rate risk is directly related to the different maturities and repricing characteristics of interest-bearing assets and liabilities, as well as to the risk of prepayment of loans and early withdrawal of time deposits, and the fact that the speed and magnitude of responses to interest rate changes vary by product.

The ALCO utilizes the results of a detailed and dynamic simulation model to quantify the estimated exposure of net interest income to sustained interest rate changes. While ALCO routinely monitors simulated net interest income sensitivity over a rolling two-year horizon, it also utilizes additional tools to monitor potential longer-term interest rate risk.

Our current simulation model attempts to capture the impact of changing interest rates on the interest income received and interest expense paid on all interest-sensitive assets and liabilities reflected on our consolidated balance sheet. This sensitivity analysis is compared to ALCO policy limits which specify a maximum tolerance level for net interest income exposure over a one year horizon, assuming no balance sheet growth and a 200 basis point upward and a 100 basis point downward shift in interest rates, and a repricing of interest-bearing assets and liabilities at their earliest reasonably predictable repricing date. We normally apply a parallel and pro-rata shift in rates for both assets and liabilities, over a 12 month period.

We occasionally are forced to make ad hoc adjustments to our model. Throughout the first three months of 2013, the targeted federal funds rate remained within a range of 0 to .25%. The resulting abnormally low short-term rates caused us to reevaluate our assumptions for the decreasing rate simulation for short-term liabilities and assets, particularly short-term liabilities, because we cannot project the effect of a deposit or other liability rate decrease below zero and prevailing rates for many of our liabilities, especially short-term deposits, are already very close to zero. Hence, although we applied our usual 100 basis point downward shift in interest rates for liabilities and assets on the long end of the yield curve, we were limited by an absolute floor of a zero interest rate for short-term modeling of our rate decreases. Consequently, for purposes of determining the effect of a downward shift in rates under our current simulation model, we made no downward shift in interest rates for our liabilities or our assets on the short end of the yield curve, even if such rates slightly exceed zero at the measurement date. We also always assume that hypothetical interest rate shifts, upward or downward, affect assets and liabilities simultaneously, depending upon the contractual maturities of the particular assets and liabilities in question. In practice, however, shifts in prevailing interest rates are typically experienced by us more rapidly in our liability portfolios (primarily deposits) than in our asset portfolios, irrespective of differences in contractual maturities (which, however, also tend to favor more rapid liabilities repricing).

Applying the simulation model analysis as of March 31, 2013, a 200 basis point increase in all interest rates demonstrated a 2.20% decrease in net interest income, and a 100 basis point decrease in long-term interest rates (with no decrease in short-term rates, adjusted as discussed above) demonstrated a 1.11% decrease in net interest income when compared with our base projection. These amounts were well within our ALCO policy limits. The preceding sensitivity analysis does not represent a forecast on our part and should not be relied upon as being indicative of expected operating results.

The hypothetical estimates underlying the sensitivity analysis are based upon numerous assumptions including: the nature and timing of changes in interest rates including yield curve shape, prepayments on loans and securities, deposit decay rates, pricing decisions on loans and deposits, reinvestment/replacement of asset and liability cash flows, and others. While assumptions are developed based upon current economic and local market conditions, we cannot make any assurance as to the predictive nature of these assumptions including how customer preferences or competitor influences might change.

Also, as market conditions vary from those assumed in the sensitivity analysis, actual results may differ due to: prepayment/refinancing levels deviating from those assumed, the varying impact of interest rate changes on caps or floors on adjustable rate assets, the potential effect of changing debt service levels on customers with adjustable rate loans, depositor early withdrawals and product preference changes, unanticipated shifts in the yield curve and other internal/external variables. Furthermore, the sensitivity analysis does not reflect actions that ALCO might take in responding to or anticipating changes in interest rates.

## Item 4.

## CONTROLS AND PROCEDURES

Senior management, including the Chief Executive Officer and Chief Financial Officer, has evaluated the effectiveness of the design and operation of Arrow's disclosure controls and procedures (as defined in Rule 13a-15(e) under the Securities Exchange Act of 1934, as amended) as of March 31, 2013. Based upon that evaluation, senior management, including the Chief Executive Officer and Chief Financial Officer, concluded that our disclosure controls and procedures were effective. Further, there were no changes made in our internal control over financial reporting that occurred during the most recent fiscal quarter that had materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

PART II - OTHER INFORMATION
Item 1.
Legal Proceedings
We are not the subject of any material pending legal proceedings, other than ordinary routine litigation occurring in the normal course of our business. On an ongoing basis, we are the subject of, or a party to, various legal claims against us, by us against other parties, or involving us, which arise in the normal course of our business. The various pending legal claims against us will not, in the opinion of management based upon consultation with counsel, result in any material liability.

Item 1.A.
Risk Factors
We believe that the risk factors identified in our Annual Report on Form 10-K for the year ended December 31, 2012, continue to represent the most significant risks to our future results of operations and financial conditions, without modification or amendment. Please refer to such risk factors listed in Part I, Item 1A. of our Annual Report filed on Form 10-K for the fiscal year ended December 31, 2012.
Item 2.
Unregistered Sales of Equity Securities and Use of Proceeds
Issuer Purchases of Equity Securities
The following table presents information about purchases by Arrow of its own equity securities (i.e., Arrow’s common stock) during the three months ended March 31, 2013:

| First Quarter 2013 Calendar Month | (A) Total Number of Shares Purchased [1] | (B) Average Price Paid Per Share [1] | (C) Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs [2] | (D) Maximum Approximate Dollar Value of Shares that May Yet be Purchased Under the Plans or Programs [3] |
|---|---|---|---|---|
| January | 13,695 | $24.10 | 10,000 | $4,762,200 |
| February | 7,186 | 24.66 | — | 4,762,200 |
| March | 60,608 | 24.71 | 40,600 | 3,761,004 |
| Total | 81,489 | 24.61 | 50,600 | |

[1] Share amounts and average prices listed in columns A and B (total number of shares purchased and the average price paid per share) include, in addition to shares repurchased under the Company’s publicly announced stock repurchase program, shares purchased in open market transactions under the Arrow Financial Corporation Automatic Dividend Reinvestment Plan (DRIP) by the administrator of the DRIP and shares surrendered (or deemed surrendered) to Arrow by holders of options to acquire Arrow common stock in connection with the exercise of such options. In the months indicated, the total number of shares purchased listed in column A included the following numbers of shares purchased through such additional methods: January – DRIP market purchases (3,695 shares); February – DRIP market purchases (3,555 shares), Employee Stock Plans (3,631 shares); March – DRIP market purchases (20,008 shares).
[2] Represents the number of shares repurchased under the Company’s publicly-announced stock repurchase program in effect during such period (i.e., the $5 million stock repurchase program authorized by the Board of Directors in November 2012 and effective January 1, 2013 (the “2013 Repurchase Program”)).
[3] Represents the dollar amount of repurchase authority remaining at each month-end during the quarter under the 2013 Repurchase Program, the Company’s only publicly-announced stock repurchase program in effect at the end of each such month.

Item 3.
Defaults Upon Senior Securities - None

Item 4.
Mine Safety Disclosures - None

Item 5.
Other Information - None

Item 6.
Exhibits

| Exhibit Number | Exhibit |
|---|---|
| 15 | Awareness Letter |
| 31.1 | Certification of Chief Executive Officer under SEC Rule 13a-14(a)/15d-14(a) |
| 31.2 | Certification of Chief Financial Officer under SEC Rule 13a-14(a)/15d-14(a) |
| 32 | Certification of Chief Executive Officer under 18 U.S.C. Section 1350 and Certification of Chief Financial Officer under 18 U.S.C. Section 1350 |
| 101.INS | XBRL Instance Document |
| 101.SCH | XBRL Taxonomy Extension Schema Document |
| 101.CAL | XBRL Taxonomy Extension Calculation Linkbase Document |
| 101.DEF | XBRL Taxonomy Extension Definition Linkbase Document |
| 101.LAB | XBRL Taxonomy Extension Labels Linkbase Document |
| 101.PRE | XBRL Taxonomy Extension Presentation Linkbase Document |

SIGNATURES

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

ARROW FINANCIAL CORPORATION
Registrant

| | |
|---|---|
| May 8, 2013<br>Date | /s/Thomas J. Murphy<br>Thomas J. Murphy, President and<br>Chief Executive Officer |
| May 8, 2013<br>Date | /s/Terry R. Goodemote<br>Terry R. Goodemote, Executive Vice President,<br>Treasurer and Chief Financial Officer<br>(Principal Financial Officer and<br>Principal Accounting Officer) |

# 56