ARROW FINANCIAL CORP
Form 10-K
March 15, 2013

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

Annual Report Pursuant to Section 13 or 15(d) of
The Securities Exchange Act of 1934
For the Fiscal Year Ended December 31, 2012
Commission File Number: 0-12507
ARROW FINANCIAL CORPORATION

(Exact name of registrant as specified in its charter)

New York	22-2448962
(State or other jurisdiction of incorporation or organization)	(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
SECURITIES REGISTERED PURSUANT TO SECTION 12(b) OF THE ACT: NONE
SECURITIES REGISTERED PURSUANT TO SECTION 12(g) OF THE ACT:
Common Stock, Par Value $1.00
(Title of Class)
Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act.
Yes x No
Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes x No
Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. 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 if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K (§ 229.405 of this chapter) is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K.
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 the definitions 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 Act). Yes x No

State the aggregate market value of the voting and non-voting common equity held by non-affiliates computed by reference to the price at which the common equity was last sold, or the average bid and asked price of such common equity, as of the last business day of the registrant's most recently completed second fiscal quarter: $284,027,478
Indicate the number of shares outstanding of each of the registrant's classes of common stock, as of the latest practicable date.

Class	Outstanding as of February 22, 2013
Common Stock, par value $1.00 per share	12,041,421

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the Registrant's Proxy Statement for the Annual Meeting of Stockholders to be held May 1, 2013 (Part III)

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*These items are incorporated by reference to the Corporation’s Proxy Statement for the Annual Meeting of Stockholders to be held May 1, 2013.

NOTE ON TERMINOLOGY

In this Annual Report on Form 10-K, the terms “Arrow,” “the registrant,” “the company,” “we,” “us,” and “our” generally refe Arrow Financial Corporation and 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. Subsidiaries of Glens Falls National include Capital Financial Group, Inc. (an insurance agency specializing in selling and servicing group health care policies and life insurance), Loomis & LaPann, Inc. (a property and casualty and sports accident and health insurance agency), Upstate Agency, LLC (a property and casualty insurance agency), Glens Falls National Insurance Agencies, LLC (a property and casualty insurance agency - currently doing business under the name of McPhillips Insurance Agency), North Country Investment Advisers, Inc. (a registered investment adviser that provides investment advice to our proprietary mutual funds) and Arrow Properties, Inc., a real estate investment trust (REIT).

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, and peer group data has been derived from such Report. This peer group is not, however, identical to either of the peer groups comprising the two bank indices included in the stock performance graphs on pages 18 and 19 of this Report.

FORWARD-LOOKING STATEMENTS

The information contained in this Annual Report on Form 10-K 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 often identify such forward-looking statements. Some of these statements, such as those included in the interest rate sensitivity analysis in Item 7A of this Report, 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 activity, both locally and nationally, as well as current management strategies for future operations and development.

Examples of forward-looking statements in this Report are referenced in the table below:

Topic	Section	Page	Location
Impact of Legislative Developments	Part I, Item 1.D.	11	Last paragraph in Section D
	Part II, Item 7.A.	26	Paragraph in "Health Care Reform"
Impact of Changing Interest Rates on Earnings	Part II, Item 7.B.I.	31	Last 3 paragraphs
	Part II, Item 7.C.II.a.	40	Last paragraph under “Automobile Loans”
	Part II, Item 7.C.II.a.	41	3rd and 4th paragraph under table
	Part II, Item 7.C.IV.	45	3rd full paragraph
	Part II, Item 7A.	53	Last 4 paragraphs
Adequacy of the Allowance for Loan Losses	Part II, Item 7.B.II.	33	1st paragraph under “II. Provision For Loan Losses and Allowance For Loan Losses”
	Part II, Item 7.C.II.a.	40	2nd paragraph under “Residential

Expected Level of Real Estate Loans			Real Estate Loans”
Liquidity	Part II, Item 7.D.	47	Last 2 paragraphs under "Liquidity"
Dividend Capacity	Part I, Item 1.C.	7	1st paragraph under "New Capital Standards to be Promulgated"
		8	2nd and 4th full paragraphs
	Part II, Item 7.E.	48	Last paragraph under "Important Changes to Regulatory Capital Standards"
	Part II, Item 7.E.	49	1st paragraph under "Dividends"
Commitments to Extend Credit	Part II, Item 8	77	3rd paragraph in Note 8
		78	Last 2 paragraphs in Note 8
VISA Estimation	Part II, Item 7.A.	27	Last paragraph under "VISA Transactions - Reversal of the Litigation Reserve"
Noninterest Income	Part II, Item 7.C.IV	34	Last 3 paragraphs
		35	First full paragraph
Pension plan return on assets	Part II, Item 8	89	2nd to last paragraph in Note 13
Realization of recognized net deferred tax assets	Part II, Item 8	90	2nd to last paragraph in Note 15

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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:

a. rapid and dramatic changes in economic and market conditions, such as the U.S. economy has recently experienced and continues to experience;
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 or other laws and regulations, the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Dodd-Frank Act or Dodd-Frank) and the rules and regulations issued or to be issued thereunder;
e. enhanced competition from unforeseen sources; and
f. similar uncertainties inherent in banking operations or business generally, including technological developments and changes.

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 another institution 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, 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 typically expressed on a tax-equivalent basis. 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 is essentially represented by goodwill for Arrow.

Adjustments for Certain Items of Income or Expense: In addition to our disclosures of net income, earnings per share (i.e. EPS), return on average assets (i.e. ROA), return on average equity (i.e. ROE) and other financial measures in accordance with GAAP, we may also provide comparative disclosures that adjust these GAAP financial measures by removing the impact of certain transactions or other material items of income or expense. We believe that the resulting non-GAAP financial measures may improve an understanding of our results of operations by separating out items that have a disproportional positive or negative impact on 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.

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.

PART I
Item 1. Business

A. GENERAL
Our holding company, Arrow Financial Corporation, a New York corporation, was incorporated on March 21, 1983 and is registered as a bank holding company within the meaning of the Bank Holding Company Act of 1956. Arrow owns two nationally chartered banks in New York (Glens Falls National and Saratoga National), and through such banks indirectly owns a health and life insurance agency (Capital Financial Group, Inc.), three primarily property and casualty insurance agencies (Loomis and LaPann, Inc., Upstate Agency, LLC and Glens Falls National Insurance Agencies, LLC), a registered investment adviser that advises our proprietary mutual funds (North Country Investment Advisers, Inc.), a Real Estate Investment Trust (Arrow Properties, Inc.) and four other non-bank subsidiaries whose operations are insignificant.
Subsidiary Banks (dollars in thousands)

	Glens Falls National	Saratoga National
Total Assets at Year-End	$1,716,629	$307,822
Trust Assets Under Administration and Investment Management at Year-End (Not Included in Total Assets)	$991,932	$54,040
Date Organized	1851	1988
Employees (full-time equivalent)	479	39
Offices	29	6
Counties of Operation	Warren, Washington, Saratoga, Essex & Clinton	Saratoga
Main Office	250 Glen Street Glens Falls, NY	171 So. Broadway Saratoga Springs, NY

The holding company’s business consists primarily of the ownership, supervision and control of our two banks. The holding company provides various advisory and administrative services and coordinates the general policies and operation of the banks. There were 518 full-time equivalent employees, including 72 employees within our insurance agency affiliates, at December 31, 2012.
We offer a full range of commercial and consumer banking and financial products. Our deposit base consists of deposits derived principally from the communities we serve. We target our lending activities to consumers and small and mid-sized companies in our immediate geographic areas. Through our banks' trust operations, we provide retirement planning, trust and estate administration services for individuals, and pension, profit-sharing and employee benefit plan administration for corporations.
On August 1, 2011, we acquired two privately owned insurance agencies located in the greater Glens Falls area, W. Joseph McPhillips, Inc. and McPhillips-Northern, Inc., which were controlled by the same group of shareholders. Each of the acquisitions was structured as a merger of the acquired agency into a newly formed limited liability company wholly owned by Arrow's principal subsidiary bank, Glens Falls National, named Glens Falls National Insurance Agencies, LLC. Both acquisitions qualified as tax-free reorganizations under the Internal Revenue Code. At closing of the acquisitions, which occurred on the same day, Arrow issued a total of 92,559 shares of its common stock (as restated for stock dividends) and $116 thousand in cash to the agencies' shareholders in exchange for all of their shares of the agencies' stock. Arrow recorded the following intangible assets as a result of the acquisitions (none of which are deductible for income tax purposes): goodwill ($1,180) and expirations ($720). The value of the expirations is being amortized over twenty years.

On February 1, 2011, we acquired Upstate Agency, Inc. ("Upstate"), a privately owned, property and casualty insurance agency with offices located in northern New York. The acquisition was structured as a merger of Upstate into a newly-formed limited liability company wholly owned by Glens Falls National, and qualified as a tax-free reorganization under the Internal Revenue Code. At closing of the acquisition and in post-closing payments to date, Arrow has issued to the former sole shareholder of Upstate, in exchange for all of his Upstate stock, 141,272 shares of Arrow's common stock (as restated for stock dividends) and approximately $2.7 million in cash. Arrow recorded the following intangible assets as a result of the acquisition (none of which are deductible for income tax purposes): goodwill ($5,040) and expirations ($2,854). The value of the expirations is being amortized over twenty years. The acquisition agreement provided for possible additional post-closing payments of Arrow's common stock to the former sole shareholder of Upstate, contingent upon the financial performance and business results of Upstate as a subsidiary of Glens Falls National over the three-year period following the closing. The present value of the expected post-closing payments was included in the basis of goodwill recognized at the acquisition date.

On April 1, 2010, we acquired Loomis & LaPann, Inc. ("Loomis"), a privately owned, property and casualty and sports accident and health insurance agency located in Glens Falls. The acquisition was structured as a merger between a newly-formed acquisition subsidiary of Glens Falls National and Loomis, and qualified as a tax-free reorganization under the Internal Revenue Code. Arrow has issued to the shareholders of Loomis, in exchange for their Loomis stock, 35,048 shares of Arrow's common stock (as restated for dividends), including the issuance of additional shares in post-closing payments to the former Loomis shareholders. At closing, Arrow recorded the following intangible assets as a result of the acquisition (none of which are deductible for income tax purposes): goodwill ($514 thousand) and portfolio expirations ($126 thousand). The value of the expirations is being amortized over twenty years. The acquisition agreement provided for possible additional post-closing payments of Arrow's common stock to the former Loomis shareholders, contingent upon the financial performance of Loomis as a subsidiary of Glens Falls National over a three-

year period following the closing. The estimated value of all expected post-closing payments was included in the basis of goodwill recognized at the acquisition date.

In July 2008, we acquired the key operating assets, including the trade name from U.S. Benefits, Inc., a provider of administrative and recordkeeping services for more complex retirement plans. This acquisition allows the Company to offer enhanced and broadened services to retirement plan clients and will complement the fiduciary services currently offered by the Company through its trust administrative and investment management activities.

In April 2005, we acquired from HSBC Bank USA, N.A. ("HSBC") three bank branches located within our service area. Our subsidiary Glens Falls National acquired two HSBC branches located in Argyle and Salem, New York, and our subsidiary Saratoga National acquired a branch located in Corinth, New York. The banks acquired substantially all deposit liabilities, the physical facilities and certain loans related to the branches.

In November 2004, we acquired all of the outstanding shares of common stock of Capital Financial Group, Inc. ("CFG"), an insurance agency headquartered in South Glens Falls, New York, which specializes in group health and life insurance products. The acquisition was structured as a tax-free exchange of Arrow's common stock for CFG's common stock with contingent payments over the five-year period subsequent to the acquisition, ending in 2009.

B. LENDING ACTIVITIES

Arrow engages in a wide range of lending activities, including commercial and industrial lending primarily to small and mid-sized companies; mortgage lending for residential and commercial properties; and consumer installment and home equity financing. We also maintain an active indirect lending program through our sponsorship of automobile dealer programs under which we purchase dealer paper, primarily from dealers that meet pre-established specifications. From time-to-time we sell a portion of our residential real estate loan originations into the secondary market, primarily to the Federal Home Loan Mortgage Corporation ("Freddie Mac") and state housing agencies, while normally retaining the servicing rights.

Generally, we continue to implement lending strategies and policies that are intended to protect the quality of the loan portfolio, including strong underwriting and collateral control procedures and credit review systems. Loans are placed on nonaccrual status either due to the delinquency status of principal and/or interest or a judgment by management that the full repayment of principal and interest is unlikely. Loans secured by home equity lines of credit are systematically placed on nonaccrual status when 120 days past due, and residential real estate loans when 150 days past due. Commercial and commercial real estate loans are evaluated on a loan-by-loan basis and are placed on nonaccrual status when 90 days past due if the full collection of principal and interest is uncertain. (See Part II, Item 7.C.II.c. "Risk Elements.") Subsequent cash payments on loans classified as nonaccrual may be applied all to principal, although income in some cases may be recognized on a cash basis.

We lend almost exclusively to borrowers within our geographic area, with the exception of our indirect consumer lending line of business, where we acquire retail paper from an extensive network of automobile dealers that operate in a geographic area (in the eastern region of upstate New York) that is somewhat larger than our normal retail service area. The loan portfolio does not include any foreign loans or any other significant risk concentrations. We do not participate in loan syndications, either as originator or as a participant. Most of the portfolio, in general, is fully collateralized, and many commercial loans are further secured by personal guarantees. However, from time to time, we buy and sell participations in loans with other financial institutions in our area of operation.

We do not engage in subprime mortgage lending as a business line and we do not extend or purchase so-called "Alt A," "negative amortization," "option ARM's" or "negative equity" mortgage loans. During 2012, we foreclosed on only six loans held in our own portfolio.

C. SUPERVISION AND REGULATION

The following generally describes the laws and regulations to which we are subject. Bank holding companies, banks and their affiliates are extensively regulated under both federal and state law. To the extent that the following information summarizes statutory or regulatory law, it is qualified in its entirety by reference to the particular

provisions of the various statutes and regulations. Any change in applicable law may have a material effect on our business and prospects.

Bank Regulatory Authorities with Jurisdiction over Arrow and its Subsidiary Banks

Arrow is a registered bank holding company within the meaning of the Bank Holding Company Act of 1956 ("BHC Act") and as such is subject to regulation by the Board of Governors of the Federal Reserve System ("FRB"). Arrow is not, at present, a so-called "financial holding company" under federal banking law. As a "bank holding company" under New York State law, Arrow is also subject to regulation by the New York State Department of Financial Services. Our two subsidiary banks are both national banks and are subject to supervision and examination by the Office of the Comptroller of the Currency ("OCC"). The banks are members of the Federal Reserve System and the deposits of each bank are insured by the Deposit Insurance Fund of the Federal Deposit Insurance Corporation ("FDIC"). The BHC Act generally prohibits Arrow from engaging, directly or indirectly, in activities other than banking, activities closely related to banking, and certain other financial activities. Under the BHC Act, a bank holding company must obtain FRB approval before acquiring, directly or indirectly, 5% or more of the voting shares of another bank or bank holding company (unless it already owns a majority of such shares). Bank holding companies are able to acquire banks or other bank holding companies located in all 50 states, subject to certain limitations. The Gramm-Leach-Bliley Act ("GLBA"), enacted in 1999, authorized bank holding companies to affiliate with a much broader array of other financial institutions than was previously permitted, including insurance companies, investment banks and merchant banks. See Item 1.D., "Recent Legislative Developments."

The FRB and the OCC have broad regulatory, examination and enforcement authority. The FRB and the OCC conduct regular examinations of the entities they regulate. In addition, banking organizations are subject to periodic reporting requirements to the regulatory authorities. The FRB and OCC have the authority to implement various remedies if they determine that the financial condition, capital, asset quality, management, earnings, liquidity or other aspects of a banking organization's operations are unsatisfactory or if they determine the banking organization is violating or has violated any law or regulation. The authority of the FRB and the OCC includes, but is not limited to, prohibiting unsafe or unsound practices; requiring affirmative action to correct a violation or practice; issuing administrative orders; requiring the organization to increase capital; requiring the organization to sell subsidiaries or other assets; restricting dividends and distributions; restricting the growth of the organization; assessing civil money penalties; removing officers and directors; and terminating deposit insurance. The FDIC may terminate a depository institution's deposit insurance upon a finding that the institution's financial condition is unsafe or unsound or that the institution has engaged in unsafe or unsound practices or has violated any applicable rule, regulation, order or condition enacted or imposed by the institution's regulatory agency.

Regulatory Supervision of Other Arrow Subsidiaries

The insurance agency subsidiaries of Arrow's banks are subject to the licensing and other provisions of New York State Insurance law and are regulated by the New York Department of Financial Services. Arrow's investment adviser subsidiary is subject to the licensing and other provisions of the federal Investment Advisers Act of 1940 and is regulated by the SEC.

Regulation of Transactions between Banks and their Affiliates

Transactions between banks and their "affiliates" are regulated by Sections 23A and 23B of the Federal Reserve Act (the "FRA"). For purposes of Sections 23A and 23B, the “affiliates” of each of our banks include Arrow and its non-bank subsidiaries, other than subsidiaries of the banks themselves, which are considered to be part of the bank that owns them under Sections 23A and 23B. Each of our banks is also considered an affiliate of the other bank under Section 23A, although certain exemptions apply to transactions between the banks. Extensions of credit that a bank may make to non-bank affiliates, or to third parties secured by securities or obligations of the non-bank affiliates, are substantially limited by the FRA and the Federal Deposit Insurance Act (the "FDIA"). Such acts further restrict the range of permissible transactions between a bank and an affiliate. A bank may engage in certain transactions, including loans and purchases of assets, with an affiliate, only if the terms and conditions of the transaction, including credit standards, are substantially the same as, or at least as favorable to the bank as, those prevailing at the time for comparable transactions with non-affiliated companies or, in the absence of comparable transactions, on terms and conditions that would be offered to non-affiliated companies.

Regulatory Capital Standards; Dividend Restrictions

An important area of banking regulation is the federal banking system's promulgation and enforcement of minimum capitalization standards for banks and bank holding companies.

New Capital Standards to be Promulgated: The discussion and disclosure below on regulatory capital is qualified in its entirety by reference to the fact that the Dodd-Frank Act, among other financial reforms, directed the federal bank regulatory authorities to promulgate new capital standards for all financial institutions, including bank holding companies and banks like ours. Under the Dodd-Frank Act, the new standards for leverage and risk-based capital, when adopted by regulators must be at least as strict (i.e., must establish minimum and target 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 U.S. federal bank regulatory

agencies, acting jointly, recently (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 require significantly more stringent standards upon full implementation than are now required for U.S. financial institutions. For more information on the Basel III standards, which are currently pending approval by participating nations, and the capital rules proposed by U.S. regulators, see Item 7, "Management's Discussion and Analysis of Financial Condition and Results of Operations," Section E, "Capital Resources and Dividends" on page 47. 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.

Current Capital Standards: Arrow is currently subject to capital standards implemented by various FRB "capital adequacy guidelines" used in the examination and supervision of bank holding companies. The FRB's risk-based capital guidelines assign risk weightings to all assets and certain off-balance sheet items and establish an 8% minimum ratio of qualified total capital to the aggregate dollar amount of risk-weighted assets (which is almost always less than the dollar amount of such assets without risk weighting). Under the risk-based guidelines, at least half of total capital must consist of "Tier 1" capital, which comprises common equity, retained earnings and a limited amount of permanent preferred stock, less goodwill. Under the FRB's guidelines, trust preferred securities may also qualify as Tier 1 capital, in an amount not to exceed 25% of Tier 1 capital. (Under the recently enacted Dodd-Frank Act, newly issued trust preferred securities will no longer qualify as Tier 1 capital; previously issued trust preferred securities for holding companies such as Arrow may continue to qualify as Tier 1 capital until maturity or redemption; however, the

pending proposed capital regulations, if adopted in the form proposed in May 2012, would impose a “phase-out” of such qualification for previously issued trust preferred securities.) The currently applicable capital guidelines limit restricted core capital elements to a percentage of the sum of core capital elements, net of goodwill less any associated deferred tax liability. We issued trust preferred securities in 2003 and 2004 to serve as part of our core capital. Up to half of total capital may consist of so-called "Tier 2" capital, comprising a limited amount of subordinated debt, preferred stock not qualifying as Tier 1 capital, certain other instruments and a limited amount of the allowance for loan losses.

The FRB's other important guideline for measuring a bank holding company's capital is the leverage ratio standard, which establishes minimum limits on the ratio of a bank holding company's "Tier 1" capital to total tangible assets (not risk-weighted). For top-rated holding companies, the minimum leverage ratio is 3%, but lower-rated companies may be required to meet substantially greater minimum ratios.

Our subsidiary banks are currently subject to capital requirements similar to the capital requirements applicable at the holding company level described above. Our banks' capital requirements have been promulgated by their primary federal regulator, the OCC. It is widely anticipated that prevailing bank capital guidelines will be strengthened by the regulatory authorities (in our case, the OCC) in upcoming years. Indirectly, such future bank capital requirements may also impact our future holding company capital requirements, because Dodd-Frank requires the regulators to promulgate holding company rules that would make consolidated bank holding company capital standards at least as strict as those applicable directly to banks.)

Under applicable law, federal banking regulators are required to take prompt corrective action with respect to depository institutions that do not meet minimum capital requirements. The regulators have established five capital classifications for banking institutions, the highest being "well-capitalized." Our holding company and both of our subsidiary banks currently qualify as "well-capitalized." Under regulations adopted by the federal bank regulators, a banking institution is considered "well-capitalized" if it has a total risk-adjusted capital ratio of 10% or greater, a Tier 1 risk-adjusted capital ratio of 6% or greater and a leverage ratio of 5% or greater and is not subject to any regulatory order or written directive regarding capital maintenance. The year-end 2012 capital ratios of our holding company and our banks are set forth in Part II, Item 7.E. "Capital Resources and Dividends" and in Note 19 "Regulatory Matters" to the consolidated financial statements under Part II, Item 8 of this Report.

A holding company's ability to pay dividends or repurchase its outstanding stock, as well as its ability to expand its business through acquisitions of additional banking organizations or permitted non-bank companies, may be restricted if its capital falls below these minimum capitalization ratios or fails to meet other informal capital guidelines that the regulators may apply from time-to-time to specific banking organizations. In addition to these potential regulatory limitations on payment of dividends, our holding company's ability to pay dividends to our shareholders, and our subsidiary banks' ability to pay dividends to our holding company are also subject to various restrictions under applicable corporate laws, including banking laws (affecting our subsidiary banks) and the New York Business Corporation Law (affecting our holding company). The ability of our holding company and banks to pay dividends in the future is, and is expected to continue to be, influenced by regulatory policies, capital guidelines and applicable law.

In cases where banking regulators have significant concerns regarding the financial condition, assets or operations of a bank or bank holding company, the regulators may take enforcement action or impose enforcement orders, formal or informal, against the organization. If the leverage ratio (Tier 1 risk-adjusted capital to total tangible assets ratio) of a bank falls below 2%, the bank may be closed and placed in receivership, with the FDIC as receiver.

The current risk-based capital guidelines that apply to Arrow are based on the 1988 capital accord of the International Basel Committee on Banking Supervision, a committee of central banks and bank supervisors, as implemented by U.S. federal banking agencies. In 2008, these federal banking agencies began to phase-in capital standards based on a second capital accord, referred to as Basel II, for large or "core" international banks (total assets of $250 billion or more or consolidated foreign exposures of $10 billion or more). Basel II emphasizes internal assessment of credit, market and operational risk, as well as supervisory assessment and market discipline in determining minimum capital requirements. In 2010 the Basel Committee released the recommended Basel III capital standards, which are referred to above and further in Item 7, “Management's Discussion and Analysis of Financial Condition and Results of

Operations,” Section E, "Capital Resources and Dividends" on page 47.

Anti-Money Laundering and OFAC

Under federal law, financial institutions must maintain anti-money laundering programs that include established internal policies, procedures, and controls. Financial institutions are also prohibited from entering into specified financial transactions and account relationships and must meet enhanced standards for due diligence and customer identification. Financial institutions must take reasonable steps to conduct enhanced scrutiny of account relationships to guard against money laundering and to report any suspicious transactions. Law enforcement authorities have been granted increased access to financial information maintained by financial institutions. Bank regulators routinely examine institutions for compliance with these obligations and they must consider an institution's compliance in connection with the regulatory review of applications, including applications for banking mergers and acquisitions. The U.S. Department of the Treasury's Office of Foreign Assets Control, or "OFAC," is responsible for helping to insure that U.S. entities do not engage in transactions with certain prohibited parties, as defined by various Executive Orders and Acts of Congress. OFAC publishes lists of persons, organizations, and countries suspected of aiding, harboring or engaging in terrorist acts, known as Specially Designated Nationals and Blocked Persons. If Arrow finds a name on any transaction, account or wire transfer that is on an OFAC list, Arrow must freeze or block such account or transaction, file a suspicious activity report and notify the appropriate authorities.

Reserve Requirements

Pursuant to regulations of the FRB, all banking organizations are required to maintain average daily reserves at mandated ratios against their transaction accounts and certain other types of deposit accounts. These reserves must be maintained in the form of vault cash or in an account at a Federal Reserve Bank.

Community Reinvestment Act

Each of Arrow's subsidiary banks is subject to the Community Reinvestment Act ("CRA") and implementing regulations. CRA regulations establish the framework and criteria by which the bank regulatory agencies assess an institution's record of helping to meet the credit needs of its community, including low and moderate-income neighborhoods. CRA ratings are taken into account by regulators in reviewing certain applications made by Arrow and its bank subsidiaries.

Privacy and Confidentiality Laws

Arrow and its subsidiaries are subject to a variety of laws that regulate customer privacy and confidentiality. GLBA requires financial institutions to adopt privacy policies, to restrict the sharing of nonpublic customer information with nonaffiliated parties upon the request of the customer, and to implement data security measures to protect customer information. The Fair Credit Reporting Act, as amended by the Fair and Accurate Credit Transactions Act of 2003 regulates use of credit reports, providing of information to credit reporting agencies and sharing of customer information with affiliates, and sets identity theft prevention standards.

D. RECENT LEGISLATIVE DEVELOPMENTS

The principal federal law enacted since the start of the financial crisis that attempts to deal with the causes of that crisis is the Dodd-Frank Act. It significantly affects all financial institutions, including Arrow and our banks. There are other earlier-enacted banking laws that continue to significantly impact our operations. The Dodd-Frank Act and these other statutes are discussed briefly below.

The 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, which will operate as an independent entity within the Federal Reserve System and is authorized to issue rules for consumer protection, some of which likely will significantly increase banks' compliance expenses, thereby reducing or restraining profitability. For depository institutions with $10 billion or less in assets (such as Arrow's banks), the banks' traditional regulatory agencies (for our banks, the OCC), and not the Bureau, will have primary examination and enforcement authority over the banks' compliance with new Bureau rules as well as all other consumer protection rules and regulations. However, the Bureau will have the right to include its examiners on a "sampling" basis in examinations conducted by the traditional regulators and will be authorized to give those agencies input and recommendations with respect to consumer protection laws and to require reports and other examination documents. The Bureau will have broad authority to curb practices it finds to be unfair, deceptive and abusive. What constitutes "abusive" behavior has been broadly defined and is very likely to create an environment conducive to increased litigation. This is likely to be exacerbated by the fact that, in addition to the federal authorities charged with enforcing the Bureau's rules, state attorneys general are also authorized to enforce those Federal consumer laws transferred to the Bureau and the rules issued by the Bureau thereunder.

Dodd-Frank also directs the federal banking authorities to issue new capital requirements for banks and holding companies which 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 47 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 to be jointly issued by the federal bank regulatory agencies were to be issued in the form as proposed in June 2012, 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.

Many of the regulations required to be promulgated by bank regulators in order to give effect to Dodd-Frank's provisions have yet to be promulgated or are pending final approval by the regulators, and will have phase-in periods even after final promulgation. The following is a summary of some additional Dodd-Frank provisions that are likely to have a material impact, positive or negative, as the case may be, on us and our customers:

1. Increase of FDIC deposit insurance to $250,000 per customer made permanent by statute.
2. The FDIC insurance assessment on banks is now asset-based, not deposit-based, which actually reduces insurance costs for most small to mid-sized institutions, like Arrow. Under the new method, our premiums were reduced from $513 thousand of FDIC and FICO assessments for the first quarter of 2011 (the last quarter under the old deposit-based method of assessment), to $267 thousand of expense for the second quarter of 2011 (under the new asset-based method), a decline of 48%.
3. New limitations imposed by Dodd-Frank on debit card interchange fees, which technically apply only to the very large banks having more than $10 billion in assets, have already had and likely will continue to have a negative impact on the fee income of smaller banks like ours, due to competitive pressures.
4. Requirements for mortgage originators to act in the best interests of a consumer and to seek to ensure that a consumer will have the capacity to repay any consumer loan.
5. Requirements for comprehensive additional residential mortgage loan related disclosures.
6. Statutory implementation of “source of strength doctrine” for both bank and savings and loan holding companies, under which the Federal Reserve can compel a holding company to contribute additional capital to its subsidiary depository institutions.
7. Limitation of current Federal preemption standards for national banks (such as our banks), that is, the Act reduces the extent to which state law is preempted by Federal law with regard to the operation of national banks. This increases the potential for State intervention in the operations of national banks.
8. Repeal of the federal prohibitions on the payment of interest on demand deposits, thereby permitting depository institutions to pay interest on business transaction and other accounts.

Full implementation of the Dodd-Frank Act will result in many new mandatory and discretionary rulemakings by numerous federal regulatory agencies. This rulemaking will continue for several more years. As a result, bank holding companies are facing thousands of new pages of regulations, not to mention increased litigation risk. Additional required rules still in the formulation process that may significantly impact our operations include those related to short-term borrowing disclosures, and disclosures regarding executive compensation. Several of these issues are highly controversial, and the implementing regulations to be forthcoming remain the focus of much discussion and concern.

Other Recent Federal Laws Affecting Banks

Federal laws enacted in 2008 addressing the financial crisis included The Emergency Economic Stabilization Act of 2008 (EESA) and the American Recovery and Reinvestment Act of 2008 (ARRA) and related governmental programs. These laws established emergency capital and liquidity support programs which enabled many major financial institutions to survive the crisis. Such program served their purpose and have largely been superseded by subsequent statutory and regulatory measures, principally Dodd-Frank. We did not participate, or need to participate in any of the emergency capital or liquidity support programs.
The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 became effective October 17, 2005. The Act addressed many areas of bankruptcy practice, including consumer bankruptcy, general and small business bankruptcy, treatment of tax claims in bankruptcy, ancillary and cross-border cases, financial contract protection amendments to Chapter 12 governing family farmer reorganization, and special protection for patients of a health care business filing for bankruptcy. This Act did not have a significant impact on our earnings or on our efforts to recover collateral on secured loans.

The Sarbanes-Oxley Act, signed into law on July 30, 2002, adopted a number of measures having a significant impact on all publicly-traded companies, including Arrow. Generally, the Act sought to improve the quality of financial reporting of these companies by compelling them to adopt good corporate governance practices and by strengthening the independence of their auditors. The Act placed substantial additional duties on directors, officers, auditors and attorneys of public companies. Among other specific measures, the Act required that chief executive officers and chief financial officers certify to the SEC in the holding company's annual and quarterly reports filed with the SEC regarding the accuracy of its financial statements contained therein and the integrity of its internal controls. The Act also accelerated insiders' reporting requirements for transactions in company securities, restricted certain executive officer and director transactions, imposed obligations on corporate audit committees, and provided for enhanced review of company filings by the SEC. As part of the general effort to improve public company auditing, the Act places limits on consulting services that may be performed by a company's independent auditors by requiring that the company's Audit Committee of the Board of Directors evaluate amounts to determine independence. The Act created a federal public company accounting oversight board (the PCAOB) to set auditing standards, inspect registered public accounting firms, and exercise enforcement powers, subject to oversight by the SEC.

In the wake of the Sarbanes-Oxley Act, the nation's stock exchanges, including the exchange on which Arrow's stock is listed, the National Association of Securities Dealers, Inc. ("NASD") promulgated a wide array of governance standards that must be followed by listed companies. The NASD standards include having a Board of Directors the majority of whose members are independent of management, and having audit, compensation and nomination committees of the Board consisting exclusively of independent directors. We have implemented a variety of corporate governance measures and procedures to comply with Sarbanes-Oxley and the amended NASD listing requirements, although we have always relied on a Board of Directors a majority of whose members are independent and independent Board committees to make important decisions regarding the Company.

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The USA Patriot Act initially adopted in 2001 and re-adopted by the U.S. Congress in 2006 with certain changes (the "Patriot Act"), imposes substantial record-keeping and due diligence obligations on banks and other financial institutions, with a particular focus on detecting and reporting money-laundering transactions involving domestic or international customers. The U.S. Treasury Department has issued and will continue to issue regulations clarifying the Patriot Act's requirements. The Patriot Act requires all financial institutions, including banks, to maintain certain anti-money laundering compliance and due diligence programs. The provisions of the Act impose substantial costs on all financial institutions, including ours.

Recent Changes in Deposit Insurance Laws and Regulations

Although the Dodd-Frank Act extended the unlimited FDIC deposit insurance coverage that had been previously established by FDIC rule for non-interest-bearing transaction accounts (such as certain checking accounts), this unlimited deposit insurance coverage terminated by statute on December 31, 2012. Consequently, as of January 1, 2013, funds held in non-interest-bearing transaction accounts at Arrow's banks no longer have unlimited deposit insurance coverage, but are subject to standard FDIC deposit insurance rules.

The FDIC collects insurance premiums on insured deposits. In recent years, the FDIC has made several modifications to its deposit insurance premium structure, the most important of which was to calibrate premiums based on the total assets (versus total deposits) of insured institutions. This has tended to benefit smaller regional banks such as ours, that typically maintain a higher ratio of deposits to total assets than the large, money-center banks. In 2007, after a several year period in which banks were charged no or very low premiums for deposit insurance, the FDIC resumed charging financial institutions an FDIC deposit insurance premium, under a new risk-based assessment system. Under this system, institutions in Risk Category I (the lowest of four risk categories) paid a rate (based on a formula) of 5 to 7 cents per $100 of assessable deposits.

In 2008, in response to a growing level of claims against the Bank Insurance Fund, resulting from the first stages of the financial crisis, the FDIC announced that it would raise the lowest rate from 5 cents to 12 cents per $100 of assessable deposits, which increase remained in effect through 2009. In addition, beginning with the second quarter of 2009, the FDIC added four new factors to the assessment rate calculation, including factors for brokered deposits, secured liabilities and unsecured liabilities.

In 2009, in light of extraordinary demands on the FDIC's insurance fund, the FDIC imposed a special assessment on all insured institutions, including our banks, at .05% of total assets as adjusted for Tier 1 capital. We charged $787 thousand to earnings in the second quarter of 2009 for this assessment, which was paid on September 30, 2009. In the fourth quarter of 2009, the FDIC collected prepaid assessments for the fourth quarter of 2009 and for all of 2010, 2011 and 2012. Our prepaid assessment amounted to $6.8 million. The expense was ratably recorded over the respective periods as directed by the FDIC.

In February of 2011, the FDIC finalized a new assessment system that took effect in the second quarter of 2011. The final rule changed the assessment base from domestic deposits to average assets minus average tangible equity, adopted a new large-bank pricing assessment scheme, and set a target size for the Deposit Insurance Fund (the successor to the Bank Insurance Fund). The changes went into effect in the second quarter of 2011. The rule (as mandated by Dodd-Frank) finalizes a target size for the Deposit Insurance Fund at 2% of insured deposits. It also implements a lower assessment rate schedule when the fund reaches 1.15% (so that the average rate over time should be about 8.5 basis points) and, in lieu of dividends, provides for a lower rate schedule when the reserve ratio reaches 2% and 2.5%. Also as mandated by Dodd-Frank, the rule changes the assessment base from adjusted domestic deposits to a bank's average consolidated total assets minus average tangible equity. The new assessment system significantly lowered our FDIC insurance assessments in second quarter of 2011, which decreased by over 48% from the first quarter of 2011.

We are unable to predict whether or to what extent the FDIC may elect to impose additional special assessments on insured institutions in upcoming years, although it is commonly understood that the FDIC insurance fund may not be adequate if bank failures continue at significant levels for any significant period of time and/or the cost to the FDIC

of the bank failures recently resolved by it should prove even greater than was initially anticipated.

E. STATISTICAL DISCLOSURE – (GUIDE 3)

Set forth below is an index identifying the location in this Report of various items of statistical information required to be included in this Report by the SEC's industry guide for Bank Holding Companies.

Required Information	Location in Report
Distribution of Assets, Liabilities and Stockholders' Equity; Interest Rates and Interest Differential	Part II, Item 7.B.I.
Investment Portfolio	Part II, Item 7.C.I.
Loan Portfolio	Part II, Item 7.C.II.
Summary of Loan Loss Experience	Part II, Item 7.C.III.
Deposits	Part II, Item 7.C.IV.
Return on Equity and Assets	Part II, Item 6.
Short-Term Borrowings	Part II, Item 7.C.V.

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F. COMPETITION

We face intense competition in all markets we serve. Traditional competitors are other local commercial banks, savings banks, savings and loan institutions and credit unions, as well as local offices of major regional and money center banks. Like all banks, we encounter strong competition in mortgage lending from a wide variety of other mortgage originators, all of whom are principally affected in this business by the rate and terms set, and the lending practices established by the very large government sponsored enterprises "Fannie Mae" and "Freddie Mac," who purchase and/or guarantee a very substantial dollar amount and number of mortgage loans, which in 2012 accounted for a large majority of the total amount of mortgage loans extended in the U.S. Additionally, non-banking financial organizations, such as consumer finance companies, insurance companies, securities firms, money market, mutual funds and credit card companies offer substantive equivalents of the various other types of loan and financial products and transactional accounts that we offer, even though these non-banking organizations are not subject to the same regulatory restrictions and capital requirements that apply to us. Under federal banking laws, such non-banking financial organizations not only may offer products comparable to those offered by commercial banks, but also may establish or acquire their own commercial banks.

G. EXECUTIVE OFFICERS OF THE REGISTRANT

The names and ages of the executive officers of Arrow and positions held by each are presented in the following table. Officers are elected annually by the Board of Directors.

Name	Age	Positions Held and Years from Which Held
Thomas J. Murphy	54	President and Chief Executive Officer of the Arrow since January 1, 2013. He has been a director of Arrow since July 2012. Mr. Murphy served as a Vice President of Arrow from 2009 to 2012. Mr. Murphy has served as Corporate Secretary from 2009 to 2012. Mr. Murphy is also the President and Chief Executive Officer of GFNB since January 1, 2013. Prior to that date he served as Senior Executive Vice President and President of GFNB since July 1, 2011. Prior to July 1, 2011, Mr. Murphy served as Senior Trust Officer of GFNB since 2010 and Cashier of GFNB since 2009. Murphy previously served as Assistant Corporate Secretary of Arrow (2008-2009), Senior Vice President of GFNB (2008-2011) and Manager of the Personal Trust Department of GFNB (2004-2011). Mr. Murphy started with the Company in 2004.
Terry R. Goodemote	49	Executive Vice President and Senior Executive Vice President of GFNB since July 1, 2011. Mr. Goodemote previously served as our Senior Vice President, Treasurer and Chief Financial Officer and as the Executive Vice President, Treasurer and Chief Financial Officer of GFNB since 2008. Mr. Goodemote was first appointed Chief Financial Officer and Treasurer of Arrow and GFNB on January 1, 2007. Prior to becoming Chief Financial Officer, Mr. Goodemote served as Senior Vice President and Head of the Accounting Division of GFNB. Mr. Goodemote started with the Company in 1992.
David S. DeMarco	51	Senior Vice President of Arrow since May 1, 2009. Mr. DeMarco has been the President of and Chief Executive Officer of SNB since January 1, 2013. Prior to that date, Mr. DeMarco served as Executive Vice President and Head of the Branch, Corporate Development, Financial Services & Marketing Division of GFNB since January 1, 2003. Mr. DeMarco started with the Company in 1987.

H. AVAILABLE INFORMATION

Our Internet address is www.arrowfinancial.com. We make available free of charge on or through our Internet website our annual report on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K, and amendments to those reports as soon as practicable after we file or furnish them with the SEC pursuant to the Exchange Act. We also make available on the internet website various other documents related to corporate

operations, including our Corporate Governance Guidelines, the charters of our principal board committees, and our codes of ethics. We have adopted a financial code of ethics that applies to Arrow's chief executive officer, chief financial officer and principal accounting officer and a business code of ethics that applies to all directors, officers and employees.

Item 1A. Risk Factors

Our financial results and the market price of our stock in future periods are subject to risks arising from many factors, including the following: (Please note that the discussions below regarding potential impact on Arrow of certain of these factors that may develop in the future are not meant to provide predictions by Arrow's management that such factors will develop, but to acknowledge the possible impact that could occur if the factors do develop.)

Difficult market conditions have adversely affected the financial services industry. For many financial institutions, dramatic declines in the U.S. housing market over the past three years, with falling home prices and increasing foreclosures and unemployment, have negatively impacted the credit performance of real estate related loans and resulted in significant write-downs of asset values. To date, the impact of these adverse market conditions has been less significant on Arrow than it has been on many other U.S. financial institutions. Write-downs at many of these other institutions, initially of asset-backed securities but spreading to other securities and loans, have caused a number of those institutions to seek additional capital, to reduce or eliminate dividends, to merge with larger and stronger institutions and, in some cases, to fail. Reflecting concern about the stability of the financial markets generally and the strength of counterparties, many lenders have reduced or ceased providing funding to borrowers, including to other financial institutions. Generally, in the financial services sector, this market turmoil and tightening of credit have led to an increased level of commercial and consumer delinquencies at many institutions, lack of consumer confidence, increased market volatility and widespread reduction of business activity. Although this turmoil has affected Arrow and our local markets less than certain other institutions and markets, the resulting economic pressure on consumers and lack of confidence in the financial markets has already, to some extent, adversely affected our business, financial condition and results of operations. Market developments may continue to negatively affect consumer confidence levels and demand for loans, and may cause adverse changes in payment patterns, causing increases in delinquencies and default rates, which may increase our charge-offs and provision for credit losses. A worsening of these conditions would likely exacerbate the adverse effects of these difficult market conditions on Arrow and others in the financial institutions industry.

We may be adversely affected by new and enhanced government regulation, especially the new rules promulgated under the Dodd-Frank Act. Even before the recent financial crisis and the new banking laws and regulations resulting therefrom, including the Dodd-Frank Act, we were subject to extensive Federal and state banking regulations and supervision. Banking regulations are intended primarily to protect our depositors' funds and the Federal deposit insurance funds, not the Company's shareholders. Regulatory requirements affect our lending practices, capital structure, investment practices, dividend policy and growth. Failure to meet minimum capital requirements could result in the imposition of limitations on our operations that would adversely impact our profitability and could, if capital levels dropped significantly, result in our being required to cease or scale back our operations or raise capital at inopportune times or unsatisfactory prices. On top of the preexisting regulatory structure, the recent changes in governing law, regulations and regulatory practices have already imposed, and likely will continue to impose, substantial additional costs on us and thereby hurt our revenues and profitability. Dodd-Frank has already required us to adopt substantial additional practices and procedures in the normal day-to-day operation of our business, and many of the new and most onerous rules and regulations required by Dodd-Frank, including new capital requirements that may be substantially enhanced from the current requirements, have not yet been implemented or in some cases even proposed. In many case, even the general structure of the new regulations required to be issued under Dodd-Frank is unclear. This uncertainty is a concern. At this time, it is difficult to predict the extent to which Dodd-Frank or the resulting regulations and rules may adversely impact the Company. It is reasonably certain, however, that Dodd-Frank will increase our costs, require us to modify certain strategies and business operations, and require us to revise our capital and liquidity structures, which, individually or collectively, may very well have a material adverse impact on our financial condition.

If economic conditions, already weak, should worsen and the U.S. experiences a recession or prolonged economic stagnation, the Company's allowance for loan losses may not be adequate to cover actual losses. Like all financial institutions, we maintain an allowance for loan losses to provide for probable loan losses at the balance sheet date. Our allowance for loan losses is based on our historical loss experience as well as an evaluation of the risks associated with our loan portfolio, including the size and composition of the portfolio, current economic conditions and geographic concentrations within the portfolio and other factors. If the economy in our geographic market area, the northeastern region of New York State, or in the U.S. generally, should deteriorate to the point that recessionary conditions return, or if the regional or national economy experiences a protracted period of stagnation, the quality of our loan portfolio may weaken significantly. If so, our allowance for loan losses may not be adequate to cover actual loan losses, and future enhanced provisions for loan losses could materially and adversely affect financial results. Moreover, weak or worsening economic conditions often lead to difficulties in other areas of our business, including growth of our business generally, thereby compounding the negative effects on earnings.

A sustained and/or significant change in domestic interest rates could negatively affect the Company's net interest income. An institution's net interest income is significantly affected by market rates of interest, including short-term and long-term rates and the relationship between the two. Interest rates are highly sensitive to many factors, which are beyond our control, including general economic conditions, policies of various governmental and regulatory agencies such as the Federal Reserve Board, and actions taken by foreign central banks. Like all financial institutions, the Company's balance sheet is affected by fluctuations in interest rates. Although both short- and long-term interest rates have remained at very low levels for the past several years, and the Federal Reserve has recently announced that its goal is to keep rates in the U.S. at these low levels at least through 2014, there is a widespread concern that the rapid growth in the money supply, another development actively promoted by the Federal Reserve and other central banks in the western world, will eventually lead to a surge in inflation in the U.S. and other developed nations, including in the cost of borrowed funds (i.e., interest rates). Any such development (i.e., a rising rate environment in the U.S.) may negatively affect banks' profitability. See the discussion under "Changes in Net Interest Income Due to Rate," on page 30 of this Report.

If economic conditions worsen significantly and the U.S. financial markets should suffer another downturn, the company may experience limited access to credit markets. As discussed under Part I, Item 7.D. "Liquidity," the Company has relationships with various third parties to provide overnight and longer-term credit arrangements. If and as these third parties may themselves have difficulty in accessing their own credit markets, we may, in turn, experience a decrease in our capacity to borrow funds from them or other third parties traditionally relied upon by banks for liquidity.

If the value of real estate in our market area were to suffer an additional material decline, a significant portion of our loan portfolio could become under-collateralized, which might have a material adverse effect on us. In addition to considering the financial strength and cash flow characteristics of borrowers, we often secure loans with real estate collateral, which in each case provides an alternate source of repayment in the event of default by the borrower. If mortgaged real property deteriorates in value significantly during the time the credit is outstanding and we are required to liquidate the collateral securing a loan to satisfy the debt, our earnings and capital could be adversely affected. Furthermore, the possibility of legislative changes at the Federal or State level adversely impacting the ability of banks to protect themselves when loans begin to go bad, including through foreclosure proceedings, may result in negative impacts to those institutions.

If securities prices should significantly decline in upcoming periods, we likely will experience a reduction in income from fiduciary activities. The most significant portion of the income we earn from managing assets in our fiduciary capacity is tied to the market value of those assets, i.e., investment securities. If stocks or other equity securities lose market value, in a sudden market crash as was experienced in 2008-2009, we may see our fiduciary income substantially reduced.

We are subject to the local economies where we operate, and unfavorable economic conditions in these areas could have a material adverse effect on our financial condition and results of operations. Our success depends upon the growth in business activity, income levels and deposits in our geographic market area. Unpredictable and unfavorable economic conditions unique to our market area may have an adverse effect on the quality of our loan portfolio and financial performance. As a community bank, we are less able than our larger regional competitors to spread the risk of unfavorable local economic conditions over a larger market area. Although our market area (northeastern New York State) has not been as severely damaged by the financial downturn of the past three years as many other areas of the U.S., this could change in future periods if the U.S. economy generally continues to suffer. Moreover, we cannot give any assurances that we, as a single enterprise, will benefit from any unique and favorable economic conditions in our market area, even if they do occur.

Current levels of market volatility. The market for certain investment securities, including mortgage-backed securities, has been highly volatile or inactive, and may not stabilize or resume in the near future. This volatility can result in significant fluctuation in the prices of those securities, some of which we hold in our investment portfolio, which could affect the results of our operations.

Changes in accounting standards may materially impact the company's financial statements. From time-to-time, the Financial Accounting Standards Board ("FASB") changes the financial accounting and reporting standards that govern the preparation of our financial statements. These changes can be hard to predict and can materially impact how we record and report our financial condition and results of operations. In some cases, we may be required to apply a new or revised standard retroactively, resulting in changes to previously reported financial statements. Specifically, changes in the fair value of our financial assets could have a significant negative impact on our asset portfolios and indirectly on our capital levels

The Company's business could suffer if it loses key personnel unexpectedly. Our success depends, in large part, on our ability to retain our key personnel for the duration of their expected terms of service. However, back-up plans are also important, in the event key personnel are unexpectedly rendered incapable of performing or depart or resign from their positions. While our Board of Directors actively reviews emergency staffing plans, any sudden unexpected change at the senior management level may adversely affect our business.

The Company relies on other companies to provide key components of the company's business infrastructure. Third-party vendors provide key components of our business infrastructure such as Internet connections, network access and mutual fund distribution. These parties are beyond our control, and any problems caused or experienced by these third parties, including their not being able to continue to provide their services to us or performing such services poorly, could adversely affect our ability to deliver products and services to our customers and conduct our business.

The soundness of other financial institutions could adversely affect Arrow. Our ability to engage in routine funding transactions could be adversely affected by the actions and commercial soundness of other financial institutions. Financial services institutions are interrelated as a result of trading, clearing, counterparty and other relationships. Arrow has exposure to many different counterparties, and we routinely execute transactions with counterparties in the financial industry, including brokers and dealers, other commercial banks, investment banks, mutual and hedge funds, and other financial institutions. As a result, defaults by, or even rumors or questions about, one or more financial services institutions, or the financial services industry generally, could lead to market-wide liquidity problems and losses or defaults by Arrow or by other institutions and organizations. Many of these transactions expose Arrow to credit risk in the event of default of our counterparty or client. In addition, Arrow's credit risk may be exacerbated when the collateral held by Arrow cannot be liquidated or is liquidated at prices not sufficient to recover the full amount of the financial instrument exposure due Arrow. There is no assurance that any such losses would not materially and adversely affect our results of operations.

The Company faces continuing and growing security risks to its own information base and to information on its customers. Arrow has implemented systems of internal controls and procedures and corporate governance policies and procedures intended to protect its business operations. In addition, we rely on the services of a variety of vendors to meet our data processing and communication needs. No matter how well designed or implemented our controls are, we cannot provide an absolute guarantee to protect business operations from every type of problem in every situation. A failure or circumvention of these controls could have a material adverse effect on Arrow's business operations and financial condition. Also the computer systems and network infrastructure that we use are always vulnerable to unforeseen disruptions, including theft of confidential customer information ("identity theft") and interruption of service as a result of fire, natural disasters, explosion, general infrastructure failure or cyber attacks. These disruptions may arise in our internally developed systems, the systems of our third- party service providers or originating from our consumer and business customers who access our systems from their own networks or digital devices to process transactions. Information security risks have increased significantly in recent years because of consumer demand to use the Internet and other electronic delivery channels to conduct financial transactions. This risk is further enhanced due to the increased sophistication and activities of organized crime, hackers, terrorists and other disreputable parties. We regularly assess and attempt to improve our security systems and disaster preparedness, including back-up systems, but the risks are substantially escalating. As a result, cybersecurity and the continued enhancement of our controls and processes to protect our systems, data and networks from attacks or unauthorized access remain a priority. Accordingly, we may be required to expend additional resources to enhance our protective measures or to investigate and remediate any information security vulnerabilities or exposures. Such costs or losses could exceed the amount of insurance coverage, if any, which would adversely affect our earnings.

Our industry is faced with technological advances and changes on a continuing basis, and failure to adapt to these advances and changes could have a material adverse impact on our business. Technological advances and changes in the financial services industry are pervasive and constant factors. For our business to remain competitive, we must comprehend developments in new products, services and delivery systems utilizing new technology and adapt to those developments. Proper implementation of new technology can increase efficiency, decrease costs and help to meet customer demand. However, many of our competitors have greater resources to invest in technological advances and changes. We may not always be successful in utilizing the latest technological advances in offering our products and services or in otherwise conducting our business. Failure to identify, adapt to and implement technological advances and changes could have a material adverse effect on our business.

Our stock price may begin to reflect market volatility more closely than it has in the past. Our stock price can fluctuate widely in response to a variety of factors, including: actual or anticipated variations in our operating results; recommendations by securities analysts; significant acquisitions or business combinations; operating and stock price performance of other companies that investors deem comparable to us; new technology used or services offered by our competitors; news reports relating to trends, concerns and other issues in the financial services industry; and

changes in government regulations. Many of these factors that may adversely affect our stock price are less reflective of our particular condition or operating results than general market fluctuations, industry-wide factors or general economic or political conditions and events, including terrorist attacks, economic slowdowns or recessions, interest rate changes, credit loss trends or currency fluctuations.

Item 1B. Unresolved Staff Comments - None

Item 2. Properties

Our main office is at 250 Glen Street, Glens Falls, New York. The building is owned by us and serves as the main office for Glens Falls National, our principal subsidiary. We own twenty-eight branch banking offices and lease seven others at market rates. We own two offices for our insurance operations and lease six others. Four of our insurance offices are located at our branch locations. We also lease office space in a building near our main office in Glens Falls. In the opinion of management, the physical properties of our holding company and our subsidiary banks are suitable and adequate. For more information on our properties, see Notes 2, 6 and 18 to the Consolidated Financial Statements contained in Part II, Item 8 of this Report.

Item 3. 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 typically are the subject of or a party to various legal claims, which arise in the normal course of our business. The various legal claims currently pending against us will not, in the opinion of management based upon consultation with counsel, result in any material liability.

Item 4. Mine Safety Disclosures - None

PART II

Item 5. Market for the Registrant's Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities

The common stock of Arrow Financial Corporation is traded on the Global Select Market of the NASDAQ Stock Market[R] under the symbol AROW.
The high and low prices listed below represent actual sales transactions, as reported by NASDAQ. All stock prices and cash dividends per share have been restated to reflect subsequent stock dividends. On September 27, 2012, we distributed a 2% stock dividend on our outstanding shares of common stock.

	2012			2011		
	Market Price		Cash	Market Price		Cash
	Low	High	Dividends Declared	Low	High	Dividends Declared
First Quarter	$22.80	$26.62	$0.245	$21.50	$26.74	$0.238
Second Quarter	22.60	24.37	0.245	21.92	24.02	0.238
Third Quarter	23.26	25.68	0.245	21.18	23.84	0.238
Fourth Quarter	22.86	25.50	0.250	21.08	23.53	0.245

The payment of cash dividends by Arrow is determined at the discretion of its Board of Directors and is dependent upon, among other things, our earnings, financial condition and other factors, including applicable legal and regulatory restrictions. See "Capital Resources and Dividends" in Part II, Item 7.E. of this Report.
There were approximately 6,964 holders of record of Arrow’s common stock at December 31, 2012. Arrow has no other class of stock outstanding.

Equity Compensation Plan Information

The following table sets forth certain information regarding Arrow's equity compensation plans as of December 31, 2012. These equity compensation plans were our 2008 Long-Term Incentive Plan ("LTIP"), our 2011 Employee Stock Purchase Plan ("ESPP") and our 2008 Directors' Stock Plan (DSP). All of these plans have been approved by Arrow's shareholders.

Plan Category	(a) Number of Securities to be Issued Upon Exercise of Outstanding Options, Warrants and Rights	(b) Weighted-Average Exercise Price of Outstanding Options, Warrants and Rights	(c) Number of Securities Remaining Available for Future Issuance Under Equity Compensation Plans (Excluding Securities Reflected in Column (a))
Equity Compensation Plans Approved by Security Holders [1][2]	442,385	$23.03	220,228
Equity Compensation Plans Not Approved by Security Holders	—	—	—
Total	442,385	$23.03	220,228

(1) All 442,385 shares of common stock listed in column (a) are issuable pursuant to outstanding stock options granted under the LTIP.

(2) The total of 220,228 shares listed in column (c) includes 37,695 shares of common stock available for future award grants under the LTIP, 3,961 shares of common stock available for future issuance under the DSP and 178,572 shares of common stock available for future issuance under the ESPP.

STOCK PERFORMANCE GRAPHS

The following two graphs provide a comparison of the total cumulative return (assuming reinvestment of dividends) for the common stock of Arrow as compared to the Russell 2000 Index, the NASDAQ Banks Index and the Zacks $1B-$5B Bank Assets Index.

The historical information set forth below may not be indicative of the future results. The first graph presents the five-year period from December 31, 2007 to December 31, 2012 and the second graph presents stock performance for the ten-year period from December 31, 2002 to December 31, 2012.

	TOTAL RETURN PERFORMANCE					
	Period Ending					
Index	2007	2008	2009	2010	2011	2012
Arrow Financial Corporation	100.00	121.80	129.66	152.95	139.87	158.32
Russell 2000 Index	100.00	66.21	84.20	106.82	102.36	119.08
NASDAQ Banks Index	100.00	72.91	60.66	72.13	64.51	77.18
Zacks $1B - $5B Bank Assets Index	100.00	92.73	81.72	90.99	80.34	91.96

Source: Prepared by Zacks Investment Research, Inc. Used with permission. All rights reserved. Copyright 1980-2013.

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TOTAL RETURN PERFORMANCE

	Period Ending										
Index	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
Arrow Financial Corporation	100.00	116.55	138.10	124.17	125.62	117.22	142.78	151.99	179.30	163.97	185.59
Russell 2000 Index	100.00	147.25	174.25	182.18	215.65	212.27	140.55	178.74	226.74	217.28	252.77
NASDAQ Banks Index	100.00	128.64	147.31	143.90	161.59	127.87	93.23	77.56	92.24	82.49	98.69
Zacks $1B - $5B Bank Assets Index	100.00	138.88	161.80	159.48	177.14	143.24	132.83	117.06	130.33	115.08	131.73

Source: Prepared by Zacks Investment Research, Inc. Used with permission. All rights reserved. Copyright 1980-2013.

The preceding stock performance graphs shall not be deemed incorporated by reference by virtue of any general statement incorporating by reference this Report into any filing under the Securities Act of 1933, as amended, or the Securities Exchange Act of 1934, as amended, except to the extent the company specifically incorporates this information by reference, and shall not otherwise be deemed filed as part of such other filings.

Unregistered Sales of Equity Securities

In connection with Arrow's acquisition by merger in August 2011 of W. Joseph McPhillips, Inc. and McPhillips-Northern, Inc., two affiliated insurance agencies specializing in the sale of property and casualty insurance, Arrow issued to the agencies' shareholders at closing and in subsequent post-closing payments, in exchange for all of their shares of the agencies, a total of 92,559 shares, as adjusted for subsequent stock dividends, of Arrow's common stock and $191 thousand in cash. All Arrow shares thus issued to the shareholders were issued without registration under the Securities Act of 1933, as amended, in reliance upon the exemption for such registration set forth in Section 3(a)(11) of the Act and Rule 147 promulgated by the Securities and Exchange Commission thereunder. This exemption was available because all of the shareholders of the acquired agencies were New York residents and the acquired agencies were both New York corporations having substantially all of their assets and business operations

in the State of New York.
In connection with Arrow's acquisition by merger in February 2011 of Upstate Agency, Inc., an insurance agency specializing in the sale of property and casualty insurance, Arrow issued at closing of the transaction and in post-closing payments to date, to the sole shareholder of Upstate, in exchange for all of his shares of the agency, a total of 141,272 shares, as adjusted for subsequent stock dividends, of Arrow's common stock and approximately $2.7 million in cash. The acquisition agreement also provided for possible post-closing payments of additional shares of Arrow's common stock to the former shareholder of Upstate, contingent upon the financial performance and business results of Upstate as a subsidiary of Glens Falls National over the three-year period following the closing of the acquisition. The maximum remaining potential value of the Arrow shares issuable under this provision is $183 thousand. All shares issued to the Upstate shareholder at the original closing and issuable to him in future post-closing payments were and will be issued without registration under the Securities Act of 1933, as amended, in reliance upon the exemption for such registration set forth in Section 3(a)(11) of the Act and Rule 147 promulgated by the Securities and Exchange Commission thereunder. This exemption was and remains available because at closing the sole shareholder of Upstate was a New York resident and Upstate was a New York corporation having substantially all of its assets and business operations in the State of New York.
In connection with Arrow's acquisition by merger in April 2010 of Loomis & LaPann, Inc., an insurance agency specializing in the sale of property and casualty insurance, Arrow issued at closing of the transaction to the shareholders of Loomis, in exchange for all of their shares of the agency, a total of 35,048 shares, as adjusted for subsequent stock dividends and post-closing payments, of Arrow's common stock. The acquisition agreement also provided for possible post-closing payments of additional shares of Arrow's common stock to the former shareholders of Loomis, contingent upon the financial performance and business results of Loomis as a subsidiary of Glens Falls National over the three-year period following the closing of the acquisition. The maximum remaining potential dollar value of Arrow stock issuable to the former shareholders of Loomis under this post-closing payment provision is $142 thousand. All shares issued to the Loomis shareholders at the original closing and after the first subsequent year, and all shares issuable to them in future post-closing payments, were and will be issued without registration under the Securities Act of 1933, as amended, in reliance upon the exemption for such registration set forth in Section 3(a)(11) of the Act and Rule 147 promulgated by the Securities and Exchange Commission thereunder. This exemption was and remains available because at closing all of the shareholders of Loomis were New York residents and Loomis was a New York corporation having substantially all of its assets and business operations in the State of New York.

Issuer Purchases of Equity Securities
The following table presents information about repurchases by us during the three months ended December 31, 2012 of our common stock (our only class of equity securities registered pursuant to Section 12 of the Securities Exchange Act of 1934):

Fourth Quarter 2012 Calendar Month	Total Number of Shares Purchased[1]	Average Price Paid Per Share[1]	Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs[2]	Maximum Approximate Dollar Value of Shares that May Yet be Purchased Under the Plans or Programs[2]
October	31,230	$24.65	30,000	$2,349,314
November	44,015	24.00	28,000	1,682,658
December	22,111	24.67	—	1,682,658
Total	97,356	24.36	58,000	

[1]The total number of shares purchased and the average price paid per share include shares purchased in open market transactions under the Arrow Financial Corporation Automatic Dividend Reinvestment Plan (the "DRIP") by the administrator of the DRIP and shares surrendered or deemed surrendered to Arrow by holders of options to acquire

Arrow common stock received by them under the stock plan in connection with the exercise of such options. In the months indicated, the listed number of shares purchased included the following numbers of shares purchased through such methods: October - DRIP purchases (1,230 shares) ; November - DRIP purchases (3,339 shares), stock options (12,676 shares); December - DRIP purchases (21,447 shares), stock options (664 shares). Monthly DRIP purchases do not reflect any so-called “netting” transactions, that is, purchases effected within the DRIP itself by the DRIP administrator consisting of monthly acquisitions of shares on behalf of purchasing participants who are investing funds in the plan from selling participants who are withdrawing funds from the plan.

[2]Includes only those shares acquired by Arrow pursuant to its publicly-announced stock repurchase programs; does not include shares purchased or subject to purchase under the DRIP or shares surrendered to Arrow upon exercise of options granted under any compensatory stock plans. Our only publicly-announced stock repurchase program in effect for the fourth quarter of 2012 was the program approved by the Board of Directors and announced in November 2011, under which the Board authorized management, in its discretion, to repurchase from time to time during 2012, in the open market or in privately negotiated transactions, up to $5 million of Arrow common stock. In November 2012, the Board authorized a similar repurchase program for 2013, also having a $5 million total authorization for stock repurchases.

Item 6. Selected Financial Data

FIVE YEAR SUMMARY OF SELECTED DATA
Arrow Financial Corporation and Subsidiaries
(Dollars In Thousands, Except Per Share Data)

Consolidated Statements of Income Data:	2012	2011	2010	2009	2008
Interest and Dividend Income	$69,379	$76,791	$84,972	$86,857	$89,508
Interest Expense	11,957	18,679	23,695	26,492	32,277
Net Interest Income	57,422	58,112	61,277	60,365	57,231
Provision for Loan Losses	845	845	1,302	1,783	1,671
Net Interest Income After Provision for Loan Losses	56,577	57,267	59,975	58,582	55,560
Noninterest Income	26,234	23,133	17,582	19,235	15,886
Net Gains on Securities Transactions	865	2,795	1,507	357	383
Noninterest Expense	(51,836)	(51,548)	(47,418)	(46,592)	(42,393)
Income Before Provision for Income Taxes	31,840	31,647	31,646	31,582	29,436
Provision for Income Taxes	9,661	9,714	9,754	9,790	8,999
Net Income	$22,179	$21,933	$21,892	$21,792	$20,437
Per Common Share: [1]					
Basic Earnings	$1.85	$1.83	$1.85	$1.85	$1.74
Diluted Earnings	1.85	1.83	1.84	1.84	1.73
Per Common Share: [1]					
Cash Dividends	$0.99	$0.96	$0.93	$0.90	$0.88
Book Value	14.62	13.87	12.88	11.92	10.68
Tangible Book Value [2]	12.42	11.64	11.42	10.51	9.30
Consolidated Year-End Balance Sheet Data:					
Total Assets	$2,022,796	$1,962,684	$1,908,336	$1,841,627	$1,665,086
Securities Available-for-Sale	478,698	556,538	517,364	437,706	315,414
Securities Held-to-Maturity	239,803	150,688	159,938	168,931	133,976
Loans	1,172,341	1,131,457	1,145,508	1,112,150	1,109,812
Nonperforming Assets [3]	9,070	8,128	4,945	4,772	4,971
Deposits	1,731,155	1,644,046	1,534,004	1,443,566	1,275,063
Federal Home Loan Bank Advances	59,000	82,000	130,000	140,000	160,000
Other Borrowed Funds	32,678	46,293	73,214	93,908	79,956
Stockholders' Equity	175,825	166,385	152,259	140,818	125,802
Selected Key Ratios:					
Return on Average Assets	1.11 %	1.13 %	1.16 %	1.24 %	1.24 %
Return on Average Equity	12.88	13.45	14.56	16.16	16.26
Dividend Payout [4]	53.51	52.46	50.54	48.91	50.87

[1]Share and per share amounts have been adjusted for subsequent stock splits and dividends, including the most recent September 2012 2% stock dividend.
[2]Tangible book value excludes goodwill and other intangible assets from total equity.
[3]Nonperforming assets consist of nonaccrual loans, loans past due 90 or more days but still accruing interest, repossessed assets, restructured loans, other real estate owned and nonaccrual investments.
[4]Dividend Payout Ratio – cash dividends per share to fully diluted earnings per share.

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Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations
Selected Quarterly Information
Dollars in thousands, except per share amounts
Share and per share amounts have been restated for the September 2012 2% stock dividend

Quarter Ended	12/31/2012	9/30/2012	6/30/2012	3/31/2012	12/31/2011
Net Income	$5,549	$5,748	$5,594	$5,288	$5,431
Transactions Recorded in Net Income (Net of Tax):					
Net Gains on Securities Transactions	94	39	86	303	—
Net Gains on Sales of Loans	476	362	324	216	259
Reversal of VISA Litigation Reserve	—	—	178	—	—
Share and Per Share Data:					
Period End Shares Outstanding	12,025	12,034	12,001	11,996	11,999
Basic Average Shares Outstanding	12,014	12,012	11,994	12,005	12,017
Diluted Average Shares Outstanding	12,032	12,032	12,009	12,031	12,024
Basic Earnings Per Share	$0.46	$0.48	$0.47	$0.44	$0.45
Diluted Earnings Per Share	0.46	0.48	0.47	0.44	0.45
Cash Dividend Per Share	0.25	0.25	0.25	0.25	0.25
Selected Quarterly Average Balances:					
Interest-Bearing Deposits at Banks	$40,065	$33,332	$55,023	$30,780	$49,101
Investment Securities	745,150	670,328	682,589	678,474	674,338
Loans	1,160,226	1,148,771	1,143,666	1,136,322	1,126,452
Deposits	1,781,778	1,701,599	1,733,320	1,683,781	1,668,062
Other Borrowed Funds	80,357	68,667	66,022	83,055	101,997
Shareholders’ Equity	176,514	174,069	170,199	167,849	168,293
Total Assets	2,064,602	1,971,215	1,994,883	1,959,741	1,963,915
Return on Average Assets	1.07 %	1.16 %	1.13 %	1.09 %	1.10 %
Return on Average Equity	12.51 %	13.14 %	13.22 %	12.67 %	12.80 %
Return on Tangible Equity [1]	14.72 %	15.50 %	15.67 %	15.07 %	15.22 %
Average Earning Assets	$1,945,441	$1,852,431	$1,881,278	$1,845,576	$1,849,891
Average Interest-Bearing Liabilities	1,612,959	1,511,634	1,565,692	1,545,098	1,547,071
Interest Income, Tax-Equivalent	17,787	18,168	18,508	18,810	19,179
Interest Expense	2,503	2,643	3,279	3,532	4,022
Net Interest Income, Tax-Equivalent	15,284	15,525	15,229	15,278	15,157
Tax-Equivalent Adjustment	1,047	1,000	975	872	832
Net Interest Margin [1]	3.13 %	3.33 %	3.26 %	3.33 %	3.25 %
Efficiency Ratio Calculation:					
Noninterest Expense	$13,117	$12,922	$12,651	$13,146	$12,455
Less: Intangible Asset Amortization	(126)	(126)	(127)	(138)	(142)
Net Noninterest Expense	$12,991	$12,796	$12,524	$13,008	$12,313
Net Interest Income, Tax-Equivalent	$15,284	$15,525	$15,229	$15,278	$15,157
Noninterest Income	6,897	6,835	6,808	6,559	6,199
Less: Net Securities Gains	(156)	(64)	(143)	(502)	—
Net Gross Income, Adjusted	$22,025	$22,296	$21,894	$21,335	$21,356
Efficiency Ratio	58.98 %	57.39 %	57.20 %	60.97 %	57.66 %
Period-End Capital Information:					
Total Stockholders’ Equity (i.e. Book Value)	$175,825	$176,314	$171,940	$168,466	$166,385
Book Value per Share	14.62	14.65	14.33	14.04	13.87

Intangible Assets	26,495		26,546		26,611		26,653		26,752	
Tangible Book Value per Share [1]	12.42		12.45		12.11		11.82		11.64	
Capital Ratios:										
Tier 1 Leverage Ratio	9.10	%	9.41	%	9.09	%	9.10	%	8.95	%
Tier 1 Risk-Based Capital Ratio	15.02	%	15.20	%	15.08	%	14.84	%	14.71	%
Total Risk-Based Capital Ratio	16.26	%	16.45	%	16.34	%	16.10	%	15.96	%
Assets Under Trust Administration and Investment Management	$1,045,972		$1,051,176		$1,019,702		$1,038,186		$973,551	

[1] See "Use of Non-GAAP Financial Measures" on page 4.

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Selected Twelve-Month Information
Dollars in thousands, except per share amounts
Share and per share amounts have been restated for the September 2012 2% stock dividend

	2012	2011	2010
Net Income	$22,179	$21,933	$21,892
Transactions Recorded in Net Income (Net of Tax):			
Net Securities Gains	$522	$1,688	$910
Net Gains on Sales of Loans	1,378	523	618
Prepayment Penalty on FHLB Advances	—	(989)	—
Period End Shares Outstanding	12,025	11,999	11,825
Basic Average Shares Outstanding	12,007	11,970	11,836
Diluted Average Shares Outstanding	12,017	11,982	11,872
Basic Earnings Per Share	$1.85	$1.83	$1.85
Diluted Earnings Per Share	1.85	1.83	1.84
Cash Dividends Per Share	0.99	0.96	0.93
Average Assets	$1,997,721	$1,943,263	$1,892,324
Average Equity	172,175	163,063	150,377
Return on Average Assets	1.11 %	1.13 %	1.16 %
Return on Average Equity	12.88	13.45	14.56
Average Earning Assets	$1,881,279	$1,839,028	$1,807,763
Average Interest-Bearing Liabilities	1,558,864	1,535,084	1,512,937
Interest Income, Tax-Equivalent [1]	73,273	80,385	88,424
Interest Expense	11,957	18,679	23,695
Net Interest Income, Tax-Equivalent [1]	61,316	61,706	64,729
Tax-Equivalent Adjustment	3,894	3,594	3,452
Net Interest Margin [1]	3.26 %	3.36 %	3.58 %
Efficiency Ratio Calculation [1]			
Noninterest Expense	$51,836	$51,548	$47,418
Less: Intangible Asset Amortization	(517)	(510)	(271)
Prepayment Penalty on FHLB Advances	—	(1,638)	—
Net Noninterest Expense	$51,319	$49,400	$47,147
Net Interest Income, Tax-Equivalent [1]	$61,316	$61,706	$64,729
Noninterest Income	27,099	25,928	19,089
Less: Net Securities Gains	(865)	(2,795)	(1,507)
Net Gross Income, Adjusted	$87,550	$84,839	$82,311
Efficiency Ratio [1]	58.62 %	58.23 %	57.28 %
Period-End Capital Information:			
Tier 1 Leverage Ratio	9.28 %	8.96 %	8.78 %
Total Stockholders' Equity (i.e. Book Value)	$175,825	$166,385	$152,259
Book Value per Share	14.62	13.87	12.88
Intangible Assets	26,495	26,752	17,241
Tangible Book Value per Share [1]	12.42	11.64	11.42
Asset Quality Information:			
Net Loans Charged-off as a Percentage of Average Loans	0.05 %	0.05 %	0.06 %
Provision for Loan Losses as a Percentage of Average Loans	0.07 %	0.08 %	0.11 %
Allowance for Loan Losses as a Percentage of Period-End Loans	1.30 %	1.33 %	1.28 %
Allowance for Loan Losses as a Percentage of Nonperforming Loans	190.37 %	197.10 %	300.57 %
Nonperforming Loans as a Percentage of Period-End Loans	0.69 %	0.67 %	0.43 %
Nonperforming Assets as a Percentage of Total Assets	0.45 %	0.41 %	0.26 %

[1] See "Use of Non-GAAP Financial Measures" on page 4.

CRITICAL ACCOUNTING POLICIES

In order to prepare our consolidated financial statements in accordance with accounting principles generally accepted in the United States of America, we were required to make estimates and assumptions that affected the amounts reported in these statements. There are uncertainties inherent in making these estimates and assumptions, which could materially affect our results of operations and financial position. We consider the following to be critical accounting policies:

The allowance for loan losses: The adequacy of the allowance for loan losses is sensitive to changes in current economic conditions that may make it difficult for borrowers to meet their contractual obligations. Any downward trend in the economy, regional or national, may require us to increase the allowance for loan losses resulting in a negative impact on our results of operations and financial condition at the same time that other areas of our operations, including new loan originations and assets under administration in our trust department may also be experiencing negative pressures from the same underlying negative economic conditions.

Liabilities for retirement plans: We have a variety of pension and retirement plans. Liabilities under these plans rely on estimates of future salary increases, numbers of employees and employee retention, discount rates and long-term rates of return on plan investments. Changes in these assumptions due to changes in the financial markets, the economy, our own operations or applicable law and regulation may result in material changes to our liability for postretirement expense, with consequent impact on our results of operations and financial condition.

Valuation allowance for deferred tax assets: Accounting standards require a reduction in the carrying amount of deferred tax assets by a valuation allowance if, based on the weight of available evidence, it is more likely than not (a likelihood of more than 50%) that some portion or all of the deferred tax assets will not be realized. The valuation allowance should be sufficient to reduce the deferred tax asset to the amount that is more likely than not to be realized. Our analysis of the need for a valuation allowance for deferred tax assets is, in part, based on an estimate of future taxable income.

Goodwill: Accounting standards require that goodwill be tested for impairment at a level of reporting referred to as a reporting unit. Impairment is the condition that exists when the carrying amount of goodwill exceeds its implied fair value. An entity may assess qualitative factors to determine whether it is more likely than not (that is, a likelihood of more than 50 percent) that the fair value of a reporting unit is less than its carrying amount, including goodwill or apply a two-step impairment analysis. If, after assessing the qualitative factors, it is determined that the fair value of a reporting unit is less than its carrying amount, we must perform the two-step impairment test. The first step of the goodwill impairment test, used to identify potential impairment, compares the fair value of a reporting unit with its carrying amount, including goodwill. The second step of the goodwill impairment test, used to measure the amount of impairment loss, compares the implied fair value of a reporting unit's goodwill with the carrying amount of that goodwill.

Other than temporary decline in the value of debt and equity securities: Accounting standards require that, for individual securities classified as either available-for-sale or held-to-maturity, an enterprise shall determine whether a decline in fair value below the amortized cost basis is other than temporary. When an other-than-temporary impairment has occurred, the amount of the other-than-temporary impairment recognized in earnings depends on whether we intend to sell the security or whether or not it is more likely than not will be required to sell the security before recovery of its amortized cost basis less any current-period credit loss. If we intend to sell the security or if it is more likely than not will be required to sell the security before recovery of its amortized cost basis less any current-period credit loss, the other-than-temporary impairment is recognized in earnings equal to the entire difference between the investment’s amortized cost basis and its fair value at the balance sheet date. If we do not intend to sell the security and it is not more likely than not that we will be required to sell the security before recovery of its amortized cost basis less any current-period credit loss, the other-than-temporary impairment is separated into the amount representing the credit loss and the amount related to all other factors. The amount of the total other-than-temporary impairment related to the credit loss is recognized in earnings. Any significant economic downturn might result, and historically have on occasion resulted, in an other-than-temporary impairment in securities held in our portfolio.

Valuation methods for securities: Most of the securities portfolio, which includes U.S. Treasury and agency securities, mortgage-backed securities, collateralized mortgage obligations, municipal securities, corporate debt and equity securities are priced using industry-standard models that consider various assumptions that include time value, yield curves, volatility factors, prepayment speeds, default rates, loss severity, current market and contractual prices for the underlying financial instruments, as well as other relevant economic measures. Substantially all of these assumptions are either observable in the marketplace, derived from observable data or are supported by observable levels at which transactions are executed in the marketplace. Municipal and corporate securities are valued using a type of matrix, or grid, pricing in which securities are benchmarked against the treasury rate based on credit rating. These model and matrix measurements are classified as Level 2 in the fair value hierarchy.

The following discussion and analysis focuses on and reviews our results of operations for each of the years in the three-year period ended December 31, 2012 and our financial condition as of December 31, 2012 and 2011. The discussion below should be read in conjunction with the selected quarterly and annual information set forth above and the consolidated financial statements and other financial data presented elsewhere in this Report. When necessary, prior-year financial information has been reclassified to conform to the current-year presentation.

A. OVERVIEW
Summary of 2012 Financial Results

We reported net income for 2012 of $22.2 million, representing diluted earnings per share ("EPS") of $1.85, an increase of two cents, or 1.1% from our 2011 result. Return on average equity ("ROE") for the 2012 year continued to be strong at 12.88%, although down from the ROE of 13.45% for the 2011 year. Return on average assets ("ROA") for 2012 continued to be strong at 1.11%, although down from ROA of 1.13% for 2011. Both decreases were principally due to our shrinking net interest margin, which led to a slight decrease, 0.6%, in our net interest income, despite the fact that our earning assets grew and our asset quality remained strong. The decrease in net interest income was more than offset by a 4.5% increase in our noninterest income.
Total assets were $2.023 billion at December 31, 2012, which represented an increase of $60.1 million, or 3.1%, above the $1.963 billion level at December 31, 2011.
Stockholders' equity was $175.8 million at December 31, 2012, an increase of $9.44 million or 5.7%, from the year earlier level. The components of the change in stockholders' equity since year-end 2011 are presented in the Consolidated Statement of Changes in Stockholders' Equity on page 59, and are discussed in more detail in the last section of this Overview on page 27 entitled, “Increase in Stockholder Equity.”

Regulatory capital: At period-end, we continue to exceed all current regulatory minimum capital requirements at both the holding company and bank levels, by a substantial amount. As of December 31, 2012 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 "Current Regulatory Capital Standards" on page 48, and "Important Proposed Changes to Regulatory Capital Standards" on page 47.

Economic recession and loan quality: During the early stages of the economic crisis in late 2008 and early 2009, our market area of northeastern New York 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 had been 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 reflected in 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 3 for peer group information). By year-end 2010, however, our loan quality began to stabilize, a trend that continued through 2011. During this period, although nonperforming loans increased slightly, charge-offs decreased. Nonperforming loans were $8.0 million at December 31, 2012, an increase of $424 thousand from year-end 2011. The ratio of nonperforming loans to period-end loans at December 31, 2012 was .69%, an increase from .67% at December 31, 2011. By way of comparison, this ratio for our peer group was 2.18% at December 31, 2012, which was a significant improvement for the peer group from its 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. Loans charged-off (net of recoveries) against our allowance for loan losses was a very

low $550 thousand for 2012, as compared to $531 thousand for 2011. At December 31, 2012, the allowance for loan losses was $15.3 million, representing 1.30% of total loans, an decrease of 3 basis points from December 31, 2011. 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 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 originate all of the residential real estate loans 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 and 2012, 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 47 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. See the discussion on p. 9 under "The Dodd-Frank Act" regarding specific provisions of Dodd-Frank that have had, or are likely to have particular significance to Arrow and its banks in their future operations and financial results.

(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 did not experience any liquidity problems or special concerns during 2012, nor did we during 2011 or 2010. The terms of our lines of credit with our correspondent banks, the FHLBNY and the Federal Reserve Bank have not changed (see our general liquidity discussion on page 46). 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 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 we 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. 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 lower rate even applied to a larger base has resulted in a significant decrease in our FDIC premiums, while even with the lower rates, the premiums paid by larger banks 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. 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 was of such funding on the Company's contingent obligation beyond its Class B Visa shares to which the Company has not recognized any economic value for these 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 December 31, 2012, our tangible book value per share (calculated based on stockholders' equity reduced by intangible assets including goodwill and other intangible assets) amounted to $12.42, an increase of $0.78, or 6.7%, from December 31, 2011. Our total stockholders' equity at December 31, 2012 increased 5.7% over the year-earlier level, and our total book value per share increased by 5.4% over the year earlier level. This increase principally reflected the following factors: i) $22.2 million net income for the period; offset in part by, ii) cash dividends of $11.8 million; and (iii) repurchases of our own common stock of $4.9 million. As of December 31, 2012, our closing stock price was $24.95, resulting in a trading multiple of 2.01 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, a cash dividend of $.25 per share for the fourth quarter of 2012 and has declared a $.25 per share cash dividend for the first quarter of 2013.

B. RESULTS OF OPERATIONS

The following analysis of net interest income, the provision for loan losses, noninterest income, noninterest expense and income taxes, highlights the factors that had the greatest impact on our results of operations for 2012 and the prior two years.

I. NET INTEREST INCOME (Tax-equivalent Basis)

Net interest income represents the difference between interest, dividends and fees earned on loans, securities and other earning assets and interest paid on deposits and other sources of funds. Changes in net interest income result from changes in the level and mix of earning assets and sources of funds (volume) and changes in the yields earned and interest rates paid (rate). Net interest margin is the ratio of net interest income to average earning assets. Net interest income may also be described as the product of average earning assets and the net interest margin. As described in the section entitled “Use of Non-GAAP Financial Measures” on page 4 of this Report we calculate net interest income on a tax-equivalent basis using a marginal tax rate of 35%.

CHANGE IN NET INTEREST INCOME
(Dollars In Thousands) (Tax-equivalent Basis)

	Year Ended December 31,			Change From Prior Year			
				2011 to 2012		2010 to 2011	
	2012	2011	2010	Amount	%	Amount	%
Interest and Dividend Income	$73,273	$80,385	$88,424	$(7,112)	(8.8)%	$(8,039)	(9.1)%

Interest Expense	11,957	18,679	23,695	(6,722)	(36.0)	(5,016)	(21.2)
Net Interest Income	$61,316	$61,706	$64,729	$(390)	(0.6)	$(3,023)	(4.7)

On a tax-equivalent basis, net interest income was $61.3 million in 2012, a decrease of $390 thousand, or .6%, from $61.7 million in 2011. This compared to an decrease of $3.0 million, or 4.7%, from 2010 to 2011. Factors contributing to the year-to-year changes in net interest income over the three-year period are discussed in the following portions of this Section B.I.

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In the following table, net interest income components are presented on a tax-equivalent basis. Changes between periods are attributed to movement in either the average daily balances or average rates for both earning assets and interest-bearing liabilities. Changes attributable to both volume and rate have been allocated proportionately between the categories.

	2012 Compared to 2011 Change in Net Interest Income Due to:			2011 Compared to 2010 Change in Net Interest Income Due to:		
Interest and Dividend Income:	Volume	Rate	Total	Volume	Rate	Total
Interest-Bearing Bank Balances	$6	$4	$10	$(58)	$(1)	$(59)
Investment Securities:						
Fully Taxable	344	(3,479)	(3,135)	1,301	(3,614)	(2,313)
Exempt from Federal Taxes	233	(141)	92	986	(1,001)	(15)
Loans	1,093	(5,172)	(4,079)	(489)	(5,163)	(5,652)
Total Interest and Dividend Income	1,676	(8,788)	(7,112)	1,740	(9,779)	(8,039)
Interest Expense:						
Deposits:						
NOW Accounts	890	(2,378)	(1,488)	601	(1,131)	(530)
Savings Deposits	120	(731)	(611)	257	(495)	(238)
Time Deposits of $100,000 or More	(305)	(321)	(626)	(233)	(37)	(270)
Other Time Deposits	(520)	(893)	(1,413)	(238)	(519)	(757)
Total Deposits	185	(4,323)	(4,138)	387	(2,182)	(1,795)
Short-Term Borrowings	(39)	(31)	(70)	(22)	(28)	(50)
Long-Term Debt	(1,628)	(886)	(2,514)	(2,058)	(1,113)	(3,171)
Total Interest Expense	(1,482)	(5,240)	(6,722)	(1,693)	(3,323)	(5,016)
Net Interest Income	$3,158	$(3,548)	$(390)	$3,433	$(6,456)	$(3,023)

The following table reflects the components of our net interest income, setting forth, for years ended December 31, 2012, 2011 and 2010 (i) average balances of assets, liabilities and stockholders' equity, (ii) interest and dividend income earned on earning assets and interest expense incurred on interest-bearing liabilities, (iii) average yields earned on earning assets and average rates paid on interest-bearing liabilities, (iv) the net interest spread (average yield less average cost) and (v) the net interest margin (yield) on earning assets. Interest income and interest rate information is presented on a tax-equivalent basis (see the discussion under "Use of Non-GAAP Financial Measures" on page 4 of this Report). The yield on securities available-for-sale is based on the amortized cost of the securities. Nonaccrual loans are included in average loans.

Average Consolidated Balance Sheets and Net Interest Income Analysis
(Tax-equivalent basis using a marginal tax rate of 35%)
(Dollars in Thousands)

Years Ended:	2012			2011			2010		
	Average Balance	Interest Income/ Expense	Rate Earned/ Paid	Average Balance	Interest Income/ Expense	Rate Earned/ Paid	Average Balance	Interest Income/ Expense	Rate Earned/ Paid
Interest-Bearing Deposits at Banks	$39,783	$108	0.27%	$37,440	$98	0.26%	$59,771	$157	0.26%
Investment Securities:									
Fully Taxable	465,105	9,286	2.00	452,264	12,421	2.75%	413,212	14,734	3.57
Exempt from Federal Taxes	229,105	9,074	3.96	223,259	8,982	4.02%	200,062	8,997	4.50
Loans	1,147,286	54,805	4.78	1,126,065	58,884	5.23%	1,134,718	64,536	5.69
Total Earning Assets	1,881,279	73,273	3.89	1,839,028	80,385	4.37%	1,807,763	88,424	4.89
Allowance for Loan Losses	(15,170)			(14,821)			(14,385)		
Cash and Due From Banks	30,936			28,844			28,717		
Other Assets	100,676			90,212			70,229		
Total Assets	$1,997,721			$1,943,263			$1,892,324		
Deposits:									
NOW Accounts	$726,660	3,564	0.49	$603,965	5,052	0.84%	$541,161	5,582	1.03
Savings Deposits	437,095	1,287	0.29	409,398	1,898	0.46%	361,949	2,136	0.59
Time Deposits of $100,000 Or More	107,665	2,007	1.86	122,897	2,633	2.14%	133,770	2,903	2.17
Other Time Deposits	212,918	3,730	1.75	238,865	5,143	2.15%	249,192	5,900	2.37
Total Interest-Bearing Deposits	1,484,338	10,588	0.71	1,375,125	14,726	1.07%	1,286,072	16,521	1.28
Short-Term Borrowings	24,225	43	0.18	56,206	92	0.16%	64,481	125	0.19
FHLBNY Term Advances and Other Long-Term Debt	50,301	1,326	2.64	103,753	3,861	3.72%	162,384	7,049	4.34
Total Interest-Bearing Liabilities	1,558,864	11,957	0.77	1,535,084	18,679	1.22%	1,512,937	23,695	1.57
Demand Deposits	240,872			221,035			205,497		
Other Liabilities	25,810			24,081			23,513		

Total Liabilities	1,825,546			1,780,200			1,741,947		
Stockholders' Equity	172,175			163,063			150,377		
Total Liabilities and Stockholders' Equity	$1,997,721			$1,943,263			$1,892,324		
Net Interest Income (Tax-equivalent Basis)		61,316			61,706			64,729	
Reversal of Tax Equivalent Adjustment		(3,894)	0.21%		(3,594)	0.20%		(3,452)	0.19%
Net Interest Income		$57,422			$58,112			$61,277	
Net Interest Spread			3.12%			3.15%			3.32%
Net Interest Margin			3.26%			3.36%			3.58%

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CHANGES IN NET INTEREST INCOME DUE TO RATE

YIELD ANALYSIS (Tax-equivalent basis)	December 31,					
	2012		2011		2010	
Yield on Earning Assets	3.89	%	4.37	%	4.89	%
Cost of Interest-Bearing Liabilities	0.77		1.22		1.57	
Net Interest Spread	3.12	%	3.15	%	3.32	%
Net Interest Margin	3.26	%	3.36	%	3.58	%

In 2012, we experienced a decrease in net interest income from 2011. During the recent period, beginning in late 2008 and extending up to the present, our earning assets have continued to reprice downwards at least as fast or faster than our cost of interest bearing liabilities. Following two years of decreases in net interest income in 2005 and 2006 (during a period of rising interest rates), we experienced four successive years of increases in net interest income from 2007 through 2010. In each of these years, we experienced a benefit from an increase in average earning assets, although the substantial increase in net interest income in 2008 was largely attributable to a widened margin during the earlier portion of the year, typical of a period in which interest rates begin to fall, as our paying liabilities reprice downwards more quickly than our earning assets. From 2009 through 2012, however, our net interest margin has been consistently under pressure and has generally declined.
The decrease in net interest income was $390 thousand, or .6%, from 2011 to 2012. Net interest income decreased $3.0 million, or 4.7%, from 2010 to 2011. In 2012, an increase in average earning assets, net of a smaller increase in average interest-bearing liabilities (i.e., changes in volume) had a $3.2 million positive impact on net interest income, while changes in rates provided a $3.5 million negative impact on our net interest income for the year, as yields on earning assets decreased more rapidly than rates paid on liabilities, the latter being more constrained by the rapid approach of zero as an absolute limit on short term, no or very low-risk rates (i.e., the "federal funds rate").
Generally, the following items have a major impact on changes in net interest income due to rate: general interest rate changes, changes in the yield curve, the ratio of our rate sensitive assets to rate sensitive liabilities ("interest rate sensitivity gap") during periods of interest rate changes, and changes in the level of nonperforming loans.

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 assets into similarly high yielding asset categories has become progressively more difficult. The modest up-tick in loan demand and in the U.S. economy generally experienced during 2012 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 and 2011 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 newer, lower-priced assets. 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 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.

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 under Item 7.A., "Quantitative and Qualitative Disclosures About Market Risk".

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CHANGES IN NET INTEREST INCOME DUE TO VOLUME
AVERAGE BALANCES
(Dollars In Thousands)

	Years Ended December 31,			Change From Prior Year			
				2011 to 2012		2010 to 2011	
	2012	2011	2010	Amount	%	Amount	%
Earning Assets	$1,881,279	$1,839,028	$1,807,763	$42,251	2.3 %	$31,265	1.7 %
Interest-Bearing Liabilities	1,558,864	1,535,084	1,512,937	23,780	1.5	22,147	1.5
Demand Deposits	240,872	221,035	205,497	19,837	9.0	15,538	7.6
Total Assets	1,997,721	1,943,263	1,892,324	54,458	2.8	50,939	2.7
Earning Assets to Total Assets	94.17 %	94.64 %	95.53 %				

2011 to 2012:
In general, an increase in average earning assets has a positive impact on net interest income. For 2012, average earning assets increased $42.3 million or 2.3% over 2011, while average interest-bearing liabilities increased $23.8 million or 1.5%. This combination led to a $3.2 million increase in net interest income, partially offsetting the negative impact of a 10 basis point decrease in our net interest margin (from 3.36% to 3.26%) between the two years which resulted in a $3.5 million decrease in net interest income.
The $42.3 million increase in average earning assets from 2011 to 2012 reflected an increase in the average balance of our securities portfolio and the average balance of total loans from 2011 to 2012. Within the loan portfolio, our three principal segments are residential real estate loans, automobile loans (primarily through our indirect lending program) and commercial loans. Through all of 2012 we sold a significant portion of our residential real estate loan originations into the secondary market, leading to a decrease in the average balance of that portfolio. The average balance of our automobile loan portfolio increased over the past year reflecting an increase in demand for new vehicles and our pricing on these loans (which, although competitive with the rates charged by other commercial banks, still left us at a disadvantage compared to the subsidized, below-market loan rates offered by the financing affiliates of the automobile manufacturers). Our commercial and commercial real estate loan portfolio also experienced growth over the past year. Overall, a significant portion of the growth in our earning assets in 2012 was in our lower yielding investment portfolio (versus the higher yields in our loan portfolio) diminishing to a degree the financial impact of our growth in total earning assets, which was 2.3% in 2012 (versus 1.7% in 2011).
The $23.8 million increase in average interest-bearing liabilities reflected the offsetting impact of an $109.2 million increase in interest-bearing deposits and an $85.4 million decrease in our other borrowed funds, primarily FHLB term advances.

2010 to 2011:
For 2011, average earning assets increased $31.3 million or 1.7% over 2010, while average interest-bearing liabilities increased $22.1 million or 1.5%. This combination had a positive impact of $3.4 million on our net interest income for the year, diminishing in part the negative effect of the decrease in our, net interest margin, which decreased by 22 basis points (from 3.58% to 3.36%) between the two years.
The $31.3 million increase in average earning assets from 2010 to 2011 reflected an increase in the average balance of our securities portfolio, while the average balance of total loans actually decreased from 2010 to 2011. Through all of 2011, we sold a substantial portion of our residential real estate loan originations leading to a decrease in the average balance of that portfolio. The average balance of our indirect portfolio also decreased between the two years, reflecting both the weak demand for new vehicles and our pricing on these loans (like many other banks, we could not compete with the subsidized, below-market loan rates offered by the financing affiliates of the automobile manufacturers). Only our commercial loan portfolio experienced growth in 2011. As in 2012, most of the growth in our earning assets was in our lower yielding investment portfolio (versus the higher yields in our loan portfolio) and such growth, in total earning assets was only 1.7% in 2011 (versus 7.1% in 2010).

The $22.1 million increase in average interest-bearing liabilities reflected the offsetting impact of an $89.1 million increase in interest-bearing deposits and a $66.9 million decrease in our other borrowed funds, primarily FHLB term advances.

Increases in the volume of loans and deposits, as well as yields and costs by type, are discussed later in this Report under Item 7.C. “Financial Condition.”

II. PROVISION FOR LOAN LOSSES AND ALLOWANCE FOR LOAN LOSSES

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. Beginning in 2010, Note 5 to our consolidated financial statements includes all of the disclosures about our method for calculating our provision for loan losses that was formerly reported in this section of managements' discussion and analysis. Note 5 also provides information about impaired loans.

SUMMARY OF THE ALLOWANCE AND PROVISION FOR LOAN LOSSES
(Dollars In Thousands) (Loans, Net of Unearned Income)

Years-Ended December 31,	2012	2011	2010	2009	2008
Period-End Loans	1,172,341	1,131,457	1,145,508	1,112,150	1,109,812
Average Loans	1,147,286	1,126,065	1,134,718	1,101,759	1,071,384
Period-End Assets	2,022,796	1,962,684	1,908,336	1,841,627	1,665,086
Nonperforming Assets, at Period-End:					
Nonaccrual Loans:					
Commercial Real Estate	2,026	1,503	2,237	2,235	2,263
Commercial Loans	1,787	6	94	309	50
Residential Real Estate Loans	2,400	2,582	916	901	100
Consumer Loans	420	437	814	945	1,056
Total Nonaccrual Loans	6,633	4,528	4,061	4,390	3,469
Loans Past Due 90 or More Days and Still Accruing Interest	920	1,662	810	270	457
Restructured	483	1,422	16	—	—
Total Nonperforming Loans	8,036	7,612	4,887	4,660	3,926
Repossessed Assets	64	56	58	59	64
Other Real Estate Owned	970	460	—	53	581
Nonaccrual Investments	—	—	—	—	400
Total Nonperforming Assets	$9,070	$8,128	$4,945	$4,772	$4,971
Allowance for Loan Losses:					
Balance at Beginning of Period	$15,003	$14,689	$14,014	$13,272	$12,401
Loans Charged-off:					
Commercial Loans	(90)	(105)	(30)	(88)	(83)
Real Estate - Commercial	(206)	—	—	—	—
Real Estate - Residential	(33)	(147)	—	(25)	(25)
Consumer Loans	(453)	(522)	(864)	(1,317)	(1,184)
Total Loans Charged-off	(782)	(774)	(894)	(1,430)	(1,292)
Recoveries of Loans Previously Charged-off:					
Commercial Loans	23	17	5	14	38
Real Estate – Commercial	—	—	—	—	197
Real Estate – Residential	—	—	—	6	2
Consumer Loans	209	226	262	369	255
Total Recoveries of Loans Previously Charged-off	232	243	267	389	492
Net Loans Charged-off	(550)	(531			