ARROW FINANCIAL CORP
Form 10-K
March 14, 2012

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, 2011
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)	(IRS Employer Identification Number)

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 definition of “large accelerated filer,” “accelerated filer” and “smaller reporting company” in Rule 12b-2 of the Exchange Act.
Large accelerated filer Accelerated filer x Non-accelerated filer Smaller reporting company
Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the 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: $275,731,916
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 17, 2012
Common Stock, par value $1.00 per share	11,892,843

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the Registrant's Proxy Statement for the Annual Meeting of Stockholders to be held April 25, 2012 (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 April 25, 2012.

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 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 303 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, 2011, 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 17 and 18 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.	10	Paragraph in "Health Care Reform"
		11	Last paragraph in Section D
	Part II, Item 7.A.	25	Paragraph in "Health Care Reform"
Impact of Changing Interest Rates on Earnings	Part II, Item 7.B.I.	30	Last 3 paragraphs
	Part II, Item 7.C.II.a.	40	Last paragraph under “Indirect Consumer Loans”
	Part II, Item 7.C.II.a.	41	3rd and 4th paragraph
	Part II, Item 7.C.IV.	45	2nd paragraph
	Part II, Item 7A.	52	Last 4 paragraphs
Adequacy of the Allowance for Loan Losses	Part II, Item 7.B.II.	32	1st paragraph under “II. Provision For Loan Losses and Allowance For Loan Losses”

Expected Level of Real Estate Loans	Part II, Item 7.C.II.a.	39	2nd paragraph under "Residential Real Estate Loans"
Liquidity	Part II, Item 7.D.	46	Last 2 paragraphs under "Liquidity"
Dividend Capacity	Part I, Item 1.C.	7	1st and 3rd paragraph under "Regulatory Capital Standards; Dividend Restrictions"
	Part II, Item 7.E.	48	3rd paragraph under table
Retirement Plans	Part II, Item 8	87	Paragraph in "Cash Flows"
Commitments to Extend Credit	Part II, Item 8	91	Last 2 paragraphs in Note 20
VISA Estimation	Part II, Item 7.A.	26	4th paragraph
Noninterest Income	Part II, Item 7.C.IV	33	Last paragraph
		34	1st paragraph

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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 laws and regulations, as are presently anticipated or, as a result of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Dodd-Frank Act or Dodd-Frank);
e. enhanced competition from unforeseen sources; and
f. similar uncertainties inherent in banking operations or business generally.

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 indirectly 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	$1,674,323	$295,645
Trust Assets Under Administration and Investment Management at Year-End (Not Included in Total Assets)	$925,869	$47,682
Date Organized	1851	1988
Employees (full-time equivalent)	482	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 521 full-time equivalent employees at December 31, 2011.
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 subsidiary of Arrow's principal subsidiary bank, Glens Falls National Bank and Trust Company, 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 90,744 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 acquisition (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 subsidiary 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, Arrow issued to the sole shareholder of Upstate, in exchange for all of his Upstate stock, 134,778 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 Arrow 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. At closing of the acquisition, Arrow issued to the shareholders of Loomis, in exchange for their Loomis stock, 27,838 shares of Arrow's common stock (as restated for dividends). 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 Arrow over a three-year period following the closing. To date, Arrow has issued 1,702 additional shares of its common stock in such post-closing payments to the former Loomis shareholders. 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. At the closing of the acquisitions, total deposits of the three branches were approximately $62 million and the related loans were approximately $8 million. The acquisition resulted in total intangible assets, including goodwill, of approximately $5.9 million.

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. As adjusted for cumulative contingent payments over the five-year period subsequent to the acquisition, we recorded the following intangible assets as a result of the acquisition (none of which are deductible for income tax purposes): goodwill ($2.277 million), covenant not to compete ($117 thousand) and portfolio expirations ($686 thousand). The value of the covenant is being amortized over five years and the value of the expirations is being amortized over twenty years. Under the acquisition agreement, we issued 109,955 shares of Arrow's common stock, including annual contingent post-closing payments of Arrow common stock. These contingent payments were recorded as additional goodwill at the time of payment.

In 2000, we formed a subsidiary, North Country Investment Advisers, Inc. (NCIA), which is an investment adviser registered with the U. S. Securities and Exchange Commission. NCIA advises two SEC-registered mutual funds, the North Country Intermediate Bond Fund and the North Country Equity Growth Fund. Currently, the investors in these funds consist primarily of individual, corporate and institutional trust customers of our Banks. However, the funds are also offered on a retail basis at most of the branch locations of our banks.

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 put on nonaccrual status when 120 days past due; 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 2011, we foreclosed on only six loans held in our own portfolio. We did not foreclose on any sold loans that we serviced for Freddie Mac.

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 is subject to regulation by the Board of Governors of the Federal Reserve System (“FRB”). Arrow is not a so-called “financial holding company” under federal banking law. Additionally, as a “bank holding company” under New York State law, Arrow is subject to regulation by the New York State Department of Financial Services. Our two subsidiary banks are both nationally chartered 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, 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.

Regulation of Transactions between Banks and their Affiliates

Arrow and its non-bank subsidiaries are “affiliates” within the meaning of Sections 23A and 23B of the Federal Reserve Act (the “FRA”) with Arrow's bank subsidiaries. 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 and subsidiaries of 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. The FRB has adopted various "capital adequacy guidelines" for its use 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 will continue to qualify as Tier 1 capital until maturity or redemption.) The 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 subject to capital requirements similar to the capital requirements applicable at the holding company level described above. Our bank's capital requirements have been promulgated by their primary federal regulator, the OCC. It is widely anticipated that prevailing capital guidelines will be strengthened by the regulatory authorities in upcoming years.

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 2011 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 13 “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. On September 12, 2010, the Group of Governors and Heads of Supervision, the oversight body of the Basel Committee, announced agreement on the calibration and phase-in arrangements for a strengthened set of capital requirements, known as Basel III. For more information on the Basel III standards, see Item 7, “Management's Discussion and Analysis of Financial Condition and Results of Operations,” Section D, “Liquidity” and Section E, “Capital Resources and Dividends.”

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 are 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.

D. RECENT LEGISLATIVE DEVELOPMENTS

As a result of the recent financial crisis that significantly damaged the economy and the financial sector of the United States, the U.S. Congress passed, and the President signed, the Dodd-Frank Act on July 21, 2010. In addition to making other significant legal and regulatory reforms, Dodd-Frank established a new regulatory body known as the Bureau of Consumer Financial Protection (the Bureau), 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 restrain banks' flexibility and profitability. 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 existing capital requirements for such institutions and may be much more onerous. Of particular importance to bank holding companies like ours, Dodd-Frank provides that any issuances of trust preferred securities on or after May 19, 2010, by bank holding companies with total assets between $500 million and $15 billion will no longer qualify as Tier 1 capital. Dodd-Frank is discussed further below.

There are several other federal laws enacted since the start of the financial crisis that affect financial institutions like us, as well as other recently-enacted banking laws that continue to significantly impact our operations. These various statutes, as well as Dodd-Frank, are discussed briefly below.

The Dodd-Frank Act

The Dodd-Frank Act, enacted in July 2010, includes many provisions affecting the banking and financial services industries, including our Company. Among other things, Dodd-Frank:

- Gives new powers to the Board of Governors of the Federal Reserve System

  The Fed is charged with monitoring the systemic safety of the financial system and directed to take proactive steps to reduce or eliminate threats to the system.
- Creates a new Federal banking agency, the Consumer Financial Protection Bureau, with broad powers.

  The Bureau will write and issue new consumer protection rules. 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 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 may be very 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.

  The activities of the Bureau will be monitored by a Bureau Oversight Council, which is charged with the duty of considering the potential benefits and costs for financial institutions and consumers of any Bureau-proposed regulation and to consider and address any objections from other Federal regulators. However, the Oversight Council will not have authority to set aside a Bureau regulation except in very limited circumstances.
- Limits 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. Specifically, Dodd-Frank increases the potential for State intervention in the operations of national banks and other Federally chartered depository institutions by creating new procedural hurdles to preemption determinations while also potentially narrowing the circumstances in which preemption would apply. Moreover, the Act provides statutory authority for State law enforcement authorities with respect to Federally chartered depository institutions.
- Makes the $250,000 limit for federal deposit insurance permanent by statute; provides unlimited federal deposit insurance until December 31, 2012 for non-interest bearing demand transaction accounts at all insured depository institutions; and repeals the federal prohibitions on the payment of interest on demand deposits, thereby permitting depository institutions to pay interest on business transaction and other accounts.
- Expands interstate branching authority for national and state banks.
- Directs Federal bank regulators to develop specific capital requirements for holding companies and depository institutions that address activities that pose risk to the financial system, such as significant activities in higher risk areas, or concentrations in assets whose reported values are based on models.
- Requires the OCC to seek to make its capital requirements for national banks countercyclical so that capital requirements increase in times of economic expansion and decrease in times of economic contraction.
- Enhances the authority of the Fed to examine non-bank subsidiaries, such as mortgage affiliates, and also gives other bank regulators the opportunity to examine and take enforcement action against such entities.
- Establishes a statutory source of strength requirement for both bank and savings and loan holding companies (thereby enabling the Fed to compel a holding company to contribute additional capital to its subsidiary banks, if the banks are undercapitalized and if the holding company possesses such capital.
-

Expands the coverage of Section 23A of the FRA to take account of the credit exposure related to additional transactions, including derivatives transactions, along with other additional restrictions under Section 23A.

- Requires mortgage originators to act in the best interests of a consumer, and seeks to ensure that a consumer will have the capacity to repay a loan that the consumer enters into.
- Mandates comprehensive additional residential mortgage loan related disclosures.

Requires mortgage loan securitizers to retain a certain amount of risk (as established by the regulatory agencies).

- However, mortgages that conform to the new regulatory standards as "qualified residential mortgages" will not be subject to risk retention requirements.

Implementation of the Act will require dozens of new mandatory and discretionary rulemakings by numerous Federal regulatory agencies over the next several years. As a result, bank holding companies are likely to be faced with thousands of new pages of regulations not to mention increased litigation risk. While many of the provisions contained in Dodd-Frank are already effective, many have delayed effective dates that have not yet been reached, which, in some cases, may be subject to considerable delay and deferral.

Earlier Federal Laws Responding to Financial Crisis.

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, such as the FDIC's Temporary Liquidity Guarantee Program (TLGP) and the U.S. Treasury's Capital Purchase Program (CPP), a component of the Troubled Asset Relief Program (TARP). In late 2008, the FDIC adopted the TLGP to boost consumer confidence in funds deposited with insured institutions. Among other things, the TLGP allowed insured institutions to participate in a program providing additional deposit insurance; specifically, full coverage of noninterest-bearing accounts through December 31, 2009 (later extended to run through December 31, 2010) at a cost of an additional 10 cents per $100 of additional insured deposits. We elected to participate in the program in 2009, at a cost to us for the additional deposit insurance of $18 thousand. We opted out of this program when it was extended in 2010.

Arrow was preliminarily approved by the U.S. Treasury Department to participate in the CPP program (part of TARP). However, in January 2009, we announced that we would not participate in the CPP due to our strong financial and liquidity positions. See Item 7, Management's Discussion and Analysis of Financial Condition and Results of Operations, page 21.

In addition, as part of the legislative response to the current financial crisis, various other Federal bills have been introduced in the U.S. Congress that would significantly affect banks. We cannot estimate the likelihood of any currently proposed banking bills being enacted into law, or the ultimate effect that any such potential legislation, if enacted, would have upon our financial condition or operations.

Health Care Reform

In March 2010, comprehensive federal health care 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 "Act"). Included among the major provisions of the Act, is a change in tax treatment of the federal drug subsidy paid with respect to eligible retirees. The Act contains provisions that may impact the Company's accounting for some of its benefit plans in future periods by increasing the expense associated with these plans, but at this point, we do not expect that the impact will be material. The exact extent of the Act's impact cannot be determined until final regulations are promulgated and additional interpretations become available. The Company will continue to monitor the effect of the Act.

Other Recently-Enacted Federal Laws Affecting Banks Like Ours, 2001-2005

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.

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

The FDIC collects both insurance premiums on insured deposits and an assessment for the Financing Corporation (FICO) bonds.

FICO Assessments. The FICO was established by the Competitive Equality Banking Act of 1987, as a mixed-ownership government corporation whose sole purpose was to issue bonds to insure thrift institutions. In the subsequent two years, FICO issued 30-year noncallable bonds in an aggregate principal amount of approximately $8.1 billion, maturing in 2017 through 2019. FICO has assessment authority, separate from the FDIC's authority to assess risk-based premiums for deposit insurance, to collect funds from all FDIC-insured institutions sufficient to pay interest on FICO bonds. The FDIC acts as collection agent for the FICO. Since the first quarter of 2000, all FDIC-insured deposits have been assessed at the same rate by FICO. For 2011, our FICO assessment was $160 thousand.

FDIC Deposit Premiums. 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. During 2008, both of our banks qualified for the 5 cent per $100 assessment rate.

The Federal Deposit Insurance Reform Act of 2005 allowed "eligible insured depository institutions" to share a one-time assessment credit pool of approximately $4.7 billion. Our credit amounted to $747 thousand. The credit was available to offset FDIC insurance premiums beginning in 2007, but not to offset the FICO bond assessment. The one-time credit fully offset our FDIC insurance premiums for 2008 and offset approximately $134 thousand of our $637 thousand 2008 FDIC premiums.

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 is being 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 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 2011, which decrease by over 48% from the first quarter of 2011 and 2012.

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 8. Note 8.

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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 and growing government supported entities "Fannie Mae" and "Freddie Mac," who purchase and/or guarantee a very substantial dollar amount and number of mortgage loans, which in 2011 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 and 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 L. Hoy	63	Chairman, President and Chief Executive Officer of Arrow since 2004, President since 1996, Chief Executive Officer since 1997, and President of Glens Falls National Bank and Trust Company ("GFNB") from 1995 to June 2011. Mr. Hoy has been a Director of Arrow since 1996 and a Director of GFNB since 1994. Mr. Hoy has been with the Company since 1974.
Thomas J. Murphy	53	Senior Executive Vice President and President of GFNB since July 1, 2011. Mr. Murphy has also served as Corporate Secretary since 2009, Senior Trust Officer of GFNB since 2010 and Cashier of GFNB since 2009. Mr. Murphy became a Vice President of Arrow beginning in 2009. Mr. 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	48	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	50	Senior Vice President since May 1, 2009. Mr. DeMarco also has served as our 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.
Raymond F. O'Conor	56	Senior Vice President since May 1, 2009. Mr. O'Conor also has served as the Chairman, President and Chief Executive Officer of Saratoga National Bank and Trust Company ("SNB") since April 2007. Prior to that, Mr. O'Conor was President and CEO of SNB since January 1, 1996. Mr. O'Conor started with the Company in 1985.

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 and institutional investors 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 the 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 prolonged economic slump, 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, northeastern region of New York State, should deteriorate or enter into a prolonged state of recession, this may have an additional adverse impact on our loan portfolio. If the quality of our portfolio should weaken due to this impact, 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, loan portfolio difficulties often accompany 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 increase 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 29 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 severely damaged by the financial downturn of the past three years as many other areas of the U.S., this could change in future period 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 or fails to provide for an orderly management succession. Our success depends, in large part, on our ability to retain our key personnel for the duration of their expected terms of service, and to arrange for an orderly succession of other, equally skilled personnel. Competition for the best people in our business can be intense. While our Board of Directors actively reviews succession 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. 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 networks or digital devices. Information security risks have increased significantly in recent years because of the increased use of the Internet and telecommunications technologies to conduct financial transactions using new digital devices. This risk is further enhanced due to the increased sophistication and activities of organized crime, hackers, terrorists and other disreputable parties. These cyber attacks and security breaches can occur through our customers' systems when connected to our network, or through retailers or other businesses where our customers use bank cards to purchase goods or services. 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.

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. 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 1, 5 and 19 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 29, 2011, we distributed a 3% stock dividend on our outstanding shares of common stock.

	2011 Market Price		Cash	2010 Market Price		Cash
	Low	High	Dividends Declared	Low	High	Dividends Declared
First Quarter	$21.93	$27.27	$0.243	$22.37	$26.12	$0.236
Second Quarter	22.36	24.50	0.243	21.71	27.66	0.236
Third Quarter	21.60	24.32	0.243	20.67	24.58	0.236
Fourth Quarter	21.50	24.00	0.250	23.30	27.68	0.243

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 6,843 holders of record of Arrow's common stock at December 31, 2011. 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, 2011. These equity compensation plans were our 2008 Long-Term Incentive Plan ("Stock Plan"), our 2011 Employee Stock Purchase Plan ("ESPP") and our 2008 Directors' Stock Plan. 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]	473,435	$22.90	651,600
Equity Compensation Plans Not Approved by Security Holders	—	—	—
Total	473,435	$22.90	651,600

(1) All 473,435 shares are common stock issuable pursuant to outstanding stock options granted under the Stock Plan and predecessor long-term incentive plans.
(2)

The total of 651,600 shares includes 112,229 shares of common stock available for future award grants under the Stock Plan, 11,039 shares of common stock available for future issuance under the Directors' Stock Plan and 528,332 shares of common stock are available for future issuance under the ESPP.

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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, 2006 to December 31, 2011 and the second graph presents stock performance for the ten-year period from December 31, 2001 to December 31, 2011.

	TOTAL RETURN PERFORMANCE					
	Period Ending					
Index	2006	2007	2008	2009	2010	2011
Arrow Financial Corporation	100.00	93.32	113.66	120.99	142.73	130.53
Russell 2000 Index	100.00	98.43	65.18	82.88	105.14	100.75
NASDAQ Banks Index	100.00	79.26	57.79	48.42	57.29	51.19
Zacks $1B - $5B Bank Assets Index	100.00	75.30	67.27	50.89	58.86	56.05

Source: Zacks Investment Research, Inc., Chicago, IL. Copyright 2012. All rights reserved. Used with permission.

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	TOTAL RETURN PERFORMANCE										
	Period Ending										
Index	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
Arrow Financial Corporation	100.00	114.32	133.24	157.88	141.95	143.61	134.01	163.23	173.76	204.98	187.45
Russell 2000 Index	100.00	79.52	117.09	138.56	144.86	171.48	168.79	111.76	142.13	180.30	172.77
NASDAQ Banks Index	100.00	102.37	131.69	150.71	147.24	165.24	130.97	95.50	80.02	94.66	84.59
Zacks $1B - $5B Bank Assets Index	100.00	118.21	158.64	190.22	184.51	208.20	156.77	140.06	105.95	122.54	116.69

Source: Zacks Investment Research, Inc., Chicago, IL. Copyright 2012. All rights reserved. Used with permission.

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 at closing of the transactions to the agencies' shareholders, in exchange for all of their shares, a total of 90,744 shares, as adjusted for subsequent stock dividends, of its common stock and $116 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 to the sole shareholder of Upstate, in exchange for all of his shares, a total of 134,778 shares, as adjusted for subsequent stock dividends, of its 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 Arrow over the three-year period following the closing of the acquisition. The maximum potential value of the Arrow shares issuable under this provision is $274 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, a total of 27,838 shares, as adjusted for subsequent stock dividends, of its 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 Arrow over the three-year period following the closing of the acquisition. As a result of the financial performance of Loomis during the first year following the closing, Arrow issued to the former shareholders, in 2011, as post-closing consideration under this provision, 1,702 additional shares, as adjusted, of its common stock. The maximum remaining potential dollar value of Arrow stock issuable to the former shareholders of Loomis under this post-closing payment provision is $187 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, 2011 of our common stock (our only class of equity securities registered pursuant to Section 12 of the Securities Exchange Act of 1934):

Fourth Quarter 2011 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	26,452	$23.61	10,000	$1,622,590
November	46,632	22.68	40,000	695,690
December	45,380	23.37	24,236	120,570
Total	118,464	23.15	74,236	

[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 2011 - DRIP purchases (2,811 shares), stock options (13,641 shares); November 2011 - DRIP purchases (3,067 shares), stock options (3,565 shares); December 2011 - DRIP purchases (21,069 shares), stock options (75 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 current publicly-announced stock repurchase program is the program approved by the Board of Directors and announced in November 2011 under which the Board authorized a twelve-month maximum cumulative purchase of $5 million in stock beginning on January 1, 2012. The plan replaced a similar prior stock repurchase plan approved by the Board and announced in April 2011. By December 31, 2011, Arrow had repurchased approximately $4.9 million of Arrow common stock under the repurchase program announced in April 2011.

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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:	2011	2010	2009	2008	2007
Interest and Dividend Income	$76,791	$84,972	$86,857	$89,508	$86,577
Interest Expense	18,679	23,695	26,492	32,277	40,283
Net Interest Income	58,112	61,277	60,365	57,231	46,294
Provision for Loan Losses	845	1,302	1,783	1,671	513
Net Interest Income After Provision for Loan Losses	57,267	59,975	58,582	55,560	45,781
Noninterest Income	23,133	17,582	19,235	15,886	16,288
Net Gains (Losses) on Securities Transactions	2,795	1,507	357	383	—
Noninterest Expense	(51,548)	(47,418)	(46,592)	(42,393)	(37,930)
Income Before Provision for Income Taxes	31,647	31,646	31,582	29,436	24,139
Provision for Income Taxes	9,714	9,754	9,790	8,999	6,807
Net Income	$21,933	$21,892	$21,792	$20,437	$17,332
Per Common Share: [1]					
Basic Earnings	$1.87	$1.89	$1.88	$1.77	$1.48
Diluted Earnings	1.87	1.88	1.88	1.76	1.47
Per Common Share: [1]					
Cash Dividends	$0.98	$0.95	$0.92	$0.90	$0.86
Book Value	14.14	13.13	12.16	10.90	10.51
Tangible Book Value [2]	11.87	11.65	10.72	9.49	9.09
Consolidated Year-End Balance Sheet Data:					
Total Assets	$1,962,684	$1,908,336	$1,841,627	$1,665,086	$1,584,846
Securities Available-for-Sale	556,538	517,364	437,706	315,414	328,496
Securities Held-to-Maturity	150,688	159,938	168,931	133,976	114,611
Loans	1,131,457	1,145,508	1,112,150	1,109,812	1,038,844
Nonperforming Assets (3)	8,128	4,945	4,772	4,971	2,336
Deposits	1,644,046	1,534,004	1,443,566	1,275,063	1,204,200
Federal Home Loan Bank Advances	82,000	130,000	140,000	160,000	160,000
Other Borrowed Funds	46,293	73,214	93,908	79,956	73,719
Stockholders' Equity	166,385	152,259	140,818	125,802	122,256
Selected Key Ratios:					
Return on Average Assets	1.13 %	1.16 %	1.24 %	1.24 %	1.11 %
Return on Average Equity	13.45	14.56	16.16	16.26	14.68
Dividend Payout [4]	52.41	50.53	48.94	51.14	58.50

[1] Share and per share amounts have been adjusted for subsequent stock splits and dividends, including the most recent September 2011 3% 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 2011 3% stock dividend

Quarter Ended	12/31/2011	9/30/2011	6/30/2011	3/31/2011	12/31/2010
Net Income	$5,431	$5,372	$5,849	$5,281	$5,188
Transactions Recorded in Net Income (Net of Tax):					
Net Gain on Securities Transactions	—	1,069	291	327	7
Net Gain on Sales of Loans	259	132	101	31	299
Prepayment Penalty on FHLB Advances	—	(989)	—	—	—
Share and Per Share Data:					
Period End Shares Outstanding	11,763	11,796	11,696	11,745	11,593
Basic Average Shares Outstanding	11,782	11,754	11,729	11,675	11,576
Diluted Average Shares Outstanding	11,788	11,776	11,741	11,698	11,630
Basic Earnings Per Share	$0.46	$0.46	$0.50	$0.45	$0.45
Diluted Earnings Per Share	0.46	0.46	0.50	0.45	0.45
Cash Dividend Per Share	0.25	0.24	0.24	0.24	0.24
Selected Quarterly Average Balances:					
Interest-Bearing Deposits at Banks	$49,101	$32,855	$31,937	$35,772	$76,263
Investment Securities	674,338	646,542	697,796	683,839	672,071
Loans	1,126,452	1,119,384	1,128,006	1,130,539	1,147,889
Deposits	1,668,062	1,554,349	1,596,876	1,564,677	1,568,466
Other Borrowed Funds	101,997	164,850	179,989	193,960	223,425
Shareholders’ Equity	168,293	166,514	161,680	155,588	154,677
Total Assets	1,963,915	1,911,853	1,961,908	1,935,409	1,970,085
Return on Average Assets	1.10 %	1.11 %	1.20 %	1.11 %	1.04 %
Return on Average Equity	12.80 %	12.80 %	14.51 %	13.77 %	13.31 %
Return on Tangible Equity [1]	15.22 %	15.19 %	17.16 %	16.07 %	14.97 %
Average Earning Assets	$1,849,891	$1,798,781	$1,857,739	$1,850,150	$1,884,402
Average Interest-Bearing Liabilities	1,547,071	1,487,923	1,559,014	1,546,849	1,579,765
Interest Income, Tax-Equivalent	19,179	19,884	20,500	20,822	21,554
Interest Expense	4,022	4,345	4,975	5,336	5,903
Net Interest Income, Tax-Equivalent	15,157	15,539	15,525	15,486	15,651
Tax-Equivalent Adjustment	832	887	944	931	908
Net Interest Margin [1]	3.25 %	3.43 %	3.35 %	3.39 %	3.30 %
Efficiency Ratio Calculation:					
Noninterest Expense	$12,455	$14,603	$12,171	$12,319	$11,770
Less: Intangible Asset Amortization	(141)	(136)	(134)	(100)	(66)
Prepayment Penalty on FHLB Advances	—	(1,638)	—	—	—
Net Noninterest Expense	$12,314	$12,829	$12,037	$12,219	$11,704
Net Interest Income, Tax-Equivalent	$15,157	$15,539	$15,525	$15,485	$15,651
Noninterest Income	6,199	7,881	6,228	5,620	4,738
Less: Net Securities Gains	—	(1,771)	(482)	(542)	(11)
Net Gross Income, Adjusted	$21,356	$21,649	$21,271	$20,563	$20,378
Efficiency Ratio	57.66 %	59.26 %	56.59 %	59.42 %	57.43 %
Period-End Capital Information:					

Total Stockholders’ Equity (i.e. Book Value)	$166,385	$168,624	$163,589	$159,188	$152,259
Book Value per Share	14.14	14.29	13.99	13.55	13.13
Intangible Assets	26,752	26,788	25,044	24,900	17,241
Tangible Book Value per Share [1]	11.87	12.02	11.85	11.43	11.65
Capital Ratios:					
Tier 1 Leverage Ratio	8.95 %	9.10 %	8.67 %	8.66 %	8.53 %
Tier 1 Risk-Based Capital Ratio	14.71 %	15.06 %	14.76 %	14.37 %	14.50 %
Total Risk-Based Capital Ratio	15.96 %	16.31 %	16.02 %	15.63 %	15.75 %
Assets Under Trust Administration and Investment Management	$973,551	$925,671	$1,017,091	$1,011,618	$984,394

[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 2011 3% stock dividend

	2011	2010	2009
Net Income	$21,933	$21,892	$21,792
Transactions Recorded in Net Income (Net of Tax):			
Other-Than-Temporary Impairment (OTTI)	—	$—	$(227)
Net Securities Gains	1,688	910	216
Net Gains on Sales of Loans	523	618	252
Prepayment Penalty on FHLB Advances	(989)	—	—
Income from Restitution Payment	—	—	272
Net Gain on Sale of Merchant Bank Card Processing	—	—	1,791
FDIC Special Assessment (see page 25)	—	—	(475)
Period End Shares Outstanding	11,763	11,593	11,582
Basic Average Shares Outstanding	11,735	11,604	11,568
Diluted Average Shares Outstanding	11,747	11,639	11,620
Basic Earnings Per Share	$1.87	$1.89	$1.88
Diluted Earnings Per Share	1.87	1.88	1.88
Cash Dividends Per Share	0.98	0.95	0.92
Average Assets	$1,943,263	$1,892,324	$1,761,006
Average Equity	163,063	150,377	134,890
Return on Average Assets	1.13%	1.16%	1.24%
Return on Average Equity	13.45	14.56	16.16
Average Earning Assets	$1,839,028	$1,807,763	$1,688,454
Average Interest-Bearing Liabilities	1,535,084	1,512,937	1,410,022
Interest Income, Tax-Equivalent [1]	80,385	88,424	90,038
Interest Expense	18,679	23,695	26,492
Net Interest Income, Tax-Equivalent [1]	61,706	64,729	63,546
Tax-Equivalent Adjustment	3,594	3,452	3,181
Net Interest Margin [1]	3.36%	3.58%	3.76%
Efficiency Ratio Calculation [1]			
Noninterest Expense	$51,548	$47,418	$46,592
Less: Intangible Asset Amortization	(510)	(271)	(324)
Prepayment Penalty on FHLB Advances	(1,638)	—	—
Net Noninterest Expense	$49,400	$47,147	$46,268
Net Interest Income, Tax-Equivalent [1]	$61,706	$64,729	$63,546
Noninterest Income	25,928	19,089	19,592
Less: Net Securities Gains	(2,795)	(1,507)	18
Net Gross Income, Adjusted	$84,839	$82,311	$83,156
Efficiency Ratio [1]	58.23%	57.28%	55.64%
Period-End Capital Information:			
Tier 1 Leverage Ratio	8.96%	8.78%	8.43%
Total Stockholders’ Equity (i.e. Book Value)	$166,385	$152,259	$140,818
Book Value per Share	14.14	13.13	12.16
Intangible Assets	26,752	17,241	16,712
Tangible Book Value per Share [1]	11.87	11.65	10.72
Asset Quality Information:			
Net Loans Charged-off as a Percentage of Average Loans	0.05%	0.06%	0.09%
Provision for Loan Losses as a Percentage of Average Loans	0.08%	0.11%	0.16

Allowance for Loan Losses as a Percentage of Period-End Loans	1.33 %	1.28 %	1.26 %
Allowance for Loan Losses as a Percentage of Nonperforming Loans	197.10 %	300.57 %	300.73 %
Nonperforming Loans as a Percentage of Period-End Loans	0.67 %	0.43 %	0.42 %
Nonperforming Assets as a Percentage of Total Assets	0.41 %	0.26 %	0.26 %

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

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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. 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 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 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 available-for-sale measured at fair value on a recurring basis: Most of the available-for-sale 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, 2011 and our financial condition as of December 31, 2011 and 2010. 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 2011 Financial Results

We reported net income for 2011 of $21.9 million, representing diluted earnings per share (EPS) of $1.87, essentially unchanged from our 2010 results. Return on average equity (ROE) for the 2011 year continued to be strong at 13.45%, although down from the ROE of 14.56% for the 2010 year. Return on average assets (ROA) for 2011 continued to be strong at 1.13%, although down from ROA of 1.16% for 2010. Both decreases were principally due to our shrinking net interest margin, which led to a decrease in our net interest income, despite the fact that our earning assets grew and our asset quality remained strong.
Total assets were $1.963 billion at December 31, 2011, which represented an increase of $54.3 million, or 2.8%, above the $1.908 billion level at December 31, 2010.
Stockholders' equity was $166.4 million at December 31, 2011, an increase of $14.1 million, or 9.3%, from the year earlier level. The components of the change in stockholders' equity since year-end 2010 are presented in the Consolidated Statement of Changes in Stockholders' Equity on page 58, and are discussed in more detail in the last section of this Overview on page 26 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, 2011 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 set forth in the proposed Basel III accords, currently under consideration by the Group of 20 advanced nations including the United States, were presently in effect, Arrow and its banks would meet all of these new, enhanced capital standards. See “CAPITAL RESOURCES - New Capital Standards to be Promulgated” and “Current Capital Standards” on page 47, and “Important Proposed Changes to Regulatory Capital and Liquidity Standards” on page 46.

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 $7.6 million at December 31, 2011, an increase of $2.7 million from year-end 2010. The increase was primarily attributable to one large commercial loan that we modified during 2011 while it was still performing. The ratio of nonperforming loans to period-end loans at December 31, 2011 was .67%, an increase from .43% at December 31, 2010. By way of comparison, this ratio for our peer group was 2.94% at December 31, 2011, which was a significant improvement for the peer group from the ratio of 3.60% at year-end 2010, but still very high when compared to the ratio of 1.09% at December 31, 2007. Loans charged-off (net of recoveries) against our allowance for loan losses was a very low $531 thousand for 2011, as compared to $627 thousand for 2010. At December 31, 2011, the allowance for loan losses was $15.0 million, representing 1.33% of total loans, an increase of 5 basis points from December 31, 2010.
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: 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: 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.
Indirect Consumer Lending (Primarily Automobile Loans): These loans comprise approximately 30% of our loan portfolio. Throughout 2011 and 2010, 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: The following recent legislation is and will continue to be particularly important to us.

(i)   Dodd-Frank Act: As a result of the recent financial crisis that significantly damaged the economy and the financial sector of the United States, the U.S. Congress passed and the President signed the Dodd-Frank Act on July 21, 2010. While many of the Act's provisions will not have any direct impact on Arrow, some of the sections will significantly impact our business operations and likely will affect our financial results. 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 restrain banks' profitability, including our banks. 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 existing capital requirements and may be much more onerous. See the discussion under "Important Proposed Changes to Regulatory Capital and Liquidity Standards" on page 46 of this Report. Dodd-Frank also provided that any new issuances of trust preferred securities (TRUPs) by bank holding companies with between $500 million and $15 billion in assets will no longer be able to qualify as Tier 1 capital, although previously issued and outstanding TRUPs of such small-to-medium-sized bank holding companies, including Arrow's $20 million of TRUPs that are currently outstanding, will continue to qualify as Tier 1 capital until maturity or redemption.
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 are some of the Dodd-Frank legal changes that are likely to have a material impact, positive or negative, as the case may be, on us and our customers:

1. FDIC deposit insurance has been substantially expanded.
2. The FDIC insurance assessment on banks is now asset-based, not deposit-based, which actually reduces insurance costs for most smaller 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, a decline of 48%.)
3. Expansion of consumer protection regulations likely will add to our regulatory compliance expense and reduce our income.
4. Limitation on debit card interchange fees, which technically applies only to the very large banks having more than $10 billion in assets, will most likely have a negative impact on the fee income of smaller banks like ours, due to competitive pressures.

Rules still in the formulation process include those related to short-term borrowing disclosures, retention of a portion of loans initiated and sold and executive compensation. Several of these issues are highly controversial, and the implementing regulations to be forthcoming will be the focus of much discussion and concern. For further information on the impact of the Dodd-Frank Act and other recent legislation developments, see "RECENT LEGISLATIVE DEVELOPMENTS" on page 8 of this Report, above.

(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 "Act"). Included among the major provisions of the Act, is a change in tax treatment of the federal drug subsidy paid with respect to eligible retirees. The Act contains provisions that may impact the Company's accounting for some of its benefit plans in future periods. However, we do not currently expect that impact to be material. The exact extent of the Act's impact, if any, cannot be determined until final regulations are promulgated and additional interpretations of the Act become available. The Company will continue to monitor the effect of the Act on its benefit plans.

Liquidity and access to credit markets: We did not experience any liquidity problems or special concerns during 2010 and 2011, and have not in 2012 through the date of this Report. The terms of our lines of credit with our correspondent banks, the FHLBNY and the Federal Reserve Bank, have not changed, except for some increases in the maximum borrowing capacity (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 (overnight borrowing arrangements with our correspondent banks, FHLBNY overnight and term credit arrangement advances and the Federal Reserve Bank discount window, as our main sources). 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. In a few well-publicized instances at the height of the crisis, liquidity was such a problem for particular institutions that they experienced a run on deposits, even though there was no reasonable expectation that depositors would lose any of their insured deposits. We maintain, and periodically test, a contingent liquidity plan whose purpose is 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 Special Assessment & Prepayment in 2009: The FDIC announced during the second quarter of 2009 that they would levy a special assessment on all FDIC insured financial institutions to rebuild the FDIC's insurance fund which was significantly depleted by bank failures during the crisis. For most insured banks (including ours), the special assessment was set as a designated percentage (0.05%) of the institution's adjusted assets (total assets less Tier 1 capital), as opposed to a percentage of covered deposits which is how the FDIC had historically set regular assessments. Institutions were instructed to estimate and accrue the special assessment expense in the second quarter of 2009. We determined that our expense was $787 thousand, which we accrued on June 30, 2009. During the third quarter of 2009 the FDIC announced that it would not impose any additional special assessments in the remainder of 2009, but would generate additional cash for the insurance fund by requiring insured institutions to prepay in the fourth quarter of 2009 their projected regular assessments for the fourth quarter of 2009 and all of 2010, 2011 and 2012. Our prepayment amount was $6.8 million, which is being amortized, as required by bank regulatory guidance, into expense during the relevant periods to which such assessment relates. As a result of Dodd-Frank, beginning with the second quarter of 2011, the calculation of regular FDIC insurance premiums for insured institutions has changed so as to be based on adjusted assets (as defined) rather than deposits, which had the effect of imposing FDIC insurance fees not only on deposits but on other sources of funding as well, including repurchase agreements. The rate, however, given the larger base (assets) on which insurance premiums are now assessed, will be a lower percentage than the rate that applied under the old deposit-based assessments. The FDIC calculated the first asset-based assessment (for the second quarter of 2011, but recognized during the third quarter of 2011), based on June 30, 2011 reported assets. Because our banks, like most small banks, have a much higher ratio of deposits to assets than the large banks maintain, we expected our FDIC premiums to actually decrease considerably.

VISA Transactions from 2008 to 2011: On March 28, 2008, VISA Inc. distributed to its member banks, including Glens Falls National, by way of a mandatory redemption of 38.7% of the Visa Class B shares held by the member banks, 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 all, of its continuing litigation liabilities under various antitrust claims, which its member banks would otherwise be required to bear. Accordingly, during the first quarter of 2008, we recorded the following transactions:

- A pre-tax gain of $749 thousand from the mandatory redemption by Visa from us of 38.7% of our Class B Visa Inc. shares, reflected as an increase in noninterest income.
- A reversal of $306 thousand of the $600 thousand accrual previously recorded by us at December 31, 2007, representing our then estimated proportional share of Visa litigation costs, which reversal was reflected as a reduction in 2008 other operating expense.

In October 2008, Visa announced that it had settled a lawsuit with Discover Financial Services, which was part of the covered litigation (including several cases) for which the Visa member banks remained contingently liable and for which Visa had established its escrow fund. Since that time, Visa has deposited the following additional amounts into the escrow fund for covered litigation: $1.1 billion in December 2008, $700 million in July 2009, $500 million in May 2010, $800 million in October 2010, $400 million in March 2011 and $1.6 billion in February 2012. These developments reduced our proportionate exposure for covered litigation but also reduced the ultimate value of our remaining Class B Visa shares, as Visa's settlement of covered litigation claims directly reduces the value of member banks' Class B stock. However, even before Visa made these additional provisions against its covered litigation expenses, we did not recognize any dollar value for our remaining Class B shares, in accordance with SEC guidance. In summary, we did not recognize any income or expense in any of the periods presented as a result of Visa's periodic deposits of additional amounts into the escrow fund or settlements of covered litigation with amounts drawn out of the fund.

In October 2011, Visa announced that the so-called interchange litigation was expected to go to trial sometime in the fall of 2012. At that time, Visa was not able to predict when the litigation would be resolved.

The estimation of our proportionate share of any potential losses on Visa's part, in excess of the escrow fund, related to the remaining covered litigation is extremely difficult and involves a high degree of uncertainty. Management has determined that the remaining $294 thousand liability included in “Other Liabilities” on our December 31, 2011 consolidated balance sheet represents the fair value of our proportionate share of the remaining covered Visa litigation obligations in excess of the escrow fund at that date, but this value is subject to change depending upon future developments in the covered litigation.

Increase in Stockholders' Equity: At December 31, 2011, our tangible book value per share (calculated based on stockholders' equity reduced by intangible assets including goodwill and other intangible assets) amounted to $11.87, an increase of $0.22, or 1.9%, from December 31, 2010. Our total stockholders' equity at December 31, 2011 increased 9.3% over the year-earlier level, and our total book value per share increased by 7.7% over the year earlier level. This increase principally reflected the following factors: i) $21.9 million net income for the period; ii) a $4.7 million net unrealized gain in securities available-for-sale, net of tax, and iii) issuance of $5.3 million of common stock in connection with our acquisition of two insurance agencies; offset in part by iv) cash dividends of $11.4 million; and (v) repurchases of our own common stock of $6.0 million. As of December 31, 2011, our closing stock price was $23.44, resulting in a trading multiple of 1.97 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 $.243 per share for the first three quarters of 2011, as adjusted for a 3% stock dividend distributed September 29, 2011, and cash dividends of $.25 per share for the fourth quarter of 2011 and the first quarter of 2012.

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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 2011 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)

	Years Ended December 31,			Change From Prior Year			
				2010 to 2011		2009 to 2010	
	2011	2010	2009	Amount	%	Amount	%
Interest and Dividend Income	$80,385	$88,424	$90,038	$(8,039)	(9.1)%	$(1,614)	(1.8)%
Interest Expense	18,679	23,695	26,492	(5,016)	(21.2)	(2,797)	(10.6)
Net Interest Income	$61,706	$64,729	$63,546	$(3,023)	(4.7)	$1,183	1.9

On a tax-equivalent basis, net interest income was $61.7 million in 2011, a decrease of $3.0 million, or 4.7%, from $64.7 million in 2010. This compared to an increase of $1.2 million, or 1.9%, from 2009 to 2010. Factors contributing to the increase in net interest income over the three-year period are discussed in the following portions of this Section B.I.
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.

	2011 Compared to 2010 Change in Net Interest Income Due to:			2010 Compared to 2009 Change in Net Interest Income Due to:		
Interest and Dividend Income:	Volume	Rate	Total	Volume	Rate	Total
Interest-Bearing Bank Balances	$(58)	$(1)	$(59)	$7	$1	$8
Investment Securities:						
Fully Taxable	1,301	(3,614)	(2,313)	1,945	(1,950)	(5)
Exempt from Federal Taxes	986	(1,001)	(15)	1,518	(974)	544
Loans	(489)	(5,163)	(5,652)	1,954	(4,115)	(2,161)
Total Interest and Dividend Income	1,740	(9,779)	(8,039)	5,424	(7,038)	(1,614)
Interest Expense:						
Deposits:						
NOW Accounts	601	(1,131)	(530)	858	(448)	410
Savings Deposits	257	(495)	(238)	344	(309)	35
Time Deposits of $100,000 or More	(233)	(37)	(270)	(488)	(327)	(815)

Other Time Deposits	(238)	(519)	(757)	(11)	(1,420)	(1,431)
Total Deposits	387	(2,182)	(1,795)	703	(2,504)	(1,801)
Short-Term Borrowings	(22)	(28)	(50)	9	(14)	(5)
Long-Term Debt	(2,058)	(1,113)	(3,171)	(680)	(311)	(991)
Total Interest Expense	(1,693)	(3,323)	(5,016)	32	(2,829)	(2,797)
Net Interest Income	$3,433	$(6,456)	$(3,023)	$5,392	$(4,209)	$1,183

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The following table reflects the components of our net interest income, setting forth, for years ended December 31, 2011, 2010 and 2009 (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:	2011			2010			2009		
	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	$37,440	$98	0.26 %	$59,771	$157	0.26 %	$56,920	$149	0.26 %
Investment Securities:									
Fully Taxable	452,264	12,421	2.75	413,212	14,734	3.57	362,059	14,739	4.07
Exempt from Federal Taxes	223,259	8,982	4.02	200,062	8,997	4.50	167,716	8,453	5.04
Loans	1,126,065	58,884	5.23	1,134,718	64,536	5.69	1,101,759	66,697	6.05
Total Earning Assets	1,839,028	80,385	4.37	1,807,763	88,424	4.89	1,688,454	90,038	5.33
Allowance for Loan Losses	(14,821)			(14,385)			(13,626)		
Cash and Due From Banks	28,844			28,717			28,096		
Other Assets	90,212			70,229			58,082		
Total Assets	$1,943,263								