

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

FORM 10-Q

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

For the Quarterly Period Ended June 30, 2014

or

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

Commission File Number: 0-12507

ARROW FINANCIAL CORPORATION

(Exact name of registrant as specified in its charter)

New York

(State or other jurisdiction of
incorporation or organization)

22-2448962

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

250 GLEN STREET, GLENS FALLS, NEW YORK 12801

(Address of principal executive offices) (Zip Code)

Registrant's telephone number, including area code: (518) 745-1000

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

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, 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). ☒ Yes ☐ No

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

Large accelerated filer

Accelerated filer ☒

Non-accelerated filer

Smaller reporting company

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

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

Class
Common Stock, par value \$1.00 per share

Outstanding as of July 31, 2014
12,351,522

ARROW FINANCIAL CORPORATION
FORM 10-Q
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PART I - Financial Information

**ARROW FINANCIAL CORPORATION AND SUBSIDIARIES
CONSOLIDATED BALANCE SHEETS**

(In Thousands, Except Share and Per Share Amounts)
(Unaudited)

| | June 30, 2014 | December 31, 2013 | June 30, 2013 |
|---|---------------------|----------------------|---------------------|
| ASSETS | | | |
| Cash and Due From Banks | \$ 35,351 | \$ 37,275 | \$ 32,706 |
| Interest-Bearing Deposits at Banks | 16,459 | 12,705 | 11,894 |
| Investment Securities: | | | |
| Available-for-Sale | 366,848 | 457,606 | 501,574 |
| Held-to-Maturity (Approximate Fair Value of \$304,259 at June 30, 2014; \$302,305 at December 31, 2013; and \$252,691 at June 30, 2013) | 297,437 | 299,261 | 248,914 |
| Federal Home Loan Bank and Federal Reserve Bank Stock | 4,583 | 6,281 | 6,136 |
| Loans | 1,344,124 | 1,266,472 | 1,204,734 |
| Allowance for Loan Losses | (15,036) | (14,434) | (14,678) |
| Net Loans | 1,329,088 | 1,252,038 | 1,190,056 |
| Premises and Equipment, Net | 28,465 | 29,154 | 29,301 |
| Goodwill | 22,003 | 22,003 | 22,003 |
| Other Intangible Assets, Net | 3,865 | 4,140 | 4,384 |
| Other Assets | 48,952 | 43,235 | 36,201 |
| Total Assets | <u>\$ 2,153,051</u> | <u>\$ 2,163,698</u> | <u>\$ 2,083,169</u> |
| LIABILITIES | | | |
| Noninterest-Bearing Deposits | \$ 286,735 | \$ 278,958 | \$ 261,910 |
| NOW Accounts | 820,589 | 817,366 | 754,371 |
| Savings Deposits | 523,626 | 498,779 | 494,586 |
| Time Deposits of \$100,000 or More | 70,600 | 78,928 | 87,369 |
| Other Time Deposits | 159,116 | 168,299 | 181,669 |
| Total Deposits | 1,860,666 | 1,842,330 | 1,779,905 |
| Federal Funds Purchased and Securities Sold Under Agreements to Repurchase | 16,896 | 11,777 | 14,738 |
| Federal Home Loan Bank Overnight Advances | 24,000 | 53,000 | 40,000 |
| Federal Home Loan Bank Term Advances | 10,000 | 20,000 | 30,000 |
| Junior Subordinated Obligations Issued to Unconsolidated Subsidiary Trusts | 20,000 | 20,000 | 20,000 |
| Other Liabilities | 23,873 | 24,437 | 20,919 |
| Total Liabilities | 1,955,435 | 1,971,544 | 1,905,562 |
| STOCKHOLDERS' EQUITY | | | |
| Preferred Stock, \$5 Par Value; 1,000,000 Shares Authorized | — | — | — |
| Common Stock, \$1 Par Value; 20,000,000 Shares Authorized (16,744,486 Shares Issued at June 30, 2014, and December 31, 2013; and 16,416,163 Shares Issued at June 30, 2013) | 16,744 | 16,744 | 16,416 |
| Additional Paid-in Capital | 230,131 | 229,290 | 219,772 |
| Retained Earnings | 32,132 | 27,457 | 30,625 |
| Unallocated ESOP Shares (74,845 Shares at June 30, 2014; 87,641 Shares at December 31, 2013; and 95,172 Shares at June 30, 2013) | (1,550) | (1,800) | (1,900) |
| Accumulated Other Comprehensive Loss | (3,489) | (4,373) | (11,739) |
| Treasury Stock, at Cost (4,319,587 Shares at June 30, 2014; 4,296,723 Shares at December 31, 2013; and 4,277,680 Shares at June 30, 2013) | (76,352) | (75,164) | (75,567) |
| Total Stockholders' Equity | 197,616 | 192,154 | 177,607 |
| Total Liabilities and Stockholders' Equity | <u>\$ 2,153,051</u> | <u>\$ 2,163,698</u> | <u>\$ 2,083,169</u> |

See Notes to Unaudited Interim Consolidated Financial Statements.

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

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|--|-----------------------------|-----------------|---------------------------|------------------|
| | 2014 | 2013 | 2014 | 2013 |
| INTEREST AND DIVIDEND INCOME | | | | |
| Interest and Fees on Loans | \$ 13,202 | \$ 12,650 | \$ 25,976 | \$ 25,433 |
| Interest on Deposits at Banks | 16 | 19 | 29 | 46 |
| Interest and Dividends on Investment Securities: | | | | |
| Fully Taxable | 2,041 | 1,639 | 4,049 | 3,435 |
| Exempt from Federal Taxes | 1,436 | 1,501 | 2,907 | 2,891 |
| Total Interest and Dividend Income | <u>16,695</u> | <u>15,809</u> | <u>32,961</u> | <u>31,805</u> |
| INTEREST EXPENSE | | | | |
| NOW Accounts | 495 | 786 | 959 | 1,564 |
| Savings Deposits | 226 | 277 | 445 | 545 |
| Time Deposits of \$100,000 or More | 201 | 305 | 431 | 624 |
| Other Time Deposits | 359 | 505 | 750 | 1,059 |
| Federal Funds Purchased and Securities Sold Under Agreements to Repurchase | 5 | 6 | 9 | 9 |
| Federal Home Loan Bank Advances | 127 | 199 | 272 | 372 |
| Junior Subordinated Obligations Issued to Unconsolidated Subsidiary Trusts | 142 | 145 | 283 | 289 |
| Total Interest Expense | <u>1,555</u> | <u>2,223</u> | <u>3,149</u> | <u>4,462</u> |
| NET INTEREST INCOME | <u>15,140</u> | <u>13,586</u> | <u>29,812</u> | <u>27,343</u> |
| Provision for Loan Losses | <u>505</u> | <u>100</u> | <u>963</u> | <u>200</u> |
| NET INTEREST INCOME AFTER PROVISION FOR LOAN LOSSES | <u>14,635</u> | <u>13,486</u> | <u>28,849</u> | <u>27,143</u> |
| NONINTEREST INCOME | | | | |
| Income From Fiduciary Activities | 1,906 | 1,758 | 3,779 | 3,332 |
| Fees for Other Services to Customers | 2,377 | 2,371 | 4,571 | 4,653 |
| Insurance Commissions | 2,293 | 2,176 | 4,737 | 4,204 |
| Net (Loss) Gain on Securities Transactions | (27) | 13 | (27) | 540 |
| Net Gain on Sales of Loans | 166 | 498 | 289 | 1,105 |
| Other Operating Income | 304 | 255 | 556 | 411 |
| Total Noninterest Income | <u>7,019</u> | <u>7,071</u> | <u>13,905</u> | <u>14,245</u> |
| NONINTEREST EXPENSE | | | | |
| Salaries and Employee Benefits | 7,880 | 7,637 | 15,522 | 15,258 |
| Occupancy Expenses, Net | 2,316 | 2,119 | 4,657 | 4,395 |
| FDIC Assessments | 282 | 267 | 555 | 531 |
| Other Operating Expense | 3,259 | 3,251 | 6,469 | 6,501 |
| Total Noninterest Expense | <u>13,737</u> | <u>13,274</u> | <u>27,203</u> | <u>26,685</u> |
| INCOME BEFORE PROVISION FOR INCOME TAXES | <u>7,917</u> | <u>7,283</u> | <u>15,551</u> | <u>14,703</u> |
| Provision for Income Taxes | <u>2,393</u> | <u>2,076</u> | <u>4,707</u> | <u>4,315</u> |
| NET INCOME | <u>\$ 5,524</u> | <u>\$ 5,207</u> | <u>\$ 10,844</u> | <u>\$ 10,388</u> |
| Average Shares Outstanding: | | | | |
| Basic | 12,348 | 12,261 | 12,351 | 12,267 |
| Diluted | 12,369 | 12,279 | 12,373 | 12,285 |
| Per Common Share: | | | | |
| Basic Earnings | \$ 0.45 | \$ 0.42 | \$ 0.88 | \$ 0.85 |
| Diluted Earnings | 0.45 | 0.42 | 0.88 | 0.85 |

Share and Per Share Amounts have been restated for the September 2013 2% stock dividend.
See Notes to Unaudited Interim Consolidated Financial Statements.

ARROW FINANCIAL CORPORATION AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

(In Thousands)
(Unaudited)

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|---|-----------------------------|-----------------|---------------------------|-----------------|
| | <u>2014</u> | <u>2013</u> | <u>2014</u> | <u>2013</u> |
| Net Income | \$ 5,524 | \$ 5,207 | \$ 10,844 | \$ 10,388 |
| Other Comprehensive Income, Net of Tax: | | | | |
| Net Unrealized Securities Holding Gains | | | | |
| Arising During the Period | 514 | (3,643) | 755 | (3,423) |
| Reclassification Adjustment for Securities Losses | | | | |
| (Gains) Included in Net Income | 16 | (8) | 16 | (326) |
| Amortization of Net Retirement Plan Actuarial Loss | 69 | 236 | 139 | 472 |
| Accretion of Net Retirement Plan Prior Service Credit | (13) | — | (26) | — |
| Other Comprehensive Income (Loss) | <u>586</u> | <u>(3,415)</u> | <u>884</u> | <u>(3,277)</u> |
| Comprehensive Income | <u>\$ 6,110</u> | <u>\$ 1,792</u> | <u>\$ 11,728</u> | <u>\$ 7,111</u> |

See Notes to Unaudited Interim Consolidated Financial Statements.

ARROW FINANCIAL CORPORATION AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY

(In Thousands, Except Share and Per Share Amounts)
(Unaudited)

| | Common Stock | Additional Paid-In Capital | Retained Earnings | Unallo- cated ESOP Shares | Accumu- lated Other Com- prehensive Income (Loss) | Treasury Stock | Total |
|---|------------------|----------------------------------|----------------------|------------------------------------|--|--------------------|-------------------|
| Balance at December 31, 2013 | \$ 16,744 | \$ 229,290 | \$ 27,457 | \$ (1,800) | \$ (4,373) | \$ (75,164) | \$ 192,154 |
| Net Income | — | — | 10,844 | — | — | — | 10,844 |
| Other Comprehensive (Loss) Income | — | — | — | — | 884 | — | 884 |
| Cash Dividends Paid, \$.50 per Share ¹ | — | — | (6,169) | — | — | — | (6,169) |
| Stock Options Exercised, Net (21,565 Shares) | — | 308 | — | — | — | 212 | 520 |
| Shares Issued Under the Directors' Stock Plan (3,872 Shares) | — | 63 | — | — | — | 38 | 101 |
| Shares Issued Under the Employee Stock Purchase Plan (9,713 Shares) | — | 146 | — | — | — | 95 | 241 |
| Stock-Based Compensation Expense | — | 180 | — | — | — | — | 180 |
| Tax Benefit for Disposition of Stock Options | — | 9 | — | — | — | — | 9 |
| Purchase of Treasury Stock (61,609 Shares) | — | — | — | — | — | (1,568) | (1,568) |
| Acquisition of Subsidiaries (3,595 Shares) | — | 56 | — | — | — | 35 | 91 |
| Allocation of ESOP Stock (12,796 Shares) | — | 79 | — | 250 | — | — | 329 |
| Balance at June 30, 2014 | <u>\$ 16,744</u> | <u>\$ 230,131</u> | <u>\$ 32,132</u> | <u>\$ (1,550)</u> | <u>\$ (3,489)</u> | <u>\$ (76,352)</u> | <u>\$ 197,616</u> |
| Balance at December 31, 2012 | \$ 16,416 | \$ 218,650 | \$ 26,251 | \$ (2,150) | \$ (8,462) | \$ (74,880) | \$ 175,825 |
| Net Income | — | — | 10,388 | — | — | — | 10,388 |
| Other Comprehensive (Loss) Income | — | — | — | — | (3,277) | — | (3,277) |
| Cash Dividends Paid, \$.49 per Share ¹ | — | — | (6,014) | — | — | — | (6,014) |
| Stock Options Exercised, Net (23,685 Shares) | — | 262 | — | — | — | 233 | 495 |
| Shares Issued Under the Directors' Stock Plan (4,255 Shares) | — | 64 | — | — | — | 42 | 106 |
| Shares Issued Under the Employee Stock Purchase Plan (10,402 Shares) | — | 141 | — | — | — | 103 | 244 |
| Shares Issued for Dividend Reinvestment Plans (17,323 Shares) | — | 260 | — | — | — | 170 | 430 |
| Stock-Based Compensation Expense | — | 189 | — | — | — | — | 189 |
| Tax Benefit for Disposition of Stock Options | — | 9 | — | — | — | — | 9 |
| Purchase of Treasury Stock (54,231 Shares) | — | — | — | — | — | (1,329) | (1,329) |
| Acquisition of Subsidiaries (9,503 Shares) | — | 139 | — | — | — | 94 | 233 |
| Allocation of ESOP Stock (7,718 Shares) | — | 58 | — | 250 | — | — | 308 |
| Balance at June 30, 2013 | <u>\$ 16,416</u> | <u>\$ 219,772</u> | <u>\$ 30,625</u> | <u>\$ (1,900)</u> | <u>\$ (11,739)</u> | <u>\$ (75,567)</u> | <u>\$ 177,607</u> |

¹ Cash dividends paid per share have been adjusted for the September 2013 2% stock dividend.

See Notes to Unaudited Interim Consolidated Financial Statements.

ARROW FINANCIAL CORPORATION AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOWS

(Dollars in Thousands)
(Unaudited)

Six Months Ended June 30,

| | 2014 | 2013 |
|---|------------------|------------------|
| Cash Flows from Operating Activities: | | |
| Net Income | \$ 10,844 | \$ 10,388 |
| Adjustments to Reconcile Net Income to Net Cash Provided by Operating Activities: | | |
| Provision for Loan Losses | 963 | 200 |
| Depreciation and Amortization | 3,854 | 4,785 |
| Allocation of ESOP Stock | 329 | 308 |
| Gains on the Sale of Securities Available-for-Sale | — | (527) |
| Gains on the Sale of Securities Held-to-Maturity | — | (18) |
| Losses on the Sale of Securities Held-to-Maturity | — | 5 |
| Losses on the Sale of Securities Available-for-Sale | 27 | — |
| Loans Originated and Held-for-Sale | (9,723) | (32,465) |
| Proceeds from the Sale of Loans Held-for-Sale | 8,993 | 35,868 |
| Net Gains on the Sale of Loans | (289) | (1,105) |
| Net Losses on the Sale of Premises and Equipment, Other Real Estate Owned and Repossessed Assets | 46 | 106 |
| Contributions to Retirement Benefit Plans | (465) | (221) |
| Deferred Income Tax Benefit | (180) | (93) |
| Shares Issued Under the Directors' Stock Plan | 101 | 106 |
| Stock-Based Compensation Expense | 180 | 189 |
| Net (Increase) Decrease in Other Assets | (714) | 3,760 |
| Net Increase (Decrease) in Other Liabilities | 67 | (2,690) |
| Net Cash Provided By Operating Activities | 14,033 | 18,596 |
| Cash Flows from Investing Activities: | | |
| Proceeds from the Sale of Securities Available-for-Sale | 40,725 | 16,273 |
| Proceeds from the Maturities and Calls of Securities Available-for-Sale | 107,292 | 60,679 |
| Purchases of Securities Available-for-Sale | (57,515) | (107,772) |
| Proceeds from the Sale of Securities Held-to-Maturity | — | 1,181 |
| Proceeds from the Maturities and Calls of Securities Held-to-Maturity | 37,435 | 17,905 |
| Purchases of Securities Held-to-Maturity | (36,380) | (29,112) |
| Net Increase in Loans | (77,926) | (36,195) |
| Proceeds from the Sales of Premises and Equipment, Other Real Estate Owned and Repossessed Assets | 918 | 440 |
| Purchase of Premises and Equipment | (618) | (1,453) |
| Cash Paid for Subsidiaries, Net | (75) | (75) |
| Net Decrease (Increase) in Other Investments | 1,698 | (344) |
| Purchase of Bank Owned Life Insurance | (5,245) | — |
| Net Cash Provided By (Used In) Investing Activities | 10,309 | (78,473) |
| Cash Flows from Financing Activities: | | |
| Net Increase in Deposits | 18,336 | 48,750 |
| Net (Decrease) Increase in Short-Term Borrowings | (23,881) | 13,060 |
| Repayments of Federal Home Loan Bank Term Advances | (10,000) | — |
| Purchase of Treasury Stock | (1,568) | (1,329) |
| Stock Options Exercised, Net | 520 | 495 |
| Shares Issued Under the Employee Stock Purchase Plan | 241 | 244 |
| Tax Benefit from Exercise of Stock Options | 9 | 9 |
| Shares Issued for Dividend Reinvestment Plans | — | 430 |
| Cash Dividends Paid | (6,169) | (6,014) |
| Net Cash (Used In) Provided By Financing Activities | (22,512) | 55,645 |
| Net Increase in Cash and Cash Equivalents | 1,830 | (4,232) |
| Cash and Cash Equivalents at Beginning of Period | 49,980 | 48,832 |
| Cash and Cash Equivalents at End of Period | \$ 51,810 | \$ 44,600 |
| Supplemental Disclosures to Statements of Cash Flow Information: | | |
| Interest on Deposits and Borrowings | \$ 3,222 | \$ 4,552 |
| Income Taxes | 4,485 | 4,011 |
| Non-cash Investing and Financing Activity: | | |
| Transfer of Loans to Other Real Estate Owned and Repossessed Assets | 932 | 684 |
| Acquisition of Subsidiaries | 91 | 233 |

See Notes to Unaudited Interim Consolidated Financial Statements.

NOTES TO INTERIM CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

Note 1. ACCOUNTING POLICIES

In the opinion of the management of Arrow Financial Corporation (Arrow), the accompanying unaudited consolidated interim financial statements contain all of the adjustments necessary to present fairly the financial position as of June 30, 2014, December 31, 2013 and June 30, 2013; the results of operations for the three and six-month periods ended June 30, 2014 and 2013; the consolidated statements of comprehensive income for the three and six-month periods ended June 30, 2014 and 2013; the changes in stockholders' equity for the six-month periods ended June 30, 2014 and 2013; and the cash flows for the six-month periods ended June 30, 2014 and 2013. All such adjustments are of a normal recurring nature. Certain prior period amounts have been reclassified to conform to the current presentation. The preparation of financial statements requires the use of management estimates. The unaudited consolidated interim financial statements should be read in conjunction with the audited annual consolidated financial statements of Arrow for the year ended December 31, 2013, included in Arrow's 2013 Form 10-K.

New Accounting Standards Updates (ASU): During 2014, through the date of this report, the FASB issued twelve accounting standards updates, only two of which apply to Arrow.

ASU 2014-01 "Investments-Equity Method and Joint Ventures" allows an entity that invests in affordable housing projects that qualify for low-income housing tax credits to make an accounting policy election to account for their investments in qualified affordable housing projects using the proportional amortization method if certain conditions are met. Under the proportional amortization method, an entity amortizes the initial cost of the investment in proportion to the tax credits and other tax benefits received and recognizes the net investment performance in the income statement as a component of income tax expense. The standard is effective for annual years beginning after December 15, 2014, with earlier adoption allowed. We adopted the proportional amortization method in the first quarter of 2014. The adoption did not have a material impact on our financial condition or results of operations.

ASU 2014-04 "Receivables - Trouble Debt Restructurings by Creditors" provides additional guidance on when an in substance repossession or foreclosure occurs and is effective for annual periods beginning after December 15, 2014. We are evaluating the impact of adopting this standard, and we do not expect that it will have a material impact on our financial condition or results of operations.

Note 2. INVESTMENT SECURITIES (In Thousands)

The following table is the schedule of Available-For-Sale Securities at June 30, 2014, December 31, 2013 and June 30, 2013:

| | Available-For-Sale Securities | | | | | |
|---|--------------------------------------|--|--|--|---|---|
| | <u>U.S. Agency Obligations</u> | <u>State and Municipal Obligations</u> | <u>Mortgage- Backed Securities - Residential</u> | <u>Corporate and Other Debt Securities</u> | <u>Mutual Funds and Equity Securities</u> | <u>Total Available- For-Sale Securities</u> |
| <u>June 30, 2014</u> | | | | | | |
| Available-For-Sale Securities, at Amortized Cost | \$ 92,328 | \$ 102,456 | \$ 148,672 | \$ 17,065 | \$ 1,120 | \$ 361,641 |
| Available-For-Sale Securities, at Fair Value | 92,186 | 102,862 | 153,770 | 16,829 | 1,201 | 366,848 |
| Gross Unrealized Gains | 4 | 413 | 5,143 | 15 | 81 | 5,656 |
| Gross Unrealized Losses | 146 | 7 | 45 | 251 | — | 449 |
| Available-For-Sale Securities, Pledged as Collateral | | | | | | 228,990 |
| <u>Maturities of Debt Securities, at Amortized Cost:</u> | | | | | | |
| Within One Year | — | 42,106 | 9,470 | — | | 51,576 |
| From 1 - 5 Years | 80,659 | 58,160 | 126,647 | 16,065 | | 281,531 |
| From 5 - 10 Years | 11,669 | 1,550 | 12,555 | — | | 25,774 |
| Over 10 Years | — | 640 | — | 1,000 | | 1,640 |
| <u>Maturities of Debt Securities, at Fair Value:</u> | | | | | | |
| Within One Year | — | 42,194 | 9,576 | — | | 51,770 |
| From 1 - 5 Years | 80,520 | 58,460 | 130,851 | 16,029 | | 285,860 |
| From 5 - 10 Years | 11,666 | 1,568 | 13,343 | — | | 26,577 |
| Over 10 Years | — | 640 | — | 800 | | 1,440 |

Available-For-Sale Securities

| | U.S. Agency Obligations | State and Municipal Obligations | Mortgage- Backed Securities - Residential | Corporate and Other Debt Securities | Mutual Funds and Equity Securities | Total Available- For-Sale Securities |
|---|----------------------------|---------------------------------------|--|--|---|---|
| <u>Securities in a Continuous Loss Position, at Fair Value:</u> | | | | | | |
| Less than 12 Months | \$ 42,888 | \$ 2,860 | \$ 8,740 | \$ — | \$ — | \$ 54,488 |
| 12 Months or Longer | 33,031 | 4,223 | 1,935 | 8,537 | — | 47,726 |
| Total | <u>\$ 75,919</u> | <u>\$ 7,083</u> | <u>\$ 10,675</u> | <u>\$ 8,537</u> | <u>\$ —</u> | <u>\$ 102,214</u> |
| Number of Securities in a Continuous Loss Position | 24 | 24 | 8 | 12 | — | 68 |
| <u>Unrealized Losses on Securities in a Continuous Loss Position:</u> | | | | | | |
| Less than 12 Months | \$ 30 | \$ — | \$ 34 | \$ — | \$ — | \$ 64 |
| 12 Months or Longer | 116 | 7 | 11 | 251 | — | 385 |
| Total | <u>\$ 146</u> | <u>\$ 7</u> | <u>\$ 45</u> | <u>\$ 251</u> | <u>\$ —</u> | <u>\$ 449</u> |
| <u>December 31, 2013</u> | | | | | | |
| Available-For-Sale Securities, at Amortized Cost | \$ 136,868 | \$ 127,224 | \$ 171,321 | \$ 17,142 | \$ 1,120 | \$ 453,675 |
| Available-For-Sale Securities, at Fair Value | 136,475 | 127,389 | 175,778 | 16,798 | 1,166 | 457,606 |
| Gross Unrealized Gains | 2 | 306 | 4,714 | 10 | 46 | 5,078 |
| Gross Unrealized Losses | 395 | 141 | 257 | 354 | — | 1,147 |
| Available-For-Sale Securities, Pledged as Collateral | | | | | | 243,769 |
| <u>Securities in a Continuous Loss Position, at Fair Value:</u> | | | | | | |
| Less than 12 Months | \$ 60,664 | \$ 29,967 | \$ 15,190 | \$ 7,375 | \$ — | \$ 113,196 |
| 12 Months or Longer | 33,849 | 4,597 | 11,841 | 6,063 | — | 56,350 |
| Total | <u>\$ 94,513</u> | <u>\$ 34,564</u> | <u>\$ 27,031</u> | <u>\$ 13,438</u> | <u>\$ —</u> | <u>\$ 169,546</u> |
| Number of Securities in a Continuous Loss Position | 26 | 107 | 13 | 19 | — | 165 |
| <u>Unrealized Losses on Securities in a Continuous Loss Position:</u> | | | | | | |
| Less than 12 Months | \$ 336 | \$ 120 | \$ 108 | \$ 92 | \$ — | \$ 656 |
| 12 Months or Longer | 59 | 21 | 149 | 262 | — | 491 |
| Total | <u>\$ 395</u> | <u>\$ 141</u> | <u>\$ 257</u> | <u>\$ 354</u> | <u>\$ —</u> | <u>\$ 1,147</u> |
| <u>June 30, 2013</u> | | | | | | |
| Available-For-Sale Securities, at Amortized Cost | \$ 151,199 | \$ 131,154 | \$ 197,775 | \$ 17,219 | \$ 1,120 | \$ 498,467 |
| Available-For-Sale Securities, at Fair Value | 150,046 | 130,444 | 203,230 | 16,711 | 1,143 | 501,574 |
| Gross Unrealized Gains | — | 135 | 5,586 | — | 23 | 5,744 |
| Gross Unrealized Losses | 1,153 | 845 | 131 | 508 | — | 2,637 |
| Available-For-Sale Securities, Pledged as Collateral | | | | | | 270,243 |
| <u>Securities in a Continuous Loss Position, at Fair Value:</u> | | | | | | |
| Less than 12 Months | \$ 150,048 | \$ 80,443 | \$ 6,750 | \$ 15,910 | \$ — | \$ 253,151 |
| 12 Months or Longer | — | 4,228 | — | 800 | — | 5,028 |
| Total | <u>\$ 150,048</u> | <u>\$ 84,671</u> | <u>\$ 6,750</u> | <u>\$ 16,710</u> | <u>\$ —</u> | <u>\$ 258,179</u> |
| Number of Securities in a Continuous Loss Position | 47 | 347 | 3 | 22 | — | 419 |

Available-For-Sale Securities

| | U.S. Agency Obligations | State and Municipal Obligations | Mortgage- Backed Securities - Residential | Corporate and Other Debt Securities | Mutual Funds and Equity Securities | Total Available- For-Sale Securities |
|---|----------------------------|---------------------------------------|--|--|---|---|
| <u>Unrealized Losses on Securities in a Continuous Loss Position:</u> | | | | | | |
| Less than 12 Months | \$ 1,153 | \$ 826 | \$ 131 | \$ 308 | \$ — | \$ 2,418 |
| 12 Months or Longer | — | 19 | — | 200 | — | 219 |
| Total | <u>\$ 1,153</u> | <u>\$ 845</u> | <u>\$ 131</u> | <u>\$ 508</u> | <u>\$ —</u> | <u>\$ 2,637</u> |

The following table is the schedule of Held-To-Maturity Securities at June 30, 2014, December 31, 2013 and June 30, 2013:

Held-To-Maturity Securities

| | State and Municipal Obligations | Mortgage- Backed Securities - Residential | Corporate and Other Debt Securities | Total Held-To Maturity Securities |
|---|---------------------------------------|--|--|--|
| <u>June 30, 2014</u> | | | | |
| Held-To-Maturity Securities, at Amortized Cost | \$ 174,888 | \$ 121,549 | \$ 1,000 | \$ 297,437 |
| Held-To-Maturity Securities, at Fair Value | 180,211 | 123,048 | 1,000 | 304,259 |
| Gross Unrealized Gains | 5,473 | 1,533 | — | 7,006 |
| Gross Unrealized Losses | 150 | 34 | — | 184 |
| Held-To-Maturity Securities, Pledged as Collateral | | | | 296,437 |
| <u>Maturities of Debt Securities, at Amortized Cost:</u> | | | | |
| Within One Year | 30,255 | — | — | 30,255 |
| From 1 - 5 Years | 81,521 | 37,372 | — | 118,893 |
| From 5 - 10 Years | 60,657 | 84,177 | — | 144,834 |
| Over 10 Years | 2,455 | — | 1,000 | 3,455 |
| <u>Maturities of Debt Securities, at Fair Value:</u> | | | | |
| Within One Year | 30,369 | — | — | 30,369 |
| From 1 - 5 Years | 84,085 | 37,752 | — | 121,837 |
| From 5 - 10 Years | 63,203 | 85,296 | — | 148,499 |
| Over 10 Years | 2,554 | — | 1,000 | 3,554 |
| <u>Securities in a Continuous Loss Position, at Fair Value:</u> | | | | |
| Less than 12 Months | \$ 2,697 | \$ 9,561 | \$ — | \$ 12,258 |
| 12 Months or Longer | 13,839 | 1,194 | — | 15,033 |
| Total | <u>\$ 16,536</u> | <u>\$ 10,755</u> | <u>\$ —</u> | <u>\$ 27,291</u> |
| Number of Securities in a Continuous Loss Position | 63 | 4 | — | 67 |
| <u>Unrealized Losses on Securities in a Continuous Loss Position:</u> | | | | |
| Less than 12 Months | \$ 29 | \$ 27 | \$ — | \$ 56 |
| 12 Months or Longer | 121 | 7 | — | 128 |
| Total | <u>\$ 150</u> | <u>\$ 34</u> | <u>\$ —</u> | <u>\$ 184</u> |

Held-To-Maturity Securities

| | State and Municipal Obligations | Mortgage- Backed Securities - Residential | Corporate and Other Debt Securities | Total Held-To Maturity Securities |
|---|---------------------------------------|--|--|--|
| December 31, 2013 | | | | |
| Held-To-Maturity Securities, at Amortized Cost | \$ 198,206 | \$ 100,055 | \$ 1,000 | \$ 299,261 |
| Held-To-Maturity Securities, at Fair Value | 202,390 | 98,915 | 1,000 | 302,305 |
| Gross Unrealized Gains | 4,762 | 24 | — | 4,786 |
| Gross Unrealized Losses | 578 | 1,164 | — | 1,742 |
| Held-To-Maturity Securities, Pledged as Collateral | | | | 298,261 |
| <u>Securities in a Continuous Loss Position, at Fair Value:</u> | | | | |
| Less than 12 Months | \$ 23,633 | \$ 85,339 | \$ — | \$ 108,972 |
| 12 Months or Longer | 5,111 | — | — | 5,111 |
| Total | <u>\$ 28,744</u> | <u>\$ 85,339</u> | <u>\$ —</u> | <u>\$ 114,083</u> |
| Number of Securities in a Continuous Loss Position | 101 | 36 | — | 137 |
| <u>Unrealized Losses on Securities in a Continuous Loss Position:</u> | | | | |
| Less than 12 Months | \$ 519 | \$ 1,164 | \$ — | \$ 1,683 |
| 12 Months or Longer | 59 | — | — | 59 |
| Total | <u>\$ 578</u> | <u>\$ 1,164</u> | <u>\$ —</u> | <u>\$ 1,742</u> |
| June 30, 2013 | | | | |
| Held-To-Maturity Securities, at Amortized Cost | \$ 200,182 | \$ 47,732 | \$ 1,000 | \$ 248,914 |
| Held-To-Maturity Securities, at Fair Value | 204,153 | 47,538 | 1,000 | 252,691 |
| Gross Unrealized Gains | 4,833 | 8 | — | 4,841 |
| Gross Unrealized Losses | 862 | 202 | — | 1,064 |
| Held-To-Maturity Securities, Pledged as Collateral | | | | 247,914 |
| <u>Securities in a Continuous Loss Position, at Fair Value:</u> | | | | |
| Less than 12 Months | \$ 39,598 | \$ 42,813 | \$ — | \$ 82,411 |
| 12 Months or Longer | 13,204 | — | — | 13,204 |
| Total | <u>\$ 52,802</u> | <u>\$ 42,813</u> | <u>\$ —</u> | <u>\$ 95,615</u> |
| Number of Securities in a Continuous Loss Position | 172 | 27 | — | 199 |
| <u>Unrealized Losses on Securities in a Continuous Loss Position:</u> | | | | |
| Less than 12 Months | \$ 712 | \$ 203 | \$ — | \$ 915 |
| 12 Months or Longer | 149 | — | — | 149 |
| Total | <u>\$ 861</u> | <u>\$ 203</u> | <u>\$ —</u> | <u>\$ 1,064</u> |

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

In the available-for-sale category at June 30, 2014, U.S. agency obligations consisted solely of U.S. Government Agency securities with an amortized cost of \$92.3 million and a fair value of \$92.2 million. Mortgage-backed securities - residential consisted of U.S. Government Agency securities with an amortized cost of \$29.4 million and a fair value of \$30.1 million and government sponsored entity (GSE) securities with an amortized cost of \$119.3 million and a fair value of \$123.7 million. In the held-to-maturity category at June 30, 2014, mortgage-backed securities-residential consisted of U.S. Government Agency securities with an amortized cost of \$4.6 million and a fair value of \$4.7 million and GSE securities with an amortized cost of \$116.9 million and a fair value of \$118.3 million.

In the available-for-sale category at December 31, 2013, U.S. agency obligations consisted solely of U.S. Government Agency securities with an amortized cost of \$136.9 million and a fair value of \$136.5 million. Mortgage-backed securities-residential consisted of U.S. Government Agency securities with an amortized cost of \$31.5 million and a fair value of \$32.2 million and GSE securities with an amortized cost of \$139.8 million and a fair value of \$143.6 million. In the held-to-maturity category at December 31, 2013, mortgage-backed securities-residential consisted of U.S. Government Agency securities with an amortized cost of \$4.9 million and a fair value of \$4.7 million and GSE securities with an amortized cost of \$95.2 million and a fair value of \$94.2 million.

In the available-for-sale category at June 30, 2013, U.S. agency obligations consisted solely of U.S. Government Agency securities with an amortized cost of \$151.2 million and a fair value of \$150.0 million. Mortgage-backed securities-residential consisted of U.S. Government Agency securities with an amortized cost of \$34.1 million and a fair value of \$35.1 million and GSE securities with an amortized cost of \$163.7 million and a fair value of \$168.1 million. In the held-to-maturity category at June 30, 2013, mortgage-backed securities-residential consisted of GSE securities with an amortized cost of \$47.7 million and a fair value of \$47.5 million.

Securities in a continuous loss position, in the tables above for June 30, 2014, December 31, 2013 and June 30, 2013, do not reflect any deterioration of the credit worthiness of the issuing entities. U.S. Agency issues, including agency-backed collateralized mortgage obligations and mortgage-backed securities, are all rated at least Aaa by Moody's or AA+ by Standard and Poor's. The state and municipal obligations are general obligations supported by the general taxing authority of the issuer, and in some cases are insured. Obligations issued by school districts are supported by state aid. For any non-rated municipal securities, credit analysis is performed in-house based upon data that has been submitted by the issuers to the NY State Comptroller. That analysis shows no deterioration in the credit worthiness of the municipalities. Subsequent to June 30, 2014, and through the date of filing this report, there were no securities downgraded below investment grade.

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

Note 3. LOANS (In Thousands)

Loan Categories and Past Due Loans

The following table presents loan balances outstanding as of June 30, 2014, December 31, 2013 and June 30, 2013 and an analysis of the recorded investment in loans that are past due at these dates. Generally, Arrow considers a loan past due 30 or more days if the borrower is two or more payments past due. Loans held-for-sale of \$1,084, \$64 and \$503 as of June 30, 2014, December 31, 2013 and June 30, 2013, respectively, are included in the residential real estate loan balances.

| Past Due Loans | | | | | | | |
|--|------------------|-------------------------|------------------------|-----------------|-------------------|-------------------|---------------------|
| | Commercial | Commercial Construction | Commercial Real Estate | Other Consumer | Automobile | Residential | Total |
| <u>June 30, 2014</u> | | | | | | | |
| Loans Past Due 30-59 Days | \$ 212 | \$ — | \$ — | \$ 30 | \$ 2,696 | \$ 439 | \$ 3,377 |
| Loans Past Due 60-89 Days | 575 | — | 443 | 6 | 811 | 1,441 | 3,276 |
| Loans Past Due 90 or more Days | 108 | — | 1,887 | — | 272 | 2,955 | 5,222 |
| Total Loans Past Due | 895 | — | 2,330 | 36 | 3,779 | 4,835 | 11,875 |
| Current Loans | 92,995 | 29,702 | 307,316 | 7,827 | 405,522 | 488,887 | 1,332,249 |
| Total Loans | <u>\$ 93,890</u> | <u>\$ 29,702</u> | <u>\$ 309,646</u> | <u>\$ 7,863</u> | <u>\$ 409,301</u> | <u>\$ 493,722</u> | <u>\$ 1,344,124</u> |
| Loans 90 or More Days Past Due and Still Accruing Interest | | | | | | | |
| | \$ — | \$ — | \$ 51 | \$ — | \$ 5 | \$ 1,269 | \$ 1,325 |
| Nonaccrual Loans | | | | | | | |
| | \$ 164 | \$ — | \$ 2,079 | \$ 1 | \$ 472 | \$ 3,469 | \$ 6,185 |
| <u>December 31, 2013</u> | | | | | | | |
| Loans Past Due 30-59 Days | \$ 304 | \$ — | \$ 200 | \$ 37 | \$ 3,233 | \$ 529 | \$ 4,303 |
| Loans Past Due 60-89 Days | 601 | — | 1,200 | 19 | 1,041 | 1,527 | 4,388 |
| Loans Past Due 90 or more Days | 177 | — | 2,034 | — | 98 | 3,113 | 5,422 |
| Total Loans Past Due | 1,082 | — | 3,434 | 56 | 4,372 | 5,169 | 14,113 |
| Current Loans | 86,811 | 27,815 | 284,685 | 7,593 | 389,832 | 455,623 | 1,252,359 |
| Total Loans | <u>\$ 87,893</u> | <u>\$ 27,815</u> | <u>\$ 288,119</u> | <u>\$ 7,649</u> | <u>\$ 394,204</u> | <u>\$ 460,792</u> | <u>\$ 1,266,472</u> |
| Loans 90 or More Days Past Due and Still Accruing Interest | | | | | | | |
| | \$ 28 | \$ — | \$ — | \$ — | \$ — | \$ 624 | \$ 652 |
| Nonaccrual Loans | | | | | | | |
| | \$ 352 | \$ — | \$ 2,048 | \$ — | \$ 219 | \$ 3,860 | \$ 6,479 |
| <u>June 30, 2013</u> | | | | | | | |
| Loans Past Due 30-59 Days | \$ 765 | \$ — | \$ 262 | \$ 16 | \$ 2,346 | \$ 1,161 | \$ 4,550 |
| Loans Past Due 60-89 Days | 655 | — | 997 | 15 | 527 | 1,196 | 3,390 |
| Loans Past Due 90 or more Days | 220 | — | 1,875 | 4 | 114 | 1,402 | 3,615 |
| Total Loans Past Due | 1,640 | — | 3,134 | 35 | 2,987 | 3,759 | 11,555 |
| Current Loans | 85,909 | 30,980 | 256,665 | 7,421 | 372,073 | 440,131 | 1,193,179 |
| Total Loans | <u>\$ 87,549</u> | <u>\$ 30,980</u> | <u>\$ 259,799</u> | <u>\$ 7,456</u> | <u>\$ 375,060</u> | <u>\$ 443,890</u> | <u>\$ 1,204,734</u> |
| Loans 90 or More Days Past Due and Still Accruing Interest | | | | | | | |
| | \$ 154 | \$ — | \$ — | \$ — | \$ — | \$ 606 | \$ 760 |
| Nonaccrual Loans | | | | | | | |
| | \$ 299 | \$ — | \$ 1,941 | \$ 7 | \$ 264 | \$ 3,080 | \$ 5,591 |

The Company disaggregates its loan portfolio into the following six categories:

Commercial - The Company offers a variety of loan options to meet the specific needs of our commercial customers including term loans, time notes and lines of credit. Such loans are made available to businesses for working capital needs such as inventory and receivables, business expansion and equipment purchases. Generally, a collateral lien is placed on equipment or other assets owned by the borrower. These loans carry a higher risk than commercial real estate loans due to the nature of the underlying collateral, which can be business assets such as equipment and accounts receivable and generally have a lower liquidation value than real estate. In the event of default by the borrower, the Company may be required to liquidate collateral at deeply discounted values. To reduce the risk, management usually obtains personal guarantees of the borrowers.

Commercial Construction - The Company offers commercial construction and land development loans to finance projects, primarily within the communities that we serve. Many projects will ultimately be used by the borrowers' businesses, while others are developed for resale.

These real estate loans are secured by first liens on the real estate, which may include apartments, commercial structures, housing businesses, healthcare facilities, and both owner-occupied and nonowner-occupied facilities. There is enhanced risk during the construction period, since the loan is secured by an incomplete project.

Commercial Real Estate - The Company offers commercial real estate loans to finance real estate purchases, refinancings, expansions and improvements to commercial properties. Commercial real estate loans are made to finance the purchases of real property which generally consists of real estate with completed structures. These commercial real estate loans are secured by first liens on the real estate, which may include apartments, commercial structures, housing businesses, healthcare facilities, and both owner and non owner-occupied facilities. These loans are typically less risky than commercial loans, since they are secured by real estate and buildings, and are generally originated in amounts of no more than 80% of the appraised value of the property.

Other Consumer Loans - The Company offers a variety of consumer installment loans to finance personal expenditures. Most of these loans carry a fixed rate of interest with principal repayment terms typically ranging from one to five years, based upon the nature of the collateral and the size of the loan. In addition to installment loans, the Company also offers personal lines of credit and overdraft protection. Several loans are unsecured, which carry a higher risk of loss.

Automobile - The Company primarily finances the purchases of automobiles indirectly through dealer relationships located throughout upstate New York and Vermont. Most of these loans carry a fixed rate of interest with principal repayment terms typically ranging from three to seven years. The majority of indirect consumer loans are underwritten on a secured basis using the underlying collateral being financed.

Residential Real Estate Mortgages - Residential real estate loans consist primarily of loans secured by first or second mortgages on primary residences. We originate adjustable-rate and fixed-rate one-to-four-family residential real estate loans for the construction, purchase or refinancing of an existing mortgage. These loans are collateralized primarily by owner-occupied properties generally located in the Company's market area. Loans on one-to-four-family residential real estate are generally originated in amounts of no more than 85% of the purchase price or appraised value (whichever is lower), or have private mortgage insurance. The Company's underwriting analysis for residential mortgage loans typically includes credit verification, independent appraisals, and a review of the borrower's financial condition. Mortgage title insurance and hazard insurance are normally required. It is our general practice to underwrite our residential real estate loans to secondary market standards. Construction loans have a unique risk, because they are secured by an incomplete dwelling. This risk is reduced through periodic site inspections, including one at each loan draw period. In addition, the Company offers fixed home equity loans as well as home equity lines of credit to consumers to finance home improvements, debt consolidation, education and other uses. Our policy allows for a maximum loan to value ratio of 80%, although periodically higher advances are allowed. The Company originates home equity lines of credit and second mortgage loans (loans secured by a second junior lien position on one-to-four-family residential real estate). Risk is generally reduced through underwriting criteria, which include credit verification, appraisals, a review of the borrower's financial condition, and personal cash flows. A security interest, with title insurance when necessary, is taken in the underlying real estate.

Allowance for Loan Losses

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

| | Allowance for Loan Losses | | | | | | | |
|---|----------------------------------|-------------------------|------------------------|----------------|-----------------|-----------------|-----------------|------------------|
| | Commercial | Commercial Construction | Commercial Real Estate | Other Consumer | Automobile | Residential | Unallocated | Total |
| <u>Roll-forward of the Allowance for Loan Losses for the Quarterly Periods:</u> | | | | | | | | |
| March 31, 2014 | \$ 1,797 | \$ 420 | \$ 3,778 | \$ 280 | \$ 4,306 | \$ 3,077 | \$ 978 | \$ 14,636 |
| Charge-offs | (43) | — | — | (12) | (83) | (30) | — | (168) |
| Recoveries | 6 | — | — | — | 57 | — | — | 63 |
| Provision | 295 | 25 | (8) | (2) | 134 | 86 | (25) | 505 |
| June 30, 2014 | <u>\$ 2,055</u> | <u>\$ 445</u> | <u>\$ 3,770</u> | <u>\$ 266</u> | <u>\$ 4,414</u> | <u>\$ 3,133</u> | <u>\$ 953</u> | <u>\$ 15,036</u> |
| March 31, 2013 | \$ 1,619 | \$ 612 | \$ 3,379 | \$ 308 | \$ 4,294 | \$ 3,392 | \$ 999 | \$ 14,603 |
| Charge-offs | (15) | — | — | (5) | (72) | — | — | (92) |
| Recoveries | 36 | — | — | — | 31 | — | — | 67 |
| Provision | (88) | 34 | (86) | (4) | 104 | 16 | 124 | 100 |
| June 30, 2013 | <u>\$ 1,552</u> | <u>\$ 646</u> | <u>\$ 3,293</u> | <u>\$ 299</u> | <u>\$ 4,357</u> | <u>\$ 3,408</u> | <u>\$ 1,123</u> | <u>\$ 14,678</u> |

Allowance for Loan Losses

| | Commercial | Commercial Construction | Commercial Real Estate | Other Consumer | Automobile | Residential | Unallocated | Total |
|--|-----------------|----------------------------|---------------------------|-------------------|-----------------|-----------------|-----------------|------------------|
| <u>Roll-forward of the Allowance for Loan Losses for the Year-to-Date Periods:</u> | | | | | | | | |
| December 31, 2013 | \$ 1,886 | \$ 417 | \$ 3,545 | \$ 272 | \$ 4,206 | \$ 3,026 | \$ 1,082 | \$ 14,434 |
| Charge-offs | (166) | — | — | (26) | (267) | (45) | — | (504) |
| Recoveries | 25 | — | — | 1 | 117 | — | — | 143 |
| Provision | 310 | 28 | 225 | 19 | 358 | 152 | (129) | 963 |
| June 30, 2014 | <u>\$ 2,055</u> | <u>\$ 445</u> | <u>\$ 3,770</u> | <u>\$ 266</u> | <u>\$ 4,414</u> | <u>\$ 3,133</u> | <u>\$ 953</u> | <u>\$ 15,036</u> |
| December 31, 2012 | \$ 2,344 | \$ 601 | \$ 3,050 | \$ 304 | \$ 4,536 | \$ 3,405 | \$ 1,058 | \$ 15,298 |
| Charge-offs | (788) | — | (11) | (13) | (170) | — | — | (982) |
| Recoveries | 40 | — | — | — | 122 | — | — | 162 |
| Provision | (44) | 45 | 254 | 8 | (131) | 3 | 65 | 200 |
| June 30, 2013 | <u>\$ 1,552</u> | <u>\$ 646</u> | <u>\$ 3,293</u> | <u>\$ 299</u> | <u>\$ 4,357</u> | <u>\$ 3,408</u> | <u>\$ 1,123</u> | <u>\$ 14,678</u> |

June 30, 2014

Allowance for loan losses

- Loans Individually
Evaluated for Impairment \$ — \$ — \$ — \$ — \$ — \$ 82 \$ — \$ 82

Allowance for loan losses

- Loans Collectively
Evaluated for Impairment \$ 2,055 \$ 445 \$ 3,770 \$ 266 \$ 4,414 \$ 3,051 \$ 953 \$ 14,954

Ending Loan Balance -

Individually Evaluated for Impairment \$ 208 \$ — \$ 1,493 \$ — \$ 125 \$ 1,695 \$ — \$ 3,521

Ending Loan Balance -

Collectively Evaluated for Impairment \$ 93,682 \$ 29,702 \$ 308,153 \$ 7,863 \$ 409,176 \$ 492,027 \$ — \$ 1,340,603

December 31, 2013

Allowance for loan losses

- Loans Individually
Evaluated for Impairment \$ — \$ — \$ — \$ — \$ — \$ — \$ — \$ —

Allowance for loan losses

- Loans Collectively
Evaluated for Impairment \$ 1,886 \$ 417 \$ 3,545 \$ 272 \$ 4,206 \$ 3,026 \$ 1,082 \$ 14,434

Ending Loan Balance -

Individually Evaluated for Impairment \$ 221 \$ — \$ 1,785 \$ — \$ 173 \$ 2,309 \$ — \$ 4,488

Ending Loan Balance -

Collectively Evaluated for Impairment \$ 87,672 \$ 27,815 \$ 286,334 \$ 7,649 \$ 394,031 \$ 458,483 \$ — \$ 1,261,984

June 30, 2013

Allowance for loan losses

- Loans Individually
Evaluated for Impairment \$ — \$ — \$ — \$ — \$ — \$ — \$ — \$ —

Allowance for loan losses

- Loans Collectively
Evaluated for Impairment \$ 1,552 \$ 646 \$ 3,293 \$ 299 \$ 4,357 \$ 3,408 \$ 1,123 \$ 14,678

Ending Loan Balance -

Individually Evaluated for Impairment \$ 33 \$ — \$ 1,481 \$ — \$ 184 \$ 1,078 \$ — \$ 2,776

Ending Loan Balance -

Collectively Evaluated for Impairment \$ 87,516 \$ 30,980 \$ 258,318 \$ 7,456 \$ 374,876 \$ 442,812 \$ — \$ 1,201,958

Through the provision for loan losses, an allowance for loan losses is maintained that reflects our best estimate of the inherent risk of loss in the Company's loan portfolio as of the balance sheet date. Additions are made to the allowance for loan losses through a periodic provision for loan losses. Actual loan losses are charged against the allowance for loan losses when loans are deemed uncollectible and recoveries of amounts previously charged off are recorded as credits to the allowance for loan losses.

Our loan officers and risk managers meet at least quarterly to discuss and review the conditions and risks associated with certain criticized and classified commercial-related relationships. In addition, our independent internal loan review department performs periodic reviews of the risk ratings on individual loans in our commercial loan portfolio.

We use a two-step process to determine the provision for loan losses and the amount of the allowance for loan losses. We measure impairment on our impaired loans on a quarterly basis. Our impaired loans are generally nonaccrual loans over \$250 thousand and all troubled debt restructured loans. Our impaired loans are generally considered to be collateral dependent with the specific reserve, if any, determined based on the value of the collateral less estimated costs to sell.

The remainder of the portfolio is evaluated on a pooled basis. For each homogeneous loan pool, we estimate a total loss factor based on the historical net loss rates adjusted for applicable qualitative factors. We update the total loss factors assigned to each loan category on a quarterly basis. For the commercial, commercial construction, and commercial real estate categories, we further segregate the loan categories by credit risk profile (pools of loans graded satisfactory, special mention and substandard). Additional description of the credit risk classifications is detailed in the Credit Quality Indicators section of this note.

We determine the annualized historical net loss rate for each loan category using a trailing three-year net charge-off average. While historical net loss experience provides a reasonable starting point for our analysis, historical net losses, or even recent trends in net losses, do not by themselves form a sufficient basis to determine the appropriate level of the allowance for loan losses. Therefore, we also consider and adjust historical net loss factors for qualitative factors that impact the inherent risk of loss associated with our loan categories within our total loan portfolio. These include:

- Changes in the volume and severity of past due, nonaccrual and adversely classified loans
- Changes in the nature and volume of the portfolio and in the terms of loans
- Changes in the value of the underlying collateral for collateral dependent loans
- Changes in lending policies and procedures, including changes in underwriting standards and collection, charge-off, and recovery practices not considered elsewhere in estimating credit losses
- Changes in the quality of the loan review system
- Changes in the experience, ability, and depth of lending management and other relevant staff
- Changes in international, national, regional, and local economic and business conditions and developments that affect the collectibility of the portfolio
- The existence and effect of any concentrations of credit, and changes in the level of such concentrations
- The effect of other external factors such as competition and legal and regulatory requirements on the level of estimated credit losses in the existing portfolio or pool

Further, due to the imprecise nature of the loan loss estimation process, the risk attributes of our loan portfolio may not be fully captured in data related to the determination of loss factors used to determine our analysis of the adequacy of the allowance for loan losses. Management, therefore, has established an unallocated portion within the allowance for loan losses reflecting the imprecision that naturally exists in the allowance for loan loss estimation process. The unallocated allowance for loan losses is not considered a significant component of the overall allowance for loan loss estimation process.

Credit Quality Indicators

The following table presents the credit quality indicators by loan category at June 30, 2014, December 31, 2013 and June 30, 2013:

| Loan Credit Quality Indicators | | | | | | | |
|--|------------|-------------------------|------------------------|----------------|------------|-------------|------------|
| | Commercial | Commercial Construction | Commercial Real Estate | Other Consumer | Automobile | Residential | Total |
| <u>June 30, 2014</u> | | | | | | | |
| <u>Credit Risk Profile by Creditworthiness Category:</u> | | | | | | | |
| Satisfactory | \$ 81,183 | \$ 29,702 | \$ 286,863 | | | | \$ 397,748 |
| Special Mention | 2,642 | — | 3,515 | | | | 6,157 |
| Substandard | 10,065 | — | 19,268 | | | | 29,333 |
| Doubtful | — | — | — | | | | — |
| <u>Credit Risk Profile Based on Payment Activity:</u> | | | | | | | |
| Performing | | | | \$ 7,862 | \$ 408,821 | \$ 488,984 | 905,667 |
| Nonperforming | | | | 1 | 480 | 4,738 | 5,219 |
| <u>December 31, 2013</u> | | | | | | | |
| <u>Credit Risk Profile by Creditworthiness Category:</u> | | | | | | | |
| Satisfactory | 79,966 | 27,815 | 267,612 | | | | 375,393 |
| Special Mention | 204 | — | 634 | | | | 838 |
| Substandard | 7,723 | — | 19,873 | | | | 27,596 |
| Doubtful | — | — | — | | | | — |
| <u>Credit Risk Profile Based on Payment Activity:</u> | | | | | | | |
| Performing | | | | 7,649 | 393,985 | 456,308 | 857,942 |
| Nonperforming | | | | — | 219 | 4,484 | 4,703 |
| <u>June 30, 2013</u> | | | | | | | |
| <u>Credit Risk Profile by Creditworthiness Category:</u> | | | | | | | |
| Satisfactory | 81,067 | 29,816 | 238,702 | | | | 349,585 |
| Special Mention | 262 | — | 1,349 | | | | 1,611 |
| Substandard | 6,220 | 1,164 | 19,748 | | | | 27,132 |
| Doubtful | — | — | — | | | | — |
| <u>Credit Risk Profile Based on Payment Activity:</u> | | | | | | | |
| Performing | | | | 7,449 | 374,796 | 440,203 | 822,448 |
| Nonperforming | | | | 7 | 264 | 3,687 | 3,958 |

We use an internally developed system of five credit quality indicators to rate the credit worthiness of each commercial loan defined as follows: 1) Satisfactory - "Satisfactory" borrowers have acceptable financial condition with satisfactory record of earnings and sufficient historical and projected cash flow to service the debt. Borrowers have satisfactory repayment histories and primary and secondary sources of repayment can be clearly identified; 2) Special Mention - Loans in this category have potential weaknesses that deserve management's close attention. If left uncorrected, these potential weaknesses may result in deterioration of the repayment prospects for the asset or in the institution's credit position at some future date. "Special mention" assets are not adversely classified and do not expose an institution to sufficient risk to warrant adverse classification. Loans which might be assigned this risk rating include loans to borrowers with deteriorating financial strength and/or earnings record and loans with potential for problems due to weakening economic or market conditions; 3) Substandard - Loans classified as "substandard" are inadequately protected by the current sound net worth or paying capacity of the borrower or the collateral pledged, if any. Loans in this category have well defined weaknesses that jeopardize the repayment. They are characterized by the distinct possibility that the bank will sustain some loss if the deficiencies are not corrected. "Substandard" loans may include loans which are likely to require liquidation of collateral to effect repayment, and other loans where character or ability to repay has become suspect. Loss potential, while existing in the aggregate amount of substandard assets, does not have to exist in individual assets classified substandard; 4) Doubtful - Loans classified as "doubtful" have all of the weaknesses inherent in those classified as "substandard" with the added characteristic that the weaknesses make collection or liquidation in full, on the basis of current existing facts, conditions, and values highly questionable and improbable. Although possibility of loss is extremely high, classification of these loans as "loss" has been deferred due to specific pending factors or events which may strengthen the value (i.e. possibility of additional collateral, injection of capital, collateral liquidation, debt restructure, economic recovery, etc). Loans classified as "doubtful" need to be placed on

non-accrual; and 5) Loss - Loans classified as "loss" are considered uncollectible and of such little value that their continuance as bankable assets is not warranted. As of the date of the balance sheet, all loans in this category have been charged-off to the allowance for loan losses. Commercial loans are evaluated on an annual basis, unless the credit quality indicator falls to a level of "substandard" or below, when the loan is evaluated quarterly. The credit quality indicator is one of the factors used to determine any loss, as further described in this footnote.

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

Impaired Loans

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

| Impaired Loans | | | | | | | | | |
|------------------------------------|------------|-------------------------|------------------------|----------------|------------|-------------|----------|--|--|
| | Commercial | Commercial Construction | Commercial Real Estate | Other Consumer | Automobile | Residential | Total | | |
| <u>June 30, 2014</u> | | | | | | | | | |
| <u>Recorded Investment:</u> | | | | | | | | | |
| With No Related Allowance | \$ 208 | \$ — | \$ 1,493 | \$ — | \$ 125 | \$ 1,121 | \$ 2,947 | | |
| With a Related Allowance | — | — | — | — | — | 574 | 574 | | |
| <u>Unpaid Principal Balance:</u> | | | | | | | | | |
| With No Related Allowance | 208 | — | 1,493 | — | 125 | 1,121 | 2,947 | | |
| With a Related Allowance | — | — | — | — | — | 574 | 574 | | |
| <u>December 31, 2013</u> | | | | | | | | | |
| <u>Recorded Investment:</u> | | | | | | | | | |
| With No Related Allowance | \$ 221 | \$ — | \$ 1,785 | \$ — | \$ 173 | \$ 2,309 | \$ 4,488 | | |
| With a Related Allowance | — | — | — | — | — | — | — | | |
| <u>Unpaid Principal Balance:</u> | | | | | | | | | |
| With No Related Allowance | 221 | — | 1,785 | — | 173 | 2,309 | 4,488 | | |
| With a Related Allowance | — | — | — | — | — | — | — | | |
| <u>June 30, 2013</u> | | | | | | | | | |
| <u>Recorded Investment:</u> | | | | | | | | | |
| With No Related Allowance | \$ 33 | \$ — | \$ 1,481 | \$ — | \$ 184 | \$ 1,078 | \$ 2,776 | | |
| With a Related Allowance | — | — | — | — | — | — | — | | |
| <u>Unpaid Principal Balance:</u> | | | | | | | | | |
| With No Related Allowance | 33 | — | 1,481 | — | 184 | 1,078 | \$ 2,776 | | |
| With a Related Allowance | — | — | — | — | — | — | — | | |
| <u>For the Quarter Ended:</u> | | | | | | | | | |
| <u>June 30, 2014</u> | | | | | | | | | |
| <u>Average Recorded Balance:</u> | | | | | | | | | |
| With No Related Allowance | \$ 211 | \$ — | \$ 1,652 | \$ — | \$ 135 | \$ 1,517 | \$ 3,515 | | |
| With a Related Allowance | — | — | — | — | — | 394 | 394 | | |
| <u>Interest Income Recognized:</u> | | | | | | | | | |
| With No Related Allowance | 2 | — | — | — | 2 | — | 4 | | |
| With a Related Allowance | — | — | — | — | — | — | — | | |
| <u>Cash Basis Income:</u> | | | | | | | | | |
| With No Related Allowance | — | — | — | — | — | — | — | | |
| With a Related Allowance | — | — | — | — | — | — | — | | |
| <u>June 30, 2013</u> | | | | | | | | | |
| <u>Average Recorded Balance:</u> | | | | | | | | | |
| With No Related Allowance | \$ 35 | \$ — | \$ 1,493 | \$ — | \$ 183 | \$ 1,082 | \$ 2,793 | | |
| With a Related Allowance | — | — | — | — | — | — | — | | |
| <u>Interest Income Recognized:</u> | | | | | | | | | |
| With No Related Allowance | 1 | — | — | — | 3 | — | 4 | | |
| With a Related Allowance | — | — | — | — | — | — | — | | |
| <u>Cash Basis Income:</u> | | | | | | | | | |
| With No Related Allowance | — | — | — | — | — | — | — | | |
| With a Related Allowance | — | — | — | — | — | — | — | | |

Impaired Loans

| | Commercial | Commercial Construction | Commercial Real Estate | Other Consumer | Automobile | Residential | Total |
|---|------------|----------------------------|---------------------------|-------------------|------------|-------------|----------|
| <u>For the Year-To-Date Period Ended:</u> | | | | | | | |
| <u>June 30, 2014</u> | | | | | | | |
| <u>Average Recorded Balance:</u> | | | | | | | |
| With No Related Allowance | \$ 215 | \$ — | \$ 1,639 | \$ — | \$ 149 | \$ 1,715 | \$ 3,718 |
| With a Related Allowance | — | — | — | — | — | 287 | 287 |
| <u>Interest Income Recognized:</u> | | | | | | | |
| With No Related Allowance | 5 | — | 10 | — | 4 | 1 | 20 |
| With a Related Allowance | — | — | — | — | — | — | — |
| <u>Cash Basis Income:</u> | | | | | | | |
| With No Related Allowance | — | — | — | — | — | — | — |
| With a Related Allowance | — | — | — | — | — | — | — |
| <u>June 30, 2013</u> | | | | | | | |
| <u>Average Recorded Balance:</u> | | | | | | | |
| With No Related Allowance | \$ 39 | \$ — | \$ 2,005 | \$ — | \$ 194 | \$ 1,084 | \$ 3,322 |
| With a Related Allowance | 345 | — | — | — | — | — | 345 |
| <u>Interest Income Recognized:</u> | | | | | | | |
| With No Related Allowance | 2 | — | — | — | 5 | 4 | 11 |
| With a Related Allowance | 72 | — | — | — | — | — | 72 |
| <u>Cash Basis Income:</u> | | | | | | | |
| With No Related Allowance | — | — | — | — | — | — | — |
| With a Related Allowance | 72 | — | — | — | — | — | 72 |

At June 30, 2014, December 31, 2013 and June 30, 2013, all impaired loans were considered to be collateral dependent and were therefore evaluated for impairment based on the fair value of collateral less estimated cost to sell. Interest income recognized in the table above, represents income earned after the loans became impaired and includes restructured loans in compliance with their modified terms and nonaccrual loans where we have recognized interest income on a cash basis.

Loans Modified in Trouble Debt Restructurings

The following table presents information on loans modified in trouble debt restructurings during the periods indicated:

| Loans Modified in Trouble Debt Restructurings During the Period | | | | | | | | | | | | | |
|---|------------|---|-------------------------|---|------------------------|---|----------------|---|------------|----|-------------|-----|--------|
| | Commercial | | Commercial Construction | | Commercial Real Estate | | Other Consumer | | Automobile | | Residential | | Total |
| | Commercial | | Commercial Construction | | Commercial Real Estate | | Other Consumer | | Automobile | | Residential | | Total |
| <u>For the Quarter Ended:</u> | | | | | | | | | | | | | |
| <u>June 30, 2014</u> | | | | | | | | | | | | | |
| Number of Loans | | — | | — | | — | | — | | — | | 1 | 1 |
| Pre-Modification Outstanding Recorded Investment | \$ | — | \$ | — | \$ | — | \$ | — | \$ | — | \$ | 574 | \$ 574 |
| Post-Modification Outstanding Recorded Investment | \$ | — | \$ | — | \$ | — | \$ | — | \$ | — | \$ | 574 | \$ 574 |
| <u>June 30, 2013</u> | | | | | | | | | | | | | |
| Number of Loans | | — | | — | | — | | — | | 3 | | — | 3 |
| Pre-Modification Outstanding Recorded Investment | \$ | — | \$ | — | \$ | — | \$ | — | \$ | 30 | \$ | — | \$ 30 |
| Post-Modification Outstanding Recorded Investment | \$ | — | \$ | — | \$ | — | \$ | — | \$ | 30 | \$ | — | \$ 30 |
| <u>For the Year-To-Date Period Ended:</u> | | | | | | | | | | | | | |
| <u>June 30, 2014</u> | | | | | | | | | | | | | |
| Number of Loans | | — | | — | | — | | — | | 1 | | 1 | 2 |
| Pre-Modification Outstanding Recorded Investment | \$ | — | \$ | — | \$ | — | \$ | — | \$ | 2 | \$ | 574 | \$ 576 |
| Post-Modification Outstanding Recorded Investment | \$ | — | \$ | — | \$ | — | \$ | — | \$ | 2 | \$ | 574 | \$ 576 |
| <u>June 30, 2013</u> | | | | | | | | | | | | | |
| Number of Loans | | — | | — | | — | | — | | 5 | | — | 5 |
| Pre-Modification Outstanding Recorded Investment | \$ | — | \$ | — | \$ | — | \$ | — | \$ | 41 | \$ | — | \$ 41 |
| Post-Modification Outstanding Recorded Investment | \$ | — | \$ | — | \$ | — | \$ | — | \$ | 41 | \$ | — | \$ 41 |

In general, loans requiring modification are restructured to accommodate the projected cashflows of the borrower. As indicated in the table above, no loans modified during the preceding twelve months subsequently defaulted as of June 30, 2014.

Note 4. GUARANTEES (In Thousands)

The following table presents the balance for standby letters of credit for the periods ended June 30, 2014, December 31, 2013 and June 30, 2013:

| Loan Commitments and Letters of Credit | | | |
|--|---------------|-------------------|---------------|
| | June 30, 2014 | December 31, 2013 | June 30, 2013 |
| <u>Notional Amount:</u> | | | |
| Commitments to Extend Credit | \$ 252,064 | \$ 237,940 | \$ 219,622 |
| Standby Letters of Credit | 3,208 | 3,345 | 3,439 |
| <u>Fair Value:</u> | | | |
| Commitments to Extend Credit | \$ — | \$ — | \$ — |
| Standby Letters of Credit | 53 | 65 | 56 |

Arrow is party to financial instruments with off-balance sheet risk in the normal course of business to meet the financing needs of its customers. These financial instruments include commitments to extend credit and standby letters of credit. Commitments to extend credit include home equity lines of credit, commitments for residential and commercial construction loans and other personal and commercial

lines of credit. Those instruments involve, to varying degrees, elements of credit and interest rate risk in excess of the amount recognized in the consolidated balance sheets. The contract or notional amounts of those instruments reflect the extent of the involvement Arrow has in particular classes of financial instruments.

Arrow's exposure to credit loss in the event of nonperformance by the other party to the financial instrument for commitments to extend credit and standby letters of credit is represented by the contractual notional amount of those instruments. Arrow uses the same credit policies in making commitments and conditional obligations as it does for on-balance sheet instruments.

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

Arrow has issued conditional commitments in the form of standby letters of credit to guarantee payment on behalf of a customer and guarantee the performance of a customer to a third party. Standby letters of credit generally arise in connection with lending relationships. The credit risk involved in issuing these instruments is essentially the same as that involved in extending loans to customers. Contingent obligations under standby letters of credit at June 30, 2014, December 31, 2013 and June 30, 2013 represent the maximum potential future payments Arrow could be required to make. Typically, these instruments have terms of 12 months or less and expire unused; therefore, the total amounts do not necessarily represent future cash requirements. Each customer is evaluated individually for creditworthiness under the same underwriting standards used for commitments to extend credit and on-balance sheet instruments. Company policies governing loan collateral apply to standby letters of credit at the time of credit extension. Loan-to-value ratios generally range from 50% for movable assets, such as inventory, to 100% for liquid assets, such as bank CD's. Fees for standby letters of credit typically range from 1% to 3% of the notional amount. Fees are collected upfront and are amortized over the life of the commitment. The fair values of Arrow's standby letters of credit at June 30, 2014, December 31, 2013 and June 30, 2013, in the table above, were the same as the carrying amounts. The fair value of standby letters of credit is based on the fees currently charged for similar agreements or the cost to terminate the arrangement with the counterparties.

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

Note 5. COMPREHENSIVE INCOME (In Thousands)

The following table presents the components of other comprehensive income for the three and six months ended June 30, 2014 and 2013 :

| | Schedule of Comprehensive Income | | | | | |
|---|---|----------------------|----------------------|----------------------------------|----------------------|----------------------|
| | <u>Three Months Ended June 30,</u> | | | <u>Six Months Ended June 30,</u> | | |
| | Tax | | Net-of-Tax Amount | Tax | | Net-of-Tax Amount |
| | Before-Tax Amount | (Expense) Benefit | | Before-Tax Amount | (Expense) Benefit | |
| <u>2014</u> | | | | | | |
| Net Unrealized Securities Holding Gains Arising During the Period | \$ 850 | \$ (336) | \$ 514 | \$ 1,249 | \$ (494) | \$ 755 |
| Reclassification Adjustment for Securities Gains Included in Net Income | 27 | (11) | 16 | 27 | (11) | 16 |
| Amortization of Net Retirement Plan Actuarial Loss | 114 | (45) | 69 | 230 | (91) | 139 |
| Accretion of Net Retirement Plan Prior Service Credit | (21) | 8 | (13) | (43) | 17 | (26) |
| Other Comprehensive Income | <u>\$ 970</u> | <u>\$ (384)</u> | <u>\$ 586</u> | <u>\$ 1,463</u> | <u>\$ (579)</u> | <u>\$ 884</u> |
| <u>2013</u> | | | | | | |
| Net Unrealized Securities Holding Gains Arising During the Period | \$ (6,034) | \$ 2,391 | \$ (3,643) | \$ (5,667) | \$ 2,244 | \$ (3,423) |
| Reclassification Adjustment for Securities Gains Included in Net Income | (13) | 5 | (8) | (540) | 214 | (326) |
| Amortization of Net Retirement Plan Actuarial Loss | 392 | (156) | 236 | 783 | (311) | 472 |
| Other Comprehensive Loss | <u>\$ (5,655)</u> | <u>\$ 2,240</u> | <u>\$ (3,415)</u> | <u>\$ (5,424)</u> | <u>\$ 2,147</u> | <u>\$ (3,277)</u> |

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

| Changes in Accumulated Other Comprehensive Income (Loss) by Component ⁽¹⁾ | | | | |
|---|---|----------------------------|--|--------------------|
| | Unrealized Gains and Losses on Available-for- Sale Securities | Defined Benefit Plan Items | | Total |
| | | Net Gain (Loss) | Net Prior Service (Cost) Credit | |
| <u>For the Quarter-To-Date periods ended:</u> | | | | |
| March 31, 2014 | \$ 2,615 | \$ (6,627) | \$ (63) | \$ (4,075) |
| Other comprehensive income before reclassifications | 514 | — | — | 514 |
| Amounts reclassified from accumulated other comprehensive income | 16 | 69 | (13) | 72 |
| Net current-period other comprehensive income | 530 | 69 | (13) | 586 |
| June 30, 2014 | <u>\$ 3,145</u> | <u>\$ (6,558)</u> | <u>\$ (76)</u> | <u>\$ (3,489)</u> |
| March 31, 2013 | \$ 5,527 | \$ (13,800) | \$ (51) | \$ (8,324) |
| Other comprehensive income before reclassifications | (3,643) | — | — | (3,643) |
| Amounts reclassified from accumulated other comprehensive income | (8) | 236 | — | 228 |
| Net current-period other comprehensive income | (3,651) | 236 | — | (3,415) |
| June 30, 2013 | <u>\$ 1,876</u> | <u>\$ (13,564)</u> | <u>\$ (51)</u> | <u>\$ (11,739)</u> |
| <u>For the Year-To-Date periods ended:</u> | | | | |
| December 31, 2013 | \$ 2,374 | \$ (6,697) | \$ (50) | \$ (4,373) |
| Other comprehensive income before reclassifications | 755 | — | — | 755 |
| Amounts reclassified from accumulated other comprehensive income | 16 | 139 | (26) | 129 |
| Net current-period other comprehensive income | 771 | 139 | (26) | 884 |
| June 30, 2014 | <u>\$ 3,145</u> | <u>\$ (6,558)</u> | <u>\$ (76)</u> | <u>\$ (3,489)</u> |
| December 31, 2012 | \$ 5,625 | \$ (14,036) | \$ (51) | \$ (8,462) |
| Other comprehensive income before reclassifications | (3,423) | — | — | (3,423) |
| Amounts reclassified from accumulated other comprehensive income | (326) | 472 | — | 146 |
| Net current-period other comprehensive income | (3,749) | 472 | — | (3,277) |
| June 30, 2013 | <u>\$ 1,876</u> | <u>\$ (13,564)</u> | <u>\$ (51)</u> | <u>\$ (11,739)</u> |

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

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

Reclassifications Out of Accumulated Other Comprehensive Income ⁽¹⁾

| Details about Accumulated Other Comprehensive Income (Loss) Components | Amounts Reclassified from Accumulated Other Comprehensive Income | Affected Line Item in the Statement Where Net Income Is Presented |
|---|--|--|
|---|--|--|

For the Quarter-to-date periods ended:

June 30, 2014

Unrealized gains and losses on available-for-sale securities

| | | |
|----|------|---------------------------------|
| \$ | (27) | Gain on Securities Transactions |
| | (27) | Total before tax |
| | 11 | Provision for Income Taxes |
| \$ | (16) | Net of tax |

Amortization of defined benefit pension items

Prior-service costs

Actuarial gains/(losses)

| | | |
|----|-------|---|
| \$ | 21 | ⁽²⁾ Salaries and Employee Benefits |
| | (114) | ⁽²⁾ Salaries and Employee Benefits |
| | (93) | Total before tax |
| | 37 | Provision for Income Taxes |
| \$ | (56) | Net of tax |

Total reclassifications for the period

| | | |
|----|------|------------|
| \$ | (72) | Net of tax |
|----|------|------------|

June 30, 2013

Unrealized gains and losses on available-for-sale securities

| | | |
|----|-----|---------------------------------|
| \$ | 13 | Gain on Securities Transactions |
| | 13 | Total before tax |
| | (5) | Provision for Income Taxes |
| \$ | 8 | Net of tax |

Amortization of defined benefit pension items

Prior-service costs

Actuarial gains/(losses)

| | | |
|----|-------|---|
| \$ | — | ⁽²⁾ Salaries and Employee Benefits |
| | (392) | ⁽²⁾ Salaries and Employee Benefits |
| | (392) | Total before tax |
| | 156 | Provision for Income Taxes |
| \$ | (236) | Net of tax |

Total reclassifications for the period

| | | |
|----|-------|------------|
| \$ | (228) | Net of tax |
|----|-------|------------|

Reclassifications Out of Accumulated Other Comprehensive Income ⁽¹⁾

| Details about Accumulated Other Comprehensive Income (Loss) Components | Amounts Reclassified from Accumulated Other Comprehensive Income | Affected Line Item in the Statement Where Net Income Is Presented |
|--|--|---|
| <u>For the Year-to-date periods ended:</u> | | |
| <u>June 30, 2014</u> | | |
| Unrealized gains and losses on available-for-sale securities | | |
| | \$ (27) | Gain on Securities Transactions |
| | (27) | Total before tax |
| | 11 | Provision for Income Taxes |
| | <u>\$ (16)</u> | Net of tax |
| Amortization of defined benefit pension items | | |
| Prior-service costs | \$ 43 ⁽²⁾ | Salaries and Employee Benefits |
| Actuarial gains/(losses) | (230) ⁽²⁾ | Salaries and Employee Benefits |
| | (187) | Total before tax |
| | 74 | Provision for Income Taxes |
| | <u>\$ (113)</u> | Net of tax |
| Total reclassifications for the period | <u>\$ (129)</u> | Net of tax |
| <u>June 30, 2013</u> | | |
| Unrealized gains and losses on available-for-sale securities | | |
| | \$ 540 | Gain on Securities Transactions |
| | 540 | Total before tax |
| | (214) | Provision for Income Taxes |
| | <u>\$ 326</u> | Net of tax |
| Amortization of defined benefit pension items | | |
| Prior-service costs | — ⁽²⁾ | Salaries and Employee Benefits |
| Actuarial gains/(losses) | \$ (783) ⁽²⁾ | Salaries and Employee Benefits |
| | (783) | Total before tax |
| | 311 | Provision for Income Taxes |
| | <u>\$ (472)</u> | Net of tax |
| Total reclassifications for the period | <u>\$ (146)</u> | Net of tax |

(1) Amounts in parentheses indicate debits to profit/loss.

(2) These accumulated other comprehensive income components are included in the computation of net periodic pension cost (see pension footnote for additional details.).

Note 6. STOCK BASED COMPENSATION PLANS

Under our 2013 Long-Term Incentive Plan, we granted options in the first quarter of 2014 to purchase shares of our common stock. The fair values of the options were estimated on the date of grant using the Black-Scholes option-pricing model. The fair value of our grants is expensed over the four year vesting period. Share and per share amounts have been restated for the September 2013 2% stock dividend.

The following table presents a roll-forward of our stock option plans and grants issued during 2014:

| Schedule of Share-based Compensation Arrangements | |
|--|---------------------------|
| | <u>Stock Option Plans</u> |
| <u>Roll-Forward of Shares Outstanding:</u> | |
| Outstanding at January 1, 2014 | 389,392 |
| Granted | 74,037 |
| Exercised | (21,565) |
| Forfeited | — |
| Outstanding at June 30, 2014 | <u>441,864</u> |
| Exercisable at Period-End | 305,508 |
| Vested and Expected to Vest | 136,356 |
| <u>Roll-Forward of Shares Outstanding - Weighted Average Exercise Price:</u> | |
| Outstanding at January 1, 2014 | \$ 22.89 |
| Granted | 25.00 |
| Exercised | 24.12 |
| Forfeited | — |
| Outstanding at June 30, 2014 | 23.18 |
| Exercisable at Period-End | 22.40 |
| Vested and Expected to Vest | 24.95 |
| <u>Grants Issued During 2013 - Weighted Average Information:</u> | |
| Fair Value | 6.04 |
| <u>Fair Value Assumptions:</u> | |
| Dividend Yield | 3.97% |
| Expected Volatility | 35.30% |
| Risk Free Interest Rate | 2.19% |
| Expected Lives (in years) | 6.85 |

The following table presents information on the amounts expensed for the periods ended June 30, 2014 and 2013:

| Share-Based Compensation Expense | | | |
|---|--|-------------|--|
| | <u>For the Three Months Ended June 30,</u> | | <u>For the Six Months Ended June 30,</u> |
| | <u>2014</u> | <u>2013</u> | <u>2014</u> |
| | | | <u>2013</u> |
| Share-Based Compensation Expense | \$ 90 | \$ 92 | \$ 180 |
| | | | \$ 189 |

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

Note 7. RETIREMENT PLANS (Dollars in Thousands)

The following tables provide the components of net periodic benefit costs for the three and six-month periods ended June 30:

| | Employees' Pension Plan | Select Executive Retirement Plan | Postretirement Benefit Plans |
|---|--|---|---|
| Net Periodic Benefit Cost | | | |
| <u>For the Three Months Ended June 30, 2014:</u> | | | |
| Service Cost | \$ 376 | \$ — | \$ 53 |
| Interest Cost | 268 | 48 | 62 |
| Expected Return on Plan Assets | (723) | — | — |
| Amortization of Prior Service (Credit) Cost | (11) | 18 | (28) |
| Amortization of Net Loss | 86 | 22 | 6 |
| Net Periodic Benefit Cost | <u>\$ (4)</u> | <u>\$ 88</u> | <u>\$ 93</u> |
| Plan Contributions During the Period | \$ — | \$ 118 | \$ 86 |
| <u>For the Three Months Ended June 30, 2013:</u> | | | |
| Service Cost | \$ 367 | \$ 5 | \$ 51 |
| Interest Cost | 276 | 10 | 69 |
| Expected Return on Plan Assets | (716) | — | — |
| Amortization of Prior Service (Credit) Cost | 9 | 20 | (29) |
| Amortization of Net Loss | 312 | 38 | 42 |
| Net Periodic Benefit Cost | <u>\$ 248</u> | <u>\$ 73</u> | <u>\$ 133</u> |
| Plan Contributions During the Period | \$ — | \$ 110 | \$ 94 |
| Net Periodic Benefit Cost | | | |
| <u>For the Six Months Ended June 30, 2014:</u> | | | |
| Service Cost | \$ 753 | \$ — | \$ 106 |
| Interest Cost | 598 | 109 | 172 |
| Expected Return on Plan Assets | (1,445) | — | — |
| Amortization of Prior Service Cost (Credit) | (22) | 36 | (57) |
| Amortization of Net Loss | 172 | 45 | 13 |
| Net Periodic Benefit Cost | <u>\$ 56</u> | <u>\$ 190</u> | <u>\$ 234</u> |
| Plan Contributions During the Period | \$ — | \$ 237 | \$ 228 |
| Estimated Future Contributions in the Current Fiscal Year | \$ — | \$ 237 | \$ 230 |
| <u>For the Six Months Ended June 30, 2013:</u> | | | |
| Service Cost | \$ 734 | \$ 27 | \$ 102 |
| Interest Cost | 629 | 48 | 150 |
| Expected Return on Plan Assets | (1,432) | — | — |
| Amortization of Prior Service (Credit) Cost | 18 | 40 | (58) |
| Amortization of Net Loss | 624 | 76 | 83 |
| Net Periodic Benefit Cost | <u>\$ 573</u> | <u>\$ 191</u> | <u>\$ 277</u> |
| Plan Contributions During the Period | \$ — | \$ 221 | \$ 175 |

We are not required to make a contribution to our qualified pension plan in 2014, and currently, we do not expect to make a contribution in 2014. Arrow makes contributions to its other post-retirement benefit plans in an amount equal to benefit payments for the year.

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

The following table presents a reconciliation of the numerator and denominator used in the calculation of basic and diluted earnings per common share ("EPS") for periods ended June 30, 2014 and 2013. All share and per share amounts have been adjusted for the September 2013 2% stock dividend.

| | Earnings Per Share | | | |
|---|---------------------------|----------------------|----------------------------|----------------------|
| | Quarterly Period Ended: | | Year-to-Date Period Ended: | |
| | <u>June 30, 2014</u> | <u>June 30, 2013</u> | <u>June 30, 2014</u> | <u>June 30, 2013</u> |
| <u>Earnings Per Share - Basic:</u> | | | | |
| Net Income | \$ 5,524 | \$ 5,207 | \$ 10,844 | \$ 10,388 |
| Weighted Average Shares - Basic | 12,348 | 12,261 | 12,351 | 12,267 |
| Earnings Per Share - Basic | \$ 0.45 | \$ 0.42 | \$ 0.88 | \$ 0.85 |
| <u>Earnings Per Share - Diluted:</u> | | | | |
| Net Income | \$ 5,524 | \$ 5,207 | \$ 10,844 | \$ 10,388 |
| Weighted Average Shares - Basic | 12,348 | 12,261 | 12,351 | 12,267 |
| Dilutive Average Shares Attributable to Stock Options | 21 | 18 | 22 | 18 |
| Weighted Average Shares - Diluted | 12,369 | 12,279 | 12,373 | 12,285 |
| Earnings Per Share - Diluted | \$ 0.45 | \$ 0.42 | \$ 0.88 | \$ 0.85 |
| Antidilutive Shares Excluded from the Calculation of Earnings Per Share | 33 | 124 | — | 126 |

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

FASB ASC Subtopic 820-10 defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles (GAAP) and requires certain disclosures about fair value measurements. We do not have any nonfinancial assets or liabilities measured at fair value on a recurring basis. The only assets or liabilities that Arrow measured at fair value on a recurring basis at June 30, 2014, December 31, 2013 and June 30, 2013 were securities available-for-sale. Arrow held no securities or liabilities for trading on such date.

The table below presents the financial instrument's fair value and the amounts within the fair value hierarchy based on the lowest level of input that is significant to the fair value measurement:

Fair Value of Assets and Liabilities Measured on a Recurring and Nonrecurring Basis

| | | Fair Value Measurements at Reporting Date Using: | | | |
|---|-------------------|---|--|--|----------------------------|
| | | Quoted Prices In Active Markets for Identical Assets (Level 1) | Significant Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) | Total Gains (Losses) |
| Fair Value | | | | | |
| <u>Fair Value of Assets and Liabilities Measured on a Recurring Basis:</u> | | | | | |
| <u>June 30, 2014</u> | | | | | |
| Securities Available-for Sale: | | | | | |
| U.S. Agency Obligations | \$ 92,186 | \$ — | \$ 92,186 | \$ — | |
| State and Municipal Obligations | 102,862 | — | 102,862 | — | |
| Mortgage-Backed Securities - Residential | 153,770 | — | 153,770 | — | |
| Corporate and Other Debt Securities | 16,829 | — | 16,829 | — | |
| Mutual Funds and Equity Securities | 1,201 | — | 1,201 | — | |
| Total Securities Available-for-Sale | <u>\$ 366,848</u> | <u>\$ —</u> | <u>\$ 366,848</u> | <u>\$ —</u> | |
| <u>December 31, 2013</u> | | | | | |
| Securities Available-for Sale: | | | | | |
| U.S. Agency Obligations | \$ 136,475 | \$ — | \$ 136,475 | \$ — | |
| State and Municipal Obligations | 127,389 | — | 127,389 | — | |
| Mortgage-Backed Securities - Residential | 175,778 | — | 175,778 | — | |
| Corporate and Other Debt Securities | 16,798 | — | 16,798 | — | |
| Mutual Funds and Equity Securities | 1,166 | — | 1,166 | — | |
| Total Securities Available-for Sale | <u>\$ 457,606</u> | <u>\$ —</u> | <u>\$ 457,606</u> | <u>\$ —</u> | |
| <u>June 30, 2013</u> | | | | | |
| Securities Available-for Sale: | | | | | |
| U.S. Agency Obligations | \$ 150,046 | \$ — | \$ 150,046 | \$ — | |
| State and Municipal Obligations | 130,444 | — | 130,444 | — | |
| Mortgage-Backed Securities - Residential | 203,230 | — | 203,230 | — | |
| Corporate and Other Debt Securities | 16,711 | — | 16,711 | — | |
| Mutual Funds and Equity Securities | 1,143 | — | 1,143 | — | |
| Total Securities Available-for Sale | <u>\$ 501,574</u> | <u>\$ —</u> | <u>\$ 501,574</u> | <u>\$ —</u> | |
| <u>Fair Value of Assets and Liabilities Measured on a Nonrecurring Basis:</u> | | | | | |
| <u>June 30, 2014</u> | | | | | |
| Other Real Estate Owned and Repossessed Assets, Net | \$ 326 | \$ — | \$ — | \$ 326 | \$ (139) |
| <u>December 31, 2013</u> | | | | | |
| Other Real Estate Owned and Repossessed Assets, Net | \$ 144 | \$ — | \$ — | \$ 144 | \$ (79) |
| <u>June 30, 2013</u> | | | | | |
| Other Real Estate Owned and Repossessed Assets, Net | \$ 1,175 | \$ — | \$ — | \$ 1,175 | \$ (64) |

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

- Level 1 - Unadjusted quoted prices in active markets that are accessible at the measurement date for identical, unrestricted assets or liabilities;
- Level 2 - Quoted prices for similar assets or liabilities in active markets, quoted prices for identical or similar assets or liabilities in markets that are not active, or inputs that are observable, either directly or indirectly, for substantially the full term of the asset or liability; and
- Level 3 - Prices or valuation techniques that require inputs that are both significant to the fair value measurement and unobservable (i.e., supported by little or no market activity).

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

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

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

The fair value of collateral dependent impaired loans was based on third-party appraisals of the collateral. The fair value of other real estate owned was based on third-party appraisals. Other assets which might have been included in this table include mortgage servicing rights, goodwill and other intangible assets. Arrow evaluates each of these assets for impairment on a quarterly basis, with no impairment recognized for these assets at June 30, 2014, December 31, 2013 and June 30, 2013.

Fair Value by Balance Sheet Grouping

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

Schedule of Fair Values by Balance Sheet Grouping

| | | | Fair Value Hierarchy | | |
|--|--------------------|---------------|----------------------|---------|-----------|
| | Carrying Amount | Fair Value | Level 1 | Level 2 | Level 3 |
| <u>June 30, 2014</u> | | | | | |
| Cash and Cash Equivalents | \$ 51,810 | \$ 51,810 | \$ 51,810 | \$ — | \$ — |
| Securities Available-for-Sale | 366,848 | 366,848 | — | 366,848 | — |
| Securities Held-to-Maturity | 297,437 | 304,259 | — | 304,259 | — |
| Federal Home Loan Bank and Federal Reserve Bank Stock | 4,583 | 4,583 | 4,583 | — | — |
| Net Loans | 1,329,088 | 1,342,104 | — | — | 1,342,104 |
| Accrued Interest Receivable | 5,849 | 5,849 | 5,849 | — | — |
| Deposits | 1,860,666 | 1,856,131 | 1,630,950 | 225,181 | — |
| Federal Funds Purchased and Securities Sold Under Agreements to Repurchase | 16,896 | 16,896 | 16,896 | — | — |
| Federal Home Loan Bank Term Advances | 34,000 | 34,427 | 24,000 | 10,427 | — |
| Junior Subordinated Obligations Issued to Unconsolidated Subsidiary Trusts | 20,000 | 20,000 | — | 20,000 | — |
| Accrued Interest Payable | 365 | 365 | 365 | — | — |
| <u>December 31, 2013</u> | | | | | |
| Cash and Cash Equivalents | \$ 49,980 | \$ 49,980 | \$ 49,980 | \$ — | \$ — |
| Securities Available-for-Sale | 457,606 | 457,606 | — | 457,606 | — |
| Securities Held-to-Maturity | 299,261 | 302,305 | — | 302,305 | — |
| Federal Home Loan Bank and Federal Reserve Bank Stock | 6,281 | 6,281 | 6,281 | — | — |
| Net Loans | 1,252,038 | 1,266,020 | — | — | 1,266,020 |
| Accrued Interest Receivable | 5,745 | 5,745 | 5,745 | — | — |
| Deposits | 1,842,330 | 1,839,613 | 1,595,103 | 244,510 | — |
| Federal Funds Purchased and Securities Sold Under Agreements to Repurchase | 11,777 | 11,777 | 11,777 | — | — |
| Federal Home Loan Bank Term Advances | 73,000 | 74,629 | 53,000 | 21,629 | — |
| Junior Subordinated Obligations Issued to Unconsolidated Subsidiary Trusts | 20,000 | 20,000 | — | 20,000 | — |
| Accrued Interest Payable | 439 | 439 | 439 | — | — |
| <u>June 30, 2013</u> | | | | | |
| Cash and Cash Equivalents | \$ 44,600 | \$ 44,600 | \$ 44,600 | \$ — | \$ — |
| Securities Available-for-Sale | 501,574 | 501,574 | — | 501,574 | — |
| Securities Held-to-Maturity | 248,914 | 252,691 | — | 252,691 | — |
| Federal Home Loan Bank and Federal Reserve Bank Stock | 6,136 | 6,136 | 6,136 | — | — |
| Net Loans | 1,190,056 | 1,198,430 | — | — | 1,198,430 |
| Accrued Interest Receivable | 5,708 | 5,708 | 5,708 | — | — |
| Deposits | 1,779,905 | 1,776,590 | 1,510,867 | 265,723 | — |
| Federal Funds Purchased and Securities Sold Under Agreements to Repurchase | 14,738 | 14,738 | 14,738 | — | — |
| Federal Home Loan Bank Term Advances | 70,000 | 70,267 | 40,000 | 30,267 | — |
| Junior Subordinated Obligations Issued to Unconsolidated Subsidiary Trusts | 20,000 | 20,000 | — | 20,000 | — |
| Accrued Interest Payable | 493 | 493 | 493 | — | — |

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

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

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

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

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

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

Report of Independent Registered Public Accounting Firm

The Board of Directors and Stockholders

Arrow Financial Corporation:

We have reviewed the consolidated balance sheets of Arrow Financial Corporation and subsidiaries (the Company) as of June 30, 2014 and 2013, and the related consolidated statements of income, comprehensive income, changes in stockholders' equity and cash flows for the three and six-month periods ended June 30, 2014 and 2013. These consolidated financial statements are the responsibility of the Company's management.

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

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

We have previously audited, in accordance with standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheet of Arrow Financial Corporation and subsidiaries as of December 31, 2013, and the related consolidated statements of income, comprehensive income, changes in stockholders' equity, and cash flows for the year then ended (not presented herein); and in our report dated March 14, 2014, we expressed an unqualified opinion on those consolidated financial statements. In our opinion, the information set forth in the accompanying consolidated balance sheet as of December 31, 2013, is fairly stated, in all material respects, in relation to the consolidated balance sheet from which it has been derived.

/s/ KPMG LLP

Albany, New York

August 6, 2014

ARROW FINANCIAL CORPORATION AND SUBSIDIARIES
MANAGEMENT'S DISCUSSION AND ANALYSIS OF
FINANCIAL CONDITION AND RESULTS OF OPERATIONS

June 30, 2014

Note on Terminology - In this Quarterly Report on Form 10-Q, the terms "Arrow," "the registrant," "the company," "we," "us," and "our" generally refer to Arrow Financial Corporation and its subsidiaries as a group, except where the context indicates otherwise.

The Company and Its Subsidiaries - Arrow is a two-bank holding company headquartered in Glens Falls, New York. Our banking subsidiaries are Glens Falls National Bank and Trust Company (Glens Falls National) whose main office is located in Glens Falls, New York, and Saratoga National Bank and Trust Company (Saratoga National) whose main office is located in Saratoga Springs, New York. Our non-bank subsidiaries include Capital Financial Group, Inc. (an insurance agency specializing in selling and servicing group health care policies); three property and casualty insurance agencies: Loomis & LaPann, Inc., Upstate Agency LLC, and McPhillips Agency which is a division of Glens Falls National Insurance Agencies LLC; North Country Investment Advisers, Inc. (a registered investment adviser that provides investment advice to our proprietary mutual funds); Glens Falls National Community Development Corporation (which invests in qualifying community development projects); and Arrow Properties, Inc. (a real estate investment trust, or REIT). All of these are wholly-owned or majority owned subsidiaries of Glens Falls National.

Our Peer Group - 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 347 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 March 31, 2014 (the most recent such Report currently available), and peer group data has been derived from such Report.

Forward Looking Statements - This Quarterly Report on Form 10-Q contains statements that are not historical in nature but rather are based on our beliefs, assumptions, expectations, estimates and projections about the future. These statements are "forward-looking statements" within the meaning of Section 21E of the Securities Exchange Act of 1934, as amended, and involve a degree of uncertainty and attendant risk. Words such as "expects," "believes," "anticipates," "estimates" and variations of such words and similar expressions are intended to identify such forward-looking statements. Some of these statements, such as those included in the interest rate sensitivity analysis in Part I, Item 3, entitled "Quantitative and Qualitative Disclosures About Market Risk," are merely presentations of what future performance or changes in future performance would look like based on hypothetical assumptions and on simulation models. Other forward-looking statements are based on our general perceptions of market conditions and trends in business activity, both our own and in the banking industry generally, as well as current management strategies for future operations and development.

Examples of Forward-Looking Statements:
Topic

| | <u>Page</u> | <u>Location</u> |
|---|--------------------|--|
| Impact of market rate structure on net interest margin, loan yields and deposit rates | 44 | 1st paragraph under "Quarterly Taxable Equivalent Yield on Loans" |
| | 45 | Last paragraph under "Quarterly Taxable Equivalent Yield on Loans" |
| | 56 | Last paragraph under "Quantitative and Qualitative Disclosures about Market Risk" |
| Provision for loan losses | 47 | 1st paragraph in section |
| Future level of nonperforming assets | 48 | Last 3 paragraphs under "Risk Elements" |
| Future level of residential real estate loans | 44 | 2nd paragraph under "Residential Real Estate Loans" |
| Future level of indirect consumer loans | 44 | Last paragraph under "Automobile Loans" |
| Future level of commercial loans | 44 | 3rd paragraph under "Commercial, Commercial Real Estate and Construction and Land Development Loans" |
| Future compliance with regulatory capital standards | 39 | 1st paragraph under "Regulatory Capital and Increase in Stockholders' Equity" |
| | 48 | "Important Future Changes to Regulatory Capital Standards" |
| Liquidity | 51 | 2nd full paragraph |
| Fees for other services to customers | 52 | 3rd paragraph under "Noninterest Income" |
| Impact of changes in mortgage rates | 46 | Paragraph under "Investment Sales, Purchases and Maturities" |
| VISA | 40 | "VISA Class B Common Stock" |

Forward-looking statements contained herein 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 such 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 experienced in the early stages of the 2008-2009 "financial crisis;"
- b. sharp fluctuations in interest rates, economic activity, and consumer spending patterns;
- c. sudden changes in the market for products we provide, such as real estate loans;
- d. significant new banking laws and regulations, including an assortment of banking regulations recently issued or still to be issued under the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the Dodd-Frank Act or Dodd-Frank);
- e. unexpected or enhanced competition from new or unforeseen sources;
- f. network attacks or unauthorized access to computer systems and network infrastructure, interruptions of service and other security risks; and
- g. similar uncertainties inherent in banking operations, the financial world, or governmental finance generally, such as periodic heightened concerns about U.S. or state governmental budgets, deficits, spending and taxes.

Readers are cautioned not to place undue reliance on forward-looking statements in this Report, which speak only as of the date hereof. We undertake no obligation to revise or update these forward-looking statements to reflect the occurrence of unanticipated events. This Quarterly Report should be read in conjunction with our Annual Report on Form 10-K for the year ended December 31, 2013.

USE OF NON-GAAP FINANCIAL MEASURES

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

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

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

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

Adjustments for Certain Items of Income or Expense: In addition to our disclosures of 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.

Selected Quarterly Information - Unaudited (dollars in thousands)

| <u>Quarter Ended</u> | <u>06/30/2014</u> | <u>03/31/2014</u> | <u>12/31/2013</u> | <u>09/30/2013</u> | <u>06/30/2013</u> |
|---|-------------------|-------------------|-------------------|-------------------|-------------------|
| Net Income | \$ 5,524 | \$ 5,320 | \$ 5,784 | \$ 5,623 | \$ 5,207 |
| <u>Transactions Recorded in Net Income (Net of Tax):</u> | | | | | |
| Net (Loss) Gain on Securities Transactions | (16) | — | — | — | 8 |
| Net Gain on Sales of Loans | 100 | 74 | 114 | 100 | 301 |
| <u>Share and Per Share Data:</u> ¹ | | | | | |
| Period End Shares Outstanding | 12,350 | 12,350 | 12,360 | 12,329 | 12,284 |
| Basic Average Shares Outstanding | 12,348 | 12,354 | 12,339 | 12,308 | 12,261 |
| Diluted Average Shares Outstanding | 12,369 | 12,378 | 12,387 | 12,344 | 12,279 |
| Basic Earnings Per Share | \$ 0.45 | \$ 0.43 | \$ 0.47 | \$ 0.46 | \$ 0.42 |
| Diluted Earnings Per Share | 0.45 | 0.43 | 0.47 | 0.46 | 0.42 |
| Cash Dividend Per Share | 0.25 | 0.25 | 0.25 | 0.25 | 0.25 |
| <u>Selected Quarterly Average Balances:</u> | | | | | |
| Interest-Bearing Deposits at Banks | \$ 22,486 | \$ 17,184 | \$ 46,853 | \$ 14,096 | \$ 26,632 |
| Investment Securities | 712,088 | 755,008 | 762,768 | 744,928 | 771,018 |
| Loans | 1,328,639 | 1,284,649 | 1,254,957 | 1,224,840 | 1,185,041 |
| Deposits | 1,900,399 | 1,887,589 | 1,904,922 | 1,800,181 | 1,801,346 |
| Other Borrowed Funds | 60,900 | 68,375 | 62,038 | 92,073 | 94,596 |
| Shareholders' Equity | 196,478 | 194,127 | 184,506 | 179,634 | 178,867 |
| Total Assets | 2,183,611 | 2,176,038 | 2,176,264 | 2,095,017 | 2,099,138 |
| Return on Average Assets | 1.01% | 0.99% | 1.05% | 1.06% | 0.99% |
| Return on Average Equity | 11.28% | 11.11% | 12.44% | 12.42% | 11.68% |
| Return on Tangible Equity ² | 12.99% | 12.84% | 14.50% | 14.55% | 13.70% |
| Average Earning Assets | \$ 2,063,213 | \$ 2,056,841 | \$ 2,064,578 | \$ 1,983,864 | \$ 1,982,691 |
| Average Interest-Bearing Liabilities | 1,680,149 | 1,678,080 | 1,686,993 | 1,614,873 | 1,641,300 |
| Interest Income, Tax-Equivalent | 17,837 | 17,439 | 17,633 | 17,032 | 16,989 |
| Interest Expense | 1,555 | 1,594 | 1,713 | 1,747 | 2,223 |
| Net Interest Income, Tax-Equivalent | 16,282 | 15,845 | 15,920 | 15,285 | 14,766 |
| Tax-Equivalent Adjustment | 1,142 | 1,173 | 1,174 | 1,158 | 1,180 |
| Net Interest Margin ³ | 3.17% | 3.12% | 3.06% | 3.06% | 2.99% |
| <u>Efficiency Ratio Calculation:</u> | | | | | |
| Noninterest Expense | \$ 13,737 | \$ 13,466 | \$ 13,385 | \$ 13,133 | \$ 13,274 |
| Less: Intangible Asset Amortization | (94) | (106) | (108) | (108) | (112) |
| Net Noninterest Expense | \$ 13,643 | \$ 13,360 | \$ 13,277 | \$ 13,025 | \$ 13,162 |
| Net Interest Income, Tax-Equivalent | \$ 16,282 | \$ 15,845 | \$ 15,920 | \$ 15,285 | \$ 14,766 |
| Noninterest Income | 7,019 | 6,886 | 6,877 | 6,939 | 7,071 |
| Less: Net Securities (Loss) Gain | 27 | — | — | — | (13) |
| Net Gross Income | \$ 23,328 | \$ 22,731 | \$ 22,797 | \$ 22,224 | \$ 21,824 |
| Efficiency Ratio | 58.48% | 58.77% | 58.24% | 58.61% | 60.31% |
| <u>Period-End Capital Information:</u> | | | | | |
| Total Stockholders' Equity (i.e. Book Value) | \$ 197,616 | \$ 194,491 | \$ 192,154 | \$ 182,683 | \$ 177,607 |
| Book Value per Share | 16.00 | 15.75 | 15.55 | 14.82 | 14.46 |
| Intangible Assets | 25,868 | 25,999 | 26,143 | 26,273 | 26,387 |
| Tangible Book Value per Share ² | 13.91 | 13.64 | 13.43 | 12.69 | 12.31 |
| <u>Capital Ratios:</u> | | | | | |
| Tier 1 Leverage Ratio | 9.39% | 9.30% | 9.19% | 9.37% | 9.19% |
| Tier 1 Risk-Based Capital Ratio | 14.49% | 14.55% | 14.70% | 14.59% | 14.82% |
| Total Risk-Based Capital Ratio | 15.57% | 15.62% | 15.77% | 15.69% | 15.96% |
| Assets Under Trust Administration and Investment Management | \$1,214,841 | \$1,182,661 | \$1,174,891 | \$1,111,085 | \$1,073,523 |

¹Share and Per Share Data have been restated for the September 27, 2013 2% stock dividend.

²Tangible Book Value and Tangible Equity exclude intangible assets from total equity. These are non-GAAP financial measures which we believe provide investors with information that is useful in understanding our financial performance (see page 35).

³Net Interest Margin is the ratio of our annualized tax-equivalent net interest income to average earning assets. This is also a non-GAAP financial measure which we believe provides investors with information that is useful in understanding our financial performance (see page 35).

Selected Six-Month Period Information
(Dollars In Thousands, Except Per Share Amounts)

| <u>Year-to-Date Period Ended</u> | <u>06/30/2014</u> | <u>06/30/2013</u> |
|---|-------------------|-------------------|
| Net Income | 10,844 | \$ 10,388 |
| <u>Transactions Recorded in Net Income (Net of Tax):</u> | | |
| Net Securities (Loss) Gain | (16) | 326 |
| Net Gain on Sales of Loans | 175 | 667 |
| Period-End Shares Outstanding | 12,350 | 12,284 |
| Basic Average Shares Outstanding | 12,351 | 12,267 |
| Diluted Average Shares Outstanding | 12,373 | 12,285 |
| Basic Earnings Per Share | \$ 0.88 | \$ 0.85 |
| Diluted Earnings Per Share | 0.88 | 0.85 |
| Cash Dividends Per Share | 0.50 | 0.49 |
| Average Assets | \$ 2,179,846 | \$ 2,069,391 |
| Average Equity | 195,309 | 177,876 |
| Return on Average Assets | 1.00% | 1.01% |
| Return on Average Equity | 11.20% | 11.78% |
| Average Earning Assets | \$ 2,060,046 | \$ 1,952,943 |
| Average Interest-Bearing Liabilities | 1,679,119 | 1,615,991 |
| Interest Income, Tax-equivalent ¹ | 35,276 | 34,048 |
| Interest Expense | 3,149 | 4,462 |
| Net Interest Income, Tax-equivalent ¹ | 32,127 | 29,586 |
| Tax-equivalent Adjustment | 2,315 | 2,243 |
| Net Interest Margin ¹ | 3.14% | 3.05% |
| <u>Efficiency Ratio Calculation ¹</u> | | |
| Noninterest Expense | \$ 27,203 | \$ 26,685 |
| Less: Intangible Asset Amortization | (200) | (236) |
| Net Noninterest Expense | \$ 27,003 | \$ 26,449 |
| Net Interest Income, Tax-equivalent ¹ | \$ 32,127 | \$ 29,586 |
| Noninterest Income | 13,905 | 14,245 |
| Less: Net Securities (Loss) Gain | 27 | (540) |
| Net Gross Income, Adjusted | \$ 46,059 | \$ 43,291 |
| Efficiency Ratio ¹ | 58.63% | 61.10% |
| <u>Period-End Capital Information:</u> | | |
| Tier 1 Leverage Ratio | 9.52% | 9.24% |
| Total Stockholders' Equity (i.e. Book Value) | \$ 197,616 | \$ 177,607 |
| Book Value per Share | 16.00 | 14.46 |
| Intangible Assets | 25,868 | 26,387 |
| Tangible Book Value per Share ¹ | 13.91 | 12.31 |
| <u>Asset Quality Information:</u> | | |
| Net Loans Charged-off as a Percentage of Average Loans, Annualized | 0.06% | 0.14% |
| Provision for Loan Losses as a Percentage of Average Loans, Annualized | 0.15% | 0.03% |
| Allowance for Loan Losses as a Percentage of Period-end Loans | 1.12% | 1.22% |
| Allowance for Loan Losses as a Percentage of Nonperforming Loans | 190.14% | 215.47% |
| Nonperforming Loans as a Percentage of Period-end Loans | 0.59% | 0.57% |
| Nonperforming Assets as a Percentage of Period-end Total Assets | 0.38% | 0.38% |

¹ See "Use of Non-GAAP Financial Measures" on page 35.

Average Consolidated Balance Sheets and Net Interest Income Analysis

(see "Use of Non-GAAP Financial Measures" on page 35)

(Fully Taxable Basis using a marginal tax rate of 35%)

(Dollars In Thousands)

Quarter Ended June 30:

| | 2014 | | | 2013 | | |
|---|--------------------|--------------------------------|-------------------------|--------------------|--------------------------------|-------------------------|
| | Average Balance | Interest Income/ Expense | Rate Earned/ Paid | Average Balance | Interest Income/ Expense | Rate Earned/ Paid |
| Interest-Bearing Deposits at Banks | \$ 22,486 | \$ 16 | 0.29% | \$ 26,632 | \$ 19 | 0.29% |
| Investment Securities: | | | | | | |
| Fully Taxable | 415,466 | 2,045 | 1.97 | 437,318 | 1,644 | 1.51 |
| Exempt from Federal Taxes | 296,622 | 2,492 | 3.37 | 333,700 | 2,612 | 3.14 |
| Loans | 1,328,639 | 13,284 | 4.01 | 1,185,041 | 12,714 | 4.30 |
| Total Earning Assets | <u>2,063,213</u> | <u>17,837</u> | 3.47 | <u>1,982,691</u> | <u>16,989</u> | 3.44 |
| Allowance for Loan Losses | (14,603) | | | (14,606) | | |
| Cash and Due From Banks | 28,493 | | | 29,965 | | |
| Other Assets | 106,508 | | | 101,088 | | |
| Total Assets | <u>\$2,183,611</u> | | | <u>\$2,099,138</u> | | |
| Deposits: | | | | | | |
| NOW Accounts | \$ 865,910 | 495 | 0.23 | \$ 796,330 | 786 | 0.40 |
| Savings Deposits | 520,028 | 226 | 0.17 | 479,480 | 277 | 0.23 |
| Time Deposits of \$100,000 or More | 71,656 | 201 | 1.13 | 87,059 | 305 | 1.41 |
| Other Time Deposits | 161,655 | 359 | 0.89 | 183,835 | 505 | 1.10 |
| Total Interest-Bearing Deposits | <u>1,619,249</u> | <u>1,281</u> | 0.32 | <u>1,546,704</u> | <u>1,873</u> | 0.49 |
| Short-Term Borrowings | 24,746 | 12 | 0.19 | 44,596 | 33 | 0.30 |
| FHLBNY Term Advances and Other Long-Term Debt | 36,154 | 262 | 2.91 | 50,000 | 317 | 2.54 |
| Total Interest-Bearing Liabilities | <u>1,680,149</u> | <u>1,555</u> | 0.37 | <u>1,641,300</u> | <u>2,223</u> | 0.54 |
| Demand Deposits | 281,150 | | | 254,642 | | |
| Other Liabilities | 25,834 | | | 24,329 | | |
| Total Liabilities | <u>1,987,133</u> | | | <u>1,920,271</u> | | |
| Stockholders' Equity | 196,478 | | | 178,867 | | |
| Total Liabilities and Stockholders' Equity | <u>\$2,183,611</u> | | | <u>\$2,099,138</u> | | |
| Net Interest Income (Tax-equivalent Basis) | | 16,282 | | | 14,766 | |
| Reversal of Tax Equivalent Adjustment | | (1,142) | 0.22% | | (1,180) | 0.24% |
| Net Interest Income | | <u>\$ 15,140</u> | | | <u>\$ 13,586</u> | |
| Net Interest Spread | | | 3.10% | | | 2.90% |
| Net Interest Margin | | | 3.17% | | | 2.99% |

Average Consolidated Balance Sheets and Net Interest Income Analysis

(see "Use of Non-GAAP Financial Measures" on page 35)
(Fully Taxable Basis using a marginal tax rate of 35%)
(Dollars In Thousands)

Six-Month Period Ended June 30:

| | 2014 | | | 2013 | | |
|---|--------------------|--------------------------------|-------------------------|--------------------|--------------------------------|-------------------------|
| | Average Balance | Interest Income/ Expense | Rate Earned/ Paid | Average Balance | Interest Income/ Expense | Rate Earned/ Paid |
| Interest-Bearing Deposits at Banks | \$ 19,850 | \$ 29 | 0.29% | \$ 33,848 | \$ 46 | 0.27% |
| Investment Securities: | | | | | | |
| Fully Taxable | 425,913 | 4,057 | 1.92 | 439,980 | 3,444 | 1.58 |
| Exempt from Federal Taxes | 307,517 | 5,054 | 3.31 | 301,617 | 4,993 | 3.34 |
| Loans | 1,306,766 | 26,136 | 4.03 | 1,177,498 | 25,565 | 4.38 |
| Total Earning Assets | 2,060,046 | 35,276 | 3.45 | 1,952,943 | 34,048 | 3.52 |
| Allowance for Loan Losses | (14,493) | | | (14,955) | | |
| Cash and Due From Banks | 29,497 | | | 30,298 | | |
| Other Assets | 104,796 | | | 101,105 | | |
| Total Assets | <u>\$2,179,846</u> | | | <u>\$2,069,391</u> | | |
| Deposits: | | | | | | |
| NOW Accounts | \$ 861,622 | 959 | 0.22 | \$ 794,012 | 1,564 | 0.40 |
| Savings Deposits | 515,254 | 445 | 0.17 | 467,462 | 545 | 0.24 |
| Time Deposits of \$100,000 or More | 73,726 | 431 | 1.18 | 89,179 | 624 | 1.41 |
| Other Time Deposits | 163,901 | 750 | 0.92 | 185,646 | 1,059 | 1.15 |
| Total Interest-Bearing Deposits | 1,614,503 | 2,585 | 0.32 | 1,536,299 | 3,792 | 0.50 |
| Short-Term Borrowings | 26,550 | 31 | 0.24 | 29,692 | 36 | 0.24 |
| FHLBNY Term Advances and Other Long-Term Debt | 38,066 | 533 | 2.82 | 50,000 | 634 | 2.56 |
| Total Interest-Bearing Liabilities | 1,679,119 | 3,149 | 0.38 | 1,615,991 | 4,462 | 0.56 |
| Demand Deposits | 279,526 | | | 251,015 | | |
| Other Liabilities | 25,892 | | | 24,509 | | |
| Total Liabilities | 1,984,537 | | | 1,891,515 | | |
| Stockholders' Equity | 195,309 | | | 177,876 | | |
| Total Liabilities and Stockholders' Equity | <u>\$2,179,846</u> | | | <u>\$2,069,391</u> | | |
| Net Interest Income (Tax-equivalent Basis) | | 32,127 | | | 29,586 | |
| Reversal of Tax Equivalent Adjustment | | (2,315) | 0.23% | | (2,243) | 0.23% |
| Net Interest Income | | <u>\$ 29,812</u> | | | <u>\$ 27,343</u> | |
| Net Interest Spread | | | 3.07% | | | 2.96% |
| Net Interest Margin | | | 3.14% | | | 3.05% |

OVERVIEW

We reported net income for the second quarter of 2014 of \$5.5 million, representing diluted earnings per share (EPS) of \$0.45. This EPS result was an increase of three cents, or 7.1%, from the EPS of \$0.42 reported for the second quarter of 2013. Return on average equity (ROE) for the 2014 quarter continued to be strong at 11.28%, although a decrease from the ROE of 11.68% for the quarter ended June 30, 2013. Return on average assets (ROA) for the 2014 second quarter was 1.01%, an increase from ROA of 0.99% for the quarter ended June 30, 2013. Although net income increased period-to-period, average equity increased at a faster pace, with the result that the return on average equity fell between the two comparative quarters. Net interest income for the 2014 second quarter was \$16.3 million on a tax-equivalent basis, an increase of \$1.5 million, or 10.3%, from net interest income of \$14.8 million for the quarter ended June 30, 2013. The net interest margin also increased from the year earlier quarter by 18 basis points, from 2.99% to 3.17%. Total assets were \$2.153 billion at June 30, 2014, which represented a decrease of \$10.6 million, or 0.5%, from the level at December 31, 2013, but an increase of \$69.9 million, or 3.4%, from the June 30, 2013 level.

The changes in net income, net interest income and net interest margin between the six-month periods are more fully described under the heading "RESULTS OF OPERATIONS," beginning on page 51.

Stockholders' equity was \$197.6 million at June 30, 2014, an increase of \$20.0 million, or 11.3%, from the year earlier level. Stockholders' equity was also up \$5.5 million, or 2.8%, from the December 31, 2013 level of \$192.2 million. The components of the change in stockholders' equity since year-end 2013 are presented in the Consolidated Statement of Changes in Stockholders' Equity on page 6, and are discussed in more detail in the next section.

Regulatory Capital and Increase in Stockholders' Equity: At period-end, we continued to exceed all current regulatory minimum capital requirements at both the holding company and bank levels, by a substantial amount. As of June 30, 2014 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 when the new enhanced capital requirements, announced by the federal bank regulatory authorities in June 2013, go into effect in 2015, we expect that Arrow and our subsidiary banks will continue to meet all of these enhanced standards. See the discussions of *"Two Sets of Current Capital Standards"* under the "Current Regulatory Capital Standards" section beginning on page 49, and "Important Future Changes to Regulatory Capital Standards" under the "CAPITAL RESOURCES" section beginning on page 48.

At June 30, 2014, our tangible book value per share (calculated based on stockholders' equity reduced by goodwill and other intangible assets) amounted to \$13.91, an increase of \$0.48, or 3.6%, from December 31, 2013 and an increase of \$1.60, or 13.0%, from the level as of June 30, 2013. Our total stockholders' equity at June 30, 2014 increased 11.3% over the year-earlier level, and our total book value per share increased by 10.7% over the year earlier level. In the past six months, total shareholders' equity increased 2.8% and our total book value per share increased by 2.9%. The increase in stockholders' equity over the first six months of 2014 principally reflected the following factors: (i) \$10.8 million net income for the period; (ii) issuance of \$862 thousand of common stock through our employee benefit and dividend reinvestment plans and (iii) \$755 thousand of unrealized net securities gains; offset in part by (iv) cash dividends of \$6.2 million; and (v) repurchases of our own common stock of \$1.6 million. As of June 30, 2014, our closing stock price was \$25.94, representing a trading multiple of 1.86 to our tangible book value. The Board of Directors declared and the Company paid quarterly cash dividends of \$.245 per share for the first three quarters of 2013, as adjusted for a 2% stock dividend distributed September 27, 2013, and cash dividends of \$.25 per share for the last quarter of 2013 and the first two quarters of 2014.

Loan Quality: The credit quality of our loan portfolio has continued in recent periods 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 34 for information on how we define our peer group).

Our net charge-offs for the second quarter of 2014 were \$105 thousand as compared to \$25 thousand for the 2013 quarter. Our ratio of net charge-offs to average loans (annualized) for the first two quarters of 2014 were 0.08% and 0.03%, respectively. By contrast, our peer group's ratio of net charge-offs to average loans for the first quarter of 2014 was 0.14%. At June 30, 2014, our allowance for loan losses was \$15.0 million representing 1.12% of total loans, down two basis points from the December 31, 2013 ratio, due to a general improvement in the credit quality in the loan portfolio, even though some commercial loans were down-graded during the second quarter of 2014.

Nonperforming loans were \$7.9 million at June 30, 2014, representing 0.59% of period-end loans. By way of comparison, this ratio for our peer group was 1.40% at March 31, 2014, and this peer ratio represented a significant improvement from the peer group's ratios of earlier years. For example, our peer group's nonperforming loans ratio was 3.60% at year-end 2010, the high-point after the onset of the 2008 recession, while our ratio has remained quite low and stable from 2008 through the date of this Report.

During the first six months of 2014, we experienced increases in outstanding balances of all three of our major loan portfolio segments, without any significant deterioration in our credit quality:

Residential Real Estate Loans: These loans, including home equity loans, made up approximately 37% of our portfolio at period-end. The residential real estate market in our service area has been stable in recent periods. Throughout the financial crisis, we have not experienced a notable increase in our foreclosure or loss rates on our residential real estate loans, primarily due to the fact that we never have originated or participated in underwriting high-risk mortgage loans, such as so called "Alt A," "negative amortization," "option ARM's" or "negative equity" loans. We originated all of the residential real estate loans currently held in our portfolio and apply conservative underwriting standards to our originations.

Commercial Loans: These loans comprised approximately 32% of our loan portfolio at period-end. Current unemployment rates in our region remain elevated from pre-crisis levels, although the local economy continues to be stable and in some areas recovering. Similarly, commercial property values in our region remain stable, and did not show significant deterioration even in the worst phases of the financial crisis. We update the appraisals on our nonperforming and watched commercial loan properties as deemed necessary, usually when the loan is downgraded or when we perceive significant market deterioration since our last appraisal.

Automobile Loans (Primarily Through Indirect Lending): These loans comprised approximately 31% of our loan portfolio. In the first six months of 2014, we did not experience any significant change in our delinquency rate or level of nonperforming loans.

Liquidity and Access to Credit Markets: We have not experienced any liquidity problems or special concerns during 2014 to date, nor did we during 2013 or 2012. The terms of our lines of credit with our correspondent banks, the FHLBNY and the Federal Reserve Bank have not changed. In general, we rely on asset-based liquidity (i.e., funds in overnight investments and cash flow from maturing investments and loans) with liability-based liquidity as a secondary source (our main liability-based sources are overnight borrowing arrangements with our correspondent banks, term credit arrangement advances from the FHLBNY and the Federal Reserve Bank discount window). During the recent financial crisis, many financial institutions, small and large, relied extensively on the Fed's discount window to support their liquidity positions, but we had no such need. We regularly perform a liquidity stress test and periodically test our contingent liquidity plan to ensure that we can generate an adequate amount of available funds to meet a wide variety of potential liquidity crises, including a severe crisis.

VISA Class B Common Stock: We continue to believe that the multi-billion dollar balance that Visa maintains in the escrow fund that it has established to cover certain litigation-related liability to third parties is substantially sufficient to defray such liability, including expenses, and thus that any contingent liability that Visa member banks, including the Company may have for such losses is not material. Member banks contingent liability, if any, would be payable out of the equity attributable to their holdings of Visa Class B Common Stock. The Company continues not to recognize any economic value for its remaining shares of Visa Class B common stock.

CHANGE IN FINANCIAL CONDITION

Summary of Selected Consolidated Balance Sheet Data

(Dollars in Thousands)

| | | At Period-End | | \$ Change | \$ Change | % Change | % Change |
|--|---------------------|----------------------|---------------------|------------------|------------------|------------------|-----------|
| | June 30, 2014 | December 31, 2013 | June 30, 2013 | From December | From June | From December | From June |
| Interest-Bearing Bank Balances | \$ 16,459 | \$ 12,705 | \$ 11,894 | \$ 3,754 | \$ 4,565 | 29.5 % | 38.4 % |
| Securities Available-for-Sale | 366,848 | 457,606 | 501,574 | (90,758) | (134,726) | (19.8)% | (26.9)% |
| Securities Held-to-Maturity | 297,437 | 299,261 | 248,914 | (1,824) | 48,523 | (0.6)% | 19.5 % |
| Loans ⁽¹⁾ | 1,344,124 | 1,266,472 | 1,204,734 | 77,652 | 139,390 | 6.1 % | 11.6 % |
| Allowance for Loan Losses | 15,036 | 14,434 | 14,678 | 602 | 358 | 4.2 % | 2.4 % |
| Earning Assets ⁽¹⁾ | 2,029,451 | 2,042,325 | 1,973,252 | (12,874) | 56,199 | (0.6)% | 2.8 % |
| Total Assets | 2,153,051 | 2,163,698 | 2,083,169 | (10,647) | 69,882 | (0.5)% | 3.4 % |
| Demand Deposits | 286,735 | 278,958 | 261,910 | 7,777 | 24,825 | 2.8 % | 9.5 % |
| NOW Accounts | 820,589 | 817,366 | 754,371 | 3,223 | 66,218 | 0.4 % | 8.8 % |
| Savings Deposits | 523,626 | 498,779 | 494,586 | 24,847 | 29,040 | 5.0 % | 5.9 % |
| Time Deposits of \$100,000 or More | 70,600 | 78,928 | 87,369 | (8,328) | (16,769) | (10.6)% | (19.2)% |
| Other Time Deposits | 159,116 | 168,299 | 181,669 | (9,183) | (22,553) | (5.5)% | (12.4)% |
| Total Deposits | <u>\$ 1,860,666</u> | <u>\$ 1,842,330</u> | <u>\$ 1,779,905</u> | <u>\$ 18,336</u> | <u>\$ 80,761</u> | 1.0 % | 4.5 % |
| Federal Funds Purchased and Securities Sold Under Agreements to Repurchase | \$ 16,896 | \$ 11,777 | \$ 14,738 | \$ 5,119 | \$ 2,158 | 43.5 % | 14.6 % |
| FHLB Advances - Overnight | 24,000 | 53,000 | 40,000 | (29,000) | (16,000) | (54.7)% | (40.0)% |
| FHLB Advances - Term | 10,000 | 20,000 | 30,000 | (10,000) | (20,000) | (50.0)% | (66.7)% |
| Stockholders' Equity | 197,616 | 192,154 | 177,607 | 5,462 | 20,009 | 2.8 % | 11.3 % |

(1) Includes Nonaccrual Loans

Municipal Deposits: Fluctuations in balances of our NOW accounts and time deposits of \$100,000 or more are largely the result of municipal deposit seasonality factors. Over the past twelve months, municipal deposits on average have ranged from 27% to over 33% of our total deposits. As of June 30, 2014, municipal deposits represented 30.2% of total deposits. Municipal deposits typically are invested in NOW accounts and time deposits of short duration. Many of our municipal deposit relationships are subject to annual renewal, by formal or informal agreement.

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

The recent financial crisis had a significant negative impact on municipal tax revenues in many regions, and consequently on municipal funds available for deposit. To date, this has not resulted in either a sustained decrease in municipal deposit levels at our banks, adjusted for seasonal fluctuations (in fact, we have experienced an increase in such deposits in the first half of 2014 - see following paragraph), or an overall increase in the average rate we pay on such deposits (despite the continuing strong competition for such deposits). However, if interest rates begin to rise significantly or the competition for municipal deposits otherwise becomes more intense, we may experience either or both of these adverse developments in the future.

Changes in Sources of Funds: In recent periods, for cost reasons and because of the sustained growth of customer deposits even at very low rates, we have lessened our reliance on wholesale funding sources and increased our reliance on customer deposits as a source of day-to-day funding. Our total deposits increased \$18.3 million, or 1.0%, from December 31, 2013 to June 30, 2014, mainly due to an increase in our municipal deposits. Our non-municipal deposit balances also increased over the past six months, although we are still experiencing a shift in balances from time deposits to savings and NOW accounts. At June 30, 2014 we borrowed \$24 million of overnight funds from the FHLB of New York, while we held \$53.0 million of overnight funds at December 31, 2013. At June 30, 2014, our term advances from the FHLB were down to \$10.0 million, as we paid-off one \$10 million advance during the second quarter of 2014.

Changes in Earning Assets: Our loan portfolio increased by \$77.7 million, or 6.1%, from December 31, 2013 to June 30, 2014. We experienced the following trends in our three largest segments:

1. **Commercial and commercial real estate loans.** Our June 30, 2014 balance for this segment increased by \$29.4 million, or 7.3%, from the December 31, 2013 total. The increase was fueled by our acquisition of several large loan participations, while demand generally continued to be moderate.
2. **Residential real estate loans.** The period-end balance increased by \$32.9 million, or 7.2% from December 31, 2013. We continued to sell some of our residential mortgage originations during the six-month period to Freddie Mac, although a smaller percentage than we sold in the same period the prior year. Demand for new mortgage loans was modest throughout the period.
3. **Automobile loans (primarily indirect loans).** The balance of these loans at June 30, 2014, increased by \$15.1 million, or 3.8%, from the December 31, 2013 balance, reflecting a modest resurgence of automobile sales region-wide and an expansion of our dealer

network for indirect lending, offset in part by the effects of a cold and snowy winter in the northeast, which depressed auto sales region-wide.

Most of our incoming cash flows for the first six months of 2014 came from the modest increase in deposit balances and to a larger extent from maturing investments. The investment securities portfolio decreased by a net of \$92.6 million, or 12.2% during the first six months of 2014. In addition to funding loan growth, we also paid-off \$10 million of FHLB term advances and reduced our overnight position.

Deposit Trends

The following two tables provide information on trends in the balance and mix of our deposit portfolio by presenting, for each of the last five quarters, the quarterly average balances by deposit type and the percentage of total deposits represented by each deposit type. The principal change over the period was the steady drop-off in time deposits, including time deposits of \$100,000 or more.

Quarterly Average Deposit Balances

(Dollars in Thousands)

| | Quarter Ended | | | | |
|------------------------------------|---------------------|---------------------|---------------------|---------------------|---------------------|
| | 6/30/2014 | 3/31/2014 | 12/31/2013 | 9/30/2013 | 6/30/2013 |
| Demand Deposits | \$ 281,150 | \$ 277,884 | \$ 279,967 | \$ 277,381 | \$ 254,642 |
| NOW Accounts | 865,910 | 857,286 | 855,106 | 749,654 | 796,330 |
| Savings Deposits | 520,028 | 510,428 | 517,542 | 509,014 | 479,480 |
| Time Deposits of \$100,000 or More | 71,656 | 75,819 | 81,804 | 85,757 | 87,059 |
| Other Time Deposits | 161,655 | 166,172 | 170,503 | 178,375 | 183,835 |
| Total Deposits | <u>\$ 1,900,399</u> | <u>\$ 1,887,589</u> | <u>\$ 1,904,922</u> | <u>\$ 1,800,181</u> | <u>\$ 1,801,346</u> |

Percentage of Total Quarterly Average Deposits

| | Quarter Ended | | | | |
|------------------------------------|---------------|---------------|---------------|---------------|---------------|
| | 6/30/2014 | 03/31/2014 | 12/31/2013 | 09/30/2013 | 06/30/2013 |
| Demand Deposits | 14.8% | 14.7% | 14.7% | 15.4% | 14.2% |
| NOW Accounts | 45.5 | 45.5 | 44.8 | 41.6 | 44.2 |
| Savings Deposits | 27.4 | 27.0 | 27.2 | 28.3 | 26.6 |
| Time Deposits of \$100,000 or More | 3.8 | 4.0 | 4.3 | 4.8 | 4.8 |
| Other Time Deposits | 8.5 | 8.8 | 9.0 | 9.9 | 10.2 |
| Total Deposits | <u>100.0%</u> | <u>100.0%</u> | <u>100.0%</u> | <u>100.0%</u> | <u>100.0%</u> |

For a variety of reasons, we typically experience little growth in average deposit balances in the first quarter of each calendar year (even though municipal balances tend to grow sharply at the very end of the first quarter), little net growth or a small contraction in the second quarter of the year (when municipal deposits normally drop off), and a return to growth in the third and fourth quarters (when municipal deposits tend to increase, sometimes substantially, to and through year-end). This pattern has held true in recent periods. Growth in average deposit balances between the second quarter of 2013 and the second quarter of 2014 came from both municipal and non-municipal deposits.

Quarterly Cost of Deposits

| | Quarter Ended | | | | |
|------------------------------------|---------------|-----------|------------|-----------|-----------|
| | 6/30/2014 | 3/31/2014 | 12/31/2013 | 9/30/2013 | 6/30/2013 |
| Demand Deposits | —% | —% | —% | —% | —% |
| NOW Accounts | 0.23 | 0.22 | 0.22 | 0.22 | 0.40 |
| Savings Deposits | 0.17 | 0.17 | 0.18 | 0.19 | 0.23 |
| Time Deposits of \$100,000 or More | 1.13 | 1.23 | 1.34 | 1.37 | 1.41 |
| Other Time Deposits | 0.89 | 0.95 | 1.01 | 1.05 | 1.10 |
| Total Deposits | 0.27 | 0.28 | 0.30 | 0.32 | 0.42 |

In keeping with industry trend lines, average rates paid by us on deposits decreased steadily over the five quarters ending June 30, 2014, for deposits generally and virtually all deposit categories, although the rate of decrease slowed in the most recent quarters (and the rate paid on our NOW accounts actually increased, by 1 basis point, in the second quarter of 2014). Over the same period, our average yield on loans also decreased, for loans generally and across almost all loan categories (see "Quarterly Taxable Equivalent Yield on Loans," page 44).

Non-Deposit Sources of Funds

We have several sources of funding other than deposits. Historically, we have borrowed funds from the Federal Home Loan Bank ("FHLB") under a variety of programs, including fixed and variable rate short-term borrowings and borrowings in the form of "structured advances." These structured advances typically have original maturities of 3 to 10 years and are callable by the FHLB at certain dates. If the advances are called, we may elect to receive replacement advances from the FHLB at the then prevailing FHLB rates of interest. In recent periods, we have reduced our utilization of FHLB advances as a source of funds.

We have also relied in the past (most recently in 2004), on the issuance of trust preferred securities (or TRUPs) to supplement our funding needs. The \$20 million principal amount of Junior Subordinated Obligations Issued to Unconsolidated Subsidiary Trusts (i.e., TRUPs) listed on our consolidated balance sheet as of June 30, 2014 currently qualifies as Tier 1 regulatory capital under regulatory capital adequacy guidelines, as discussed under "Capital Resources" beginning on page 48 of this Report. These trust preferred securities are subject to early redemption by us if the proceeds cease to qualify as Tier 1 capital of Arrow for any reason, or if certain other unanticipated but negative events should occur, such as any adverse change in tax laws that denies the Company the ability to deduct interest paid on these obligations for federal income tax purposes. Under Dodd-Frank, no future issuances of TRUPs by banking organizations of our size will qualify as Tier 1 regulatory capital. Under the final bank capital rules recently issued by the federal bank authorities pursuant to Dodd-Frank, our outstanding TRUPs will be eligible for treatment as Tier 1 capital until they mature or are earlier redeemed by us.

Loan Trends

The following two tables present, for each of the last five quarters, the quarterly average balances by loan type and the percentage of total loans represented by each loan type. Over the last five quarters, the average balances of all loan types have fairly steadily increased, except for other consumer loans (i.e., non-automobile loans), which have remained stable and represent only 2.0% of the total portfolio.

Quarterly Average Loan Balances

(Dollars in Thousands)

| | Quarter Ended | | | | |
|---------------------------------------|---------------------|---------------------|---------------------|---------------------|---------------------|
| | 6/30/2014 | 3/31/2014 | 12/31/2013 | 9/30/2013 | 6/30/2013 |
| Commercial and Commercial Real Estate | \$ 431,614 | \$ 412,507 | \$ 397,503 | \$ 386,973 | \$ 379,533 |
| Residential Real Estate | 343,816 | 332,142 | 322,080 | 316,582 | 305,222 |
| Home Equity | 107,580 | 103,694 | 99,722 | 94,726 | 91,339 |
| Consumer Loans - Automobile | 419,407 | 409,723 | 408,273 | 398,329 | 380,993 |
| Other Consumer Loans (1) | 26,222 | 26,583 | 27,379 | 28,230 | 27,954 |
| Total Loans | <u>\$ 1,328,639</u> | <u>\$ 1,284,649</u> | <u>\$ 1,254,957</u> | <u>\$ 1,224,840</u> | <u>\$ 1,185,041</u> |

Percentage of Total Quarterly Average Loans

| | Quarter Ended | | | | |
|---------------------------------------|---------------|---------------|---------------|---------------|---------------|
| | 6/30/2014 | 3/31/2014 | 12/31/2013 | 9/30/2013 | 6/30/2013 |
| Commercial and Commercial Real Estate | 32.5% | 32.1% | 31.7% | 31.6% | 32.0% |
| Residential Real Estate | 25.9 | 25.9 | 25.6 | 25.9 | 25.7 |
| Home Equity | 8.1 | 8.1 | 8.0 | 7.7 | 7.7 |
| Consumer Loans - Automobile | 31.5 | 31.9 | 32.5 | 32.5 | 32.2 |
| Other Consumer Loans (1) | 2.0 | 2.0 | 2.2 | 2.3 | 2.4 |
| Total Loans | <u>100.0%</u> | <u>100.0%</u> | <u>100.0%</u> | <u>100.0%</u> | <u>100.0%</u> |

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

Maintenance of High Quality in the Loan Portfolio

For many reasons, including our conservative credit underwriting standards, we largely avoided the negative impact on asset quality that many other banks suffered during the financial crisis. From the start of the crises through the date of this Report, we have not experienced a significant deterioration in our loan portfolios. In general, we underwrite our residential real estate loans to secondary market standards for prime loans. We have never engaged in subprime mortgage lending as a business line, whether in residential mortgage loans, car loans or other consumer loans. We never extended or purchased any so-called "Alt-A", "negative amortization", "option ARM", or "negative equity" mortgage loans. On occasion we have made loans to borrowers having a FICO score of 650 or below, where special circumstances justify doing so, or have had extensions of credit outstanding to borrowers who have developed credit problems after origination resulting in deterioration of their FICO scores.

Residential Real Estate Loans: In recent years, residential real estate and home equity loans have represented the largest single segment of our loan portfolio (comprising approximately 37% of the entire portfolio at June 30, 2014), eclipsing both our commercial and commercial real estate loans (32% of the portfolio) and automobile loans (31% of the portfolio). Our gross originations for residential real estate loans (including refinancings of pre-existing mortgage loans) were \$59.6 million and \$66.4 million for the first six months of 2014 and 2013, respectively. These origination totals exceeded the sum of repayments and prepayments in the respective quarters, but in each period we also sold a portion of these originations (in the 2013 period, a significant portion thereof) on or immediately after origination. In the first six months of 2013, we sold \$34.8 million, or 52.4% of our originations during the period, whereas in the first six months of 2014, we only sold \$8.8 million, or 14.8% of our originations. During 2014, we introduced competitive products for variable rate (adjustable)

residential real estate and construction loans. None of these variable rate loans were subprime loans. We did not sell any of these variable rate loans to the secondary market.

Even though short-term rates have remained very low since 2008, rates on conventional real estate mortgages have fluctuated over the past few years in response to several programs undertaken by the Federal Reserve. If the current historically unprecedented low-rate environment for newly originated residential real estate loans persists, we may continue to sell a significant portion of our loan originations and, as a result, may even experience a decrease in our outstanding balances in this segment of our portfolio. Moreover, if our local economy or real estate market suffers a major downturn, the demand for residential real estate loans in our service area may decrease, which also may negatively impact our real estate portfolio and our financial performance. Management believes it is not possible at this point to project whether mortgage rates or interest rates generally will experience meaningful and substantial increases in upcoming periods, or what the overall effect of any such increase will be on our mortgage loan portfolio or our loan portfolio generally, or on our net interest income, net income or financial results, in upcoming periods.

Commercial, Commercial Real Estate and Commercial Construction Loans: Over the last decade, we have experienced moderate and occasionally strong demand for commercial and commercial real estate loans. These loan balances have generally increased in dollar amount and have slightly increased as a percentage of the overall loan portfolio. For the first six months of 2014, loan growth was strong in this category, as outstanding balances increased by \$29.4 million over the December 31, 2013 level, enhanced by several large loan participations acquired by us.

Substantially all commercial and commercial real estate loans in our portfolio were extended to businesses or borrowers located in our regional market. Many of the loans in the commercial portfolio have variable rates tied to prime, FHLBNY rates or U.S. Treasury indices. We have not experienced any significant weakening in the quality of our commercial loan portfolio in recent years.

It is entirely possible, however, that we may experience a reduction in the demand for such loans and/or a weakening in the quality of our commercial and commercial real estate loan portfolio in upcoming periods. Generally, however, the business sector, at least in our service area, appeared to be in reasonably good financial condition at period-end.

Automobile Loans (primarily through indirect lending): At June 30, 2014, our automobile loans (primarily loans originated through dealerships located in upstate New York and Vermont) represented the third largest category of loans in our portfolio, and continued to be a significant component of our business comprising almost a third of our loan portfolio.

Beginning in 2012, there was a nation-wide resurgence in automobile sales, due in the view of many to an aging fleet and a modest resurgence in consumer optimism. Although our new automobile loan volume for the first three months of 2014 slowed down somewhat due to a cold and snowy winter, our automobile loan portfolio still grew in the first half of 2014 by \$15.1 million, or 3.8%, from our December 31, 2013 balance.

It has been widely noted that the recent upsurge in auto lending was accompanied by a general weakening of underwriting standards. We have not altered or weakened our lending standards for indirect (auto) loans. We saw no significant change in our net charge-offs on automobile loans for the first six months of 2014. Our experienced lending staff not only utilizes credit evaluation software tools but also reviews and evaluates each loan individually. We believe our disciplined approach to evaluating risk has contributed to maintaining our strong loan quality in this portfolio. If weakness in auto demand returns, our portfolio is likely to experience limited, if any, overall growth, either in real terms or as a percentage of the total portfolio, regardless of whether the auto company lending affiliates continue to offer highly-subsidized loans.

The following table indicates the annualized tax-equivalent yield of each loan category for the past five quarters.

Quarterly Taxable Equivalent Yield on Loans

| | Quarter Ended | | | | |
|---------------------------------------|---------------|-----------|------------|-----------|-----------|
| | 6/30/2014 | 3/31/2014 | 12/31/2013 | 9/30/2013 | 6/30/2013 |
| Commercial and Commercial Real Estate | 4.47% | 4.49% | 4.65% | 4.52% | 4.61% |
| Residential Real Estate | 4.50 | 4.55 | 4.53 | 4.62 | 4.75 |
| Home Equity | 2.93 | 2.95 | 2.94 | 2.98 | 3.00 |
| Automobile | 3.32 | 3.41 | 3.54 | 3.68 | 3.83 |
| Other Consumer Loans | 5.49 | 5.54 | 5.72 | 5.95 | 5.97 |
| Total Loans | 4.01 | 4.06 | 4.15 | 4.18 | 4.30 |

In summary, average yields in our loan portfolio have steadily declined over the last year, dropping 29 basis points, or 6.7%, from the second quarter of 2013 to the second quarter of 2014. This decrease continued a long-term trend, resulting principally from the Federal Reserve's multi-year policy of generating and maintaining ultra-low rates in financial markets generally, on both short-term and long-term debt, as well as continuing competition for loans from other lenders. To the extent that this declining rate environment may be "bottoming out" or even in the early stages of reversing itself, due to recent Federal Reserve tapering of its monetary easing policy, the impact of such a change, if it is in fact occurring, has not yet revealed itself in our loan portfolio. Nor would we expect that any bottoming out of prevailing rates would have an immediate impact on our portfolio yields generally.

In the second quarter of 2014, the average yield on our loan portfolio declined by 5 basis points from the first quarter of 2014, from 4.06% to 4.01%. The decrease was exacerbated by extremely competitive pressures on rates for automobile loans--our indirect loan portfolio experienced a 9 basis point decrease from the prior quarter. The yields in the other four categories also decreased from the prior quarter. The 5 basis point decrease in average yield on our total loan portfolio in the just-completed quarter, as compared to the prior quarter, was not matched by a similar decrease in our average cost of deposits during the quarter; our average deposit cost was nearly unchanged from the prior quarter. Despite the more rapid drop in average loan yield than average deposit cost, our net-interest margin

in the second quarter of 2014 increased by 5 basis points over the net interest margin in the 2014 first quarter, from 3.12% to 3.17%. The principal reason for the margin increase was a significant shift in our asset portfolio from investment securities to loans.

In general, the yield (tax-equivalent interest income divided by average loans) on our loan portfolio and other earning assets has been impacted by changes in prevailing interest rates. We expect that such will likely continue to be the case; that is, that loan yields will continue to rise and fall with changes in prevailing market rates, although the timing and degree of responsiveness will be influenced by a variety of other factors, including the extent of federal government and Federal Reserve participation in the home mortgage market, the makeup of our loan portfolio, the shape of the yield curve, consumer expectations and preferences, and the rate at which the portfolio expands. Additionally, there is a significant amount of cash flow from normal amortization and prepayments in all loan categories, and much of this cash flow reprices at current rates for credit, as new loans are generated at the current yields. Thus, even if prevailing rates for loans stabilize in upcoming periods, our average rate on our portfolio may continue to decline as older credits in our portfolio bearing generally higher rates continue to mature and roll over or are redeployed into lower priced loans.

Investment Portfolio Trends

The following table presents the changes in the period-end balances for the securities available-for-sale and the securities held-to-maturity investment portfolios from December 31, 2013 to June 30, 2014 (in thousands). The principal change in our investment portfolio over the six-month period was a substantial fall-off in securities available-for-sale, which declined during the period by \$90.8 million, or 19.7%, as proceeds from maturing or sold securities were re-deployed into the loan portfolio.

| | Fair Value at Period-End | | | Net Unrealized Gain (Loss) | | |
|--|--------------------------|-------------------|--------------------|----------------------------|-----------------|-----------------|
| | 06/30/2014 | 12/31/2013 | Change | 06/30/2014 | 12/31/2013 | Change |
| Securities Available-for-Sale: | | | | | | |
| U.S. Agency Securities | \$ 92,186 | \$ 136,475 | \$ (44,289) | \$ (142) | \$ (393) | \$ 251 |
| State and Municipal Obligations | 102,862 | 127,389 | (24,527) | 406 | 165 | 241 |
| Mortgage-Backed Securities-Residential | 153,770 | 175,778 | (22,008) | 5,098 | 4,457 | 641 |
| Corporate and Other Debt Securities | 16,829 | 16,798 | 31 | (236) | (344) | 108 |
| Mutual Funds and Equity Securities | 1,201 | 1,166 | 35 | 81 | 46 | 35 |
| Total | \$ 366,848 | \$ 457,606 | \$ (90,758) | \$ 5,207 | \$ 3,931 | \$ 1,276 |
| Securities Held-to-Maturity: | | | | | | |
| State and Municipal Obligations | \$ 180,211 | \$ 202,390 | \$ (22,179) | \$ 5,323 | \$ 4,184 | \$ 1,139 |
| Mortgage-Backed Securities-Residential | 123,048 | 98,915 | 24,133 | 1,499 | (1,140) | 2,639 |
| Corporate and Other Debt Securities | 1,000 | 1,000 | — | — | — | — |
| Total | \$ 304,259 | \$ 302,305 | \$ 1,954 | \$ 6,822 | \$ 3,044 | \$ 3,778 |

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

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

Other-Than-Temporary Impairment

Each quarter we evaluate all investment securities with a fair value less than amortized cost, both in the available-for-sale portfolio and the held-to-maturity portfolio, to determine if there exists other-than-temporary impairment for any such security as defined under generally accepted accounting principles. There were no other-than-temporary impairment losses in the first six months of 2014.

Increase in Net Unrealized Securities Gains: Nearly all of the change in our net unrealized gains or losses is attributable to changes in the yield curve between the two period-ends, that is, there has been little or no change in the credit-worthiness of the issuers.

Investment Sales, Purchases and Maturities
(In Thousands)

| Sales | <u>Three Months Ended</u> | | <u>Six Months Ended</u> | |
|---|---------------------------|-------------------|-------------------------|-------------------|
| | <u>06/30/2014</u> | <u>06/30/2013</u> | <u>06/30/2014</u> | <u>06/30/2013</u> |
| Available-For-Sale Portfolio: | | | | |
| Mortgage-Backed Securities-Residential | \$ — | \$ — | \$ — | \$ 10,666 |
| U.S. Agency Securities | 40,729 | — | 40,729 | 5,057 |
| Other | 23 | 12 | 23 | 23 |
| Total | <u>40,752</u> | <u>12</u> | <u>40,752</u> | <u>15,746</u> |
| Net (Losses) Gains on Securities Transactions | (27) | — | (27) | 527 |
| Proceeds on the Sales of Securities | <u>\$ 40,725</u> | <u>\$ 12</u> | <u>\$ 40,725</u> | <u>\$ 16,273</u> |
| Held-to-Maturity Portfolio: | | | | |
| State and Municipal Obligations | \$ — | \$ 1,168 | \$ — | \$ 1,168 |
| Net Gains on Securities Transactions | — | 13 | — | 13 |
| Proceeds on the Sales of Securities | <u>\$ —</u> | <u>\$ 1,181</u> | <u>\$ —</u> | <u>\$ 1,181</u> |

In recent periods, the steady decline in prevailing interest rates to historically low levels has increased the likelihood of greater mortgage refinancing activity. We regularly review our holdings of collateralized mortgage obligations for those mortgages that revealed higher credit scores and/or moderate loan-to-value ratios, i.e., where refinancing may appear to be a greater probability. We also regularly review the underlying prepayment speed of individual issues to identify mortgage pools that may experience accelerating principal payments. In 2013 we selectively sold collateralized mortgage obligations that were experiencing accelerating prepayments speeds and that were also selling at a premium, so as to capture the gain since prepayments (redemptions) of such securities typically are at par. If the multi-year widespread decline in mortgage rates may in fact be ending, and/or if such rates may now begin to increase, we would expect that refinancings as well as pre-payments of outstanding mortgage loans, including those in our portfolio, may diminish in upcoming periods, as would our anticipatory sales of loans that we deem likely to be refinanced or prepaid.

Investment Purchases - Available-for-Sale Portfolio

| | <u>Three Months Ended</u> | | <u>Six Months Ended</u> | |
|--------------------------------------|---------------------------|-------------------|-------------------------|-------------------|
| | <u>06/30/2014</u> | <u>06/30/2013</u> | <u>06/30/2014</u> | <u>06/30/2013</u> |
| Purchases | | | | |
| U.S. Agency Securities | \$ 40,599 | \$ 24,002 | \$ 53,185 | \$ 39,002 |
| State and Municipal Obligations | — | 39,487 | 4,308 | 60,164 |
| Other | 11 | 4,355 | 22 | 8,606 |
| Total Purchases | <u>\$ 40,610</u> | <u>\$ 67,844</u> | <u>\$ 57,515</u> | <u>\$ 107,772</u> |
| <u>Maturities & Calls</u> | \$ 62,385 | \$ 37,833 | \$ 107,292 | \$ 60,679 |

Investment Purchases - Held-to-Maturity Portfolio

| | <u>Three Months Ended</u> | | <u>Six Months Ended</u> | |
|--|---------------------------|-------------------|-------------------------|-------------------|
| | <u>06/30/2014</u> | <u>06/30/2013</u> | <u>06/30/2014</u> | <u>06/30/2013</u> |
| Purchases | | | | |
| State and Municipal Obligations | \$ 1,052 | \$ 10,182 | \$ 6,943 | \$ 29,112 |
| Mortgage-Backed Securities-Residential | — | — | 29,437 | — |
| Total Purchases | <u>\$ 1,052</u> | <u>\$ 10,182</u> | <u>\$ 36,380</u> | <u>\$ 29,112</u> |
| <u>Maturities & Calls</u> | \$ 20,874 | \$ 11,090 | \$ 37,435 | \$ 17,905 |

Asset Quality

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

Summary of the Allowance and Provision for Loan Losses

(Dollars in Thousands, Loans Stated Net of Unearned Income)

| | 6/30/2014 | 03/31/2014 | 12/31/2013 | 9/30/2013 | 6/30/2013 |
|---|------------------|------------------|------------------|------------------|------------------|
| <u>Loan Balances:</u> | | | | | |
| Period-End Loans | \$1,344,124 | \$ 1,310,423 | \$ 1,266,472 | \$1,243,370 | \$1,204,734 |
| Average Loans, Year-to-Date | 1,306,766 | 1,284,649 | 1,208,954 | 1,193,452 | 1,177,498 |
| Average Loans, Quarter-to-Date | 1,328,639 | 1,284,649 | 1,254,957 | 1,224,840 | 1,185,041 |
| Period-End Assets | 2,153,051 | 2,221,581 | 2,163,698 | 2,156,858 | 2,083,169 |
| <u>Allowance for Loan Losses, Year-to-Date:</u> | | | | | |
| Allowance for Loan Losses, Beginning of Period | \$ 14,434 | \$ 14,434 | \$ 15,298 | \$ 15,298 | \$ 15,298 |
| Provision for Loan Losses, YTD | 963 | 458 | 200 | 200 | 200 |
| Loans Charged-off, YTD | (504) | (336) | (1,411) | (1,165) | (982) |
| Recoveries of Loans Previously Charged-off | 143 | 80 | 347 | 251 | 162 |
| Net Charge-offs, YTD | (361) | (256) | (1,064) | (914) | (820) |
| Allowance for Loan Losses, End of Period | <u>\$ 15,036</u> | <u>\$ 14,636</u> | <u>\$ 14,434</u> | <u>\$ 14,584</u> | <u>\$ 14,678</u> |
| <u>Allowance for Loan Losses, Quarter-to-Date:</u> | | | | | |
| Allowance for Loan Losses, Beginning of Period | \$ 14,636 | \$ 14,434 | \$ 14,584 | \$ 14,678 | \$ 14,603 |
| Provision for Loan Losses, QTD | 505 | 458 | — | — | 100 |
| Loans Charged-off, QTD | (168) | (336) | (246) | (183) | (92) |
| Recoveries of Loans Previously Charged-off | 63 | 80 | 96 | 89 | 67 |
| Net Charge-offs, QTD | (105) | (256) | (150) | (94) | (25) |
| Allowance for Loan Losses, End of Period | <u>\$ 15,036</u> | <u>\$ 14,636</u> | <u>\$ 14,434</u> | <u>\$ 14,584</u> | <u>\$ 14,678</u> |
| <u>Nonperforming Assets, at Period-End:</u> | | | | | |
| Nonaccrual Loans | \$ 6,185 | \$ 6,284 | \$ 6,479 | \$ 6,171 | \$ 5,591 |
| Restructured | 398 | 380 | 641 | 446 | 461 |
| Loans Past Due 90 or More Days and Still Accruing Interest | 1,325 | 347 | 652 | 927 | 760 |
| Total Nonperforming Loans | 7,908 | 7,011 | 7,772 | 7,544 | 6,812 |
| Reposessed Assets | 40 | 138 | 63 | 18 | 34 |
| Other Real Estate Owned | 326 | 198 | 81 | 481 | 1,141 |
| Total Nonperforming Assets | <u>\$ 8,274</u> | <u>\$ 7,347</u> | <u>\$ 7,916</u> | <u>\$ 8,043</u> | <u>\$ 7,987</u> |
| <u>Asset Quality Ratios:</u> | | | | | |
| Allowance to Nonperforming Loans | 190.14% | 208.76% | 185.71% | 193.32% | 215.47% |
| Allowance to Period-End Loans | 1.12 | 1.12 | 1.14 | 1.17 | 1.22 |
| Provision to Average Loans (Quarter) ⁽¹⁾ | 0.15 | 0.14 | — | — | 0.03 |
| Provision to Average Loans (YTD) ⁽¹⁾ | 0.15 | 0.14 | 0.02 | 0.02 | 0.03 |
| Net Charge-offs to Average Loans (Quarter) ⁽¹⁾ | 0.03 | 0.08 | 0.05 | 0.03 | 0.01 |
| Net Charge-offs to Average Loans (YTD) ⁽¹⁾ | 0.06 | 0.08 | 0.09 | 0.10 | 0.14 |
| Nonperforming Loans to Total Loans | 0.59 | 0.53 | 0.61 | 0.61 | 0.57 |
| Nonperforming Assets to Total Assets | 0.38 | 0.33 | 0.37 | 0.37 | 0.38 |

⁽¹⁾ Annualized

Provision for Loan Losses

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

In the second quarter of 2014, we made a \$505 thousand provision for loan losses, compared to provisions of \$100 thousand for the second quarter of 2013, no provisions for the third and fourth quarters of 2013 and a provision of \$458 for the first quarter of 2014. A variety of factors and events during the second 2014 quarter dictated the amount of the provision, including a significant increase in loan balances, and a modest increase in substandard loans (see Note 3 to our unaudited interim consolidated financial statements for a discussion on how we classify our credit quality indicators as well as the balance in each category), offset, in part, by some improvement in several qualitative factors.

The ratio of the allowance for loan losses to total loans was 1.12% at June 30, 2014, down two basis points from 1.14% at December 31, 2013. The decline in the allowance for loan losses as a percentage of total loans was principally due to improvements in several key credit quality measurements. Although during the quarter internally classified loans (loans rated special mention, substandard or doubtful) as a percentage of total loans increased slightly, the percentage of nonperforming loans to total loans and the ratio of net charge-offs to average loans decreased. The overall size of the allowance grew, due primarily to loan portfolio growth.

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

Risk Elements

Our nonperforming assets at June 30, 2014 amounted to \$8.3 million, an increase of \$358 thousand, or 4.5%, from the December 31, 2013 total and an increase of \$287 thousand or 3.6%, from the year earlier total. Our recent levels of nonperforming assets remain significantly below our peer group averages for the corresponding dates. At June 30, 2014, our ratio of loans past due 90 or more days plus nonaccrual loans plus other real estate owned to total assets was .38%, nearly unchanged from our ratio at June 30, 2013. Both ratios are well below the ratio of 1.36% for our peer group at March 31, 2014 (the latest date for which peer group information is available).

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

Loans Past Due 30-89 Days and Accruing Interest

| | 6/30/2014 | 12/31/2013 | 6/30/2013 |
|-------------------------------|-----------------|-----------------|-----------------|
| Commercial Loans | \$ 787 | \$ 905 | \$ 1,415 |
| Commercial Real Estate Loans | 200 | 1,400 | 1,259 |
| Other Consumer Loans | 36 | 56 | 31 |
| Automobile Loans | 3,480 | 4,229 | 2,852 |
| Residential Real Estate Loans | 1,608 | 1,698 | 2,177 |
| Total Delinquent Loans | <u>\$ 6,111</u> | <u>\$ 8,288</u> | <u>\$ 7,734</u> |

At June 30, 2014, our loans in this category totaled \$6.1 million, or 0.45% of loans then outstanding, a decrease of \$2.2 million, or 26.3%, from the \$8.3 million of such loans at December 31, 2013. The year-end 2013 total equaled .65% of loans then outstanding. The decrease from December 31, 2013 is primarily attributable to a substantial decrease in non-current commercial real estate loans, as one large loan was brought current.

The number and dollar amount of our performing loans that demonstrate characteristics of potential weakness from time-to-time (potential problem loans) typically is a very small percentage of our portfolio. See the table of Credit Quality Indicators in Note 3 to our unaudited interim consolidated financial statements. We consider all performing commercial and commercial real estate loans classified as substandard or lower (as reported in Note 3) to be potential problem loans. The dollar amount of such loans at June 30, 2014 (\$27.1 million) was up slightly from the dollar amount of such loans at December 31, 2013 (\$25.4 million). The amount of such loans depends principally on economic conditions in our geographic market area of northeastern New York State. The economy in this area has been relatively strong in recent years, but any general weakening of the U.S. economy in upcoming periods would likely have an adverse effect on the economy in our market area as well, and on our commercial and commercial real estate portfolio.

As of June 30, 2014, we held for sale two real estate properties in other real estate owned. As a result of our conservative underwriting standards, we do not expect to acquire a significant number of other real estate properties in the near term as a result of payment defaults or the foreclosure process, nor do we expect significant losses to be incurred generally in our residential real estate portfolio.

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

CAPITAL RESOURCES

Important Future Changes to Regulatory Capital Standards (To Be Phased-In from 2015 to 2019)

Please see our discussion in our Form 10-K for December 31, 2013 on the impact of the Dodd-Frank Act on regulatory capital standards for U.S. insured depository financial institutions, and specifically, on the new higher regulatory capital standards that were set for banks by bank regulators in July 2013 and will become effective in stages over upcoming years.

In general, the new standards, which will begin to take effect for banking organization like us in 2015, set higher minimum capital ratios, expand the risk-weighted categories of assets and add a new capital ratio, a "common equity tier 1 capital ratio" (CET1). The new rules as part of their general thrust in requiring enhanced capital for all banks also introduce a new concept, a so-called "capital conservation buffer" (set to reach 2.5% in 2019), which will be added over a phase-in period to each of the new minimum capital ratios (which by themselves are somewhat higher than the current minimum ratios).

Under the new rules, outstanding TRUPs previously issued by small- to medium-sized financial institutions such as Arrow will continue to qualify as tier 1 capital, up to a limit of 25% of tier 1 capital (including such TRUP's and other grandfathered tier 1 capital components), until the TRUPs mature or are redeemed. Also under the new rules, accumulated other comprehensive income (AOCI) may be deducted from capital, if the organization exercises its irrevocable option not to include AOCI in capital. We estimate that if

the new capital rules, which are being phased-in from 2015 through 2019, had been effective on June 30, 2014, our holding company and each of our banks still would have met each of the higher minimum capital requirements for financial institutions under these new rules, including the capital conservation buffer.

Current Regulatory Capital Standards

The discussion and disclosure below on current regulatory capital standards is qualified in its entirety by reference to the fact that, as discussed above, new, more stringent regulatory capital standards have recently been issued by bank regulators, as required under the Dodd-Frank Act, and will become effective in stages over upcoming periods.

Regulatory capital, although a financial measure that is not provided for or governed by GAAP, nevertheless has been exempted by the SEC from the definition of "non-GAAP financial measures" in the SEC's Regulation G governing disclosure by registered companies of non-GAAP financial measures. Thus, certain information which is generally required to be presented in connection with our disclosure of non-GAAP financial measures need not be provided, and has not been provided, for the regulatory capital measures discussed below.

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

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

Capital Ratios: The table below sets forth the capital ratios of our holding company and subsidiary banks, Glens Falls National and Saratoga National, as of June 30, 2014:

| | Tier 1 Leverage Ratio | Tier 1 Risk-Based Capital Ratio | Total Risk-Based Capital Ratio |
|---------------------------------------|-----------------------------|--|---|
| Arrow Financial Corporation | 9.39% | 14.49% | 15.57% |
| Glens Falls National Bank & Trust Co. | 9.00% | 14.40% | 15.49% |
| Saratoga National Bank & Trust Co. | 9.61% | 12.63% | 13.66% |
| Regulatory Minimum | 4.00 | 4.00 | 8.00 |
| FDICIA's "Well-Capitalized" Standard | 5.00 | 6.00 | 10.00 |

At June 30, 2014 our holding company and both banks exceeded the minimum capital ratios established under the currently applicable regulatory guidelines, and also qualified as "well-capitalized", the highest category, in the capital classification scheme set by federal bank regulatory agencies (see the further discussion under "Supervision and Regulation" in Part I Item 1.C. of this Report). The minimum capital ratios listed in the above table are those currently effective for financial institutions, not the higher minimum capital ratios that will become effective in upcoming periods.

Capital Components; Stock Repurchases; Dividends

Stockholders' Equity: Stockholders' equity was \$197.6 million at June 30, 2014, an increase of \$5.5 million, or 2.8%, from the prior year-end. The most significant contributions to this increase in stockholders' equity were net income of \$10.8 million, equity received from our various stock-based compensation and dividend reinvestment plans of \$862 thousand and \$755 thousand of unrealized net securities gains, net of tax. These positive factors were offset, in part, by cash dividends of \$6.2 million, and purchases of our own common stock of \$1.6 million. See the Consolidated Statement of Changes in Stockholders' Equity on page 6 of this report for all of the changes in stockholders' equity between December 31, 2013 and June 30, 2014.

Stock Repurchase Program: At its regular meeting in November 2013, the Board of Directors approved a 12-month stock repurchase program (the "2014 program") authorizing the repurchase, at the discretion of senior management, during calendar year 2014 of up to \$5 million of Arrow's common stock in open market or privately negotiated transactions. This program replaced a similar \$5 million stock repurchase program which was approved by the Board in November 2012 for calendar year 2013 (the "2013 program"). Under the 2013 program, a total of \$1.2 million of outstanding stock was repurchased by the Company during 2013. Under the 2014 program, as under the 2013 program, management is authorized to effect stock repurchases from time-to-time, to the extent that it believes the Company's stock is reasonably priced and such repurchases appear to be an attractive use of available capital and in the best interests of stockholders. Through June 30, 2014, 44,436 shares having an aggregate purchase price of \$1.1 million had been repurchased by the Company under the 2014 program.

| | | | | Cash Dividends Declared |
|---|----|--------------|------|-------------------------------|
| | | Market Price | | |
| | | Low | High | |
| <u>2013</u> | | | | |
| First Quarter | \$ | 23.14 | \$ | 0.245 |
| Second Quarter | | 22.95 | | 0.245 |
| Third Quarter | | 24.25 | | 0.245 |
| Fourth Quarter | | 24.91 | | 0.250 |
| <u>2014</u> | | | | |
| First Quarter | \$ | 24.50 | \$ | 0.250 |
| Second Quarter | | 24.80 | | 0.250 |
| Third Quarter (dividend payable September 15, 2014) | | | | 0.250 |

| | | Quarter Ended June 30, | | |
|--|-----------|------------------------|-----------|---------------|
| | | 2014 | 2013 | |
| Cash Dividends Per Share | \$ | 0.250 | \$ | 0.245 |
| Diluted Earnings Per Share | | 0.45 | | 0.42 |
| Dividend Payout Ratio | | 55.56% | | 58.33% |
| Total Equity (in thousands) | \$ | 197,616 | \$ | 177,607 |
| Shares Issued and Outstanding (in thousands) | | 12,350 | | 12,284 |
| Book Value Per Share | \$ | 16.00 | \$ | 14.46 |
| Intangible Assets (in thousands) | \$ | 25,868 | \$ | 26,387 |
| Tangible Book Value Per Share | \$ | 13.91 | \$ | 12.31 |

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

In addition to liquidity from federal funds, short-term balances at the Federal Reserve Bank, investment securities and loans, we have supplemented available operating liquidity with additional off-balance sheet sources such as federal funds lines of credit and

credit lines with the Federal Home Loan Bank of New York ("FHLBNY"). Our federal funds lines of credit are with two correspondent banks totaling \$35 million, but we did not draw on these lines during 2014.

To support our borrowing relationship with the FHLBNY, we have pledged collateral, including mortgage-backed securities and residential mortgage loans. Our unused borrowing capacity at the FHLBNY was approximately \$239.7 million at June 30, 2014. In addition we have identified brokered certificates of deposit as an appropriate off-balance sheet source of funding accessible in a relatively short time period. Also, our two bank subsidiaries have each established a borrowing facility with the Federal Reserve Bank of New York, pledging certain consumer loans as collateral for potential "discount window" advances, which we maintain for contingency liquidity purposes. At June 30, 2014, the amount available under this facility was approximately \$309.9 million, but there were no advances then outstanding.

We measure and monitor our basic liquidity as a ratio of liquid assets to total short-term liabilities, both with and without the availability of borrowing arrangements. Based on the level of overnight funds investments, available liquidity from our investment securities portfolio, cash flows from our loan portfolio, our stable core deposit base and our significant borrowing capacity, we believe that our liquidity is sufficient to meet all funding needs that may arise in connection with any reasonably likely events or occurrences. At June 30, 2014, our basic liquidity ratio, including our FHLB collateralized borrowing capacity, was 10.7% of total assets, or \$231 million, well in excess of our internally-set minimum target ratio 4% of total assets, an excess of \$145 million.

Throughout the recent years of financial instability, our liquidity position has remained strong, and depositors and investors in the wholesale funding markets have showed no hesitations in placing or maintaining their funds with our banks. The financial markets have been challenging for many financial institutions, and the widely accepted view is that during the 2008-2010 crisis a lack of liquidity was as great a problem for many troubled institutions as a capital shortfall. As a result, liquidity premiums widened and many banks experienced certain liquidity constraints, including substantially increased pricing to retain deposit balances. Because of Arrow's favorable credit quality and strong balance sheet, Arrow did not experience any significant liquidity constraints during the crisis or thereafter through the date of this Report and was never forced to pay premium rates to obtain retail deposits or other funds from any source.

RESULTS OF OPERATIONS **Three Months Ended June 30, 2014 Compared With** **Three Months Ended June 30, 2013**

Summary of Earnings Performance

(Dollars in Thousands, Except Per Share Amounts)

| | Quarter Ended | | Change | % Change |
|----------------------------|---------------|------------|---------|----------|
| | 06/30/2014 | 06/30/2013 | | |
| Net Income | \$ 5,524 | \$ 5,207 | \$ 317 | 6.1% |
| Diluted Earnings Per Share | 0.45 | 0.42 | 0.03 | 7.1 |
| Return on Average Assets | 1.01% | 0.99% | 0.02 % | 2.0 |
| Return on Average Equity | 11.28% | 11.68% | (0.40)% | (3.4) |

We reported earnings (net income) of \$5.5 million and diluted earnings per share (EPS) of \$.45 for the second quarter of 2014, compared to net income of \$5.2 million and diluted EPS of \$.42 for the second quarter of 2013.

We experienced net losses of \$16 thousand, net of tax, on the sale of securities in the 2014 quarter, compared to net gains of \$8 thousand, net of tax, in the 2013 quarter.

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

Net Interest Income

Summary of Net Interest Income

(Taxable Equivalent Basis, Dollars in Thousands)

| | Quarter Ended | | Change | % Change |
|--------------------------------------|---------------|------------|--------|----------|
| | 06/30/2014 | 06/30/2013 | | |
| Interest and Dividend Income | \$ 17,837 | \$ 16,989 | \$ 848 | 5.0% |
| Interest Expense | 1,555 | 2,223 | (668) | (30.0) |
| Net Interest Income | 16,282 | 14,766 | 1,516 | 10.3 |
| Tax-Equivalent Adjustment | 1,142 | 1,180 | (38) | (3.2) |
| Average Earning Assets (1) | 2,063,213 | 1,982,691 | 80,522 | 4.1 |
| Average Interest-Bearing Liabilities | 1,680,149 | 1,641,300 | 38,849 | 2.4 |
| Yield on Earning Assets (1) | 3.47% | 3.44% | 0.03% | 0.9 |
| Cost of Interest-Bearing Liabilities | 0.37 | 0.54 | (0.17) | (31.5) |
| Net Interest Spread | 3.10 | 2.90 | 0.20 | 6.9 |
| Net Interest Margin | 3.17 | 2.99 | 0.18 | 6.0 |

(1) Includes Nonaccrual Loans

Between the second quarter of 2013 and the second quarter of 2014, our net interest margin (net interest income on a tax-equivalent basis by average earning assets, annualized) increased by 18 basis points, from 2.99% to 3.17%, representing a 6.0% increase in our margin. Most of this increase occurred in the first two quarters of 2014. (See the discussion under "Use of Non-GAAP Financial Measures," on page 35, regarding our net interest margin and net interest income, which are commonly used non-GAAP financial measures.) Among other things, this increase in net interest margin reflected a decrease in the cost of several municipal NOW accounts, which renewed their contracts effective on July 1, 2013. In management's view, despite this positive recent development in our net interest margin, our persistent multi-year experience of margin compression may well continue in upcoming periods, and if rates do begin to move broadly upward, our liabilities generally may reprice more rapidly than our assets. Net interest income for the just completed quarter, on a taxable equivalent basis, increased by \$1.52 million, or 10.3%, from the second quarter of 2013, as the increase in our net interest margin between the periods was enhanced by the positive impact of a 4.1% increase in the level of our average earning assets. The impact of recent interest rate changes on our net interest margin and net interest income are discussed above in this Report under the sections entitled "Deposit Trends" and "Loan Trends."

As discussed previously under the heading "Asset Quality" beginning on page 47, the provision for loan losses for the second quarter of 2014 was \$505 thousand versus a \$100 thousand provision for the 2013 quarter.

Noninterest Income

Summary of Noninterest Income

(Dollars in Thousands)

| | Quarter Ended | | Change | % Change |
|--|-----------------|-----------------|----------------|--------------|
| | 06/30/2014 | 06/30/2013 | | |
| Income From Fiduciary Activities | \$ 1,906 | \$ 1,758 | \$ 148 | 8.4% |
| Fees for Other Services to Customers | 2,377 | 2,371 | 6 | 0.3 |
| Insurance Commissions | 2,293 | 2,176 | 117 | 5.4 |
| Net (Loss) Gain on Securities Transactions | (27) | 13 | (40) | (307.7) |
| Net Gain on the Sale of Loans | 166 | 498 | (332) | (66.7) |
| Other Operating Income | 304 | 255 | 49 | 19.2 |
| Total Noninterest Income | <u>\$ 7,019</u> | <u>\$ 7,071</u> | <u>\$ (52)</u> | <u>(0.7)</u> |

Total noninterest income in the just completed quarter was \$7.0 million, a decrease of \$52 thousand, or 0.7%, from total noninterest income of \$7.1 million for the second quarter of 2013. We experienced increases in insurance commissions, income from fiduciary activities and other operating income. These net increases were more than offset, however, by securities losses in the 2014 quarter and a decrease in net gains on the sale of loans, as we began to taper our sale of loans to the secondary market during the second half of 2013 and the first two quarters of 2014.

Insurance commission income rose from \$2.2 million for the second quarter of 2013 to \$2.3 million for the second quarter of 2014, an increase of \$117 thousand, or 5.4%. This increase was attributable to organic growth within our four agencies. Income from fiduciary activities in the 2014 quarter increased by \$148 thousand, or 8.4%, from the comparable 2013 quarter. This source of noninterest income typically tracks the dollar value of assets under administration. At quarter-end 2014, the market value of assets under trust administration and investment management amounted to \$1.215 billion, an increase of \$141.3 million, or 13.2%, from June 30, 2013. The increase was generally attributable to a significant rise in the equity markets between the reporting dates and the net addition of new accounts.

Fees for other services to customers includes service charges on deposit accounts, debit card interchange fees, revenues related to the sale of mutual funds to our customers by third party providers and servicing income on sold loans. Effective October 1, 2011 Visa announced new, reduced debit interchange rates and related modifications to comply with new debit card interchange fee rules promulgated by the Federal Reserve under the Dodd-Frank Act. This reduced rate structure has had, and will continue to have, a slight but noticeable negative impact on our fee income. However, debit card usage by our customers continues to grow which has offset at least in part, the negative effect of reduced debit interchange rates. If this usage continues to grow, it will continue to offset the negative impact of reduced interchange fees. Generally, we do not believe that Visa's new limits on interchange fees resulting from Dodd-Frank will have a material adverse impact on our financial condition or results of operations in future periods. However, there is currently a lawsuit challenging the existing post Dodd-Frank fee structure as too high. The Federal Reserve Bank successfully asked the court to permit retention of the current fee structure until the case is settled. Fees for Other Services to Customers was essentially unchanged in the 2014 quarter, compared to the 2013 quarter.

The increase in other operating income in the second quarter of 2014 versus the second quarter of 2013, was primarily due to gains recognized in our investment in business incubator types of limited partnerships.

Noninterest Expense

Summary of Noninterest Expense

(Dollars in Thousands)

| | Quarter Ended | | Change | % Change |
|------------------------------------|------------------|------------------|---------------|----------|
| | 06/30/2014 | 06/30/2013 | | |
| Salaries and Employee Benefits | \$ 7,880 | \$ 7,637 | \$ 243 | 3.2% |
| Occupancy Expense of Premises, Net | 1,268 | 1,117 | 151 | 13.5 |
| Furniture and Equipment Expense | 1,048 | 1,002 | 46 | 4.6 |
| FDIC and FICO Assessments | 282 | 267 | 15 | 5.6 |
| Amortization | 94 | 112 | (18) | (16.1) |
| Other Operating Expense | 3,165 | 3,139 | 26 | 0.8 |
| Total Noninterest Expense | <u>\$ 13,737</u> | <u>\$ 13,274</u> | <u>\$ 463</u> | 3.5 |
| Efficiency Ratio | 58.48% | 60.31% | (1.83)% | (3.0) |

Noninterest expense for the second quarter of 2014 was \$13.7 million, an increase of \$463 thousand, or 3.5%, from the expense for the second quarter of 2013. For the second quarter of 2014, our efficiency ratio was 58.48%. This ratio, which is a commonly used non-GAAP financial measure in the banking industry, is a comparative measure of a financial institution's operating efficiency. The efficiency ratio (a ratio where lower is better) is the ratio of noninterest expense (excluding, under our definition, intangible asset amortization) to (i) net interest income (on a tax-equivalent basis) plus (ii) noninterest income (excluding net securities gains or losses). The efficiency ratio is further discussed on page 35 of this Report under the heading "Use of Non-GAAP Financial Measures." The favorable change in our efficiency ratio between the periods reflected the fact that our core gross income grew faster than our operating expenses. Our efficiency ratios in recent periods have also compared favorably to the ratios of our peer group, even adjusting for the definitional difference. For the year quarter ended March 31, 2014 (the most recent reporting period for which peer group information is available), the peer group efficiency ratio was 71.24%, and our ratio was 59.24% (not adjusted).

Salaries and employee benefits expense increased 3.2% in the second quarter of 2014 over the 2013 quarter, representing the offsetting effects of a 6.1% increase in salaries and a 3.9% decrease in benefits. The decrease in our benefit expenses was primarily attributable to lower pension costs.

The increase in occupancy expense was distributed among all categories including maintenance, utilities, depreciation, taxes, rental expense and insurance.

The increase in furniture and equipment expense was primarily attributable an increase in data processing expenses.

The category demonstrating the largest increase in other operating expense between the periods was third party computer processing expenses, offset to a large extent by reductions in costs to carry real estate acquired through foreclosure and legal expenses.

Income Taxes

Summary of Income Taxes

(Dollars in Thousands)

| | Quarter Ended | | Change | % Change |
|----------------------------|---------------|------------|--------|----------|
| | 06/30/2014 | 06/30/2013 | | |
| Provision for Income Taxes | \$ 2,393 | \$ 2,076 | \$ 317 | 15.3% |
| Effective Tax Rate | 30.2% | 28.5% | 1.7 | 6.0 |

The provisions for federal and state income taxes amounted to \$2.4 million and \$2.1 million for the respective three-month periods of 2014 and 2013. The increase in the effective tax rate was primarily attributable to a one-time historical rehabilitation tax credit in the 2013 period.

RESULTS OF OPERATIONS

Six Months Ended June 30, 2014 Compared With Six Months Ended June 30, 2013

Summary of Earnings Performance

(Dollars in Thousands, Except Per Share Amounts)

| | Six Month Period Ended | | Change | % Change |
|----------------------------|------------------------|------------|---------|----------|
| | 06/30/2014 | 06/30/2013 | | |
| Net Income | \$ 10,844 | \$ 10,388 | \$ 456 | 4.4% |
| Diluted Earnings Per Share | 0.88 | 0.85 | 0.03 | 3.5 |
| Return on Average Assets | 1.00% | 1.01% | (0.01)% | (1.0) |
| Return on Average Equity | 11.20% | 11.78% | (0.58)% | (4.9) |

We reported earnings (net income) of \$10.8 million and diluted earnings per share (EPS) of \$.88 for the six-month period of 2014, compared to net income of \$10.4 million and diluted EPS of \$.85 for the 2013 six-month period.

There were net losses on the sales of securities in the 2014 six-month period of \$16 thousand, net of tax, compared to net gains of \$326 thousand, net of tax, in the 2013 six-month period. Moreover, our net gain on sales of loans in the 2014 six-month period was only \$289 thousand, compared to \$1.1 million of net gains on sales of loans in the 2013 period.

The following narrative discusses the changes between the respective six-month periods in net interest income, noninterest income, noninterest expense and income taxes.

Net Interest Income

Summary of Net Interest Income

(Taxable Equivalent Basis, Dollars in Thousands)

| | Six Month Period Ended | | | |
|--------------------------------------|------------------------|------------|----------|----------|
| | 06/30/2014 | 06/30/2013 | Change | % Change |
| Interest and Dividend Income | \$ 35,276 | \$ 34,048 | \$ 1,228 | 3.6% |
| Interest Expense | 3,149 | 4,462 | (1,313) | (29.4) |
| Net Interest Income | 32,127 | 29,586 | 2,541 | 8.6 |
| Tax-Equivalent Adjustment | 2,315 | 2,243 | 72 | 3.2 |
| Average Earning Assets (1) | 2,060,046 | 1,952,943 | 107,103 | 5.5 |
| Average Interest-Bearing Liabilities | 1,679,119 | 1,615,991 | 63,128 | 3.9 |
| Yield on Earning Assets (1) | 3.45% | 3.52% | (0.07)% | (2.0) |
| Cost of Interest-Bearing Liabilities | 0.38 | 0.56 | (0.18) | (32.1) |
| Net Interest Spread | 3.07 | 2.96 | 0.11 | 3.7 |
| Net Interest Margin | 3.14 | 3.05 | 0.09 | 3.0 |

(1) Includes Nonaccrual Loans

Our net interest margin (net interest income on a tax-equivalent basis by average earning assets, annualized) increased by nine basis points, from 3.05% to 3.14%, between the 2013 six-month period and the 2014 six-month period, representing a 3.0% increase in the margin. (See the discussion under "Use of Non-GAAP Financial Measures," on page 35, regarding our net interest margin and net interest income, which are commonly used non-GAAP financial measures.) Net interest income for the just completed six-month period, on a taxable equivalent basis, increased by \$2.5 million, or 8.6%, from the 2013 six-month period, as the increase in our net interest margin between the periods was enhanced by the positive impact of a 5.5% increase in the level of our average earning assets. The reasons for the change in net interest income and net interest margin between the two periods, and management's views regarding possible future changes in our net interest income and net interest margin, are discussed above under "RESULTS OF OPERATIONS --Three Months Ended June 30, 2014 Compared with Three Months Ended June 30, 2013 -- Net Interest Income" on page 51. The impact of recent interest rate changes in the U.S. economy generally on our net interest margin and net interest income are discussed above in this Report under the sections entitled "Deposit Trends" and "Loan Trends."

As discussed previously under the heading "Asset Quality" beginning on page 47, the provision for loan losses for the six-month periods ended June 30, 2014 and 2013 was \$963 thousand and \$200 thousand, respectively.

Noninterest Income

Summary of Noninterest Income

(Dollars in Thousands)

| | Six Month Period Ended | | | |
|--|------------------------|------------------|-----------------|--------------|
| | 06/30/2014 | 06/30/2013 | Change | % Change |
| Income From Fiduciary Activities | \$ 3,779 | \$ 3,332 | \$ 447 | 13.4% |
| Fees for Other Services to Customers | 4,571 | 4,653 | (82) | (1.8) |
| Insurance Commissions | 4,737 | 4,204 | 533 | 12.7 |
| Net (Loss) Gain on Securities Transactions | (27) | 540 | (567) | (105.0) |
| Net Gain on the Sale of Loans | 289 | 1,105 | (816) | (73.8) |
| Other Operating Income | 556 | 411 | 145 | 35.3 |
| Total Noninterest Income | <u>\$ 13,905</u> | <u>\$ 14,245</u> | <u>\$ (340)</u> | <u>(2.4)</u> |

Total noninterest income in the just completed six-month period was \$13.9 million, a decrease of \$340 thousand, or 2.4%, from total noninterest income of \$14.2 million for the 2013 period. We experienced increases in insurance commissions, income from fiduciary activities and other operating income. These increases were more than offset by the loss on the sale of securities in the 2014 quarter (versus the gain in the 2013 period), a decrease in fees for other services to customers and a decrease in net gains on the sale of loans as we began to taper our sale of loans to the secondary market during the second half of 2013 and the first six months of 2014.

Insurance commission income rose from \$4.2 million for the first six months of 2013 to \$4.7 million for the first six months of 2014, an increase of \$533 thousand, or 12.7%. This increase was primarily attributable to an increase in annual contingent commission income received from certain insurance carriers in the 2014 period but also from organic growth from our four insurance agencies. Income from fiduciary activities increased \$447 thousand, or 13.4%, from the comparable 2013 period. See our discussion on the changes in the market value of assets under trust administration and investment management in the previous section analyzing the quarter-to-quarter changes.

Fees for other services to customers includes service charges on deposit accounts, debit card interchange fees, revenues related to the sale of mutual funds to our customers by third party providers and servicing income on sold loans. We can give no assurances in this regard. The small decrease in fees for other services to customers between the 2013 six-month period and the 2014 six-month period was primarily attributable to decreased revenues in the 2014 period related to the sale of mutual funds to our customers by third party providers. See the discussion in the preceding quarter-to-quarter analysis regarding fees for other services to customers for certain cautions concerning future receipt of revenues in this area beginning on page 52.

The increase in other operating income in the 2014 period versus the 2013 period, was primarily due to a decrease in losses on the sale of other real estate owned in the 2014 period and to gains recognized in our investment in business incubator types of limited partnerships.

Noninterest Expense

Summary of Noninterest Expense

(Dollars in Thousands)

| | Six Month Period Ended | | Change | % Change |
|------------------------------------|------------------------|------------------|---------------|----------|
| | 06/30/2014 | 06/30/2013 | | |
| Salaries and Employee Benefits | \$ 15,522 | \$ 15,258 | \$ 264 | 1.7% |
| Occupancy Expense of Premises, Net | 2,573 | 2,327 | 246 | 10.6 |
| Furniture and Equipment Expense | 2,084 | 2,068 | 16 | 0.8 |
| FDIC and FICO Assessments | 555 | 531 | 24 | 4.5 |
| Amortization | 200 | 236 | (36) | (15.3) |
| Other Operating Expense | 6,269 | 6,265 | 4 | 0.1 |
| Total Noninterest Expense | <u>\$ 27,203</u> | <u>\$ 26,685</u> | <u>\$ 518</u> | 1.9 |
| Efficiency Ratio | 58.63% | 61.10% | (2.47)% | (4.0) |

Noninterest expense for the 2014 six-month period was \$27.2 million, an increase of \$518 thousand, or 1.9%, from the expense for the 2013 six-month period. For the 2014 six-month period, our efficiency ratio was 58.63% versus 61.1% in the 2013 period. This ratio, which is a commonly used non-GAAP financial measure in the banking industry, is a comparative measure of a financial institution's operating efficiency. The efficiency ratio (a ratio where lower is better) is the ratio of noninterest expense (excluding, under our definition, intangible asset amortization) to (i) net interest income (on a tax-equivalent basis) plus (ii) noninterest income (excluding net securities gains or losses). See the discussion on page 35 of this Report under the heading "Use of Non-GAAP Financial Measures." The efficiency ratio included by the Federal Reserve Board in its "Peer Holding Company Performance Reports" excludes net securities gains or losses from the denominator (as does our calculation), but unlike our ratio does not exclude intangible asset amortization from the numerator. The favorable change in our efficiency ratio between the periods reflected the fact that our core gross income grew faster than our operating expenses. Our efficiency ratios in recent periods have also compared favorably to the ratios of our peer group, even adjusting for the definitional difference. For the quarter ended March 31, 2014 (the most recent reporting period for which peer group information is available), the peer group efficiency ratio was 71.24%, and our ratio was 59.24% (not adjusted).

Salaries and employee benefits expense increased 1.7% for the 2014 six-month period, compared to the 2013 period, representing a 4.6% increase in salaries offset in part by a 4.8% decrease in benefits. The decrease in our benefit expenses was primarily attributable to lower pension costs.

The increase in occupancy expense was distributed among all categories including maintenance, utilities, depreciation, taxes, rental expense and insurance.

The increase in furniture and equipment expense was primarily attributable to increases in data processing expenses.

The subcategory of other operating expense demonstrating the largest increase between the periods was third party computer processing expenses, which was almost completely offset by reductions in other subcategories, including costs to carry real estate acquired through foreclosure, legal and telecommunications expenses.

Income Taxes

Summary of Income Taxes

(Dollars in Thousands)

| | Six Month Period Ended | | Change | % Change |
|----------------------------|------------------------|------------|--------|----------|
| | 06/30/2014 | 06/30/2013 | | |
| Provision for Income Taxes | \$ 4,707 | \$ 4,315 | \$ 392 | 9.1% |
| Effective Tax Rate | 30.3% | 29.3% | 1.0 | 3.4 |

The provisions for federal and state income taxes amounted to 4.7 million and \$4.3 million for the respective six-month periods of 2014 and 2013. The increase in the effective tax rate was primarily attributable to a one-time historical rehabilitation tax credit in the 2013 period.

Item 3.**QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK**

In addition to credit risk in our loan portfolio and liquidity risk, discussed on page 50 of this Report, we have market risk in our business activities. Market risk is the possibility that changes in future market rates (interest rates) or prices (fees for products and services) will make our position less valuable. The ongoing monitoring and management of market risk, principally interest rate risk, is an important component of our asset/liability management process, which is governed by policies that are reviewed and approved annually by the Board of Directors. The Board of Directors delegates responsibility for carrying out asset/liability oversight and control to management's Asset/Liability Committee ("ALCO"). In this capacity ALCO develops guidelines and strategies impacting our asset/liability profile based upon estimated market risk sensitivity, policy limits and overall market interest rate levels and trends. As of the date of this report, we have not made use of derivatives, such as interest rate swaps, in our risk management process.

Interest rate risk is the exposure of our net interest income to changes in interest rates. Interest rate risk is directly related to the different maturities and repricing characteristics of interest-bearing assets and liabilities, as well as to the risk of prepayment of loans and early withdrawal of time deposits, and the fact that the speed and magnitude of responses to interest rate changes vary by product.

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

Our current simulation model captures the impact of changing interest rates on the interest income received and interest expense paid on all interest rate-sensitive assets and liabilities reflected on our consolidated balance sheet. This sensitivity analysis is compared to pre-established ALCO policy limits which specify a maximum tolerance level for net interest income exposure over a one year horizon. Our current sensitivity analysis model examines both a hypothetical upward shift of interest rates (currently, 200 basis points) and a hypothetical downward shift in interest rates (currently, 100 basis points, subject to certain limitations), and assumes no subsequent change in the balance sheet and a repricing of interest-bearing assets and liabilities at their earliest reasonably predictable repricing date. For repricing purposes, we normally assume a parallel and pro-rata shift in rates for both assets and liabilities, over a 12 month period.

We occasionally are forced to make ad hoc adjustments to our model. During recent years, the Federal Reserve's targeted federal funds rate has remained within a range of 0 to .25%. The resulting abnormally low short-term rates have led us to revise our standard model for the decreasing interest rate simulation for short-term liabilities and assets. We have applied our usual 100 basis point downward shift in interest rates for liabilities and assets on the long end of the yield curve, but we have been limited by an absolute floor of a zero interest rate for the modeling of our short-term liabilities and assets. Consequently, for purposes of determining the effect of a downward shift in rates under our current simulation model, we have made no downward shift in interest rates for our short-term liabilities and assets, even if such rates slightly exceed zero at the measurement date. We also assume that hypothetical interest rate shifts, upward or downward, affect assets and liabilities simultaneously, depending upon the contractual maturities of the particular assets and liabilities in question. In practice, however, shifts in prevailing interest rates typically affect our liability portfolios (primarily deposits) more rapidly than our asset portfolios, irrespective of differences in contractual maturities.

Applying the simulation model analysis as of June 30, 2014, a 200 basis point increase in all interest rates demonstrated a 3.73% decrease in net interest income over the ensuing 12 month period, and a 100 basis point decrease in long-term interest rates (with no decrease in short-term rates, or adjusted as discussed above) demonstrated a 1.31% decrease in net interest income, when compared with our base projection. These amounts were well within our ALCO policy limits. The preceding sensitivity analysis does not represent a forecast on our part and should not be relied upon as being indicative of expected operating results.

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

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

In general, our interest-bearing liabilities will reprice more rapidly in a rising rate environment than our interest-earning assets, resulting in a short-term decrease in net interest income as reported in the simulation analysis, above. However, many of our interest-earning assets have relatively short lives and within a few quarters after the first year period following a rise in rates we would expect that the positive impact from the repricing of the interest-earning assets upward will more than make up for the continuing increases in interest expense.

Item 4.**CONTROLS AND PROCEDURES**

Senior management, including the Chief Executive Officer and Chief Financial Officer, has evaluated the effectiveness of the design and operation of Arrow's disclosure controls and procedures (as defined in Rule 13a-15(e) under the Securities Exchange Act of 1934, as amended) as of June 30, 2014. Based upon that evaluation, senior management, including the Chief Executive Officer and Chief Financial Officer, concluded that our disclosure controls and procedures were effective. Further, there were no changes made in our internal control over financial reporting that occurred during the most recent fiscal quarter that had materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

PART II - OTHER INFORMATION

Item 1.

Legal Proceedings

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

Item 1.A.

Risk Factors

We believe that the risk factors identified in our Annual Report on Form 10-K for the year ended December 31, 2013, continue to represent the most significant risks to our future results of operations and financial conditions, without modification or amendment. Please refer to such risk factors listed in Part I, Item 1A. of our Annual Report on Form 10-K for the fiscal year ended December 31, 2013.

Item 2.

Unregistered Sales of Equity Securities and Use of Proceeds

Unregistered Sales of Equity Securities

None

Issuer Purchases of Equity Securities

The following table presents information about purchases by Arrow of its common stock during the three months ended June 30, 2014:

| Second Quarter 2014 Calendar Month | (A) Total Number of Shares Purchased ¹ | (B) Average Price Paid Per Share ¹ | (C) | (D) |
|---------------------------------------|---|---|---|--|
| | | | 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 ³ |
| April | 6,511 | \$ 25.31 | 5,000 | \$ 4,155,217 |
| May | 12,573 | 25.00 | 10,536 | 3,891,140 |
| June | 18,305 | 25.19 | — | 3,891,140 |
| Total | <u>37,389</u> | <u>25.15</u> | <u>15,536</u> | |

¹ Share amounts and average prices listed in columns A and B (total number of shares purchased and the average price paid per share) include, in addition to shares repurchased under the Company's publicly announced stock repurchase program, shares purchased in open market transactions under the Arrow Financial Corporation Automatic Dividend Reinvestment Plan (DRIP) by the administrator of the DRIP and shares surrendered (or deemed surrendered) to Arrow by holders of options to acquire Arrow common stock in connection with the exercise of such options. In the months indicated, the total number of shares purchased listed in column A included the following numbers of shares purchased through such additional methods: April – DRIP market purchases (1,046 shares), exercise of stock options (465 shares); May – DRIP market purchases (2,037 shares); June – DRIP market purchases (18,305 shares).

² Shares repurchased by the Company under its publicly-announced stock repurchase program (i.e., the \$5 million stock repurchase program authorized by the Board of Directors in November 2013 and effective January 1, 2014 (the "2014 Repurchase Program")) during the quarter.

³ Represents the dollar amount of repurchase authority remaining at each month-end during the quarter under the 2014 Repurchase Program, the Company's only publicly-announced stock repurchase program in effect at the end of each such month.

Item 3.

Defaults Upon Senior Securities - None

Item 4.

Mine Safety Disclosures - None

Item 5.

Other Information - None

Item 6.
Exhibits

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

SIGNATURES

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

ARROW FINANCIAL CORPORATION

Registrant

August 6, 2014

Date

/s/Thomas J. Murphy

Thomas J. Murphy, President and
Chief Executive Officer

August 6, 2014

Date

/s/Terry R. Goodemote

Terry R. Goodemote, Executive Vice President,
Treasurer and Chief Financial Officer
(Principal Financial Officer and
Principal Accounting Officer)