ARROW FINANCIAL CORP
Form 10-K
March 14, 2017

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

Annual Report Pursuant to Section 13 or 15(d) of
The Securities Exchange Act of 1934
For the Fiscal Year Ended December 31, 2016
Commission File Number: 0-12507
ARROW FINANCIAL CORPORATION

(Exact name of registrant as specified in its charter)

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

250 GLEN STREET, GLENS FALLS, NEW YORK 12801
(Address of principal executive offices) (Zip Code)
Registrant’s telephone number, including area code: (518) 745-1000
SECURITIES REGISTERED PURSUANT TO SECTION 12(b) OF THE ACT: NONE
SECURITIES REGISTERED PURSUANT TO SECTION 12(g) OF THE ACT:
Common Stock, Par Value $1.00
(Title of Class)
Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes x No
Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes x No
Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. x Yes

No
Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Website, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§ 232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). x Yes No
Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K (§ 229.405 of this chapter) is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K.
x
Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of “large accelerated filer,” “accelerated filer” and “smaller reporting company” in Rule 12b-2 of the Exchange Act.

Large accelerated filer	Accelerated filer x	Non-accelerated filer	Smaller reporting company

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Act). Yes x No
State the aggregate market value of the voting and non-voting common equity held by non-affiliates computed by reference to the price at which the common equity was last sold, or the average bid and asked price of such common equity, as of the last business day of the registrant’s most recently completed second fiscal quarter: $393,513,749
Indicate the number of shares outstanding of each of the registrant’s classes of common stock, as of the latest practicable date.

Class	Outstanding as of February 28, 2017
Common Stock, par value $1.00 per share	13,510,698

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the Registrant’s Proxy Statement for the Annual Meeting of Stockholders to be held May 3, 2017 (Part III)

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*These items are incorporated by reference to the Corporation’s Proxy Statement for the Annual Meeting of Stockholders to be held May 3, 2017.

NOTE ON TERMINOLOGY

In this Annual Report on Form 10-K, the terms “Arrow,” “the registrant,” “the company,” “we,” “us,” and “our” generally refe Arrow Financial Corporation and subsidiaries as a group, except where the context indicates otherwise. 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 325 domestic (U.S.-based) bank holding companies with $1 to $3 billion in total consolidated assets as identified in the Federal Reserve Board’s most recent “Bank Holding Company Performance Report” (which is the Performance Report for the most recently available period ending September 30, 2016), and peer group data has been derived from such Report. This peer group is not, however, identical to either of the peer groups comprising the two bank indices included in the stock performance graphs on pages 19 and 20 of this Report.

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. Active subsidiaries of Glens Falls National include Capital Financial Group, Inc. (an insurance agency specializing in selling and servicing group health care policies and life insurance), Upstate Agency, LLC (a property and casualty insurance agency), Glens Falls National Insurance Agencies, LLC (a property and casualty insurance agency - currently doing business under the name of McPhillips Insurance Agency), North Country Investment Advisers, Inc. (a registered investment adviser that provides investment advice to our proprietary mutual funds) and Arrow Properties, Inc. (a real estate investment trust, or REIT). Our holding company also owns directly two subsidiary business trusts, organized in 2003 and 2004 to issue trust preferred securities (TRUPs), which are still outstanding.

FORWARD-LOOKING STATEMENTS

The information contained in this Annual Report on Form 10-K contains statements that are not historical in nature but rather are based on our beliefs, assumptions, expectations, estimates and projections about the future. These statements are “forward-looking statements” within the meaning of Section 21E of the Securities Exchange Act of 1934, as amended, and involve a degree of uncertainty and attendant risk. Words such as “expects,” “believes,” “anticipates,” “estimates” and variations of such words and similar expressions often identify such forward-looking statements. Some of these statements, such as those included in the interest rate sensitivity analysis in Item 7A of this Report, entitled “Quantitative and Qualitative Disclosures About Market Risk,” are merely presentations of what future performance or changes in future performance would look like based on hypothetical assumptions and on simulation models. Other forward-looking statements are based on our general perceptions of market conditions and trends in activity, both locally and nationally, as well as current management strategies for future operations and development.

Forward-looking statements in this Report include the following:

Topic	Section	Page	Location
Dividend Capacity	Part I, Item 1.C.	8	First paragraph under "Dividend Restrictions; Other Regulatory Sanctions"
	Part II, Item 7.E.	48	First paragraph under "Dividends"
Impact of Legislative Developments	Part I, Item 1.D.	10	Last paragraph in Section D
	Part II, Item 7.A.	11	Paragraph in "Health Care Reform"
Visa Stock		28	Paragraph under "Visa Class B Common Stock"

	Part II, Item 7.A.		
Impact of Changing Interest Rates on Earnings	Part II, Item 7.C.II.a.	41	Last paragraph under “Automobile Loans”
	Part II, Item 7.C.II.a.	40	Last two paragraphs
	Part II, Item 7A.	52	Last four paragraphs
Adequacy of the Allowance for Loan Losses	Part II, Item 7.B.II.	33	First paragraph under “II. Provision For Loan Losses and Allowance For Loan Losses”
Noninterest Income	Part II, Item 7.C.III	34	Paragraphs four and five under "2016 Compared to 2015"
Expected Level of Real Estate Loans	Part II, Item 7.C.II.a.	40	Paragraphs under “Residential Real Estate Loans”
Expected Level of Commercial Loans	Part II, Item 7.C.II.a.	41	Paragraphs under “Commercial, Commercial Real Estate and Construction and Land Development Loans”
Expected Level of Nonperforming Assets	Part II, Item 7.C.II.c.	43	Last two paragraphs under "Potential Problem Loans"
Liquidity	Part II, Item 7.D.	47	Last two paragraphs under "Liquidity"
Commitments to Extend Credit	Part II, Item 8	81	Last two paragraphs in Note 8
Pension plan return on assets	Part II, Item 8	96	Second to last paragraph in Note 13
Realization of recognized net deferred tax assets	Part II, Item 8	97	Second to last paragraph in Note 15

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

a. rapid and dramatic changes in economic and market conditions, such as the U.S. economy experienced during the financial crisis of 2008-2010;
b. sharp fluctuations in interest rates, economic activity, or consumer spending patterns;
c. sudden changes in the market for products we provide, such as real estate loans;
d. significant changes in banking or other laws and regulations, including both enactment of new legal or regulatory measures (e.g., the Dodd-Frank Act) or the modification or elimination of pre-existing measures
e. significant changes in U.S. monetary or fiscal policy, including new or revised monetary programs or targets adopted or announced by the Federal Reserve ("monetary tightening or easing") or significant new federal legislation materially affecting the federal budget ("fiscal tightening or expansion");
f. enhanced competition from unforeseen sources (e.g., so-called Fintech enterprises); and
g. similar uncertainties inherent in banking operations or business generally, including technological developments and changes.

We are under no duty to update any of the forward-looking statements after the date of this Annual Report on Form 10-K to conform such statements to actual results. All forward-looking statements, express or implied, included in this report and the documents we incorporate by reference and that are attributable to the Company are expressly qualified in their entirety by this cautionary statement. This cautionary statement should also be considered in connection with any subsequent written or oral forward-looking statements that the Company or any persons acting on our behalf may issue.

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

The Efficiency Ratio: Financial institutions often use an "efficiency ratio" as a measure of expense control. The efficiency ratio typically is defined as the ratio of noninterest expense to net interest income and noninterest income. Net interest income as utilized in calculating the efficiency ratio is typically the same as the net interest income presented in Selected Financial Information table discussed in the preceding paragraph, i.e., it is expressed on a tax-equivalent basis. Moreover, many 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 (which is included in noninterest expense under GAAP but may not be included therein for purposes of calculating the efficiency ratio) and securities gains or losses (which are reflected in the calculation of noninterest income under GAAP but may be ignored for purposes of calculating the efficiency ratio). We make these adjustments.

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 in our case, essentially represents goodwill.

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Adjustments for Certain Items of Income or Expense: In addition to our regular utilization in our public filings and disclosures of the various non-GAAP measures commonly utilized by financial institutions discussed above, we also may elect from time to time, in connection with our presentation of various financial measures prepared in accordance with GAAP, such as net income, earnings per share (i.e. EPS), return on average assets (i.e. ROA), and return on average equity (i.e. ROE), to provide as well certain comparative disclosures that adjust these GAAP financial measures, typically by removing therefrom the impact of certain transactions or other material items of income or expense that are unusual or unlikely to be repeated. We do so only if we believe that inclusion of the resulting non-GAAP financial measures may improve the average investor's understanding of our results of operations by separating out items that have a disproportional positive or negative impact on the particular period in question or by otherwise permitting a better comparison from period-to-period in our results of operations with respect to our fundamental lines of business, including the commercial banking business.
We believe that the non-GAAP financial measures disclosed by us from time-to-time are useful in evaluating our performance and that such information should be considered as supplemental in nature, and not as a substitute for or superior to, the related financial information prepared in accordance with GAAP. Our non-GAAP financial measures may differ from similar measures presented by other companies.

PART I

Item 1. Business

A. GENERAL

Our holding company, Arrow Financial Corporation, a New York corporation, was incorporated on March 21, 1983 and is registered as a bank holding company within the meaning of the Bank Holding Company Act of 1956. Arrow owns two nationally- chartered banks in New York (Glens Falls National and Saratoga National), and through such banks indirectly owns various non-bank subsidiaries, including three insurance agencies, a registered investment adviser and a REIT. See "The Company and Its Subsidiaries," above.

Subsidiary Banks (dollars in thousands)

	Glens Falls National	Saratoga National
Total Assets at Year-End	$ 2,158,385	$ 443,258
Trust Assets Under Administration and Investment Management at Year-End (Not Included in Total Assets)	$ 1,217,312	$ 84,096
Date Organized	1851	1988
Employees (full-time equivalent)	473	51
Offices	30	9
Counties of Operation	Warren, Washington, Saratoga, Essex & Clinton	Saratoga, Albany & Rensselaer
Main Office	250 Glen Street Glens Falls, NY	171 So. Broadway Saratoga Springs, NY

The holding company's business consists primarily of the ownership, supervision and control of our two banks, including the banks' subsidiaries. The holding company provides various advisory and administrative services and coordinates the general policies and operation of the banks. There were 524 full-time equivalent employees, including

62 employees within our insurance agency affiliates, at December 31, 2016.

We offer a broad range of commercial and consumer banking and financial products. Our deposit base consists of deposits derived principally from the communities we serve. We target our lending activities to consumers and small and mid-sized companies in our immediate geographic areas. Through our banks' trust operations, we provide retirement planning, trust and estate administration services for individuals, and pension, profit-sharing and employee benefit plan administration for corporations.

B. LENDING ACTIVITIES

Arrow engages in a wide range of lending activities, including commercial and industrial lending primarily to small and mid-sized companies; mortgage lending for residential and commercial properties; and consumer installment and home equity financing. We also maintain an active indirect lending program through our sponsorship of automobile dealer programs under which we purchase dealer paper, primarily from dealers that meet pre-established specifications. From time to time, we sell a portion of our residential real estate loan originations into the secondary market, primarily to the Federal Home Loan Mortgage Corporation ("Freddie Mac") and governmental agencies. Normally, we retain the servicing rights on mortgage loans originated and sold by us into the secondary markets, subject to our periodic determinations on the continuing profitability of such activity.

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

We lend almost exclusively to borrowers within our normal retail service area in northeastern New York State, with the exception of our indirect consumer lending line of business, where we acquire retail paper from an extensive network of automobile dealers

that operate in a larger area of upstate New York, and in central and southern Vermont. The loan portfolio does not include any foreign loans or any other significant risk concentrations. We do not generally participate in loan syndications, either as originator or as a participant. However, from time to time, we buy participations in individual loans, typically commercial loans, originated by other financial institutions in New York and adjacent states. In recent periods, the total dollar amount of such participations has fluctuated, but generally represents less than 20% of commercial loans outstanding. Most of the portfolio is fully collateralized, and many commercial loans are further supported by personal guarantees.
We do not engage in subprime mortgage lending as a business line and we do not extend or purchase so-called "Alt A," "negative amortization," "option ARM's" or "negative equity" mortgage loans.

C. SUPERVISION AND REGULATION
The following generally describes the laws and regulations to which we are subject. Bank holding companies, banks and their affiliates are extensively regulated under both federal and state law. To the extent that the following information summarizes statutory or regulatory law, it is qualified in its entirety by reference to the particular provisions of the various statutes and regulations. Any change in applicable law may have a material effect on our business operations, customers, prospects and investors.

Bank Regulatory Authorities with Jurisdiction over Arrow and its Subsidiary Banks

Arrow is a registered bank holding company within the meaning of the Bank Holding Company Act of 1956 ("BHC Act") and as such is subject to regulation by the Board of Governors of the Federal Reserve System ("FRB"). As a "bank holding company" under New York State law, Arrow is also subject to regulation by the New York State Department of Financial Services. Our two subsidiary banks are both national banks and are subject to supervision and examination by the Office of the Comptroller of the Currency ("OCC"). The banks are members of the Federal Reserve System and the deposits of each bank are insured by the Deposit Insurance Fund of the Federal Deposit Insurance Corporation ("FDIC"). The BHC Act generally prohibits Arrow from engaging, directly or indirectly, in activities other than banking, activities closely related to banking, and certain other financial activities. Under the BHC Act, a bank holding company generally must obtain FRB approval before acquiring, directly or indirectly, voting shares of another bank or bank holding company, if after the acquisition the acquiror would own 5 percent or more of a class of the voting shares of that other bank or bank holding company. Bank holding companies are able to acquire banks or other bank holding companies located in all 50 states, subject to certain limitations. Bank holding companies that meet certain qualifications may choose to apply to the Federal Reserve Board for designation as "financial holding companies." If they obtain such designation, they will thereafter be eligible to acquire or otherwise affiliate with a much broader array of other financial institutions than "bank holding companies" are eligible to acquire or affiliate with, including insurance companies, investment banks and merchant banks. Arrow has not attempted to become, and has not been designated as, a financial holding company. See Item 1.D., "Recent Legislative Developments."

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

Regulatory Supervision of Other Arrow Subsidiaries

The insurance agency subsidiaries of Glens Falls National are subject to the licensing and other provisions of New York State Insurance Law and are regulated by the New York State Department of Financial Services. Arrow's investment adviser subsidiary is subject to the licensing and other provisions of the federal Investment Advisers Act of 1940 and is regulated by the Securities and Exchange Commission (SEC).

Regulation of Transactions between Banks and their Affiliates

Transactions between banks and their "affiliates" are regulated by Sections 23A and 23B of the Federal Reserve Act (FRA). Each of our organization's non-bank subsidiaries (other than the business trusts we formed to issue our TRUPs) is a subsidiary of one of our banks, and also is an "operating subsidiary" under Sections 23A and 23B. This means the non-bank subsidiary is considered to be part of the bank that owns it and thus is not an affiliate of the bank for purposes of Section 23A and 23B. However, each of our two banks is an affiliate of the other bank, and our holding company (Arrow) is also an affiliate of each bank. Extensions of credit that a bank may make to affiliates, or to third parties secured by securities or obligations of the affiliates, are substantially limited by the FRA and the Federal Deposit Insurance Act (FDIA). Such acts further restrict the range of permissible transactions between a bank and any affiliate, including a bank affiliate. Furthermore, under the FRA, a bank may engage in certain transactions, including loans and purchases of assets, with a non-bank affiliate, only if certain special conditions, including collateral requirements for loans, are met and if the other terms and conditions of the transaction, including interest rates and credit standards, are substantially the same as, or at least as favorable to the bank as, those prevailing at the time for comparable transactions by the bank with non-affiliated companies or, in the absence of comparable transactions, on terms and conditions that would be offered by the bank to non-affiliated companies.

Regulatory Capital Standards

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

Bank Capital Rules. The Dodd-Frank Act, among other things, directed U.S. bank regulators to promulgate revised capital standards for U.S. banking organizations, which needed be at least as strict (i.e., must establish minimum capital levels that are at least as high) as the regulatory capital standards that were in effect for U.S. insured depository financial institutions at the time Dodd-Frank was enacted in 2010.

In July 2013, federal bank regulators, including the FRB and the OCC, approved their revised bank capital rules aimed at implementing these Dodd-Frank capital requirements. These rules were also intended to coordinate U.S. bank capital standards with the current drafts of the Basel III proposed bank capital standards for all of the developed world's banking organizations. The federal regulators' revised capital rules (the "Capital Rules"), which impose significantly higher minimum capital ratios on U.S. financial institutions than the rules they replaced, became effective for our holding company and banks on January 1, 2015, and will be fully phased in by 2019.

The revised Capital Rules, like the rules they replaced, consist of two basic types of capital measures, a leverage ratio and set of risk-based capital measures. Within these two broad types of rules, however, significant changes were made in the revised Capital Rules, as discussed below.

Leverage Rule. The revised Capital Rules did not fundamentally alter the structure of the leverage rule that previously applied to banks and bank holding companies, except to increase the minimum required leverage ratio from 3.0% to 4.0%. The leverage ratio continues to be defined as the ratio of the institution's "Tier 1" capital (as defined under the new leverage rule) to total tangible assets (again, as defined under the revised leverage rule).

Risk-Based Capital Measures. The principal changes under the revised Capital Rules involve the other basic type of regulatory capital measures, the so-called risk-based capital measures. As a general matter, risk-based capital measures assign various risk weightings to all of the institution's assets, by asset type, and to certain off-balance sheet items, and then establish minimum levels of capital to the aggregate dollar amount of such risk-weighted assets. The general effect of the revised risk-based Capital Rules was to increase most of the pre-existing risk-based minimum capital ratios and to introduce several new minimum capital ratios and capital definitions. The basic result was to increase required capital for banks and their holding companies.

Under the revised risk-based Capital Rules, there are 8 major risk-weighted categories of assets (although there are several additional super-weighted categories for high-risk assets that are generally not held by community banking organizations like ours). The revised rules also are more restrictive in their definitions of what qualify as capital components. Most importantly, the revised rules, as required under Dodd-Frank, added several risk-based capital measures that also must be met. One such measure is the "common equity tier 1 capital ratio" (CET1). For this ratio, only common equity (basically, common stock plus surplus plus retained earnings) qualifies as capital (i.e., CET1). Preferred stock and trust preferred securities, which qualified as Tier 1 capital under the old Tier 1 risk-based capital measure (and continue to qualify as capital under the revised Tier 1 risk-based capital measure), are not included in CET1 capital. Technically, under the revised rules, CET1 capital also includes most elements of accumulated other comprehensive income (AOCI), including unrealized securities gains and losses, as part of both total regulatory capital (numerator) and total assets (denominator). However, smaller banking organizations like ours were given the opportunity to make a one-time irrevocable election to include or not to include certain elements of AOCI, most notably unrealized securities gains or losses. We made such an election, i.e., not to include unrealized securities gains and losses in calculating our CET1 ratio under the revised Capital Rules. The minimum CET1 ratio under the revised rules, effective January 1, 2015, is 4.50%, which will remain constant throughout the phase-in period.

Consistent with the general theme of higher capital levels, the revised Capital Rules also increased the minimum ratio for Tier 1 risk-based capital, which was 4.0%, to 6.0%, effective January 1, 2015. The minimum level for total risk-based capital under the revised Capital Rules remained at 8.0%, the same level as under the old rules.

The revised Capital Rules incorporate a capital concept, the so-called "capital conservation buffer" (set at 2.5%, after full phase-in), which must be added to each of the minimum required risk-based capital ratios (i.e., the minimum CET1 ratio, the minimum Tier 1 risk-based capital ratio and the minimum total risk-based capital ratio). The capital conservation buffer is being phased-in over four years beginning January 1, 2016 (see the table below). When, during economic downturns, an institution's capital begins to erode, the first deductions from a regulatory perspective would be taken against the conservation buffer. To the extent that such deductions should erode the buffer below the required level (2.5% of total risk-based assets), the institution will not necessarily be required to replace the buffer deficit immediately, but will face restrictions on paying dividends and other negative consequences until the buffer is fully replenished.

Also under the revised Capital Rules, and as required under Dodd-Frank, TRUPs issued by small- to medium-sized banking organizations (such as ours) that were outstanding on the Dodd-Frank grandfathering date for TRUPS (May 19, 2010) will continue to qualify as tier 1 capital, up to a limit of 25% of tier 1 capital, until the TRUPs mature or are redeemed. See the discussion of grandfathered TRUPs in section D of this item under "The Dodd-Frank Act."

The following is a summary of the revised definitions of capital under the various new risk-based measures in the revised Capital Rules:

Common Equity Tier 1 Capital (CET1): Equals the sum of common stock instruments and related surplus (net of treasury stock), retained earnings, accumulated other comprehensive income (AOCI), and qualifying minority interests, minus applicable regulatory adjustments and deductions. Such deductions will include AOCI, if the organization has exercised its irrevocable option not to include AOCI in capital (we made such an election). Mortgage-servicing assets, deferred tax assets, and investments in financial institutions are limited to 15 percent of CET1 in the aggregate and 10 percent of CET1 for each such item individually.
Additional Tier 1 Capital: Equals the sum of noncumulative perpetual preferred stock, tier 1 minority interests, grandfathered TRUPs, and Troubled Asset Relief Program instruments, minus applicable regulatory adjustments and deductions.
Tier 2 Capital: Equals the sum of subordinated debt and preferred stock, total capital minority interests not included in Tier 1, and allowance for loan and lease losses (not exceeding 1.25 percent of risk-weighted assets) minus applicable regulatory adjustments and deductions.

The following table presents the transition schedule applicable to our holding company and banks under the revised Capital Rules:

Year, as of January 1	2016	2017	2018	2019
Minimum CET1 Ratio	4.500%	4.500%	4.500%	4.500 %
Capital Conservation Buffer ("Buffer")	0.625%	1.250%	1.875%	2.500 %
Minimum CET1 Ratio Plus Buffer	5.125%	5.750%	6.375%	7.000 %
Minimum Tier 1 Risk-Based Capital Ratio	6.000%	6.000%	6.000%	6.000 %
Minimum Tier 1 Risk-Based Capital Ratio Plus Buffer	6.625%	7.250%	7.875%	8.500 %
Minimum Total Risk-Based Capital Ratio	8.000%	8.000%	8.000%	8.000 %
Minimum Total Risk-Based Capital Ratio Plus Buffer	8.625%	9.250%	9.875%	10.500%
Minimum Leverage Ratio	4.000%	4.000%	4.000%	4.000 %

These minimum capital ratios, especially the CET1 ratio (4.5%) and the enhanced Tier 1 risk-based capital ratio (6.0%), which began to apply to our organization on January 1, 2015, represent a heightened and more restrictive capital regime than institutions like ours previously had to meet, and the four year phase-in of the regulatory capital buffer, which began January 1, 2016, will add to the stress on banks' profitability.
At December 31, 2016, our holding company and both of our banks exceeded by a substantial amount each of the applicable minimum capital ratios established under the revised Capital Rules, including the minimum CET1 Ratio, the minimum Tier 1 Risk-Based Capital Ratio, the minimum Total Risk-Based Capital Ratio, and the minimum Leverage Ratio, including in the case of each risk-based ratio, the phased-in portion of the capital buffer. See Note 19 to our audited financial statements, beginning on page 102, for a presentation of our period-end ratios for 2016 and 2015.

Regulatory Capital Classifications. Under applicable banking law, federal banking regulators are required to take prompt corrective action with respect to depository institutions that do not meet minimum capital requirements. The regulators have established five capital classifications for banking institutions, ranging from the highest category of "well-capitalized" to the lowest category of "critically under-capitalized". As a result of the regulators' adoption of the revised Capital Rules, the definitions for determining which of the five capital classifications a particular banking organization will fall into were changed, effective as of January 1, 2015. Under the revised capital classifications, a banking institution is considered "well-capitalized" if it meets the following capitalization standards on the date of measurement: a CET1 risk-based capital ratio of 6.50% or greater, a Tier 1 risk-based capital ratio of 8.00% or greater, and a total risk-based capital ratio of 10.00% or greater, provided the institution is not subject to any

regulatory order or written directive regarding capital maintenance.
As of December 31, 2016, our holding company and both of our banks qualified as "well-capitalized" under the revised capital classification scheme.

Dividend Restrictions; Other Regulatory Sanctions

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

In cases where banking regulators have significant concerns regarding the financial condition, assets or operations of a bank holding company or one of its banks, the regulators may take enforcement action or impose enforcement orders, formal or informal, against the holding company or the particular bank. If the ratio of tangible equity to total assets of a bank falls to 2% or below, the bank will likely be closed and placed in receivership, with the FDIC as receiver.

Cybersecurity

In additional to the provisions in the Gramm-Leach-Bliley Act relating to data security, Arrow and its subsidiaries are subject to many federal and state laws, regulations and regulatory interpretations which impose standards and requirements related to cybersecurity. For example, in March 2015, federal regulators issued two related statements regarding cybersecurity. One statement indicates that financial institutions should design multiple layers of security controls to establish lines of defense and to ensure that their risk management processes also address the risk posed by compromised customer credentials, including security measures to reliably authenticate customers accessing internet-based services of the financial institution. The other statement indicates that a financial institution's management is expected to maintain sufficient business continuity planning processes to ensure the rapid recovery, resumption and maintenance of the institution's operations after a cyber-attack involving destructive malware. A financial institution is also expected to develop appropriate processes to enable recovery of data and business operations and address rebuilding network capabilities and restoring data if the institution or its critical service providers fall victim to this type of cyber-attack. Financial institutions that fail to observe this regulatory guidance on cybersecurity may be subject to various regulatory sanctions, including financial penalties.

Anti-Money Laundering and OFAC

Under federal law, financial institutions must maintain anti-money laundering programs that include established internal policies, procedures, and controls. Financial institutions are also prohibited from entering into specified financial transactions and account relationships and must meet enhanced standards for due diligence and customer identification. Financial institutions must take reasonable steps to conduct enhanced scrutiny of account relationships to guard against money laundering and to report any suspicious transactions. Law enforcement authorities have been granted increased access to financial information maintained by financial institutions. Bank regulators routinely examine institutions for compliance with these obligations and they must consider an institution's compliance in connection with the regulatory review of applications, including applications for banking mergers and acquisitions. The U.S. Department of the Treasury's Office of Foreign Assets Control, or "OFAC," is responsible for helping to insure that U.S. entities do not engage in transactions with certain prohibited parties, as defined by various Executive Orders and Acts of Congress. OFAC publishes lists of persons, organizations, and countries suspected of aiding, harboring or engaging in terrorist acts, known as Specially Designated Nationals and Blocked Persons. If Arrow finds a name on any transaction, account or wire transfer that is on an OFAC list, Arrow must freeze or block such account or transaction, file a suspicious activity report and notify the appropriate authorities. The U.S. Treasury Department's Financial Crises Enforcement Network ("FinCEN") issued a final rule in 2016 increasing customer due diligence requirements for banks, including adding a requirement to identify and verify the identity of beneficial owners of customers that are legal entities, subject to certain exclusions and exemptions. Compliance with this rule is required in May 2018.

Reserve Requirements

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

Community Reinvestment Act

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

Privacy and Confidentiality Laws

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

The Dodd-Frank Act

As a result of the 2008-2009 financial crisis, the U.S. Congress passed and the President signed Dodd-Frank on July 21, 2010. While some of the Act's provisions have not had, and likely will not have, any direct impact on Arrow, other provisions have impacted or likely will impact our business operations and financial results in a significant way. These include the establishment of a new regulatory body known as the Consumer Financial Protection Bureau (CFPB), which operates as an independent entity within the Federal Reserve System and is authorized to issue rules for consumer protection, some of which have increased, and likely will continue to increase banks' compliance expenses, thereby negatively impacting profitability. For depository institutions with $10 billion or less in assets (such as Arrow's banks), the banks' traditional regulatory agencies (for our banks, the OCC), and not the CFPB, will have primary examination and enforcement authority over the banks' compliance with new CFPB rules as well as all other consumer protection rules and regulations. However, the CFPB has the right to include its examiners on a "sampling" basis in examinations conducted by the traditional regulators and is authorized to give those agencies input and recommendations with respect to consumer protection laws and to require reports and other examination documents. The CFPB has broad authority to curb practices it finds to be unfair, deceptive and abusive. What constitutes "abusive" behavior has been broadly defined and is very likely to create an environment conducive to increased litigation. This is likely to be exacerbated by the fact that, in addition to the federal authorities charged with enforcing the CFPB's rules, state attorneys general are also authorized to enforce certain of the Federal consumer laws transferred to the jurisdiction of the CFPB and the rules issued by the CFPB thereunder.
Dodd-Frank also directed the federal banking authorities to issue new capital requirements for banks and holding companies. See the discussion under “Regulatory Capital Standards” on pages 7 and 8 of this Report. Dodd-Frank also provided that any new issuances of trust preferred securities (TRUPs) by bank holding companies having between $500 million and $15 billion in assets (such as Arrow) will no longer be able to qualify as Tier 1 capital, although previously issued TRUPs of such bank holding companies that were outstanding on the Dodd-Frank grandfathering date (May 19, 2010), including the $20 million of TRUPs issued by Arrow before that date, will continue to qualify as Tier 1 capital until maturity or earlier redemption, subject to certain limitations. The new bank Capital Rules, in their final form, preserve this "grandfathered" status of TRUPs previously issued by small- to mid-sized financial institutions like Arrow before the grandfathering date. Generally, however, TRUPs, which were an important financing tool for community banks such as ours, can no longer be counted on as a viable source of new capital for banks, unless the U.S. Congress passes legislation that specifically accords regulatory capital status to newly-issued TRUPs.
Bank regulators have not finished promulgating all the rules required to be issued by them under Dodd-Frank. To date, implementation of Dodd-Frank provisions has resulted in many new mandatory and discretionary rule-makings by regulatory authorities, a process that is still not completed, almost seven years after Dodd-Frank's enactment. As a result, bank holding companies and their bank and non-bank operating subsidiaries have faced thousands of new pages of regulations and associated regulatory burdens still being formulated, several of which are highly controversial and the implementation of which has proven to be costly and time consuming.
Various legislative proposals have been advanced for consideration or possible consideration by the U.S. Congress that would rescind or substantially modify various provisions of Dodd-Frank. At present, we are not able to estimate the likelihood of adoption of any such provisions or the potential impact thereof if adopted.

Sarbanes-Oxley Act

The Sarbanes-Oxley Act of 2002 implemented a broad range of corporate governance, accounting and reporting requirements for companies that have securities registered under the Exchange Act. These requirements include: (1) requirements for audit committees, including independence and financial expertise; (2) certification of financial statements by the chief executive officer and chief financial officer of the reporting company; (3) standards for auditors and regulation of audits; (4) disclosure and reporting requirements for the reporting company and directors and executive officers; and (5) a range of civil and criminal penalties for fraud and other violations of securities laws.

The USA Patriot Act

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

Incentive Compensation

The Dodd-Frank Act required the federal bank regulatory agencies and the SEC to establish joint regulations or guidelines prohibiting incentive-based payment arrangements at specified regulated entities, such as the Company, having at least $1 billion in total assets that encourage inappropriate risks by providing an executive officer, employee, director or principal shareholder with excessive compensation, fees, or benefits or that could lead to material financial loss to the entity. In addition, these regulators must establish regulations or guidelines requiring enhanced disclosure to regulators of incentive-based compensation arrangements. Final regulations and/or guidelines have not yet been issued by the agencies under this provision of Dodd-Frank.

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However, in 2010, the FRB, OCC and FDIC issued comprehensive final guidance on incentive compensation policies intended to ensure that the incentive compensation policies of banking organizations do not undermine the safety and soundness of such organizations by encouraging excessive risk-taking. The guidance, which covers all employees that have the ability to materially affect the risk profile of an organization, either individually or as part of a group, is based upon the key principles that a banking organization's incentive compensation arrangements should (i) provide incentives that do not encourage risk-taking beyond the organization's ability to effectively identify and manage risks, (ii) be compatible with effective internal controls and risk management, and (iii) be supported by strong corporate governance, including active and effective oversight by the organization's board of directors. Management believes the current and past compensation practices of the Company do not encourage excessive risk taking or undermine the safety and soundness of the organization.
The FRB will review, as part of the regular, risk-focused examination process, the incentive compensation arrangements of banking organizations, such as the Company, that are not "large, complex banking organizations." These reviews will be tailored to each organization based on the scope and complexity of the organization's activities and the prevalence of incentive compensation arrangements. The findings of the supervisory initiatives will be included in reports of examination. Deficiencies will be incorporated into the organization's supervisory ratings, which can affect the organization's ability to make acquisitions and take other actions. Enforcement actions may be taken against a banking organization if its incentive compensation arrangements, or related risk-management control or governance processes, pose a risk to the organization's safety and soundness and the organization is not taking prompt and effective measures to correct the deficiencies.

Deposit Insurance Laws and Regulations

In February of 2011, the FDIC finalized a new assessment system that took effect in the second quarter of 2011. The final rule changed the assessment base from domestic deposits to average assets minus average tangible equity, adopted a new large-bank pricing assessment scheme, and set a target size for the Deposit Insurance Fund. The changes went into effect in the second quarter of 2011. The rule (as mandated by Dodd-Frank) finalizes a target size for the Deposit Insurance Fund Reserve Ratio at 2% of insured deposits. It also implements a lower assessment rate schedule when the ratio reaches 1.15% (so that the average rate over time should be about 8.5 basis points) and, in lieu of dividends, provides for a lower rate schedule when the reserve ratio reaches 2% and 2.5%. Also as mandated by Dodd-Frank, the rule changes the assessment base from adjusted domestic deposits to a bank's average consolidated total assets minus average tangible equity.
In August of 2016, the FDIC announced that the reserve ratio reached 1.17% at the end of June, 2016. This represents the highest level the ratio has reached in more than eight years. The reduction in assessment rates went into effect in the third quarter of 2016. We are unable to predict whether or to what extent the FDIC may elect to impose additional special assessments on insured institutions in upcoming years, if bank failures should once again become a significant problem.

D. RECENT LEGISLATIVE DEVELOPMENTS

Health Care Reform
Various proposals have been discussed for consideration that would substantially modify various health care laws. At present, we are not able to estimate the likelihood of adoption of any such provisions or the potential impact thereof if adopted.

Other Legislative Initiatives
From time to time, various legislative and regulatory initiatives are introduced in Congress and state legislatures, as well as by regulatory authorities. These initiatives may include proposals to expand or contract the powers of bank holding companies and depository institutions or proposals to change the financial institution regulatory environment.

Such legislation could change banking laws and the operating environment of our company in substantial, but unpredictable ways. We cannot predict whether any such legislation will be enacted, and, if enacted, the effect that it, or any implementing regulations would have on our financial condition or results of operations.

E. STATISTICAL DISCLOSURE – (GUIDE 3)

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

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

F. COMPETITION

We face intense competition in all markets we serve. Competitors include traditional local commercial banks, savings banks and credit unions, non-traditional internet-based lending alternatives, as well as local offices of major regional and money center banks. Like all banks, we encounter strong competition in the mortgage lending space from a wide variety of other mortgage originators, all of whom are principally affected in this business by the rate and terms set, and the lending practices established from time-to-time by the very large government sponsored enterprises ("GSEs") engaged in residential mortgage lending, most importantly, “Fannie Mae” and “Freddie Mac.” For many years, these GSEs have purchased and/or guaranteed a very substantial percentage of all newly-originated mortgage loans in the U.S., and in recent years, a large majority of such originations. Additionally, non-banking financial organizations, such as consumer finance companies, insurance companies, securities firms, money market funds, mutual funds, credit card companies, wealth management enterprises, and Fintech companies offer substantive equivalents of the various other types of loan and financial products and services and transactional accounts that we offer, even though these non-banking organizations are not subject to the same regulatory restrictions and capital requirements that apply to us. Under federal banking laws, such non-banking financial organizations not only may offer products and services comparable to those offered by commercial banks, but also may establish or acquire their own commercial banks.

G. EXECUTIVE OFFICERS OF THE REGISTRANT

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

Name	Age	Positions Held and Years from Which Held
Thomas J. Murphy, CPA	58	President and Chief Executive Officer of Arrow since January 1, 2013. He has been a director of Arrow since July 2012. Mr. Murphy served as a Vice President of Arrow from 2009 to 2012, and as Corporate Secretary from 2009 to 2012. Mr. Murphy also has been the President and Chief Executive Officer of GFNB since January 1, 2013. Prior to that date he served as Senior Executive Vice President of Arrow and President of GFNB commencing July 1, 2011. Prior to July 1, 2011, Mr. Murphy served as Senior Trust Officer of GFNB (since 2010) and Cashier of GFNB (since 2009). Mr. Murphy previously served as Assistant Corporate Secretary of Arrow (2008-2009), Senior Vice President of GFNB (2008-2011) and Manager of the Personal Trust Department of GFNB (2004-2011). Mr. Murphy started with the Company in 2004.
Terry R. Goodemote, CPA	53	Chief Financial Officer of Arrow since January 1, 2007. He also has been Executive Vice President of Arrow (since January 1, 2013); prior to that, he was Senior Vice President of Arrow (since 2008). Mr. Goodemote also serves as Chief Financial Officer of GFNB (since January 1, 2007) and as Senior Executive Vice President of GFNB (since July 1, 2011). Before that he was Executive Vice President of GFNB (since 2008). Prior to becoming Chief Financial Officer, Mr. Goodemote served as Senior Vice President and Head of the Accounting Division of GFNB. Mr. Goodemote started with the Company in 1992. On February 7, 2017, the company announced Mr. Goodemote's intention is to retire from the company. He intends to continue in his current role until his successor is chosen.
David S. DeMarco	55	Senior Vice President of Arrow since May 1, 2009. Mr. DeMarco has been the President and Chief Executive Officer of SNB since January 1, 2013. Prior to that date, Mr. DeMarco served as Executive Vice President and Head of the Branch, Corporate Development, Financial Services & Marketing Division of GFNB since January 1, 2003. Mr. DeMarco started with the Company in 1987.
David D. Kaiser	56	Senior Vice President of Arrow since February 1, 2015. Mr. Kaiser has also served as Executive Vice President of GFNB since 2012 and as Chief Credit Officer of GFNB and SNB since 2011. Previously, he served as the Corporate Banking Manager for GFNB from 2005 to 2011. Mr. Kaiser started with the Company in 2000.

H. AVAILABLE INFORMATION
Our Internet address is www.arrowfinancial.com. We make available, free of charge on or through our internet website, our annual report on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K, and amendments to those reports as soon as practicable after we file or furnish them with the SEC pursuant to the Exchange Act. We also make available on the internet website various other documents related to corporate operations, including our Corporate Governance Guidelines, the charters of our principal board committees, and our codes of ethics. We have adopted a financial code of ethics that applies to Arrow's chief executive officer, chief financial officer and principal accounting officer and a business code of ethics that applies to all directors, officers and employees of our holding company and its subsidiaries.

Item 1A. Risk Factors

Our financial results and the market price of our stock are subject to risks arising from many factors, including the risks listed below, as well as other risks and uncertainties. Any of these risks could materially and adversely affect our business, financial condition or results of operations. (Please note that the discussion below regarding the potential impact on Arrow of certain of these factors that may develop in the future is not meant to provide predictions by Arrow's management that such factors will develop, but to acknowledge the possible negative consequences to our company and business if certain conditions develop.)

Difficult market conditions continue to present significant challenges to the profitability of the U.S. commercial banking industry and its core business of making and servicing loans and any substantial downturn in the U.S. economy generally could adversely affect our ability to maintain steady growth in our loan portfolio and our earnings. Many existing or potential loan customers of commercial banks, especially individuals and small businesses, continue to experience financial and budgetary pressures that both challenge their ability to service their existing indebtedness and sharply restrict their ability or willingness to incur additional indebtedness. The demand for loans has generally increased in recent years, and very low prevailing rates of interest for all types of credit still exist, which makes borrowing more affordable and attractive to customers of all types. However, while the U.S. economy and our regional economy have shown signs of improvement in recent years, consumers and small businesses are still struggling under heavy debt loads, which will continue to weigh against any surge in growth or profitability in the banking sector. This cautionary scenario confronts us as it confronts all commercial banks, large and small, and could adversely affect our ability to originate loans.

We face continuing and growing security risks to our information base including the information we maintain relating to our customers, and any breaches in the security systems we have implemented to protect this information could have a material negative effect on our business operations and financial condition. In the ordinary course of business, Arrow relies on electronic communications and information systems to conduct our operations and to store sensitive data. Arrow employs an in-depth, layered, defensive approach that leverages people, processes and technology to manage and maintain cybersecurity controls. Arrow employs a variety of preventative and detective tools to monitor, block, and provide alerts regarding suspicious activity, as well as to report on any suspected advanced persistent threats. We have implemented and regularly review and update extensive systems of internal controls and procedures as well as corporate governance policies and procedures intended to protect our business operations, including the security and privacy of all confidential customer information. In addition, we rely on the services of a variety of vendors to meet our data processing and communication needs. No matter how well designed or implemented our controls are, we cannot provide an absolute guarantee to protect our business operations from every type of cybersecurity or other security problem in every situation. A failure or circumvention of these controls could have a material adverse effect on our business operations and financial condition. Notwithstanding the strength of our defensive measures, the threat from cyber attacks is severe, attacks are sophisticated and increasing in volume, and attackers respond rapidly to changes in defensive measures. While to date, Arrow has not experienced a significant compromise, significant data loss or any material financial losses related to cybersecurity attacks, our systems and those of our customers and third-party service providers are under constant threat. Risks and exposures related to cybersecurity attacks are expected to remain high for the foreseeable future due to the rapidly evolving nature and sophistication of these threats, as well as due to the expanding use of Internet banking, mobile banking and other technology-based products and services by us and our customers.

The computer systems and network infrastructure that we use are always vulnerable to unforeseen disruptions, including theft of confidential customer information (“identity theft”) and interruption of service as a result of fire, natural disasters, explosion, general infrastructure failure or cyber attacks. These disruptions may arise in our internally developed systems, or the systems of our third-party service providers or may originate from the actions of our consumer and business customers who access our systems from their own networks or digital devices to process transactions. Information security and cyber security risks have increased significantly in recent years because of consumer demand to use the Internet and other electronic delivery channels to conduct financial transactions. Cybersecurity risk is a major concern to financial services regulators and all financial service providers, including our company. These risks are further exacerbated due to the increased sophistication and activities of organized crime, hackers, terrorists and other disreputable parties. We regularly assess and test our security systems and disaster preparedness, including back-up systems, but the risks are substantially escalating. As a result, cybersecurity and the continued enhancement of our controls and processes to protect our systems, data and networks from attacks or unauthorized access remain a priority. Accordingly, we may be required to expend additional resources to enhance our protective measures or to investigate and remediate any information security vulnerabilities or exposures. Any breach of our system security could result in disruption of our operations, unauthorized access to confidential customer information, significant regulatory costs, litigation exposure and other possible damages, loss or liability. Such costs or losses could exceed the amount of available insurance coverage, if any, and would adversely affect our earnings. Also, any failure to prevent a security breach or to quickly and effectively deal with such a breach could negatively impact customer confidence, damaging our reputation and undermining our ability to attract and keep customers. In addition, if we fail to observe any of the cybersecurity requirements in federal or state laws, regulations or regulatory guidance, we could be subject to various sanctions, including financial penalties.

The quality of our bank loan portfolio remains strong but could erode somewhat if the U.S. economy or our regional economy experiences even a modest downturn; any such erosion could have an adverse impact on our financial condition. Home prices in all regions of the U.S., including our market area in northeastern New York, have stabilized or even strengthened somewhat in recent periods. Delinquency and charge-off rates in our loan portfolio remain very low. However, we like most banks continue to have substantial exposure in our portfolio to borrowers, particularly individual and small business borrowers, who if confronted by an economic downturn of any consequence, including one that results in their loss of their job or the failure of their business, may quickly fall in arrears on their borrowings including on our loans to them. We believe not only that the quality of our loan portfolio is strong but also that our allowance is entirely adequate to cover all embedded risk. However, any downturn of consequence in the economy, nationwide or in our region, would likely require increased provisions to our allowance, potentially damaging our financial condition and results.

Persistent volatility in the U.S. equity markets, coupled with economic instability and uncertainty, has an adverse effect on the core business of the U.S. commercial banking sector which could adversely impact our financial results. The U.S. financial sector, particularly that portion that is focused on the equity markets (i.e., “Wall Street”), has largely recovered from the 2008-2009 financial crisis, although periods of enhanced volatility continue to surface-. At the same time, the wider U.S. economy, especially the business sector that underlies the day-to-day health of U.S. commercial banks (“Main Street”), continues to experience only very modest growth. In some areas of the U.S. and some sectors of the U.S. economy. companies, workers and municipalities have not returned to the levels of financial health they enjoyed before the 2008-2009 crisis. Commercial banks like ours are much more closely tied, in terms of growth and profits, to the Main Street sector than the Wall Street sector. Accordingly, our financial results and condition may continue to be pressured by the modest and uneven growth that continues to characterize the U.S. economy generally and our regional economy as well.

Any future economic or financial downturn, including any significant correction in the equity markets, may negatively affect the volume of income attributable to, and demand for, fee-based services of banks such as ours, including our fiduciary business, which could negatively impact our financial condition and results of operation. Revenues from our trust and wealth management business are dependent on the level of assets under management. Any significant downturn in the equity markets may lead our trust and wealth management customers to liquidate their investments, or may diminish account values for those customers who elect to leave their portfolios with us, in either case reducing our assets under management and thereby decreasing our revenues from this important sector of our business. Our other fee-based businesses are also susceptible to a sudden economic or financial downturn.

Rulemaking under Dodd-Frank continues to unfold; these and other regulations being promulgated may adversely affect our Company and certain players in the financial industry as a whole. Even before the financial crisis and the resulting new banking laws and regulations, including Dodd-Frank, we were subject to extensive Federal and state banking regulations and supervision. Banking laws and regulations are intended primarily to protect bank depositors’ funds (and indirectly the Federal deposit insurance funds) as well as bank retail customers, who may lack the sophistication to understand or appreciate bank products and services. These laws and regulations generally are not, however, aimed at protecting or enhancing the returns on investment enjoyed by bank shareholders.

Our depositor/customer awareness of the changing regulatory environment is particularly true of the set of laws and regulations under Dodd-Frank, which were passed in the aftermath of the 2008-2009 financial crisis and in large part were intended to better protect bank customers (and to some degree, banks) against a wide variety of lending products and aggressive lending practices that pre-dated the crisis and are seen as having contributed to its severity. Although not all banks offered such products or engaged in such practices, all banks are affected by the new laws and regulations to some degree.

Dodd-Frank restricts our lending practices, requires us to expend substantial additional resources to safeguard customers, significantly increases our regulatory burden, and subjects us to significantly higher minimum capital requirements which, in the long run, may serve as a drag on our earnings, growth and ultimately on our dividends and stock price (the new capital standards are separately addressed in the following risk factor).

While it is difficult to predict the full extent to which Dodd-Frank and the resulting new regulations and rules may adversely impact our business or financial results, or the extent to which regulations previously adopted under Dodd-Frank or the provisions of Dodd-Frank itself may be rescinded or modified in upcoming periods, as a result of recent political developments,we believe the changes flowing from Dodd-Frank will continue to increase our costs. Furthermore, we also believe that any potential changes to Dodd-Frank will require us to continue to modify certain strategies, business operations and capital and liquidity structures which, individually or collectively, may very well have a material adverse impact on our financial condition.

Revised capital and liquidity standards adopted by the U.S. banking regulators require banks and bank holding companies to maintain more and higher quality capital and greater liquidity than has historically been the case. Capital standards, particularly those adopted as a result of Dodd-Frank, continue to have a significant effect on banks and bank holding companies, including Arrow. Although many of the remedial measures contained in Dodd-Frank and the regulations promulgated thereunder may be reconsidered at the federal legislative and regulatory levels as a result of the recent U.S. elections and political developments, the revised and enhanced regulatory capital standards adopted by bank regulators in response to the mandates in Dodd-Frank are generally perceived as less likely to be rescinded or relaxed than some of the other restrictive or burdensome changes mandated by Dodd-Frank. Thus, many if perhaps not all of the enhanced bank capital standards promulgated under Dodd-Frank are widely expected to remain in effect, including the capital buffers yet to be fully phased in, forcing bank holding companies and their bank subsidiaries to maintain substantially higher levels of capital as a percentage of their assets, with a greater emphasis on common equity as opposed to other components of capital. The need to maintain more and higher quality capital, as well as greater liquidity, and generally increased regulatory scrutiny with respect to capital levels, may at some point limit our business activities, including lending, and our ability to expand. It could also result in our being required to take steps to increase our regulatory capital and may dilute shareholder value or limit our ability to pay dividends or otherwise return capital to our investors through stock repurchases.

If economic conditions should worsen and the U.S. experiences a recession or prolonged economic stagnation, the quality of our loan portfolio may weaken so significantly that our allowance for loan losses may not be adequate to cover actual or expected loan losses. Like all financial institutions, we maintain an allowance for loan losses to provide for probable loan losses at the balance sheet date. Our allowance for loan losses is based on our historical loss experience as well as an evaluation of the risks associated with our loan portfolio, including the size and composition of the portfolio, current economic conditions and geographic concentrations within the portfolio and other factors. While we have continued to enjoy a very high level of quality in our loan portfolio generally and very low levels of loan charge-offs and non-performing loans, if the economy in our geographic market area should deteriorate to the point that recessionary conditions return, or if the regional or national economy experiences a protracted period of stagnation, the quality of our loan portfolio may weaken so significantly that our allowance for loan losses may not be adequate to cover actual or expected loan losses. If so, future increases in provisions for loan losses could materially and adversely affect financial results. Moreover, weak or worsening economic conditions often lead to difficulties in other areas of our business, including growth of our business generally, thereby compounding the negative effects on earnings.

Although rates have begun to rise somewhat, the current interest rate environment, still is not particularly favorable for commercial banks or their core businesses, and any future significant increases in prevailing rates may ultimately have a negative impact on our prospects and performance. Prevailing market interest rates, and changes in those rates, have a direct and material impact on the financial performance and condition of commercial banks. A bank’s net interest income generally comprises the majority of its total income, and changes in prevailing rates for bank assets and bank liabilities significantly affect its net interest income. Currently, market interest rates in the U.S., across all maturities and for all types of loans, although beginning to rise, still remain low. Lending institutions such as commercial banks remain in a very challenging position.

After raising the Fed funds rate by 25 basis points in December 2016, the Fed elected to raise the Fed funds rate again in December 2016, again by 25 basis points. Presumably, short-term interest rates will rise again accordingly. Moreover, the general expectation is that the Fed will proceed with additional rate rises this year and perhaps next year. These increases in market rates, although possibly helpful to banks at least initially as loans reprice upward, may nevertheless be expected ultimately to adversely impact the commercial banking sector in certain respects. If rate rises persist, it may be expected that bank liabilities (deposits) also will reprice upward, pressuring margins once again. Additionally, if rates rise substantially, especially long-term rates, economic growth is likely to be negatively impacted at some point, and the housing sector particularly may suffer significant damage. It was out of concern for the long-run health of the U.S. economy at large that led the Fed to pursue the imposition of a long-term, low-rate environment, and it is to be expected that the Fed will approach further rate increases with great caution and abandon or defer future increases if any weakness in the economy should surface. Whatever the Fed and the other central banks in the developed world elect to do from the standpoint of monetary policy, their decisions will affect the activities, results of operations and profitability of banks and bank holding companies such as Arrow. We cannot predict the nature or timing of future changes in monetary and other policies or the effect that they may have on our operations or financial condition.

We operate in a highly competitive industry and market areas that could negatively affect our growth and profitability. Competition for commercial banking and other financial services is fierce in our market areas. In one or more aspects of business, our subsidiaries compete with other commercial banks, savings and loan associations, credit unions, finance companies, Internet-based financial services companies, mutual funds, insurance companies, brokerage and investment banking companies, and other financial intermediaries. Additionally, due to their size, many competitors may be able to achieve economies of scale and, as a result, may offer a broader range of products and services, as well as better pricing for those products and services, than we can. Technology has lowered barriers to entry and made it possible for non-banks to offer products and services traditionally provided by banks, such as automatic transfer and automatic payment systems. In addition, many of our competitors are not subject to the same extensive Federal regulations that govern bank holding companies and Federally insured banks. Failure to offer competitive services in our market areas could significantly weaken our market position, adversely affecting our growth, which, in turn, could have a material adverse effect on our financial condition and results of operations.

The Company relies on the operations of our banking subsidiaries to provide liquidity which, if limited, could impact our ability to pay dividends to our shareholders or to repurchase our common stock. We are a bank holding company, a separate legal entity from our subsidiaries. Our bank holding company does not have significant operations of its own. The ability of our subsidiaries, including our bank and insurance subsidiaries, to pay dividends is limited by various statutes and regulations. It is possible, depending upon the financial condition of our subsidiaries and other factors, that our subsidiaries might be restricted at some point in their ability to pay dividends to the holding company, including by a bank regulator asserting that the payment of such dividends or other payments would constitute an unsafe or unsound practice. In addition, under Dodd-Frank, we are subjected to consolidated capital requirements at the holding company level. If our holding company or its bank subsidiaries are required to retain or increase capital, we may not be able to maintain our cash dividends or pay dividends at all, or to repurchase shares of our common stock.

If economic conditions worsen and the U.S. financial markets should suffer a downturn, we may experience limited access to credit markets. As discussed under Part I, Item 7.D. “Liquidity,” we maintain borrowing relationships with various third parties that enable us to obtain from them, on relatively short notice, overnight and longer-term funds sufficient to enable us to fulfill our obligations to customers, including deposit withdrawals. If, in the context of a downturn in the U.S. economy or financial markets, these third parties should encounter difficulty in accessing their own credit markets, we may, in turn, experience a decrease in our capacity to borrow funds from them or other third parties traditionally relied upon by banks for liquidity.

We are subject to the local economies where we operate, and unfavorable economic conditions in these areas could have a material adverse effect on our financial condition and results of operations. Much of our success depends upon the growth in business activity, income levels and deposits in our geographic market area. Although our market area has experienced a stabilizing of economic conditions in recent years and even periods of modest growth, if unpredictable or unfavorable economic conditions unique to our market area should occur in upcoming periods, such will likely have an adverse effect on the quality of our loan portfolio and financial performance. As a community bank, we are less able than our larger regional competitors to spread the risk of unfavorable local economic conditions over a larger market area. Moreover, we cannot give any assurances that we, as a single enterprise, will benefit from any unique and favorable economic conditions in our market area, even if they do occur.
Changes in accounting standards may materially and negatively impact our financial statements. From time-to-time, the Financial Accounting Standards Board (“FASB”) changes the financial accounting and reporting standards that govern the preparation of our financial statements. These changes can be hard to predict and can materially impact how we record and report our financial condition and results of operations. In some cases, we may be required to apply a new or revised standard retroactively, resulting in changes to previously reported financial statements. Specifically, changes in the fair value of our financial assets could have a significant negative impact on our asset portfolios and indirectly on our capital levels.
Our business could suffer if we lose key personnel unexpectedly or if employee wages increase significantly. Our success depends, in large part, on our ability to retain our key personnel for the duration of their expected terms of service. On an ongoing basis, we prepare and review back-up plans, in the event key personnel are unexpectedly rendered incapable of performing or depart or resign from their positions. However, any sudden unexpected change at the senior management level may adversely affect our business. In addition, should our industry begin to experience a shortage of qualified employees, we like other financial institutions may have difficulty attracting and retaining entry level or higher bracket personnel and also may experience, as a result of such shortages or the enactment of higher minimum wage laws locally or nationwide, increased salary expense, which would likely negatively impact our results of operations.
We rely on other companies to provide key components of our business infrastructure. Third-party vendors provide key components of our business infrastructure such as Internet connections, network access and mutual fund distribution. The financial health and operational capabilities of these third parties are for the most part beyond our control, and any problems experienced by these third parties, such that they may not be able to continue to provide services to us or to perform such services consistent with our expectations, could adversely affect our ability to deliver products and services to our customers and to conduct our business.
Problems encountered by other financial institutions could adversely affect us. Our ability to engage in routine funding transactions could be adversely affected by financial or commercial problems confronting other financial institutions. Financial services institutions are interrelated as a result of trading, clearing, counterparty and other relationships. We have exposure to many different counterparties in the normal course of business, and we routinely execute transactions with counterparties in the financial services industry, including brokers and dealers, other commercial banks, investment banks, mutual and hedge funds, and other financial institutions. As a result, defaults by, or even rumors or questions about, one or more financial services institutions, or the financial services industry generally, could lead to market-wide liquidity problems and losses or defaults by us or by other financial institutions on whom we rely or with whom we interact. Some of these transactions expose us to credit risk in the event of default of our counterparty or client. In addition, our credit risk may be exacerbated when the collateral held by us cannot be liquidated or only may be liquidated at prices not sufficient to recover the full amount due us under the underlying financial instrument held by us. There is no assurance that any such losses would not materially and adversely affect our results of operations.
Our industry is faced with technological advances and changes on a continuing basis, and failure to adapt to these advances and changes could have a material adverse impact on our business. Technological advances and changes in the financial services industry are pervasive and constant factors. The retail financial services sector, like many other retail goods and services sectors, is currently in the throes of revolutionary change, involving new delivery and communications systems and technologies that are extraordinarily far-reaching and impactful. For us to remain

competitive, we must comprehend and adapt to these systems and technologies . Proper implementation of new technologies can increase efficiency, decrease costs and help to meet customer demand. However, many of our competitors have greater resources to invest in technological advances and changes. We may not always be successful in utilizing the latest technological advances in offering our products and services or in otherwise conducting our business. Failure to identify, consider, adapt to and implement technological advances and changes could have a material adverse effect on our business.

Item 1B. Unresolved Staff Comments - None

Item 2. Properties

Our main office is at 250 Glen Street, Glens Falls, New York. The building is owned by us and serves as the main office for Arrow and Glens Falls National, our principal subsidiary bank. The main office of our other banking subsidiary, Saratoga National, is in Saratoga Springs, New York. We own twenty-nine branch banking offices, lease ten branch banking offices and lease two residential loan origination offices, all at market rates. Our insurance agencies are co-located in four bank-owned branches, as well

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as four leased bank branches and 1 owned stand-alone building. We also lease office space in buildings and parking lots near our main office in Glens Falls as well as a back-up site for business continuity purposes.
In the opinion of management, the physical properties of our holding company and our various subsidiaries are suitable and adequate. For more information on our properties, see Notes 2, 6 and 18 to the Consolidated Financial Statements contained in Part II, Item 8 of this Report.

Item 3. Legal Proceedings

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

Item 4. Mine Safety Disclosures - None

PART II

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

The common stock of Arrow Financial Corporation is traded on the Global Select Market of the National Association of Securities Dealers, Inc. ("NASDAQ®")Stock Market under the symbol AROW.
The high and low prices listed below represent actual sales transactions, as reported by NASDAQ®. All stock prices and cash dividends per share have been restated to reflect subsequent stock dividends. On September 29, 2016, we distributed a 3% stock dividend on our outstanding shares of common stock.

	2016			2015		
	Market Price		Cash	Market Price		Cash
	Low	High	Dividends Declared	Low	High	Dividends Declared
First Quarter	$23.83	$26.74	$ 0.243	$24.32	$26.20	$ 0.238
Second Quarter	25.16	29.51	0.243	24.06	26.65	0.238
Third Quarter	28.62	34.08	0.243	25.30	27.18	0.238
Fourth Quarter	30.56	41.70	0.250	25.07	28.39	0.243

The payment of cash dividends by Arrow is determined at the discretion of its Board of Directors and is dependent upon, among other things, our earnings, financial condition and other factors, including applicable legal and regulatory restrictions. See "Capital Resources and Dividends" in Part II, Item 7.E. of this Report.
Based on information received from our transfer agent and various brokers, custodians and agents, we estimate there were approximately 7,000 beneficial owners of Arrow's common stock at December 31, 2016. Arrow has no other class of stock outstanding.

Equity Compensation Plan Information
The following table sets forth certain information regarding Arrow's equity compensation plans as of December 31, 2016. These equity compensation plans were (i) our 2013 Long-Term Incentive Plan ("LTIP"), and its predecessors, our 2008 Long-Term Incentive Plan and our 1998 Long-Term Incentive Plan; (ii) our 2014 Employee Stock Purchase Plan ("ESPP"); and (iii) our 2013 Directors' Stock Plan ("DSP"). All of these plans have been approved by Arrow's shareholders.

Plan Category	(a) Number of Securities to be Issued Upon Exercise of Outstanding Options, Warrants and Rights	(b) Weighted-Average Exercise Price of Outstanding Options, Warrants and Rights	(c) Number of Securities Remaining Available for Future Issuance Under Equity Compensation Plans (Excluding Securities Reflected in

			Column (a)
Equity Compensation Plans Approved by Security Holders [1][2]	355,651	$ 22.52	511,293
Equity Compensation Plans Not Approved by Security Holders	—		—
Total	355,651		511,293

(1) All 355,651 shares of common stock listed in column (a) are issuable pursuant to outstanding stock options granted under the LTIP or its predecessor plans.

(2) The total of 511,293 shares listed in column (c) includes (i) 367,775 shares of common stock available for future award grants under the LTIP, (ii) 115,554 shares of common stock available for future issuance under the ESPP, and (iii) 27,964 shares of common stock available for future issuance under the DSP.

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STOCK PERFORMANCE GRAPHS

The following two graphs provide a comparison of the total cumulative return (assuming reinvestment of dividends) for the common stock of Arrow as compared to the Russell 2000 Index, the NASDAQ Banks Index and the Zacks $1B-$5B Bank Assets Index.
The first graph presents comparative stock performance for the five-year period from December 31, 2011 to December 31, 2016 and the second graph presents comparative stock performance for the fifteen-year period from December 31, 2001 to December 31, 2016.
The historical information in the graphs and accompanying tables may not be indicative of future performance of Arrow stock on the various stock indices.

	TOTAL RETURN PERFORMANCE					
	Period Ending					
Index	2011	2012	2013	2014	2015	2016
Arrow Financial Corporation	100.00	113.12	127.72	140.05	146.51	232.25
Russell 2000 Index	100.00	116.35	161.52	169.42	161.95	196.45
NASDAQ Banks Index	100.00	119.64	171.23	179.93	195.98	265.31
Zacks $1B - $5B Bank Assets Index	100.00	118.73	161.37	169.29	185.89	267.98

Source: Prepared by Zacks Investment Research, Inc. Used with permission.

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TOTAL RETURN PERFORMANCE

Index	Period Ending 2001	2002	2003	2004	2005	2006	2007	2008
Arrow Financial Corporation	100.00	114.37	133.42	158.20	142.19	144.44	135.32	165.76
Russell 2000 Index	100.00	79.52	117.09	138.68	144.93	171.55	168.87	111.81
NASDAQ Banks Index	100.00	102.37	131.69	150.81	147.31	165.41	130.91	95.44
Zacks $1B - $5B Bank Assets Index	100.00	118.21	164.17	195.13	190.45	220.30	173.64	160.60

TOTAL RETURN PERFORMANCE (Cont'd.)

Index	Period Ending 2009	2010	2011	2012	2013	2014	2015	2016
Arrow Financial Corporation	177.11	209.52	192.14	217.34	245.41	269.08	281.50	446.24
Russell 2000 Index	142.19	180.38	172.85	201.11	279.18	292.85	279.92	339.57
NASDAQ Banks Index	79.42	94.44	84.46	101.05	144.63	151.98	165.53	224.09
Zacks $1B - $5B Bank Assets Index	125.68	145.68	139.24	165.32	224.69	235.72	258.83	373.14

Source: Prepared by Zacks Investment Research, Inc. Used with permission.

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

Unregistered Sales of Equity Securities
None.

Issuer Purchases of Equity Securities
The following table presents information about repurchases by Arrow during the three months ended December 31, 2016 of our common stock (our only class of equity securities registered pursuant to Section 12 of the Securities Exchange Act of 1934):

Fourth Quarter 2016 Calendar Month	(a) Total Number of Shares Purchased[1]	(b) Average Price Paid Per Share[1]	(c) Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs[2]	(d) Maximum Approximate Dollar Value of Shares that May Yet be Purchased Under the Plans or Programs[2]
October	3,979	$ 32.40	—	$ 4,505,130
November	7,035	35.82	—	4,505,130
December	14,603	40.10	—	4,505,130
Total	25,617	37.73	—	

[1]The total number of shares purchased and the average price paid per share listed in columns (a) and (b) consist of (i) any shares purchased in such periods in open market or private transactions under the Arrow Financial Corporation Automatic Dividend Reinvestment Plan (the "DRIP") by the administrator of the DRIP, and (ii) shares surrendered or deemed surrendered to Arrow in such periods by holders of options to acquire Arrow common stock received by them under Arrow's long-term incentive plans ("LTIPs") in connection with their stock-for-stock exercise of such options. In the months indicated, the listed number of shares purchased included the following numbers of shares purchased by Arrow through such methods: October - DRIP purchases (2,789 shares), stock-for-stock option exercises (1,190 shares); November - DRIP purchases (1,891 shares), stock-for-stock option exercises (5,144 shares); December - DRIP purchases (12,360 shares), stock-for-stock option exercises (2,243 shares).
[2]Includes only those shares acquired by Arrow pursuant to its publicly-announced stock repurchase programs. Our only publicly-announced stock repurchase program in effect for the fourth quarter of 2016 was the program approved by the Board of Directors and announced in November 2015, under which the Board authorized management, in its discretion, to repurchase from time to time during 2016, in the open market or in privately negotiated transactions, up to $5 million of Arrow common stock subject to certain exceptions (the "2016 Program"). Arrow did not repurchase any of its shares in the fourth quarter of 2016 under the 2016 Program. In October 2016, the Board authorized a repurchase program for 2017 similar to its 2016 program, which also authorizes management to repurchase up to $5 million of stock in the ensuing year (2017).

Item 6. Selected Financial Data

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

Consolidated Statements of Income Data:	2016	2015	2014	2013	2012
Interest and Dividend Income	$76,915	$70,738	$66,861	$64,138	$69,379
Interest Expense	5,356	4,813	5,767	7,922	11,957
Net Interest Income	71,559	65,925	61,094	56,216	57,422
Provision for Loan Losses	2,033	1,347	1,848	200	845
Net Interest Income After Provision for Loan Losses	69,526	64,578	59,246	56,016	56,577
Noninterest Income	27,854	27,995	28,206	27,521	26,234
Net (Losses) Gains on Securities Transactions	(22)	129	110	540	865
Noninterest Expense	(59,609)	(57,430)	(54,028)	(53,203)	(51,836)
Income Before Provision for Income Taxes	37,749	35,272	33,534	30,874	31,840
Provision for Income Taxes	11,215	10,610	10,174	9,079	9,661
Net Income	$26,534	$24,662	$23,360	$21,795	$22,179
Per Common Share: [1]					
Basic Earnings	$1.98	$1.86	$1.76	$1.65	$1.69
Diluted Earnings	1.97	1.85	1.76	1.65	1.69
Per Common Share: [1]					
Cash Dividends	$0.98	$0.96	$0.94	$0.92	$0.90
Book Value	17.27	16.05	15.16	14.50	13.38
Tangible Book Value [2]	15.45	14.18	13.22	12.53	11.36
Consolidated Year-End Balance Sheet Data:					
Total Assets	$2,605,242	$2,446,188	$2,217,420	$2,163,698	$2,022,796
Securities Available-for-Sale	346,996	402,309	366,139	457,606	478,698
Securities Held-to-Maturity	345,427	320,611	302,024	299,261	239,803
Loans	1,753,268	1,573,952	1,413,268	1,266,472	1,172,641
Nonperforming Assets [3]	7,186	8,924	8,162	7,916	9,070
Deposits	2,116,546	2,030,423	1,902,948	1,842,330	1,731,155
Federal Home Loan Bank Advances	178,000	137,000	51,000	73,000	59,000
Other Borrowed Funds	55,836	43,173	39,421	31,777	32,678
Stockholders' Equity	232,852	213,971	200,926	192,154	175,825
Selected Key Ratios:					
Return on Average Assets	1.06 %	1.05 %	1.07 %	1.04 %	1.11 %
Return on Average Equity	11.79	11.86	11.79	12.11	12.88
Dividend Payout [4]	49.75	51.89	53.41	55.76	53.25
Average Equity to Average Assets	8.95	8.88	9.05	8.56	8.62

[1]Share and per share amounts have been adjusted for subsequent stock splits and dividends, including the most recent September 29, 2016 3% stock dividend.
[2]Tangible book value excludes goodwill and other intangible assets from total equity.
[3]Nonperforming assets consist of nonaccrual loans, loans past due 90 or more days but still accruing interest, repossessed assets, restructured loans, other real estate owned and nonaccrual investments.
[4]Dividend Payout Ratio – cash dividends per share to fully diluted earnings per share.

Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations
Selected Quarterly Information
Dollars in thousands, except per share amounts
Share and per share amounts have been restated for the September 2016 3% stock dividend

Quarter Ended	12/31/2016	9/30/2016	6/30/2016	3/31/2016	12/31/2015
Net Income	$6,600	$6,738	$6,647	$6,549	$6,569
Transactions Recorded in Net Income (Net of Tax):					
Net (Loss) Gain on Securities Transactions	(101)	—	88	—	14
Period End Shares Outstanding	13,483	13,426	13,388	13,361	13,328
Basic Average Shares Outstanding	13,441	13,407	13,372	13,343	13,306
Diluted Average Shares Outstanding	13,565	13,497	13,429	13,379	13,368
Basic Earnings Per Share	$0.49	$0.50	$0.50	$0.49	$0.49
Diluted Earnings Per Share	0.49	0.50	0.49	0.49	0.49
Cash Dividend Per Share	0.250	0.243	0.243	0.243	0.243
Selected Quarterly Average Balances:					
Interest-Bearing Deposits at Banks	$34,731	$21,635	$22,195	$21,166	$44,603
Investment Securities	684,906	696,712	701,526	716,523	716,947
Loans	1,726,738	1,680,850	1,649,401	1,595,018	1,556,234
Deposits	2,160,156	2,063,832	2,082,449	2,069,964	2,075,825
Other Borrowed Funds	157,044	209,946	165,853	143,274	127,471
Shareholders' Equity	230,198	228,048	223,234	218,307	213,219
Total Assets	2,572,425	2,528,124	2,496,795	2,456,431	2,442,964
Return on Average Assets	1.02 %	1.06 %	1.07 %	1.07 %	1.07 %
Return on Average Equity	11.41 %	11.75 %	11.98 %	12.07 %	12.22 %
Return on Tangible Equity[2]	12.77 %	13.18 %	13.47 %	13.62 %	13.86 %
Average Earning Assets	$2,446,375	$2,399,197	$2,373,122	$2,332,707	$2,317,784
Average Paying Liabilities	1,933,974	1,892,583	1,891,017	1,867,455	1,854,549
Interest Income, Tax-Equivalent	20,709	20,222	20,154	19,549	19,422
Interest Expense	1,404	1,405	1,284	1,263	1,231
Net Interest Income, Tax-Equivalent	19,305	18,817	18,870	18,286	18,191
Tax-Equivalent Adjustment	939	940	917	923	912
Net Interest Margin [3]	3.14 %	3.12 %	3.20 %	3.15 %	3.11 %
Efficiency Ratio Calculation:					
Noninterest Expense	$15,272	$15,082	$14,884	$14,370	$14,242
Less: Intangible Asset Amortization	73	74	74	75	78
Net Noninterest Expense	$15,199	$15,008	$14,810	$14,295	$14,164
Net Interest Income, Tax-Equivalent	$19,305	$18,817	$18,870	$18,286	$18,191
Noninterest Income	6,648	7,114	7,194	6,875	6,687
Less: Net Securities (Losses) Gains	(166)	—	144	—	23
Net Gross Income	$26,119	$25,931	$25,920	$25,161	$24,855
Efficiency Ratio	58.19 %	57.88 %	57.14 %	56.81 %	56.99 %
Period-End Capital Information:					
Total Stockholders' Equity (i.e. Book Value)	$232,852	$229,208	$225,373	$220,703	$213,971
Book Value per Share	17.27	17.07	16.83	16.52	16.05

Intangible Assets	24,569	24,675	24,758	24,872	24,980
Tangible Book Value per Share [2]	15.45	15.23	14.98	14.66	14.18
Capital Ratios:					
Tier 1 Leverage Ratio	9.47 %	9.44 %	9.37 %	9.36 %	9.25 %
Common Equity Tier 1 Capital Ratio	12.97 %	12.80 %	12.74 %	12.84 %	12.82 %
Tier 1 Risk-Based Capital Ratio	14.14 %	13.98 %	13.95 %	14.08 %	14.08 %
Total Risk-Based Capital Ratio	15.15 %	14.99 %	14.96 %	15.09 %	15.09 %
Assets Under Trust Administration and Investment Management	$1,301,408	$1,284,051	$1,250,770	$1,231,237	$1,232,890

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

Selected Twelve-Month Information
Dollars in thousands, except per share amounts
Share and per share amounts have been restated for the September 2016 3% stock dividend

	2016	2015	2014
Net Income	$26,534	$24,662	$23,360
Transactions Recorded in Net Income (Net of Tax):			
Net Securities (Losses) Gains	$(13)	$78	$67
Period End Shares Outstanding	13,483	13,328	13,260
Basic Average Shares Outstanding	13,391	13,281	13,242
Diluted Average Shares Outstanding	13,476	13,330	13,272
Basic Earnings Per Share	$1.98	$1.86	$1.76
Diluted Earnings Per Share	1.97	1.85	1.76
Cash Dividends Per Share	0.98	0.96	0.94
Average Assets	$2,513,645	$2,341,467	$2,190,480
Average Equity	224,969	208,017	198,208
Return on Average Assets	1.06 %	1.05 %	1.07 %
Return on Average Equity	11.79	11.86	11.79
Average Earning Assets	$2,388,042	$2,218,440	$2,068,611
Average Interest-Bearing Liabilities	1,896,351	1,777,867	1,675,285
Interest Income, Tax-Equivalent [1]	80,636	74,227	70,188
Interest Expense	5,356	4,813	5,767
Net Interest Income, Tax-Equivalent [1]	75,280	69,414	64,421
Tax-Equivalent Adjustment	3,721	3,489	3,327
Net Interest Margin [1]	3.15 %	3.13 %	3.11 %
Efficiency Ratio Calculation [1]			
Noninterest Expense	$59,609	$57,430	$54,028
Less: Intangible Asset Amortization	297	327	387
Net Noninterest Expense	$59,312	$57,103	$53,641
Net Interest Income, Tax-Equivalent [1]	$75,280	$69,414	$64,421
Noninterest Income	27,832	28,124	28,316
Less: Net Securities (Losses) Gains	(22)	129	110
Net Gross Income, Adjusted	$103,134	$97,409	$92,627
Efficiency Ratio [1]	57.51 %	58.62 %	57.91 %
Period-End Capital Information:			
Tier 1 Leverage Ratio	9.47 %	9.25 %	9.44 %
Total Stockholders’ Equity (i.e. Book Value)	$232,852	$213,971	$200,926
Book Value per Share	17.27	16.05	15.15
Intangible Assets	24,569	24,980	25,628
Tangible Book Value per Share [1]	15.45	14.18	13.22
Asset Quality Information:			
Net Loans Charged-off as a Percentage of Average Loans	0.06 %	0.06 %	0.05 %
Provision for Loan Losses as a Percentage of Average Loans	0.12 %	0.09 %	0.14 %
Allowance for Loan Losses as a Percentage of Period-End Loans	0.97 %	1.02 %	1.10 %
Allowance for Loan Losses as a Percentage of Nonperforming Loans	309.31 %	232.24 %	200.41 %
Nonperforming Loans as a Percentage of Period-End Loans	0.31 %	0.44 %	0.55 %
Nonperforming Assets as a Percentage of Total Assets	0.28 %	0.36 %	0.37 %

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

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Arrow Financial Corporation
Reconciliation of Non-GAAP Financial Information
(Dollars In Thousands, Except Per Share Amounts)

Footnotes:

1. Share and Per Share Data have been restated for the September 29, 2016 3% stock dividend.

2. Tangible Book Value, Tangible Equity, and Return on Tangible Equity exclude goodwill and other intangible assets, net from total equity. These are non-GAAP financial measures which we believe provide investors with information that is useful in understanding our financial performance.

	12/31/2016	9/30/2016	6/30/2016	3/31/2016	12/31/2015
Total Stockholders' Equity (GAAP)	$232,852	$229,208	$225,373	$220,703	$213,971
Less: Goodwill and Other Intangible assets, net	24,569	24,675	24,758	24,872	24,980
Tangible Equity (Non-GAAP)	$208,283	$204,533	$200,615	$195,831	$188,991
Period End Shares Outstanding	13,483	13,426	13,388	13,361	13,328
Tangible Book Value per Share (Non-GAAP)	$15.45	$15.23	$14.98	$14.66	$14.18
Net Income	6,600	6,738	6,647	6,549	6,569
Return on Tangible Equity (Net Income/Tangible Equity - Annualized)	12.77 %	13.18 %	13.47 %	13.62 %	13.86 %

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

	12/31/2016	9/30/2016	6/30/2016	3/31/2016	12/31/2015
Interest Income (GAAP)	$19,770	$19,282	$19,237	$18,626	$18,510
Add: Tax Equivalent Adjustment (Non-GAAP)	939	940	917	923	912
Interest Income - Tax Equivalent (Non-GAAP)	$20,709	$20,222	$20,154	$19,549	$19,422
Net Interest Income (GAAP)	$18,366	$17,877	$17,953	$17,363	$17,279
Add: Tax-Equivalent adjustment (Non-GAAP)	939	940	917	923	912
Net Interest Income - Tax Equivalent (Non-GAAP)	$19,305	$18,817	$18,870	$18,286	$18,191
Average Earning Assets	2,446,375	2,399,197	2,373,122	2,332,707	2,317,784
Net Interest Margin (Non-GAAP)	3.14 %	3.12 %	3.20 %	3.15 %	3.11 %

4. Financial Institutions often use the "efficiency ratio", a non-GAAP ratio, as a measure of expense control. We believe the efficiency ratio provides investors with information that is useful in understanding our financial performance. We define our efficiency ratio as the ratio of our noninterest expense to our net gross income (which equals our tax-equivalent net interest income plus noninterest income, as adjusted).

5. For the current quarter, all of the regulatory capital ratios in the table above, as well as the Total Risk-Weighted Assets and Common Equity Tier 1 Capital amounts listed in the table below, are estimates based on, and calculated in accordance with bank regulatory capital rules. All prior quarters reflect actual results. The December 31, 2016 CET1 ratio listed in the tables (i.e., 12.92%) exceeds the sum of the required minimum CET1 ratio plus the fully phased-in Capital Conservation Buffer (i.e., 7.00%).

	12/31/2016	9/30/2016	6/30/2016	3/31/2016	12/31/2015
Total Risk Weighted Assets	1,707,829	1,690,646	1,662,381	1,617,957	1,590,129
Common Equity Tier 1 Capital	221,472	216,382	211,801	207,777	203,848

Common Equity Tier 1 Ratio	12.97 %	12.80 %	12.74 %	12.84 %	12.82 %

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CRITICAL ACCOUNTING ESTIMATES

Our significant accounting principles, as described in Note 2 - Summary of Significant Accounting Policies to the Consolidated Financial Statements are essential in understanding the MD&A. Many of our significant accounting policies require complex judgments to estimate the values of assets and liabilities. We have procedures and processes in place to facilitate making these judgments. The more judgmental estimates are summarized in the following discussion. In many cases, there are numerous alternative judgments that could be used in the process of determining the inputs to the models. Where alternatives exist, we have used the factors that we believe represent the most reasonable value in developing the inputs. Actual performance that differs from
our estimates of the key variables could impact our results of operations.

Allowance for loan losses: The allowance for loan losses represents management's estimate of probable losses inherent in the Company's loan portfolio. Our process for determining the allowance for loan losses is discussed in Note 2 - Summary of Significant Accounting Policies and Note 5 - Loans to the Consolidated Financial Statements. We evaluate our allowance at the portfolio segment level and our portfolio segments are commercial, commercial real estate, residential real estate, and consumer loans. Due to the variability in the drivers of the assumptions used in this process, estimates of the portfolio's inherent risks and overall collectability change with changes in the economy, individual industries, and borrowers' ability and willingness to repay their obligations. The degree to which any particular assumption affects the allowance for loan losses depends on the severity of the change and its relationship to the other assumptions. Key judgments used in determining the allowance for loan losses for individual commercial loans include credit quality indicators, collateral values and estimated cash flows for impaired loans. For pools of loans we consider our historical net loss experience, and as necessary, adjustments to address current events and conditions, considerations regarding economic uncertainty, and overall credit conditions. The historical loss factors incorporate a rolling twelve quarter look-back period for each loan segment in order to reduce the volatility associated with improperly weighting short-term fluctuations. The process of determining the level of the allowance for loan losses requires a high degree of judgment. Any downward trend in the economy, regional or national, may require us to increase the allowance for loan losses resulting in a negative impact on our results of operations and financial condition.

Pension and retirement plans: Management is required to make various assumptions in valuing its pension and postretirement plan assets, expenses and liabilities. The most significant assumptions include the expected rate of return on plan assets, the discount rate, and the rate of increase in future compensation levels. Changes to these assumptions could impact earnings in future periods. The Company utilizes an actuarial firm to assist in determining the various rates used to estimate pension obligations and expense, including the evaluation of market interest rates and discounted cash flows in setting the appropriate discount rate. In addition, the Company reviews expected inflationary and merit increases to compensation in determining the rate of increase in future compensation levels. Changes in these assumptions due to market conditions and governing laws and regulations may result in material changes to the Company's pension and other postretirement plan assets, expenses and liabilities.

Other than temporary decline in the value of debt and equity securities: Management systematically evaluates individual securities classified as either available-for-sale or held-to-maturity to determine whether a decline in fair value below the amortized cost basis is other than temporary. Management considers historical values and current market conditions as a part of the assessment. The amount of the total other-than-temporary impairment related to the credit loss, if any, is recognized in earnings and the amount of the total other-than-temporary impairment related to other factors is generally recognized in other comprehensive income, net of applicable taxes unless the Company intends to sell the security prior to the recovery of the unrealized loss or it is more likely than not that the Company would be forced to sell the security, in which case the entire impairment is recognized in earnings. Any significant economic downturn might result, and historically have on occasion resulted, in an other-than-temporary impairment in securities held in our investment portfolio.

A. OVERVIEW

The following discussion and analysis focuses on and reviews our results of operations for each of the years in the three-year period ended December 31, 2016 and our financial condition as of December 31, 2016 and 2015. The discussion below should be read in conjunction with the selected quarterly and annual information set forth above and the consolidated financial statements and other financial data presented elsewhere in this Report. When necessary, prior-year financial information has been reclassified to conform to the current-year presentation.

Summary of 2016 Financial Results: We reported net income for 2016 of $26.5 million, an increase of $1.9 million or 7.6% over the 2015 total. Diluted earnings per share ("EPS") for 2016 was $1.97, an increase of $0.12, or 6.5% from our 2015 EPS. Return on average equity ("ROE") for the 2016 year continued to be strong at 11.79%, down from our ROE of 11.86% for the 2015 year. Return on average assets ("ROA") for 2016 also continued to be strong at 1.06%, an increase from an ROA of 1.05% for 2015.

The driving factor behind our increase in net income was a significant increase year-over-year in our net interest income, which increased to $71.6 million in 2016 from $65.9 million in 2015, an 8.5% increase. Tax-equivalent net interest income (a non-GAAP measure, see p. 4) was $75.3 million for 2016, an increase of $5.9 million or 8.5% over the $69.4 million total for 2015. This increase in net interest income was primarily attributable to the significant amount of loan growth we experienced during the year. See our analysis of changes in the loan portfolio beginning on page 40. Our noninterest income, including net gains (losses) on securities transactions, decreased in 2016 by $292 thousand, or 1.0%, while our noninterest expense increased by $2.2 million, or 3.8%. The

increased provision for loan losses in 2016 over 2015 of $686 thousand was primarily due to the significant growth in our loan portfolio. Asset quality measures remained strong throughout the year.
Total assets were $2.6 billion at December 31, 2016, which represented an increase of $159.1 million, or 6.5%, above the $2.4 billion level at December 31, 2015. Virtually all asset growth was the result of organic internal growth from our existing branch network, as opposed to acquisitions.
Total Stockholders' equity was $232.9 million at December 31, 2016, an increase of $18.9 million, or 8.8%, from the year earlier level. The components of the change in stockholders' equity since year-end 2015 are presented in the Consolidated Statement of Changes in Stockholders' Equity on page 59. Total book value per share increased by 7.6% over the prior year level. At December 31, 2016, our tangible book value per share, a non-GAAP financial measure calculated based on tangible book value (total stockholders' equity minus intangible assets including goodwill) was $15.45, an increase of $1.27, or 9.0%, over the December 31, 2015 amount. This increase in total stockholders' equity during 2016 principally reflected the following factors: (i) $26.5 million net income for the period, plus (ii) $3.1 million of equity received from our various stock-based compensation plans, plus (iii) a $1.1 million increase in accumulated other comprehensive income, reduced by (iv) cash dividends of $13.1 million; and (v) repurchases of our own common stock of $2.1 million. As of December 31, 2016, our closing stock price was $40.50, resulting in a trading multiple of 2.62 to our tangible book value. The Board of Directors declared and the Company paid a cash dividend of $0.243 per share for each of the first three quarters of 2016, as adjusted for a 3% stock dividend distributed September 29, 2016, a cash dividend of $0.25 per share for the fourth quarter of 2016, and has declared a $0.25 per share cash dividend for the first quarter of 2017.

Regulatory capital: As of December 31, 2016, we continued to exceed all regulatory minimum capital requirements at both the holding company and bank levels, by a substantial amount. As of January 1, 2015, we became subject to revised bank regulatory capital standards adopted in 2013 by federal bank regulatory agencies pursuant to the Dodd-Frank Act. These revised regulatory standards generally require financial institutions to meet higher minimum capital levels, measured in new ways. The standards are being phased in over a 5-year time period ending in 2019. See "Regulatory Capital Standards" on pages 7 and 8.

Economic trends and loan quality: During the past three years, economic activity in our market area has been generally positive, but employment growth and average hourly wages have been less than the national average. Single family home values in upstate New York have generally increased at a higher rate than the national average over the same period. Our nonperforming loans were $5.5 million at December 31, 2016, a decrease of $1.4 million, or 20.4%, from year-end 2015, even with substantial portfolio growth. The ratio of nonperforming loans to period-end loans at December 31, 2016 was 0.31%, a decrease from 0.44% at December 31, 2015. By way of comparison, this ratio for our peer group was 0.83% at September 30, 2016 which itself was a significant improvement for the peer group from its ratio of 3.60% at year-end 2010, and is now below the group's ratio of 1.09% at December 31, 2007 (i.e., before the financial crisis). Loans charged-off (net of recoveries) against our allowance for loan losses amounted to $1.1 million for 2016, an increase of $180 thousand from 2015. Our ratio of net charge-offs to average loans was 0.06% for 2016, compared to our peer group ratio of 0.07% for the period ended September 30, 2016. At December 31, 2016, our allowance for loan losses was $17.0 million, representing 0.97% of total loans, a decrease of 5 basis points from the December 31, 2015 ratio.

Our major loan segments are:
Commercial Loans: These loans comprise approximately 6% of our loan portfolio. The business sector in our service area, including small- and mid-sized businesses with headquarters in the area, continued to be in reasonably good financial condition at period-end, and some lines of business appear to be experiencing modest improvement during the year.
Commercial Real Estate Loans: These loans comprise approximately 25% of our loan portfolio. Commercial property values in our region have remained stable in recent periods, although it should be noted such values did not show

significant deterioration even in the worst phases of the financial crisis. We update the appraisals on our nonperforming and watched commercial properties as deemed necessary, usually when the loan is downgraded or when we perceive significant market deterioration since our last appraisal.
Residential Real Estate Loans: These loans, including home equity loans, make up approximately 39% of our portfolio. We have not experienced any significant increase in our delinquency and foreclosure rates, primarily due to the fact that we not have originated or participated in underwriting high-risk mortgage loans, such as so called "Alt A," "negative amortization," "option ARM's" or "negative equity" loans. We originate all of the residential real estate loans held in our portfolio and apply conservative underwriting standards to all of our originations. The residential real estate market in our service area has been stable in recent periods. If long-term interest rates, which decreased during the second quarter of 2016 before rebounding modestly during the third quarter, do not increase significantly above their period-end levels, we may continue to experience a modest volume of mortgage refinancings. We typically sell a portion, sometimes a significant portion, of our residential real estate mortgage originations to the secondary market, although our sales of originations as a portion of our total originations have diminished somewhat in recent periods.
Consumer Loans (Primarily Indirect Automobile Loans): These loans comprise approximately 31% of our loan portfolio. Throughout the past three years we did not experience any significant change in our level of charge-offs on these loans or in our overall average delinquency rate for automobile loans. Employment in our service area continues to expand modestly, and unemployment rates remain low, well off their post-crisis levels.

Liquidity and access to credit markets: We did not experience any liquidity problems or special concerns during 2016, nor during the prior two years. The terms of our lines of credit with our correspondent banks, the FHLBNY and the Federal Reserve Bank have not changed (see our general liquidity discussion on page 47). In general, we principally 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, an arrangement for overnight borrowing and term credit advances from the FHLBNY, and an additional arrangement for short-term advances at the Federal Reserve Bank discount window). 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, like other former Visa member banks, bear some indirect contingent liability for Visa's future liability on such claims to the extent that Visa's liability might exceed the remaining escrow amount. In light of the current state of covered litigation at Visa, which is winding down, as well as the substantial remaining dollar amounts in Visa's escrow fund, we determined that the balance that Visa maintains in its escrow fund is substantially sufficient to satisfy Visa's remaining direct liability to such claims without further resort to the contingent liability of the former Visa member banks such as ours. At December 31, 2016, the Company held 45,686 shares of Visa Class B common stock. There continue to be restrictions remaining on Visa Class B shares held by us. We continue not to recognize any economic value for these shares.

B. RESULTS OF OPERATIONS

The following analysis of net interest income, the provision for loan losses, noninterest income, noninterest expense and income taxes, highlights the factors that had the greatest impact on our results of operations for December 31, 2016 and the prior two years.

I. NET INTEREST INCOME (Tax-equivalent Basis)

Net interest income represents the difference between interest, dividends and fees earned on loans, securities and other earning assets and interest paid on deposits and other sources of funds. Changes in net interest income result from changes in the level and mix of earning assets and sources of funds (volume) and changes in the yields earned and interest rates paid (rate). Net interest margin is the ratio of net interest income to average earning assets. Net interest income may also be described as the product of average earning assets and the net interest margin. As described in the section entitled “Use of Non-GAAP Financial Measures” on page 4 of this Report, for purposes of our presentation of Selected Financial Information in this Report, including in this Item 7, "Management's Discussion and Analysis of Financial Conditions and Results of Operations," we calculate net interest income on a tax-equivalent basis, producing a non-GAAP financial measure. For our 2016 adjustment, we used a marginal tax rate of 35%. See the discussion and calculation of our 2016 tax equivalent net interest income and net interest margin on page 4 of this Report.

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

	Years Ended December 31,			Change From Prior Year			
				2015 to 2016		2014 to 2015	
	2016	2015	2014	Amount	%	Amount	%
Interest and Dividend Income	$80,636	$74,227	$70,188	$6,409	8.6 %	$4,039	5.8 %
Interest Expense	5,356	4,813	5,767	543	11.3	(954)	(16.5)
Net Interest Income	$75,280	$69,414	$64,421	$5,866	8.5	$4,993	7.8

On a tax-equivalent basis, net interest income was $75.3 million in 2016, an increase of $5.9 million, or 8.5%, from $69.4 million in 2015. This compared to an increase of $5.0 million, or 7.8%, from 2014 to 2015. Factors contributing to the year-to-year changes in net interest income over the three-year period are discussed in the following portions of this Section B.I.

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

	2016 Compared to 2015 Change in Net Interest Income Due to:			2015 Compared to 2014 Change in Net Interest Income Due to:		
Interest and Dividend Income:	Volume	Rate	Total	Volume	Rate	Total
Interest-Bearing Bank Balances	$(26)	$85	$59	$12	$2	$14
Investment Securities:						
Fully Taxable	(199)	88	(111)	428	(337)	91
Exempt from Federal Taxes	306	91	397	(536)	731	195
Loans	6,808	(744)	6,064	5,455	(1,716)	3,739
Total Interest and Dividend Income	6,889	(480)	6,409	5,359	(1,320)	4,039
Interest Expense:						
Deposits:						
Interest-Bearing Checking Accounts	3	—	3	103	(549)	(446)
Savings Deposits	86	104	190	50	(148)	(98)
Time Deposits of $100,000 or More	60	37	97	(102)	(312)	(414)
Other Time Deposits	(38)	(46)	(84)	(170)	(442)	(612)
Total Deposits	111	95	206	(119)	(1,451)	(1,570)
Short-Term Borrowings	182	83	265	44	17	61
Long-Term Debt	203	(131)	72	797	(242)	555
Total Interest Expense	496	47	543	722	(1,676)	(954)
Net Interest Income	$6,393	$(527)	$5,866	$4,637	$356	$4,993

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The following table reflects the components of our net interest income, setting forth, for years ended December 31, 2016, 2015 and 2014: (i) average balances of assets, liabilities and stockholders' equity, (ii) interest and dividend income earned on earning assets and interest expense incurred on interest-bearing liabilities, (iii) average yields earned on earning assets and average rates paid on interest-bearing liabilities, (iv) the net interest spread (average yield less average cost) and (v) the net interest margin (yield) on earning assets. Interest income, net interest income and interest rate information is presented on a tax-equivalent basis, using a marginal tax rate of 35% (see the discussion under "Use of Non-GAAP Financial Measures" on page 4 of this Report). The yield on securities available-for-sale is based on the amortized cost of the securities. Nonaccrual loans are included in average loans.

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

Years Ended:	2016			2015			2014		
	Average Balance	Interest Income/ Expense	Rate Earned/ Paid	Average Balance	Interest Income/ Expense	Rate Earned/ Paid	Average Balance	Interest Income/ Expense	Rate Earned/ Paid
Interest-Bearing Deposits at Banks	$24,950	$153	0.61 %	$32,562	$94	0.29 %	$28,266	$80	0.28 %
Investment Securities:									
Fully Taxable	420,885	7,950	1.89 %	431,445	8,061	1.87 %	408,989	7,970	1.95 %
Exempt from Federal Taxes	278,982	9,187	3.29 %	269,667	8,790	3.26 %	286,929	8,595	3.00 %
Loans	1,663,225	63,346	3.81 %	1,484,766	57,282	3.86 %	1,344,427	53,543	3.98 %
Total Earning Assets	2,388,042	80,636	3.38 %	2,218,440	74,227	3.35 %	2,068,611	70,188	3.39 %
Allowance for Loan Losses	(16,449)			(15,595)			(14,801)		
Cash and Due From Banks	33,207			31,007			30,383		
Other Assets	108,845			107,615			106,287		
Total Assets	$2,513,645			$2,341,467			$2,190,480		
Deposits:									
Interest-Bearing Checking Accounts	$912,461	1,279	0.14 %	$915,565	1,276	0.14 %	$861,457	1,722	0.20 %
Savings Deposits	616,208	931	0.15 %	554,330	741	0.13 %	521,595	839	0.16 %
Time Deposits of $100,000 Or More	69,489	453	0.65 %	59,967	356	0.59 %	70,475	770	1.09 %
Other Time Deposits	129,084	658	0.51 %	136,396	742	0.54 %	158,592	1,354	0.85 %
Total Interest-Bearing Deposits	1,727,242	3,321	0.19 %	1,666,258	3,115	0.19 %	1,612,119	4,685	0.29 %
Short-Term Borrowings	94,109	393	0.42 %	45,595	128	0.28 %	29,166	67	0.23 %
FHLBNY Term Advances and	75,000	1,642	2.19 %	66,014	1,570	2.38 %	34,000	1,015	2.99 %

Other Long-Term Debt									
Total Interest-Bearing Liabilities	1,896,351	5,356	0.28 %	1,777,867	4,813	0.27 %	1,675,285	5,767	0.34 %
Demand Deposits	366,956			329,017			290,922		
Other Liabilities	25,369			26,566			26,065		
Total Liabilities	2,288,676			2,133,450			1,992,272		
Stockholders’ Equity	224,969			208,017			198,208		
Total Liabilities and Stockholders’ Equity	$2,513,645			$2,341,467			$2,190,480		
Net Interest Income (Tax-equivalent Basis)		75,280			69,414			64,421	
Reversal of Tax Equivalent Adjustment		(3,721)	0.16 %		(3,489)	0.16 %		(3,327)	0.16 %
Net Interest Income		$71,559			$65,925			$61,094	
Net Interest Spread			3.10 %			3.08 %			3.05 %
Net Interest Margin			3.15 %			3.13 %			3.11 %

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CHANGES IN NET INTEREST INCOME DUE TO RATE

YIELD ANALYSIS (Tax-equivalent basis)	December 31,		
	2016	2015	2014
Yield on Earning Assets	3.38%	3.35%	3.39%
Cost of Interest-Bearing Liabilities	0.28	0.27	0.34
Net Interest Spread	3.10%	3.08%	3.05%
Net Interest Margin	3.15%	3.13%	3.11%

Our increase in net interest income on a tax-equivalent basis (a non-GAAP measure, see discussion on p. 4) from 2015 to 2016 was $5.9 million, or 8.5%, which continued the trend of increasing net interest income experienced by us in 2015 and 2014. These increases were similar to increases in our average earning assets during the respective year aided in 2016 by a continued slight increase in our net interest margin.

During 2016, our net interest margin (NIM) increased two basis points, as our yield on earning assets increased more than our cost of interest bearing liabilities. Our NIM has continued to increase as we have repositioned our asset portfolio in favor of loans versus investment securities. While our continued loan growth has been the primary driver for maintaining a stable NIM for the past three years, our increased ratio of non-interest-bearing demand deposits to total deposits has helped limit the increase in our cost of funds. We can give no assurances regarding our NIM in 2017 or following periods, even though the Fed has raised short term rates in December of each of the last two years and has signaled the markets that additional rate increases are likely in 2017. We continue to believe that the Fed will be extremely cautious in following through on additional rate increases in future periods.

Our existing, higher-rate assets continue to mature and pay off at a faster pace than we originate new loans (at slightly higher rates) and purchase new investment securities (at slightly higher rates). As a result, we may continue to experience margin compression in upcoming periods, even if prevailing rates ascend slowly. In this light, no assurances can be given that our net interest income will increase in 2017 and subsequent periods, even if asset growth continues or increases, or that net earnings will continue to grow.

A discussion of the models we use in projecting the impact on net interest income resulting from possible changes in interest rates vis-à-vis the repricing patterns of our earning assets and interest-bearing liabilities is included later in this report under Item 7.A., "Quantitative and Qualitative Disclosures About Market Risk."

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

	Years Ended December 31,			Change From Prior Year			
				2015 to 2016		2014 to 2015	
	2016	2015	2014	Amount	%	Amount	%
Earning Assets	$2,388,042	$2,218,440	$2,068,611	$169,602	7.6 %	$149,829	7.2 %
Interest-Bearing Liabilities	1,896,351	1,777,867	1,675,285	118,484	6.7	102,582	6.1
Demand Deposits	366,956	329,017	290,922	37,939	11.5	38,095	13.1
Total Assets	2,513,645	2,341,467	2,190,480	172,178	7.4	150,987	6.9
Earning Assets to Total Assets	95.00 %	94.75 %	94.44 %				

2016 Compared to 2015: In general, an increase in average earning assets has a positive impact on net interest income. For 2016, average earning assets increased $169.6 million or 7.6% over 2015, while average interest-bearing liabilities increased $118.5 million, or 6.7%, and non-interest bearing demand deposits increased $37.9 million or 11.5%. The growth in our net earning assets and demand deposits were the primary factors in the $5.9 million, or 7.8%, increase in our net interest income in 2016 (on a tax-equivalent basis).

An underlying factor in our net asset growth in 2016, and the resulting increase in our net interest income, was a positive change in the mix of our earning assets. The $169.6 million increase in average earning assets from 2015 to 2016 resulted from the average balance of our securities portfolio remaining virtually unchanged, while the average balance of our total loans increased substantially. Within the loan portfolio, our three principal segments are residential real estate loans, automobile loans (primarily through our indirect lending program) and commercial loans. We continued to sell a portion of our residential real estate loan originations into the secondary market in 2016, approximately 16% of our originations. Additionally, we originated a higher volume of residential mortgages in 2016 than in the prior two years and as a result, we experienced a significant increase in the average balance of this segment of the portfolio in 2016. The average balance of our automobile loan portfolio also increased in 2016, reflecting continuing strong demand in automobile sales and our determination to remain competitive on our pricing of these loans with respect to other commercial banks (although we remained at a disadvantage compared to the subsidized, below-market loan rates offered by the financing affiliates of the automobile manufacturers). Our commercial and commercial real estate loan portfolio also experienced growth during 2016.

The $118.5 million increase in average interest-bearing liabilities during 2016 was primarily attributable to an increase in deposits from our existing branch network and secondarily to a $41 million increase in our FHLBNY advances.

2015 Compared to 2014: For 2015, average earning assets increased $149.8 million or 7.2% over 2014, while average interest-bearing liabilities increased $102.6 million, or 6.1%. The growth in our net earning assets was the primary factor in the $4.7 million, or 7.2%, increase in our net interest income in 2015 (on a tax-equivalent basis).

An underlying factor in our net asset growth in 2015, and the resulting increase in our net interest income, was a positive change in the mix of our earning assets. The $149.8 million increase in average earning assets from 2014 to 2015 resulted from a slight increase in the average balance of our securities portfolio, while the average balance of our total loans increased substantially. Within the loan portfolio, our three principal segments are residential real estate loans, automobile loans (primarily through our indirect lending program) and commercial loans. We sold a portion of our residential real estate loan originations into the secondary market in 2015, but such sales were a significantly smaller percentage of our originations than in either of the prior two years. Additionally, we originated a higher volume of residential mortgages in 2015 than in the prior two years. As a result, we experienced a significant increase in the average balance of this segment of the portfolio in 2015. The average balance of our automobile loan portfolio also increased in 2015, reflecting continuing strong demand in automobile sales and our determination to remain competitive on our pricing of these loans with respect to other commercial banks (although we remained at a disadvantage compared to the subsidized, below-market loan rates offered by the financing affiliates of the automobile manufacturers). Our commercial and commercial real estate loan portfolio also experienced growth during 2015.

The $102.6 million increase in average interest-bearing liabilities during 2015 was primarily attributable to an increase in deposits from our existing branch network and secondarily to a $49 million increase in our FHLBNY advances.

II. PROVISION FOR LOAN LOSSES AND ALLOWANCE FOR LOAN LOSSES

We consider our accounting policy relating to the allowance for loan losses to be a critical accounting policy, given the uncertainty involved in evaluating the level of the allowance required to cover credit losses inherent in the loan portfolio, and the material effect that such judgments may have on our results of operations. We recorded a $2.0 million provision for loan losses for 2016, compared to the $1.3 million provision for 2015. The level of the 2016 provision was impacted primarily by the significant growth in loan balances during 2016. Our analysis of the method we employ for determining the amount of the loan loss provision is explained in detail in Notes 2 and 5 to the audited financial statements.

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

Years-Ended December 31,	2016	2015	2014	2013	2012
Period-End Loans	$1,753,268	$1,573,952	$1,413,268	$1,266,472	$1,172,341
Average Loans	1,663,225	1,484,766	1,344,427	1,208,954	1,147,286
Period-End Assets	2,605,242	2,446,188	2,217,420	2,163,698	2,022,796
Nonperforming Assets, at Period-End:					
Nonaccrual Loans:					
Commercial Real Estate	875	2,402	2,071	2,048	2,026
Commercial Loans	155	387	473	352	1,787
Residential Real Estate Loans	2,574	3,195	3,940	3,860	2,400
Consumer Loans	589	449	415	219	420
Total Nonaccrual Loans	4,193	6,433	6,899	6,479	6,633
Loans Past Due 90 or More Days and Still Accruing Interest	1,201	187	537	652	920
Restructured	106	286	333	641	483
Total Nonperforming Loans	5,500	6,906	7,769	7,772	8,036
Repossessed Assets	101	140	81	63	64
Other Real Estate Owned	1,585	1,878	312	81	970
Total Nonperforming Assets	$7,186	$8,924	$8,162	$7,916	$9,070
Allowance for Loan Losses:					
Balance at Beginning of Period	$16,038	$15,570	$14,434	$15,298	$15,003
Loans Charged-off:					
Commercial Loans	(97)	(62)	(212)	(926)	(90)
Real Estate - Commercial	(195)	(7)	—	(11)	(206)
Real Estate - Residential	(107)	(326)	(91)	(15)	(33)
Consumer Loans	(871)	(711)	(718)	(459)	(453)
Total Loans Charged-off	(1,270)	(1,106)	(1,021)	(1,411)	(782)
Recoveries of Loans Previously Charged-off:					
Commercial Loans	23	33	86	88	23
Real Estate – Commercial	—	—	—	—	—
Real Estate – Residential	6	—	—	—	—
Consumer Loans	182	194	223	259	209
Total Recoveries of Loans Previously Charged-off	211	227	309	347	232
Net Loans Charged-off	(1,059)	(879)	(712)	(1,064)	(550)

Provision for Loan Losses					
Charged to Expense	2,033	1,347	1,848	200	845
Balance at End of Period	$17,012	$16,038	$15,570	$14,434	$15,298
Asset Quality Ratios:					
Net Charge-offs to Average Loans	0.06 %	0.06 %	0.05 %	0.09 %	0.05 %
Provision for Loan Losses to Average Loans	0.12 %	0.09 %	0.14 %	0.02 %	0.07 %
Allowance for Loan Losses to Period-end Loans	0.97 %	1.02 %	1.10 %	1.14 %	1.30 %
Allowance for Loan Losses to Nonperforming Loans	309.31 %	232.24 %	200.41 %	185.71 %	190.37 %
Nonperforming Loans to Period-end Loans	0.31 %	0.44 %	0.55 %	0.61 %	0.69 %
Nonperforming Assets to Period-end Assets	0.28 %	0.36 %	0.37 %	0.37 %	0.45 %

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ALLOCATION OF THE ALLOWANCE FOR LOAN LOSSES
(Dollars in Thousands)

	2016	2015	2014	2013	2012
Commercial Loans	$1,017	$1,827	$2,382	$2,303	$2,945
Real Estate-Commercial	5,677	4,520	3,846	3,545	3,050
Real Estate-Residential	4,198	3,790	3,369	3,026	3,405
Consumer Loans	6,120	5,554	5,210	4,478	4,840
Unallocated	—	347	763	1,082	1,058
Total	$17,012	$16,038	$15,570	$14,434	$15,298

The allowance for loan losses increased to $17.0 million at year-end 2016 from $16.0 million at year-end 2015, an increase of 6.1%. However, the loan portfolio increased at an even faster rate during 2016 (the portfolio at year-end 2016 was up by 11.4% compared to year-end 2015), with the result that the allowance for loan losses as a percentage of period-end total loans declined to 0.97% at year-end 2016 from 1.02% at year-end 2015, a decrease of 4.90%.
A variety of factors were considered in evaluating the adequacy of the allowance for loan losses at December 31, 2016 and the provision for loan losses for the year, including:

Factors leading to an increase in the provision for loan losses:
- Loan growth in all three major portfolio segments (commercial, automobile and residential real estate)
- A small increase in classified construction and commercial real estate loans
- A slight increase in the historical loss factor for commercial real estate and automobile loans
- Modest increases in the qualitative factors for automobile and other consumer loans

Factors leading to a decrease in the provision for loan losses:
- A decrease in the historical loss factor for commercial loans
- A general decrease in most qualitative factors for certain loan segments, primarily for the commercial loan segment (related to the nature and volume of the portfolio and loan terms), but also for the residential real estate loan segment (related to a general improvement in collateral values).

See Note 5 to our audited financial statements for a complete list of all the factors used to calculate the provision for loan losses, including the factors that did not change during the year.
Most of our adversely classified loans (special mention and substandard - see our definition for these classifications in Note 5 to our audited financial statements) continued to perform under their contractual terms. The decrease in nonaccrual and impaired loans from 2015 to 2016 was primarily due to just two loans: one transferred to other real estate owned, and one that paid-off during 2016.

III. NONINTEREST INCOME
The majority of our noninterest income constitutes fee income from services, principally fees and commissions from fiduciary services, deposit account service charges, insurance commissions, net gains (losses) on securities transactions and other recurring fee income.

ANALYSIS OF NONINTEREST INCOME
(Dollars In Thousands)

	Years Ended December 31,			Change From Prior Year			
				2015 to 2016		2014 to 2015	
	2016	2015	2014	Amount	%	Amount	%
Income from Fiduciary Activities	$7,783	$7,762	$7,468	$21	0.3 %	$294	3.9 %
Fees for Other Services to Customers	9,469	9,220	9,261	249	2.7	(41)	(0.4)
Insurance Commissions	8,668	8,967	9,455	(299)	(3.3)	(488)	(5.2)

Net (Loss) Gain on Securities Transactions	(22)	129	110	(151)	(117.1)	19	17.3
Net Gain on Sales of Loans	821	692	784	129	18.6	(92)	(11.7)
Other Operating Income	1,113	1,354	1,238	(241)	(17.8)	116	9.4
Total Noninterest Income	$27,832	$28,124	$28,316	$(292)	(1.0)	$(192)	(0.7)

2016 Compared to 2015: Total noninterest income in 2016 was $27.8 million, a decrease of $292 thousand, or 1.0%, from total noninterest income of $28.1 million for 2015. Sales of securities resulted in a loss of $22 thousand in 2016 compared to a gain of $129 thousand in 2015, a net decrease of $151 thousand. Net gains on the sales of loans increased in 2016 to $821 thousand, from $692 thousand in 2015, an increase of $129 thousand, or 18.6%. Income from fiduciary activities increased from 2015 to 2016, by $21 thousand and insurance commissions decreased by $299 thousand, or 3.3% from 2015 to 2016, and other operating income decreased by $241 thousand, or 17.8% between the two years.

Assets under trust administration and investment management at December 31, 2016 were $1.301 billion, an increase of $68.5 million, or 5.6%, from the prior year-end balance of $1.233 billion. Income from fiduciary services for 2016 increased by $21 thousand, or 0.3% above the total for 2015. Much of the increase in balance of assets under trust administration and investment management was attributable to activity late in the third quarter, primarily in response to market performance. In addition, a significant portion of the current year's growth was derived from increased custodial accounts which are business lines that generate lower fee income as a percentage of assets under management.

Fees for other services to customers (primarily service charges on deposit accounts, revenues related to the sale of mutual funds to our customers by third party providers, income from debit card transactions, and servicing income on sold loans) were $8.5 million for 2016, an increase of $249 thousand, or 2.7%, from 2015. The principal cause of the increase was an increase in income from debit card transactions, offset in part by a decline in fee income from service changes on deposit accounts and overdraft fee income. In 2011, VISA reduced its debit interchange rates to comply with new Debit Charges Regulatory Requirements issued by the Federal Reserve Board. In subsequent years, this reduced rate structure imposed on large banks has resulted in smaller banks like ours reducing rates as well, for competitive reasons, which has negatively impacted our fee income. However, debit card usage by our customers continues to grow, which has had (and if such growth persists, will continue to have) a positive impact on our debit card fee income that in most subsequent periods has largely offset or more than offset the negative impact of lower rates.

Noninterest income from insurance commissions decreased by $299 thousand, or 3.3%, between the two periods. This net decrease was primarily attributable to our sale in October 2015 of a specialty line of insurance business previously maintained by one of our insurance agency subsidiaries, specifically, insurance services to out-of-market amateur sports management associations (see "Sale of Loomis Agency" below) which was partially offset by an increase in the contingent annual payments we receive based on the loss experience of our property and casualty insurance clients. We expect that income from insurance commissions will continue to constitute a significant and stable source of noninterest income for us in upcoming periods. We may continue in the future to expand our market profile in this line of business, including through suitable acquisitions, if favorable opportunities should arise.

Net gains on sales of loans amounted to $821 thousand during 2016 an increase of $129 thousand or 18.6% over the 2015 level. This reflects a similar percentage increase in total loans sold between the two years, which increased from $21.1 million in 2015 to $25.0 million in 2016, an 18.7% increase. The rate at which we sell mortgage loan originations in future periods will depend on various circumstances, including prevailing mortgage rates, other lending opportunities, capital and liquidity needs, and the ready availability of a market for such sales. We are unable to predict what our retention rate of such loans in future periods may be, although our retention rates have increased in each of the last 3 years, as the long-term decline in mortgage rates has bottomed out and rates have stabilized. We generally retain servicing rights for loans originated and sold by us, which also generates additional noninterest income in subsequent periods (fees for other services to customers). Other operating income includes net gains on the sale of other real estate owned as well as other miscellaneous revenues, which tend to fluctuate from year to year.

2015 Compared to 2014: Total noninterest income in 2015 was $28.1 million, a decrease of $192 thousand, or 0.7%, from total noninterest income of $28.3 million for 2014. Net gains on the sales of securities increased in 2015 to $129 thousand from $110 thousand in 2014, a net increase of $19 thousand or 17.3%, and net gains on the sales of loans decreased in 2015 to $692 thousand, from $784 thousand in 2014, a decrease of $92 thousand, or 11.7%. Income from fiduciary activities and other operating income both increased from 2014 to 2015, by $294 thousand and $116 thousand, respectively, while insurance commissions, net gains on the sale of loans and fees for other services to customers decreased from 2014 to 2015, by $488 thousand, $92 thousand and $41 thousand, respectively.

Assets under trust administration and investment management at December 31, 2015 were $1.233 billion, up from the prior year-end balance of $1.227 billion. Largely as a result of such increase our income from fiduciary services for 2015 increased by $294 thousand, or 3.9%, above the total for 2014. A significant portion of our fiduciary fees is indexed to the dollar amount of assets under administration. Any significant downturn in the U.S. stock or bond markets in future periods would likely have a corresponding negative impact on our income from fiduciary activities.

Fees for other services to customers (primarily service charges on deposit accounts, revenues related to the sale of mutual funds to our customers by third party providers, income from debit card transactions, and servicing income on sold loans) were $9.2 million for 2015, a decrease of $41 thousand, or .4%, from 2014. The principal cause of the decrease was decline in fee income from service charges on deposit accounts and overdraft fee income, offset in part by an increase in income from debit card transactions. Debit card usage by our customers continues to grow, which has had a positive impact on our debit card fee income.

Noninterest income from insurance commissions decreased by $488 thousand, or 5.2%, between the two periods. The decrease was primarily attributable to a change in the contingent annual payments we receive based on the loss experience of our customers, and to a lesser extent by our sale, in October 2015, of a specialty line of insurance business previously maintained by one of our insurance agency subsidiaries, specifically, insurance services to out-of-market amateur sports management associations. See "Sale of Loomis Agency", below. We expect that income from insurance commissions will continue to constitute a significant and stable source of noninterest income for us in upcoming periods. We may continue in the future to expand our market profile in this line of business, including through suitable acquisitions, if favorable opportunities should arise.

As noted above, our net gains on sales of loans decreased significantly, by 11.7%, between 2014 and 2015. Moreover, because our total mortgage loan originations increased significantly between the two years, loan sales as a percentage of our total originations decreased by an even higher percentage between the two years. Correspondingly, our retention rate of originations increased between 2014 and 2015.

Other operating income includes net gains on the sale of other real estate owned as well as other miscellaneous revenues, which tend to fluctuate from year to year. Included in other operating income for 2015 were a net gain on the sale of one of our

insurance agency subsidiaries ($204 thousand) and net gains recognized in our investment in limited partnerships ($260 thousand), offset in part, by the write-down of a bank-owned property ($404 thousand), which we transferred into other real estate owned and held for sale in the fourth quarter of 2015.I
Sale of Loomis Agency. In October 2015 we sold 100% of the stock of one of our wholly-owned subsidiary insurance agencies, Loomis and LaPann ("Loomis"), to a local insurance agency headquartered in Glens Falls, NY. Historically, Loomis specialized in servicing sports accident and health insurance needs of customers primarily located outside of New York State, and in addition sold property and casualty insurance in our local market area. Before selling Loomis, we transferred most of its property and casualty insurance accounts to another of our subsidiary insurance agencies.

IV. NONINTEREST EXPENSE
Noninterest expense is the measure of the delivery cost of services, products and business activities of a company. The key components of noninterest expense are presented in the following table.

ANALYSIS OF NONINTEREST EXPENSE
(Dollars In Thousands)

	Years Ended December 31,			Change From Prior Year			
				2015 to 2016		2014 to 2015	
	2016	2015	2014	Amount	%	Amount	%
Salaries and Employee Benefits	$34,330	$33,064	$30,941	$1,266	3.8 %	$2,123	6.9 %
Occupancy Expense of Premises, Net	4,983	5,005	4,898	(22)	(0.4)	107	2.2
Furniture and Equipment Expense	4,419	4,262	4,092	157	3.7	170	4.2
FDIC Regular Assessment	1,076	1,186	1,117	(110)	(9.3)	69	6.2
Amortization of Intangible Assets	297	327	387	(30)	(9.2)	(60)	(15.5)
Other Operating Expense	14,504	13,586	12,593	918	6.8	993	7.9
Total Noninterest Expense	$59,609	$57,430	$54,028	$2,179	3.8	$3,402	6.3
Efficiency Ratio	57.51 %	58.62 %	57.91 %	(1.11)%	(1.9)	0.71 %	1.2

2016 compared to 2015: Noninterest expense for 2016 amounted to $59.6 million, an increase of $2.2 million, or 3.8%, from 2015. For 2016, our efficiency ratio was 57.51%. 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), as we define it, is the ratio of operating noninterest expense (excluding intangible asset amortization and any FHLB prepayment penalties) to net interest income (on a tax-equivalent basis) plus operating noninterest income (excluding net securities gains or losses). See the discussion of the efficiency ratio on page 4 of this Report under the heading “Use of Non-GAAP Financial Measures.” Our efficiency ratios in recent periods compared favorably to the ratios of our peer group. For the nine month period ended September 30, 2016, our peer group ratio (as calculated by the Federal Reserve Bank's most recently available report) was 67.14%, compared to our ratio for such period (not adjusted) of 57.15%.
Salaries and employee benefits expense, which typically represents between 55% and 60% of total noninterest expense, increased by $1.3 million, or 3.8%, from 2015 to 2016. The net increase reflects a 2.9% increase in employee benefits, including increases in expenses related to our defined benefit pension and post retirement plans, health benefit plans and incentive compensation plans. Salary expenses increased by 4.2% and were attributable to increased staffing levels as we expanded in our southern market area and to normal salary increases.
Occupancy expense remained consistent while furniture and equipment expenses increased modestly from 2015 to 2016. The increase in equipment expense was primarily attributable to increased data processing costs.
Other operating expense increased $918.0 thousand, or 6.8%, from 2015. This was primarily the result of an increase in the cost of providing our customers with a wide and more complex variety of electronic banking products and services.

2015 compared to 2014: Noninterest expense for 2015 amounted to $57.4 million, an increase of $3.4 million, or 6.3%, from 2014. For 2015, our efficiency ratio was 58.09%. 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. See the discussion of the efficiency ratio on page 4 of this Report under the heading “Use of Non-GAAP Financial Measures” and in the current period paragraph above. For the nine-month period ended September 30, 2015, our peer group ratio (as calculated by the Federal Reserve Bank's most recently available report) was 68.6%, compared to our ratio for such period (not adjusted) of 58.4%.

Salaries and employee benefits expense, which typically represents between 55% and 60% of total noninterest expense, increased by $2.1 million, or 6.9%, from 2014 to 2015. The net increase reflects a 10.2% increase in employee benefits, including increases in expenses related to our defined benefit pension and post retirement plans, health benefit plans and incentive compensation plans. Salary expenses increased by 5.7% and were attributable to increased staffing levels as we expanded in our southern market area and to normal salary increases.

Both building and equipment expenses increased modestly from 2014 to 2015. For buildings, the increase was primarily attributable to increases in maintenance and net rental expense, while the increase in equipment expense was primarily attributable to increased data processing costs.

Other operating expense increased $993.0 thousand, or 7.9% from 2014. This was primarily the result of an increase in outsourced third party providers, including operating costs to implement an Enterprise Performance Management (EPM) system. In addition, during 2015 there were increased legal and professional fees and an increase in the cost of providing our customers with a wide and more complex variety of electronic banking products and services.

V. INCOME TAXES
The following table sets forth our provision for income taxes and effective tax rates for the periods presented.

INCOME TAXES AND EFFECTIVE RATES
(Dollars In Thousands)

	Years Ended December 31,			Change From Prior Year			
				2015 to 2016		2014 to 2015	
	2016	2015	2014	Amount	%	Amount	%
Provision for Income Taxes	$11,215	$10,610	$10,174	$605	5.7 %	$436	4.3 %
Effective Tax Rate	29.7 %	30.1 %	30.3 %	(0.4)%	(1.3)%	(0.2)%	(0.7)%

The provisions for federal and state income taxes amounted to $11.2 million for 2016, $10.6 million for 2015, and $10.2 million for 2014. The effective income tax rates for 2016, 2015 and 2014 were 29.7%, 30.1% and 30.3%, respectively. The changes reflect fluctuations in the ratio of tax-equivalent income to pre-tax income.

C. FINANCIAL CONDITION

I. INVESTMENT PORTFOLIO
Investment securities are classified as held-to-maturity, trading, or available-for-sale, depending on the purposes for which such securities are acquired and thereafter held. Securities held-to-maturity are debt securities that we have both the positive intent and ability to hold to maturity; such securities are stated at amortized cost. Debt and equity securities that are bought and held principally for the purpose of sale in the near term are classified as trading securities and are reported at fair value with unrealized gains and losses included in earnings. Debt and equity securities not classified as either held-to-maturity or trading securities are classified as available-for-sale and are reported at fair value with unrealized gains and losses excluded from earnings and reported net of taxes in accumulated other comprehensive income or loss. During 2016, 2015 and 2014, we held no trading securities. Set forth below is certain information about our securities available-for-sale portfolio and securities held-to-maturity portfolio as of recent year-ends.

Securities Available-for-Sale:
The following table sets forth the carrying value of our securities available-for-sale portfolio at year-end December 31, 2016, December 31, 2015 and December 31, 2014.

SECURITIES AVAILABLE-FOR-SALE
(In Thousands)

	December 31,		
	2016	2015	2014
U.S. Government & Agency Obligations	$147,377	$155,782	$137,603
State and Municipal Obligations	27,690	52,408	81,730
Mortgage-Backed Securities - Residential	167,239	178,588	128,827
Corporate and Other Debt Securities	3,308	14,299	16,725

Mutual Funds and Equity Securities	1,382	1,232	1,254
Total	$346,996	$402,309	$366,139

In all periods, Mortgage-Backed Securities-Residential consisted solely of mortgage pass-through securities and Collateralized Mortgage Obligations ("CMOs") issued or guaranteed by U.S. federal agencies. Mortgage pass-through securities provide to the investor monthly portions of principal and interest pursuant to the contractual obligations of the underlying mortgages. CMOs are pools of mortgage-backed securities, the repayments on which have been separated into two or more components (tranches), where each tranche has a separate estimated life and yield. Our practice has been to purchase only pass-through securities and CMOs that are issued or guaranteed by U.S. federal agencies, and the tranches of CMOs that we purchase generally are those having shorter maturities. Included in our Corporate and Other Debt Securities for each of the periods are corporate bonds that were highly rated (i.e., investment grade) at the time of purchase, although in some cases the securities had been downgraded before the reporting date, but were still investment grade.

The following table sets forth the maturities of the debt securities in our available-for-sale portfolio as of December 31, 2016. CMOs and other mortgage-backed securities are included in the table based on their expected average lives.

MATURITIES OF DEBT SECURITIES AVAILABLE-FOR-SALE
(In Thousands)

	Within One Year	After 1 But Within 5 Years	After 5 But Within 10 Years	After 10 Years	Total
U.S. Government & Agency Obligations	—	147,377	—	—	147,377
State and Municipal Obligations	16,994	9,628	508	560	27,690
Mortgage-Backed Securities - Residential	5,753	100,447	61,039	—	167,239
Corporate and Other Debt Securities	2,508	—	—	800	3,308
Total	25,255	257,452	61,547	1,360	345,614

The following table sets forth the tax-equivalent yields of the debt securities in our available-for-sale portfolio at December 31, 2016.

YIELDS ON SECURITIES AVAILABLE-FOR-SALE
(Fully Tax-Equivalent Basis)

	Within One Year	After 1 But Within 5 Years	After 5 But Within 10 Years	After 10 Years	Total
U.S. Government & Agency Obligations	— %	1.51 %	— %	— %	1.51 %
State and Municipal Obligations	1.40	2.15	7.25	8.14	1.90
Mortgage-Backed Securities - Residential	2.48	2.06	2.32	—	2.17
Corporate and Other Debt Securities	0.95	—	—	3.59	1.70
Total	1.60	1.75	2.36	5.22	1.86

The yields on obligations of states and municipalities exempt from federal taxation were computed on a fully tax-equivalent basis using a marginal tax rate of 35%. The yields on other debt securities shown in the table above are calculated by dividing annual interest, including accretion of discounts and amortization of premiums, by the amortized cost of the securities at December 31, 2016.

At December 31, 2016 and 2015, the weighted average maturity was 3.4 and 2.8 years, respectively, for debt securities in the available-for-sale portfolio.

At December 31, 2016, the net unrealized losses on securities available-for-sale amounted to $619 thousand. The net unrealized gain or loss on such securities, net of tax, is reflected in accumulated other comprehensive income/loss. For 2016, the net unrealized losses were primarily attributable to an average increase in market rates between the date of purchase and the balance sheet date, resulting in lower valuations of the portfolio securities. The net unrealized gains on securities available-for-sale was $1.0 million at December 31, 2015. For both periods, the net unrealized gain was primarily attributable to an average decrease in market rates between the date of purchase and the balance sheet date resulting in higher valuations of the portfolio securities.

For further information regarding our portfolio of securities available-for-sale, see Note 4 to the Consolidated Financial Statements contained in Part II, Item 8 of this Report.

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Securities Held-to-Maturity:
The following table sets forth the carrying value of our portfolio of securities held-to-maturity at December 31 of each of the last three years.

SECURITIES HELD-TO-MATURITY
(In Thousands)

	December 31,		
	2016	2015	2014
State and Municipal Obligations	$268,892	$226,053	$188,472
Mortgage Backed Securities - Residential	75,535	93,558	112,552
Corporate and Other Debt Securities	1,000	1,000	1,000
Total	$345,427	$320,611	$302,024

For a description of certain categories of securities held in the securities held-to-maturity portfolio on the reporting dates, as listed in the table above, specifically, "Mortgage-Backed Securities--Residential" and "Corporate and Other Debt Securities," see the paragraph under "SECURITIES AVAILABLE-FOR-SALE" table, above.
For information regarding the fair value of our portfolio of securities held-to-maturity at December 31, 2016, see Note 4 to the Consolidated Financial Statements contained in Part II, Item 8 of this Report.

The following table sets forth the maturities of our portfolio of securities held-to-maturity as of December 31, 2016.

MATURITIES OF DEBT SECURITIES HELD-TO-MATURITY
(In Thousands)

	Within One Year	After 1 But Within 5 Years	After 5 But Within 10 Years	After 10 Years	Total
State and Municipal Obligations	$32,456	$86,070	$146,603	$3,763	$268,892
Mortgage Backed Securities - Residential	—	61,712	13,823	—	75,535
Corporate and Other Debt Securities	1,000	—	—	—	1,000
Total	$33,456	$147,782	$160,426	$3,763	$345,427

The following table sets forth the tax-equivalent yields of our portfolio of securities held-to-maturity at December 31, 2016.

YIELDS ON SECURITIES HELD-TO-MATURITY
(Fully Tax-Equivalent Basis)

	Within One Year	After 1 But Within 5 Years	After 5 But Within 10 Years	After 10 Years	Total
State and Municipal Obligations	2.52%	4.09%	2.90%	4.47%	3.26%
Mortgage Backed Securities - Residential	—	2.21	2.57	—	2.28%
Corporate and Other Debt Securities	7.00	—	—	—	7.00%
Total	2.52%	2.38%	2.65%	5.00%	2.56%

The yields shown in the table above are calculated by dividing annual interest, including accretion of discounts and amortization of premiums, by the amortized cost of the securities at December 31, 2016. Yields on obligations of states and municipalities exempt from federal taxation were computed on a fully tax-equivalent basis using a marginal tax rate of 35%.

At December 31, 2016 and 2015, the weighted average maturity was 4.3 and 3.8 years, respectively, for the debt securities in the held-to-maturity portfolio.

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II. LOAN PORTFOLIO

The amounts and respective percentages of loans outstanding represented by each principal category on the dates indicated were as follows:

a. Types of Loans
(Dollars In Thousands)

	December 31,									
	2016		2015		2014		2013		2012	
	Amount	%	Amount	%	Amount	%	Amount	%	Amount	%
Commercial	$105,155	6	$102,587	7	$99,511	7	$87,893	7	$105,536	9
Commercial Real Estate – Construction	36,948	2	31,018	2	18,815	1	27,815	2	29,149	2
Commercial Real Estate – Other	394,698	23	353,921	22	321,297	23	288,119	23	245,177	21
Consumer	537,361	31	464,523	29	437,041	31	401,853	32	355,784	31
Residential Real Estate	679,106	39	621,903	40	536,604	38	460,792	36	436,695	37
Total Loans	1,753,268	100	1,573,952	100	1,413,268	100	1,266,472	100	1,172,341	100
Allowance for Loan Losses	(17,012)		(16,038)		(15,570)		(14,434)		(15,298)	
Total Loans, Net	$1,736,256		$1,557,914		$1,397,698		$1,252,038		$1,157,043	

Maintenance of High Quality in the Loan Portfolio: For many reasons, including our credit underwriting standards and our market stability, we largely avoided the negative impact on asset quality that many other banks suffered during and after the 2008-2009 financial crisis. From the start of the crisis through the date of this Report, we did not experience 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. We have not 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 justified doing so, or have had extensions of credit outstanding to borrowers who developed credit problems after origination resulting in deterioration of their FICO scores.

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

However, like all other banks we operate in an environment in which identifying opportunities for secure and profitable expansion of our loan portfolio remains challenging, competition is intense, and margins are very tight. If the U.S. economy and our regional economy continue to experience only very modest growth, our individual borrowers will presumably continue to proceed cautiously in taking on new or additional debt. Many small businesses are operating on very narrow margins and many families continue to live on very tight budgets. If the U.S. economy or our regional economy worsens in upcoming periods, which we think unlikely but possible, we may experience elevated charge-offs, higher provisions to our loan loss reserve, and increasing expense related to asset maintenance and supervision.

Residential Real Estate Loans: In recent years, residential real estate and home equity loans have represented the largest single segment of our loan portfolio (comprising approximately 39% of the entire portfolio at December 31,

2016), eclipsing both other consumer loans (31% of the portfolio) and our commercial and commercial real estate loans (31%). Our gross originations for residential real estate loans (including refinancings of mortgage loans) were $153.6 million, $144.2 million and $131.2 million for the years 2016, 2015, and 2014, respectively. During each of these years, these gross origination totals have significantly exceeded the sum of repayments and prepayments of such loans previously in the portfolio, but we have also sold significant portions of these originations in the secondary market, primarily to Freddie Mac, particularly when rates on conventional 30-year fixed rate real estate mortgages reached historically low levels in the 2013-2014 period. Sales of originations amounted to $25.0 million for 2016, $21.1 million for 2015 and $29.8 million for 2014, which represented a significant percentage of the gross originations in each year (16.3%, 14.6% and 22.7%, respectively). We expect to continue to sell a portion of our mortgage loan originations in upcoming periods, although perhaps a decreasing percentage of overall originations if rates continue their slow rise across longer maturities. At the same time, if prevailing rates rise substantially, we may see a slowdown in loan growth and perhaps decreasing total originations, particularly if the general economy also falters. At some point, it is possible that we may experience a decrease in our outstanding balances in this largest segment of our portfolio. Additionally, if our local economy or real estate market should suffer a major downturn, the quality of our real estate portfolio may also be negatively impacted.
The Federal Reserve wound down its quantitative easing program in 2014. Although it was expected that the winding down process might lead to, or accompany, a general rise in long-term mortgage loan rates, the 30-year and 15-year rates have not experienced any significant increase, and have in some markets actually decreased, in ensuing periods. While economic conditions have generally improved, which led in part to the Fed's decision to terminate its quantitative easing program in 2014, management

is not able to predict at this point when, or if, mortgage rates or interest rates generally will experience a meaningful and substantial increase, or what the overall effect of such an increase would be on our mortgage loan portfolio or our loan portfolio generally, or on our net interest income, net income or financial results, in future periods.

Commercial, Commercial Real Estate and Construction and Land Development Loans: Over the last decade, we have experienced moderate and occasionally strong demand for commercial and commercial real estate loans. These loan balances have generally increased, both in dollar amount and as a percentage of the overall loan portfolio, and this segment of our portfolio was the segment least affected by the 2008-2009 crisis. Particularly over the last three years, commercial and commercial real estate loan growth was significant as outstanding balances increased by $49.3 million, $47.9 million, and $35.8 million in 2016, 2015 and 2014, respectively. Growth was restrained somewhat by heightened competition for credits in an extremely low rate environment.
Substantially all commercial and commercial real estate loans in our portfolio were extended to businesses or borrowers located in our regional markets. Many of the loans in the commercial portfolio have variable rates tied to prime or FHLBNY rates. Although on a national scale the commercial real estate market suffered a major downturn in the 2008-2009 period (from which it has largely recovered), we did not experience any significant weakening in the quality of our commercial loan portfolio even in the depths of the crisis, nor have we in the subsequent years. However, it is entirely possible that we may experience a reduction in the demand for commercial and commercial real estate loans and/or a weakening in the quality of our portfolio in upcoming periods. But at period-end 2016, the business sector, at least in our service area, appeared to be in reasonably good financial condition.

Automobile Loans (primarily through indirect lending): At December 31, 2016, our automobile loans (primarily loans originated through dealerships located primarily in upstate New York and Vermont) represented nearly a third of loans in our portfolio, and continue to be a significant component of our business.
During recent years. including 2016, there was a nationwide resurgence in automobile sales, due initially to an aging fleet but more recently to a modest growth in consumer optimism. Our automobile loan origination volume for the last three years was very strong at $286.7 million, $228.8 million and $222.9 million for 2016, 2015 and 2014, respectively.
Our indirect automobile loan portfolio reflects a modest shift to a slightly larger (but still very small in absolute terms) percentage of such loans that have been extended to individuals with lower credit scores matching a widely noted recent development auto lending generally. In addition, our average maturity for automobile loan originations has expanded in recent years as well, again reflective of a larger market development. In 2016, net charge-offs on our automobile loans remained very low. at 0.13% of average balances. Net charge-offs were $662 thousand for 2016 compared to net charge-offs of $498 thousand for 2015, an increase that reflected this modest shift in the quality of the portfolio noted above. Our experienced lending staff not only utilizes credit evaluation software tools but also reviews and evaluates each loan individually prior to the loan being funded. We believe our disciplined approach to evaluating risk has contributed to maintaining our strong loan quality in this portfolio. However, if weakness in auto demand returns, our portfolio is likely to experience limited, if any, overall growth, either in absolute amounts or as a percentage of the total portfolio, regardless of whether the auto company affiliates are offering highly-subsidized loans. If demand levels off, or slackens, so will our financial performance in this important loan category.

The following table indicates the changing mix in our loan portfolio by including the quarterly average balances for our significant loan products for the past five quarters. The remaining quarter-by-quarter tables present the percentage of total loans represented by each category and the annualized tax-equivalent yield of each category.

LOAN PORTFOLIO
Quarterly Average Loan Balances
(Dollars In Thousands)

	Quarters Ended				
	12/31/2016	9/30/2016	6/30/2016	3/31/2016	12/31/2015

Commercial and Commercial Real Estate	$532,456	$524,523	$519,775	$502,392	$495,173
Residential Real Estate	490,427	470,865	462,253	451,330	438,987
Home Equity	135,939	133,009	131,513	130,227	128,085
Consumer Loans[1]	567,916	552,454	535,860	511,069	493,989
Total Loans	$1,726,738	$1,680,851	$1,649,401	$1,595,018	$1,556,234

Percentage of Total Quarterly Average Loans

	Quarters Ended				
	12/31/2016	9/30/2016	6/30/2016	3/31/2016	12/31/2015
Commercial and Commercial Real Estate	30.8 %	31.2 %	31.5 %	31.5 %	31.8 %
Residential Real Estate	28.4	28.0	28.0	28.3	28.2
Home Equity	7.9	7.9	8.0	8.2	8.2
Consumer Loans[1]	32.9	32.9	32.5	32.0	31.8
Total Loans	100.0%	100.0 %	100.0 %	100.0 %	100.0 %

Quarterly Tax-Equivalent Yield on Loans

	Quarters Ended				
	12/31/2016	9/30/2016	6/30/2016	3/31/2016	12/31/2015
Commercial and Commercial Real Estate	4.29%	4.28 %	4.44 %	4.32 %	4.37 %
Residential Real Estate	4.09	4.20	4.22	4.22	4.21
Home Equity	3.11	3.13	3.08	3.05	2.92
Consumer Loans[1]	3.18	3.19	3.18	3.17	3.19
Total Loans	3.78%	3.82 %	3.86 %	3.82 %	3.83 %

[1] Other Consumer Loans includes certain home improvement loans secured by mortgages. However, these same loan balances are reported as
Residential Real Estate in the table of period-end balances on page 40, captioned "Types of Loans."

During the fourth quarter of 2016, the average yield on our loan portfolio from the average yield during the fourth quarter of 2015, fell slightly from 3.83% to 3.78%. The yields on new 30 year fixed-rate residential real estate loans (the choice of most of our mortgage customers) remained very low during all five quarters. We continued to sell a portion of our originations to the secondary market, specifically, to Freddie Mac, although we retained a higher proportion of our gross originations in 2016 than in 2015, continuing a multi-year trend of expanding our retention rate versus our sale rate.

In 2016, the average yield on the loan portfolio continued to decline at a slightly faster pace then the cost of our deposits, although our net interest margin held steady during the year. We expect that average loan yields may begin to stabilize in 2017; any slight increase in origination rates are likely to be counterbalanced, for a period of time, by continuing repayments of even higher rate maturing loans.

In general, the yield (tax-equivalent interest income divided by average loans) on our loan portfolio and other earning assets has historically been impacted by changes in prevailing interest rates, as previously discussed in this Report beginning on page 31 under the heading "Impact of Interest Rate Changes." We expect that such will continue to be the case; that is, that loan yields will continue to rise and fall with changes in prevailing market rates, although the timing and degree of responsiveness will be influenced by a variety of other factors, including the extent of federal government and Federal Reserve participation in the home mortgage market, the makeup of our loan portfolio, the shape of the yield curve, consumer expectations and preferences, and the rate at which the portfolio expands. Additionally, there is a significant amount of cash flow from normal amortization and prepayments in all loan categories, and this cash flow reprices at current rates as new loans are generated at the current yields. Thus, even if prevailing rates remain flat or even increase slightly 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.

The following table indicates the respective maturities and interest rate structure of our commercial and commercial real estate construction loans at December 31, 2016. For purposes of determining relevant maturities, loans are assumed to mature at (but not before) their scheduled repayment dates as required by contractual terms. Demand loans and overdrafts are included in the "Within 1 Year" maturity category. Most of the commercial construction loans are made with a commitment for permanent financing, whether extended by us or unrelated third parties. The maturity distribution below reflects the final maturity of the permanent financing.

b. Maturities and Sensitivities of Loans to Changes in Interest Rates
(In Thousands)

	Within 1 Year	After 1 But Within 5 Years	After 5 Years	Total
Commercial	$18,861	$58,159	$28,135	$105,155
Commercial Real Estate - Construction	10,602	18,225	8,121	36,948

Total	$29,463	$76,384	$36,256	$142,103
Fixed Interest Rates	$2,315	$38,576	$17,476	$58,367
Variable Interest Rates	27,148	37,808	18,780	83,736
Total	$29,463	$76,384	$36,256	$142,103

COMMITMENTS AND LINES OF CREDIT

Stand-by letters of credit represent extensions of credit granted in the normal course of business, which are not reflected in the financial statements at a given date because the commitments are not funded at that time. As of December 31, 2016, our total contingent liability for standby letters of credit amounted to $3.4 million. In addition to these instruments, we also have issued lines of credit to customers, including home equity lines of credit, commitments for residential and commercial construction loans and other personal and commercial lines of credit, which also may be unfunded or only partially funded from time-to-time. Commercial lines, generally issued for a period of one year, are usually extended to provide for the working capital requirements of the borrower. At December 31, 2016, we had outstanding unfunded loan commitments in the aggregate amount of approximately $383.6 million.

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c. Risk Elements

1. Nonaccrual, Past Due and Restructured Loans
The amounts of nonaccrual, past due and restructured loans at year-end for each of the past five years are presented in the table on page 33 under the heading "Summary of the Allowance and Provision for Loan Losses."
Loans are placed on nonaccrual status either due to the delinquency status of principal and/or interest or a judgment by management that the full repayment of principal and interest is unlikely. Unless already placed on nonaccrual status, loans secured by home equity lines of credit are put on nonaccrual status when 120 days past due and residential real estate loans are put on nonaccrual status when 150 days past due. Commercial and commercial real estate loans are evaluated on a loan-by-loan basis and are placed on nonaccrual status when 90 days past due if the full collection of principal and interest is uncertain. Under the Uniform Retail Credit Classification and Account Management Policy established by banking regulators, fixed-maturity consumer loans not secured by real estate must generally be charged-off no later than when 120 days past due. Loans secured with non-real estate collateral in the process of collection are charged-down to the value of the collateral, less cost to sell. Open-end credits, residential real estate loans and commercial loans are evaluated for charge-off on a loan-by-loan basis when placed on nonaccrual status.
We had no material commitments to lend additional funds on outstanding nonaccrual loans at December 31, 2016.
Loans past due 90 days or more and still accruing interest are those loans which were contractually past due 90 days or more but because of expected repayments, were still accruing interest.
The balance of loans 30-89 days past due totaled $9.1 million at December 31, 2016 and represented 0.52% of loans outstanding at that date, as compared to approximately $8.1 million, or 0.51% of loans outstanding at December 31, 2015. These non-current loans at December 31, 2016 were composed of approximately $6.4 million of consumer loans (principally indirect automobile loans), $2.5 million of residential real estate loans and $0.3 million of commercial and commercial real estate loans.
We evaluate nonaccrual loans over $250 thousand and all troubled debt restructured loans individually for impairment. All our impaired loans are measured based on either (i) the present value of expected future cash flows discounted at the loan's effective interest rate, (ii) the loan's observable market price or (iii) the fair value of the collateral, less cost to sell, if the loan is collateral dependent. We determine impairment for collateralized loans based on the fair value of the collateral less estimated cost to sell. For other impaired loans, impairment is determined by comparing the recorded value of the loan to the present value of the expected cash flows, discounted at the loan's effective interest rate. We determine the interest income recognition method for impaired loans on a loan-by-loan basis. Based upon the borrowers' payment histories and cash flow projections, interest recognition methods include full accrual or cash basis. Our method for measuring all other loans is described in detail in Notes 2 and 5 to the consolidated financial statements.
The loan note to the consolidated financial statements, i.e., Note 5 (beginning on page 72) contains detailed information on modified loans and impaired loans.

2. Potential Problem Loans
On at least a quarterly basis, we re-evaluate our internal credit quality rating for commercial loans that are either past due or fully performing but exhibit certain characteristics that could reflect a potential weakness. Loans are placed on nonaccrual status when the likely amount of future principal and interest payments are expected to be less than the contractual amounts, even if such loans are not past due.
Periodically we review the loan portfolio for evidence of potential problem loans. Potential problem loans are loans that are currently performing in accordance with contractual terms, but where known information about possible credit problems of the borrower causes doubt about the ability of the borrower to comply with the loan payment terms and may result in disclosure of such loans as nonperforming at some time in the future. In our credit monitoring program, we treat loans that are classified as substandard but continue to accrue interest as potential problem loans. At December 31, 2016, we identified 101 commercial loans totaling $34.8 million as potential problem loans. At December 31, 2015, we identified 111 commercial loans totaling $24.6 million as potential problem loans. For these

loans, although positive factors such as payment history, value of supporting collateral, and/or personal or government guarantees led us to conclude that accounting for them as non-performing at year-end was not warranted, other factors, specifically, certain risk factors related to the loan or the borrower justified concerns that they may become nonperforming at some point in the future.
The overall level of our performing loans that demonstrate characteristics of potential weakness from time-to-time is for the most part dependent on economic conditions in northeastern New York State, which in turn are generally impacted at least in part by economic conditions in the U.S. On both the regional and national levels, economic conditions have largely recovered from the 2008-2009 financial crisis, although growth in the economy remained slow by comparison to previous historical post-recession recoveries. If growth remains weak , potential problem loans likely will continue at or near their present levels or may even increase.

3. Foreign Outstandings - None

4. Loan Concentrations
The loan portfolio is well diversified. There are no concentrations of credit that exceed 10% of the portfolio, other than the general categories reported in the preceding Section C.II.a. of this Item 7, beginning on page 40. For further discussion, see Note 1 to the Consolidated Financial Statements in Part II, Item 8 of this Report.

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5. Other Real Estate Owned and Repossessed Assets

Other real estate owned ("OREO") primarily consists of real property acquired in foreclosure. OREO is carried at fair value less estimated cost to sell. We establish allowances for OREO losses, which are determined and monitored on a property-by-property basis and reflect our ongoing estimate of the property's estimated fair value less costs to sell. For all periods, all OREO was held for sale. All repossessed assets for each of the five years in the table below consist of motor vehicles.

Distribution of OREO and Repossessed Assets (In Thousands)	December 31,				
	2016	2015	2014	2013	2012
Single Family 1 - 4 Units	$795	$1,357	$—	$41	$552
Commercial Real Estate	790	521	312	40	418
Other Real Estate Owned, Net	1,585	1,878	312	81	970
Repossessed Assets	101	140	81	63	64
Total OREO and Repossessed Assets	$1,686	$2,018	$393	$144	$1,034

The following table summarizes changes in the net carrying amount of OREO and the number of properties for each of the periods presented.

Schedule of Changes in OREO (In Thousands)	2016	2015	2014	2013	2012
Balance at Beginning of Year	$1,878	$312	$81	$970	$460
Properties Acquired Through Foreclosure	1,009	1,889	469	392	950
Transfer of Bank Property	—	270	—	—	—
Subsequent Write-downs to Fair Value	(162)	(9)	—	—	—
Sales	(1,140)	(584)	(238)	(1,281)	(440)
Balance at End of Year	$1,585	$1,878	$312	$81	$970
Number of Properties, Beginning of Year	6	1	2	7	