

ARROW FINANCIAL CORP
Form 10-Q
May 09, 2018

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

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

For the Quarterly Period Ended March 31, 2018

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

Commission File Number: 0-12507

ARROW FINANCIAL CORPORATION

(Exact name of registrant as specified in its charter)

New York
(State)

22-2448962

or
other jurisdiction of
incorporation No.)

(I.R.S.
Employer
Identification

or
organization)
250 GLEN STREET,
GLENS FALLS, NEW
YORK 12801

(Address of principal
executive offices) (Zip
Code)

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

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

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

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

Large accelerated filer Accelerated
filer
(Do not
check if a
Non-accelerated filer smaller
reporting
company)

Smaller reporting company
Emerging growth company
If an emerging growth company, indicate
by check mark if the registrant has elected
not to use the extended transition period
for complying with any new or revised
financial accounting standard provided
pursuant to Section 13(a) of the Exchange
Act.

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

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

Class	Outstanding as of April 30, 2018
Common Stock, par value \$1.00 per share	13,969,371

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PART I - FINANCIAL INFORMATION

Item 1.

FINANCIAL STATEMENTS

ARROW FINANCIAL CORPORATION AND SUBSIDIARIES

CONSOLIDATED BALANCE SHEETS

(In Thousands, Except Share and Per Share Amounts)

(Unaudited)

	March 31, 2018	December 31, 2017	March 31, 2017
ASSETS			
Cash and Due From Banks	\$29,525	\$42,562	\$50,158
Interest-Bearing Deposits at Banks	70,747	30,276	14,645
Investment Securities:			
Available-for-Sale	305,589	300,200	347,159
Held-to-Maturity (Approximate Fair Value of \$324,937 at March 31, 2018; \$335,901 at December 31, 2017; and \$335,105 at March 31, 2017)	330,124	335,907	335,211
Equity Securities	1,579	—	—
Other Investments	4,780	9,949	6,826
Loans	1,993,037	1,950,770	1,810,805
Allowance for Loan Losses	(19,057)	(18,586)	(17,216)
Net Loans	1,973,980	1,932,184	1,793,589
Premises and Equipment, Net	27,815	27,619	26,585
Goodwill	21,873	21,873	21,873
Other Intangible Assets, Net	2,172	2,289	2,575
Other Assets	58,503	57,606	57,765
Total Assets	\$2,826,687	\$2,760,465	\$2,656,386
LIABILITIES			
Noninterest-Bearing Deposits	\$452,347	\$441,945	\$402,506
Interest-Bearing Checking Accounts	944,161	907,315	959,170
Savings Deposits	762,220	694,573	696,625
Time Deposits over \$250,000	85,403	38,147	30,993
Other Time Deposits	167,142	163,136	167,242
Total Deposits	2,411,273	2,245,116	2,256,536
Federal Funds Purchased and Securities Sold Under Agreements to Repurchase	74,957	64,966	32,035
Federal Home Loan Bank Overnight Advances	—	105,000	32,000
Federal Home Loan Bank Term Advances	45,000	55,000	55,000
Junior Subordinated Obligations Issued to Unconsolidated Subsidiary Trusts	20,000	20,000	20,000
Other Liabilities	22,723	20,780	24,704
Total Liabilities	2,573,953	2,510,862	2,420,275
STOCKHOLDERS' EQUITY			
Preferred Stock, \$5 Par Value; 1,000,000 Shares Authorized	—	—	—
Common Stock, \$1 Par Value; 20,000,000 Shares Authorized (18,481,301 Shares Issued and Outstanding at March 31, 2018; 18,481,301 at December 31, 2017 and 17,943,201 at March 31, 2017)	18,481	18,481	17,943
Additional Paid-in Capital	290,980	290,219	271,517
Retained Earnings	34,093	28,818	31,901
Unallocated ESOP Shares (9,643 Shares at March 31, 2018; 9,643 Shares at December 31, 2017 and 19,466 Shares at March 31, 2017)	(200)	(200)	(400)

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Accumulated Other Comprehensive Loss	(11,285) (8,514) (6,680)
Treasury Stock, at Cost (4,516,444 Shares at March 31, 2018; 4,541,524 Shares at December 31, 2017 and 4,442,292 Shares at March 31, 2017)	(79,335) (79,201) (78,170)
Total Stockholders' Equity	252,734	249,603	236,111	
Total Liabilities and Stockholders' Equity	\$2,826,687	\$2,760,465	\$2,656,386	

See Notes to Unaudited Interim Consolidated Financial Statements.

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ARROW FINANCIAL CORPORATION AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF INCOME

(In Thousands, Except Per Share Amounts)

(Unaudited)

	Three Months Ended March 31,	
	2018	2017
INTEREST AND DIVIDEND INCOME		
Interest and Fees on Loans	\$18,858	\$16,402
Interest on Deposits at Banks	134	60
Interest and Dividends on Investment Securities:		
Fully Taxable	1,893	1,990
Exempt from Federal Taxes	1,533	1,545
Total Interest and Dividend Income	22,418	19,997
INTEREST EXPENSE		
Interest-Bearing Checking Accounts	387	331
Savings Deposits	522	291
Time Deposits over \$250,000	204	55
Other Time Deposits	259	228
Federal Funds Purchased and Securities Sold Under Agreements to Repurchase	16	7
Federal Home Loan Bank Advances	414	445
Junior Subordinated Obligations Issued to Unconsolidated Subsidiary Trusts	214	179
Total Interest Expense	2,016	1,536
NET INTEREST INCOME	20,402	18,461
Provision for Loan Losses	746	358
NET INTEREST INCOME AFTER PROVISION FOR LOAN LOSSES	19,656	18,103
NONINTEREST INCOME		
Income From Fiduciary Activities	2,197	2,018
Fees for Other Services to Customers	2,380	2,256
Insurance Commissions	1,903	2,198
Net Unrealized Gain on Equity Securities	18	—
Net Gain on Sales of Loans	38	45
Other Operating Income	353	178
Total Noninterest Income	6,889	6,695
NONINTEREST EXPENSE		
Salaries and Employee Benefits	9,369	9,147
Occupancy Expenses, Net	2,541	2,544
FDIC Assessments	217	226
Other Operating Expense	3,829	3,558
Total Noninterest Expense	15,956	15,475
INCOME BEFORE PROVISION FOR INCOME TAXES	10,589	9,323
Provision for Income Taxes	2,058	2,692
NET INCOME	\$8,531	\$6,631
Average Shares Outstanding ¹ :		
Basic	13,936	13,889
Diluted	14,016	14,001

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Per Common Share:

Basic Earnings	\$0.61	\$0.48
Diluted Earnings	0.61	0.47

¹ 2017 Share and Per Share Amounts have been restated for the September 28, 2017 3% stock dividend.
See Notes to Unaudited Interim Consolidated Financial Statements.

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ARROW FINANCIAL CORPORATION AND SUBSIDIARIES
 CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

(In Thousands)

(Unaudited)

	Three Months Ended March 31,	
	2018	2017
Net Income	\$8,531	\$6,631
Other Comprehensive Income, Net of Tax:		
Net Unrealized Securities Holding Gains (Losses)	(2,485)	47
Arising During the Period		
Amortization of Net Retirement Plan Actuarial Loss	46	109
Accretion of Net Retirement Plan Prior	(1)	(2)
Service Credit		
Other Comprehensive Income (Loss)	(2,440)	154
Comprehensive Income	\$6,091	\$6,785

See Notes to Unaudited Interim Consolidated Financial Statements.

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

	Common Stock	Additional Paid-In Capital	Retained Earnings	Unallo-cated ESOP Shares	Accumu-lated Other Com- prehensive Loss	Treasury Stock	Total
Balance at December 31, 2017	\$ 18,481	\$ 290,219	\$ 28,818	\$ (200)	\$ (8,514)	\$ (79,201)	\$ 249,603
Net Income	—	—	8,531	—	—	—	8,531
Other Comprehensive Loss	—	—	—	—	(2,440)	—	(2,440)
Impact of the Adoption of ASU 2014-09	—	—	(102)	—	—	—	(102)
Impact of the Adoption of ASU 2016-01	—	—	331	—	(331)	—	—
Cash Dividends Paid, \$.25 per Share	—	—	(3,485)	—	—	—	(3,485)
Stock Options Exercised, Net (27,662 Shares)	—	307	—	—	—	303	610
Shares Issued Under the Employee Stock Purchase Plan (3,674 Shares)	—	76	—	—	—	40	116
Shares Issued for Dividend Reinvestment Plans (12,459 Shares)	—	289	—	—	—	142	431
Stock-Based Compensation Expense	—	89	—	—	—	—	89
Purchase of Treasury Stock (18,715 Shares)	—	—	—	—	—	(619)	(619)
Balance at March 31, 2018	\$ 18,481	\$ 290,980	\$ 34,093	\$ (200)	\$ (11,285)	\$ (79,335)	\$ 252,734
Balance at December 31, 2016	\$ 17,943	\$ 270,880	\$ 28,644	\$ (400)	\$ (6,834)	\$ (77,381)	\$ 232,852
Net Income	—	—	6,631	—	—	—	6,631
Other Comprehensive Income	—	—	—	—	154	—	154
Cash Dividends Paid, \$.243 per Share 1	—	—	(3,374)	—	—	—	(3,374)
Stock Options Exercised, Net (16,721 Shares)	—	187	—	—	—	201	388
Shares Issued Under the Directors' Stock Plan (554 Shares)	—	14	—	—	—	8	22
Shares Issued Under the Employee Stock Purchase Plan (3,049 Shares)	—	69	—	—	—	37	106
Shares Issued for Dividend Reinvestment Plans (12,447 Shares)	—	284	—	—	—	141	425
Stock-Based Compensation Expense	—	83	—	—	—	—	83
Purchase of Treasury Stock (33,970 Shares)	—	—	—	—	—	(1,176)	(1,176)
Balance at March 31, 2017	\$ 17,943	\$ 271,517	\$ 31,901	\$ (400)	\$ (6,680)	\$ (78,170)	\$ 236,111

¹ Cash dividends paid per share have been adjusted for the September 28, 2017 3% stock dividend.
See Notes to Unaudited Interim Consolidated Financial Statements.

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

	Three Months Ended March 31,	
	2018	2017
Cash Flows from Operating Activities:	2018	2017
Net Income	\$8,531	\$6,631
Adjustments to Reconcile Net Income to Net Cash Provided by Operating Activities:		
Provision for Loan Losses	746	358
Depreciation and Amortization	1,199	1,524
Net Unrealized Gains on Equity Securities	(18) —
Loans Originated and Held-for-Sale	(12,326	) (2,186)
Proceeds from the Sale of Loans Held-for-Sale	12,520	1,818
Net Gains on the Sale of Loans	(38	) (45)
Net Losses on the Sale of Premises and Equipment, Other Real Estate Owned and Repossessed Assets	32	7
Contributions to Retirement Benefit Plans	(134	) (165)
Deferred Income Tax Benefit	(220	) (82)
Shares Issued Under the Directors' Stock Plan	—	22
Stock-Based Compensation Expense	89	83
Tax Benefit from Exercise of Stock Options	112	45
Net Increase in Other Assets	(395	) (886)
Net Increase in Other Liabilities	2,185	2,817
Net Cash Provided By Operating Activities	12,283	9,941
Cash Flows from Investing Activities:		
Proceeds from the Maturities and Calls of Securities Available-for-Sale	9,380	11,826
Purchases of Securities Available-for-Sale	(19,979	) (12,324)
Proceeds from the Maturities and Calls of Securities Held-to-Maturity	6,459	10,474
Purchases of Securities Held-to-Maturity	(921	) (556)
Net Increase in Loans	(42,968	) (57,637)
Proceeds from the Sales of Premises and Equipment, Other Real Estate Owned and Repossessed Assets	437	304
Purchase of Premises and Equipment	(627	) (247)
Proceeds from the Sale of a Subsidiary, Net	—	23
Net Decrease in Other Investments	5,169	4,086
Net Cash Used By Investing Activities	(43,050	) (44,051)
Cash Flows from Financing Activities:		
Net Increase in Deposits	166,157	139,990
Net Decrease in Short-Term Federal Home Loan Bank Borrowings	(105,000	) (91,000)
Net Increase (Decrease) in Short-Term Borrowings	9,991	(3,801)
Repayments of Federal Home Loan Bank Term Advances	(10,000) —
Purchase of Treasury Stock	(619	) (1,176)
Stock Options Exercised, Net	610	388
Shares Issued Under the Employee Stock Purchase Plan	116	106
Shares Issued for Dividend Reinvestment Plans	431	425
Cash Dividends Paid	(3,485	) (3,374)
Net Cash Provided By Financing Activities	58,201	41,558
Net Increase in Cash and Cash Equivalents	27,434	7,448

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Cash and Cash Equivalents at Beginning of Period	72,838	57,355
Cash and Cash Equivalents at End of Period	\$100,272	\$64,803
Supplemental Disclosures to Statements of Cash Flow Information:		
Interest on Deposits and Borrowings	\$1,949	\$1,539
Income Taxes	390	294
Non-cash Investing and Financing Activity:		
Transfer of Loans to Other Real Estate Owned and Repossessed Assets	270	359

See Notes to Unaudited Interim Consolidated Financial Statements.

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NOTES TO INTERIM CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

Note 1. ACCOUNTING POLICIES

In the opinion of the management of Arrow Financial Corporation (Arrow, the Company, we, or us), the accompanying unaudited interim consolidated financial statements contain all of the adjustments necessary to present fairly the financial position as of March 31, 2018, December 31, 2017 and March 31, 2017; the results of operations for the three-month periods ended March 31, 2018 and 2017; the consolidated statements of comprehensive income for the three-month periods ended March 31, 2018 and 2017; the changes in stockholders' equity for the three-month periods ended March 31, 2018 and 2017; and the cash flows for the three-month periods ended March 31, 2018 and 2017. All such adjustments are of a normal recurring nature.

Management's Use of Estimates -The preparation of the consolidated financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the consolidated financial statements and the reported amounts of income and expenses during the reporting period. Our most significant estimate is the allowance for loan losses. Other estimates include the evaluation of other-than-temporary impairment of investment securities, goodwill impairment, pension and other postretirement liabilities and an analysis of a need for a valuation allowance for deferred tax assets. Actual results could differ from those estimates.

A material estimate that is particularly susceptible to significant change in the near term is the allowance for loan losses. In connection with the determination of the allowance for loan losses, management obtains appraisals for properties. The allowance for loan losses is management's best estimate of probable loan losses incurred as of the balance sheet date. While management uses available information to recognize losses on loans, future adjustments to the allowance for loan losses may be necessary based on changes in economic conditions.

The unaudited interim consolidated financial statements should be read in conjunction with the audited annual consolidated financial statements of Arrow for the year ended December 31, 2017, included in Arrow's Annual Report on Form 10-K for the year ended December 31, 2017.

Recently Adopted and Recently Issued Accounting Standards

The following accounting standards have been adopted in the first quarter of 2018:

ASU 2016-01 "Recognition and Measurement of Financial Assets and Financial Liabilities" significantly changed the income statement impact of equity investments. For Arrow, the standard became effective for the first quarter of 2018, and requires that equity investments be measured at fair value, with changes in fair value measured in net income. The cumulative effect of the January 1, 2018 adoption was an increase to retained earnings of \$331 thousand with a corresponding decrease to Accumulated Other Comprehensive Loss. For periods prior to January 1, 2018, equity securities were classified as available-for-sale and stated at fair value with unrealized gains and losses reported as a separate component of accumulated other comprehensive income, net of tax. ASU 2016-01 also emphasized the existing requirement to use exit prices to measure fair value for disclosure purposes and clarifies that entities not make use of a practicability exception in determining the fair value of loans. Accordingly, we refined the calculation used to determine the disclosed fair value of our loans as part of adopting this standard. See Note 9. Fair Value of Financial Instruments.

ASU 2016-15, "Statement of Cash Flows (Topic 230) - Classification of Certain Cash Receipts and Cash Payments" will reduce existing diversity in practice with respect to eight specific cash flow issues. The amendment is effective for fiscal years beginning after December 15, 2017, including interim periods within those fiscal years. Early adoption is permitted, including adoption in an interim period. If an entity early adopts the amendments in an interim

period, any adjustments should be reflected as of the beginning of the fiscal year that includes the interim period. An entity that elects early adoption must adopt all of the amendments in the same period. The amendments in this update should be applied using a retrospective transition method to each period presented. Arrow adopted this ASU in the first quarter of 2018.

ASU 2017-01 "Business Combinations" defines when a set of assets and activities constitutes a business for the purposes of determining whether transactions should be accounted for as acquisitions (or disposals) of assets or businesses. Previously, the three elements required to be present in a business are inputs, processes, and outputs. The amendments in this update allow for a business to consist of inputs, processes, and the ability to create output. For Arrow, the standard became effective in the first quarter of 2018. This update had no effect on our accounting for acquisitions and dispositions of businesses.

ASU 2017-07 "Compensation-Retirement Benefits" improves the presentation of net periodic pension cost and net periodic post-retirement benefit cost by requiring that an employer disaggregate the service cost component from the other components of net benefit cost. The amendments also provide explicit guidance on how to present the service cost component and the other components of net benefit cost in the income statement and allow only the service cost component of net benefit cost to be eligible for capitalization. For Arrow, the standard became effective in the first quarter of 2018. In accordance with the practical expedient adoption method, for all periods presented Arrow used the amounts disclosed in the retirement plans footnote for the prior period retrospective reclassification of the non-service cost components out of salaries and benefits and into other operating expenses. The adoption of this change in accounting for pension costs did not have a material impact on our financial position or the results of operations.

ASU 2017-09 "Compensation-Stock Compensation" provides guidance about which changes to the terms and conditions of a share-based payment award require an entity to apply modification accounting in Topic 718. The guidance highlights the requirements for applying modification accounting and the exception criteria relating to changes in share-based payment terms. For Arrow, the standard became

effective in the first quarter of 2018. The adoption of this change in accounting for share-based payment awards did not have a material impact on our financial position or the results of operations in periods subsequent to its adoption. ASU 2014-09 - "Revenue from Contracts with Customers (Topic 606)" clarifies the principles for recognizing revenue and supersedes most current revenue recognition guidance. The ASU is intended to clarify and converge the revenue recognition principles under current generally accepted accounting principles (GAAP) to streamline revenue recognition requirements in addition to expanding required revenue recognition disclosures. In August 2015, the Financial Accounting Standards Board (FASB) issued ASU 2015-14, Deferral of the Effective Date, which provides a one year deferral to the effective date, therefore, ASU 2014-09 is effective for public companies for annual periods, and interim periods within those annual periods, beginning on or after December 15, 2017. As such, the Company adopted ASU 2014-09 as of January 1, 2018 using the modified retrospective approach, and have identified the recognition of revenue related to specific types of fiduciary activities and specific types of revenue from insurance commissions to be in the scope of this guidance. Regarding fiduciary activities, under prior GAAP, revenue was recognized from settling client estates over the time period the work was performed. With the adoption of Topic 606, revenue will be recognized when the performance obligation is completed, which is when the settlement of the client estate is closed. This change will not have a material impact on our consolidated financial statements. Regarding revenue from property and casualty insurance policies in which the client elected to pay premiums in installments, under prior GAAP, revenue was recognized when the client premiums were billed. With the adoption of Topic 606, revenue is recognized when the performance obligation is substantially completed, i.e., when the insurance policy is issued. This change will not have a material impact to our consolidated financial statements. The adoption of Topic 606 related to the previously described fiduciary activity and insurance commission required a cumulative effect adjustment as of January 1, 2018 to decrease retained earnings by \$102 thousand. Additional information related to net revenue generated from contracts with customers is as follows:

Revenue Recognition - Accounting Standard Codification ("ASC") Topic 606, Revenue from Contracts with Customers ("ASC Topic 606"), establishes principles for reporting information about the nature, amount, timing and uncertainty of revenue and cash flows arising from the entity's contracts to provide goods or services to customers. The core principle requires an entity to recognize revenue to depict the transfer of promised goods or services a customer in an amount that reflects the consideration to which the entity expects to receive in exchange for those goods or services as performance obligations are satisfied.

The majority of the Company's revenue-generating transactions are not subject to ASC Topic 606, including revenue generated from financial instruments, such as loans and investment securities which are presented in our consolidated income statements as components of net interest income. The following is a description of principal activities from which the Company generates its revenue from noninterest income sources that are within the scope of ASC Topic 606:

Income From Fiduciary Activities: represents revenue derived mainly through the management of client investments which is based on the market value of these assets and the fee schedule contained in the applicable account management agreement. Since the revenue is mainly based on the market value of assets, this amount can be volatile as financial markets increase and decrease based on various economic factors. The terms of the account management agreements generally specify that the performance obligations are completed each quarter. Accordingly, we mainly recognize revenue from fiduciary activities on a quarterly basis.

Fees for Other Services to Customers: represents general service fees for monthly deposit account maintenance and account activity plus fees from other deposit-based services. Revenue is recognized when the performance obligation is completed, which is generally on a monthly basis for account maintenance services, or upon the completion of a deposit-related transaction. Payment for such performance obligations are generally received at the time the performance obligations are satisfied.

Insurance Commissions: represents commissions and fees paid by insurance carriers for both property and casualty insurance policies, and for services performed for employment benefits clients. Revenue from our property and casualty business is recognized when our performance obligation is satisfied, which is generally the effective date of the bound coverage since there are no significant performance obligations remaining. Revenue from our employment

benefit brokerage business is recognized when our benefit servicing performance obligations are satisfied, generally on a monthly basis.

The following accounting standards have been issued and become effective for the Company at a future date:

ASU 2016-02 "Leases" will require the recognition of operating leases. In February 2016, the FASB issued ASU 2016-02, Leases (Topic 842). ASU 2016-02 requires lessees to recognize right of use assets and lease liabilities on the balance sheet for all leases with terms longer than 12 months. For leases with a term of 12 months or less, a lessee is permitted to make an accounting policy election by class of underlying asset not to recognize a right of use asset and lease liability. Additionally, when measuring assets and liabilities arising from a lease, optional payments should be included only if the lessee is reasonably certain to exercise an option to extend the lease, exercise a purchase option or not exercise an option to terminate the lease. In January 2018, the FASB issued ASU 2018-01, Leases (Topic 842): Land Easement Practical Expedient for Transition to Topic 842. ASU 2018-01 was issued to address concerns about the cost and complexity of complying with the transition provisions of ASU 2018-01. Early adoption is permitted in any interim or annual period. For Arrow, the standard becomes effective in the first quarter of 2019. We do not expect that the adoption of this change in accounting for operating leases will have a material impact on our financial position or the results of operations in periods subsequent to its adoption. As of March 31, 2018, we have less than \$2.2 million in minimum lease payments for existing operating leases of branch and insurance locations with varying expiration dates from 2018 to 2031.

ASU 2016-13 "Financial Instruments - Credit Losses" will change the way we and other financial entities recognize losses on credit instruments, primarily loans and available-for-sale securities. Currently, loan losses are recognized using an "incurred loss" methodology that delays recognition until it is probable a loss has been incurred. Under the ASU, the incurred loss model will be replaced with a methodology that reflects current expected credit losses (CECL) over the life of the instrument and requires consideration of a broader range of reasonable and supportable information to inform credit loss estimates. Currently, credit losses on available-for-sale securities reduce the carrying value of the instrument and cannot be reversed. Under the ASU, the amount of the credit loss is carried as a valuation allowance and can be reversed. For Arrow, the standard is effective for the first quarter of 2020 and early adoption is allowed in 2019. We plan on adopting the standard in the first quarter of 2020, in order to maximize the accumulation of data needed to calculate the new

CECL methodologies. The ASU describes several acceptable methodologies for calculating expected losses on a loan or a pool of loans. Although other methodologies are allowed, we plan on only using the methodologies described in the ASU. Arrow is still evaluating criteria for loan segments and the appropriate methodology for each segment. We expect that the use of the CECL methodology will result in higher levels of the allowance for loan losses than the incurred loss model. The initial adjustment will not be reported in earnings, but as the cumulative effect of a change in accounting principle. We expect that the adoption of the new standard will have a material impact on the level of the allowance for loan losses, but we do not expect that the periodic provision for loan losses to be materially higher than our historic amounts. The adoption of the standard will have an impact on shareholders' equity, but we expect that we will remain well-capitalized under current regulatory calculations. The standard also requires new disclosures about the loan portfolio. Both the FASB and banking regulators have made estimates of the range of percentage increases in the allowance for loan losses. One FASB board member has commented that the initial range of 30% to 50% for increases in bank allowances is too high, and that the most likely range is in the single digits, although some institutions will experience higher increases. Due to our historical low level of loan losses and our current conservative underwriting standards, we believe that the increase in our loan loss allowance will be in the single digits. The FASB's Transition Research Group for credit losses still has several outstanding unresolved questions, some of which may have a significant impact on CECL calculations. In 2016 we selected a third-party software product to calculate our CECL methodologies. We also began to accumulate a database of monthly loan data, beginning with June 2015, of the fields needed to make the loss calculations under the new CECL methodologies. During 2018, we plan on refining our loan segment criteria and, for most segments, we will calculate expected losses (for an expanding database) using two or more of the applicable methodologies before determining the most appropriate methodology for each loan segment or sub-segment.

ASU 2017-04 "Intangibles-Goodwill and Other" changes the procedures for evaluating impairment of goodwill. Prior to the adoption of this standard, entities were required to perform procedures to determine the fair value of the underlying assets and liabilities following the guidance for determining the fair value of assets and liabilities in a business combination. This additional step to impairment testing has been eliminated. Under this standard, entities should perform goodwill impairment testing by comparing the fair value of a reporting unit to its carrying value. This change should reduce the cost and complexity of evaluating goodwill for impairment. For Arrow, the standard becomes effective in the first quarter of 2019, however, early adoption is permitted. This amendment will not affect our assessment of goodwill impairment since we currently perform the analysis of comparing carrying value to fair value of our reporting units that have goodwill and we have not had to perform a Step 2 Impairment Test to date. ASU 2017-08 "Receivables-Nonrefundable Fees and Other Costs" amends the amortization period for certain purchased callable debt securities held at a premium. This shortens the amortization period for the premium to the earliest call date. Under GAAP, entities generally amortize the premium as an adjustment of yield over the contractual life of the instrument. For Arrow, the standard becomes effective in the first quarter of 2019. We do not expect that the adoption of this change in accounting for certain callable debt securities will have a material impact on our financial position or the results of operations in periods subsequent to its adoption.

Note 2. INVESTMENT SECURITIES (In Thousands)

Management determines the appropriate classification of securities at the time of purchase. Securities reported as held-to-maturity are those debt securities which Arrow has both the positive intent and ability to hold to maturity and are stated at amortized cost. Securities available-for-sale are reported at fair value, with unrealized gains and losses reported in accumulated other comprehensive income or loss, net of taxes. Beginning January 1, 2018, upon adoption of ASU 2016-01, equity securities with readily determinable fair values are stated at fair value with realized and unrealized gains and losses reported in income. For periods prior to January 1, 2018, equity securities were classified as available-for-sale and stated at fair value with unrealized gains and losses reported as a separate component of accumulated other comprehensive income, net of tax.

The following table is the schedule of Available-For-Sale Securities at March 31, 2018, December 31, 2017 and March 31, 2017:

Available-For-Sale Securities

	U.S. Government & Agency Obligations	State and Municipal Obligations	Mortgage- Backed Securities	Corporate and Other Debt Securities	Mutual Funds and Equity Securities	Total Available- For-Sale Securities
March 31, 2018						
Available-For-Sale Securities, at Amortized Cost	\$ 60,264	\$ 9,741	\$ 240,033	\$ 1,000	\$	—\$311,038
Available-For-Sale Securities, at Fair Value	59,657	9,743	235,389	800	—	305,589
Gross Unrealized Gains	—	7	347	—	—	354
Gross Unrealized Losses	607	5	4,991	200	—	5,803
Available-For-Sale Securities, Pledged as Collateral						229,857
Maturities of Debt Securities, at Amortized Cost:						
Within One Year	\$ 13,018	\$ 8,363	\$ 891	\$ —		\$ 22,272
From 1 - 5 Years	47,246	650	121,977	—		169,873
From 5 - 10 Years	—	208	71,473	—		71,681
Over 10 Years	—	520	45,692	1,000		47,212
Maturities of Debt Securities, at Fair Value:						
Within One Year	\$ 12,949	\$ 8,360	\$ 896	\$ —		\$ 22,205
From 1 - 5 Years	46,708	655	118,649	—		166,012
From 5 - 10 Years	—	208	70,140	—		70,348
Over 10 Years	—	520	45,704	800		47,024
Securities in a Continuous Loss Position, at Fair Value:						
Less than 12 Months	\$ 17,128	\$ 7,421	\$ 112,078	\$ —	\$	—\$136,627
12 Months or Longer	42,529	—	80,759	800	—	124,088
Total	\$ 59,657	\$ 7,421	\$ 192,837	\$ 800	\$	—\$260,715
Number of Securities in a Continuous Loss Position	14	29	69	1	—	113

Unrealized Losses on
Securities in a Continuous
Loss Position:

Less than 12 Months	\$ 266	\$ 6	\$ 1,940	\$ —	\$	—\$2,212
12 Months or Longer	341	—	3,050	200	—	3,591
Total	\$ 607	\$ 6	\$4,990	\$ 200	\$	—\$5,803

Disaggregated Details:

US Treasury Obligations, at Amortized Cost	\$ —
US Treasury Obligations, at Fair Value	—
US Agency Obligations, at Amortized Cost	60,264
US Agency Obligations, at Fair Value	59,657

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Available-For-Sale Securities

	U.S. Government & Agency Obligations	State and Municipal Obligations	Mortgage- Backed Securities	Corporate and Other Debt Securities	Mutual Funds and Equity Securities	Total Available- For-Sale Securities
US Government Agency Securities, at Amortized Cost			\$ 59,446			
US Government Agency Securities, at Fair Value			59,469			
Government Sponsored Entity Securities, at Amortized Cost			180,587			
Government Sponsored Entity Securities, at Fair Value			175,920			
December 31, 2017						
Available-For-Sale Securities, at Amortized Cost	\$ 60,328	\$ 10,351	\$ 229,077	\$ 1,000	\$ 1,120	\$ 301,876
Available-For-Sale Securities, at Fair Value	59,894	10,349	227,596	800	1,561	300,200
Gross Unrealized Gains	—	9	485	—	441	935
Gross Unrealized Losses	434	11	1,966	200	—	2,611
Available-For-Sale Securities, Pledged as Collateral, at Fair Value						183,052
Securities in a Continuous Loss Position, at Fair Value:						
Less than 12 Months	\$ 20,348	\$ 8,498	\$ 70,930	\$ —	\$ —	\$ 99,776
12 Months or Longer	39,546	—	80,759	800	—	121,105
Total	\$ 59,894	\$ 8,498	\$ 151,689	\$ 800	\$ —	\$ 220,881
Number of Securities in a Continuous Loss Position	14	36	55	1	—	106
Unrealized Losses on Securities in a Continuous Loss Position:						
Less than 12 Months	\$ 172	\$ 11	\$ 363	\$ —	\$ —	\$ 546
12 Months or Longer	262	—	1,603	200	—	2,065
Total	\$ 434	\$ 11	\$ 1,966	\$ 200	\$ —	\$ 2,611
Disaggregated Details:						
US Treasury Obligations, at Amortized Cost	\$ —					
US Treasury Obligations, at Fair Value	—					
US Agency Obligations, at Amortized Cost	60,328					
	59,894					

US Agency Obligations, at Fair Value	
US Government Agency Securities, at Amortized Cost	\$ 40,832
US Government Agency Securities, at Fair Value	40,832
Government Sponsored Entity Securities, at Amortized Cost	188,245
Government Sponsored Entity Securities, at Fair Value	186,764

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Available-For-Sale Securities

	U.S. Government & Agency Obligations	State and Municipal Obligations	Mortgage- Backed Securities	Corporate and Other Debt Securities	Mutual Funds and Equity Securities	Total Available- For-Sale Securities
March 31, 2017						
Available-For-Sale Securities, at Amortized Cost	\$ 147,012	\$ 25,467	\$ 170,601	\$ 3,501	\$ 1,120	\$ 347,701
Available-For-Sale Securities, at Fair Value	147,231	25,507	169,728	3,298	1,395	347,159
Gross Unrealized Gains	270	40	934	—	275	1,519
Gross Unrealized Losses	52	—	1,806	203	—	2,061
Available-For-Sale Securities, Pledged as Collateral						295,797

Securities in a Continuous

Loss Position, at Fair Value:

Less than 12 Months	\$ 42,937	\$ 828	\$ 127,931	\$ 2,498	\$ —	\$ 174,194
12 Months or Longer	—	—	—	800	—	800
Total	\$ 42,937	\$ 828	\$ 127,931	\$ 3,298	\$ —	\$ 174,994
Number of Securities in a Continuous Loss Position	11	5	41	4	—	61

Unrealized Losses on Securities
in a Continuous Loss Position:

Less than 12 Months	\$ 52	\$ —	\$ 1,806	\$ 3	\$ —	\$ 1,861
12 Months or Longer	—	—	—	200	—	200
Total	\$ 52	\$ —	\$ 1,806	\$ 203	\$ —	\$ 2,061

Disaggregated Details:

US Treasury Obligations, at Amortized Cost	\$ 54,649					
US Treasury Obligations, at Fair Value	\$ 54,695					
US Agency Obligations, at Amortized Cost	\$ 92,363					
US Agency Obligations, at Fair Value	92,536					
US Government Agency Securities, at Amortized Cost			\$ 1,616			
US Government Agency Securities, at Fair Value			1,625			
Government Sponsored Entity Securities, at Amortized Cost			168,985			
Government Sponsored Entity Securities, at Fair Value			168,103			

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The following table is the schedule of Held-To-Maturity Securities at March 31, 2018, December 31, 2017 and March 31, 2017:

Held-To-Maturity Securities

	State and Municipal Obligations	Mortgage- Backed Securities	Corporate and Other Debt Securities	Total Held-To- Maturity Securities
March 31, 2018				
Held-To-Maturity Securities, at Amortized Cost	\$ 272,938	\$ 57,186	\$ —	—\$330,124
Held-To-Maturity Securities, at Fair Value	268,605	56,333	—	324,938
Gross Unrealized Gains	646	—	—	646
Gross Unrealized Losses	4,979	853	—	5,832
Held-To-Maturity Securities, Pledged as Collateral				307,273
Maturities of Debt Securities, at Amortized Cost:				
Within One Year	\$ 35,115	\$ —	\$ —	—\$35,115
From 1 - 5 Years	81,312	51,243	—	132,555
From 5 - 10 Years	153,111	5,943	—	159,054
Over 10 Years	3,400	—	—	3,400
Maturities of Debt Securities, at Fair Value:				
Within One Year	\$ 35,160	\$ —	\$ —	—\$35,160
From 1 - 5 Years	81,634	50,490	—	132,124
From 5 - 10 Years	148,412	5,843	—	154,255
Over 10 Years	3,399	—	—	3,399
Securities in a Continuous Loss Position, at Fair Value:				
Less than 12 Months	\$ 101,695	\$ 53,076	\$ —	—\$154,771
12 Months or Longer	65,012	3,257	—	68,269
Total	\$ 166,707	\$ 56,333	\$ —	—\$223,040
Number of Securities in a Continuous Loss Position	495	47	—	542
Unrealized Losses on Securities in a Continuous Loss Position:				
Less than 12 Months	\$ 1,981	\$ 767	\$ —	—\$2,748
12 Months or Longer	2,998	86	—	3,084
Total	\$ 4,979	\$ 853	\$ —	—\$5,832
Disaggregated Details:				
US Government Agency		\$ 2,530		

Securities, at Amortized Cost	
US Government Agency	
Securities, at Fair Value	2,483
Government Sponsored Entity	
Securities, at Amortized Cost	54,656
Government Sponsored Entity	
Securities, at Fair Value	53,850

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Held-To-Maturity Securities

	State and Municipal Obligations	Mortgage- Backed Securities	Corporate and Other Debt Securities	Total Held-To- Maturity Securities
December 31, 2017				
Held-To-Maturity Securities, at Amortized Cost	\$ 275,530	\$ 60,377	\$	—\$335,907
Held-To-Maturity Securities, at Fair Value	275,353	60,548	—	335,901
Gross Unrealized Gains	1,691	269	—	1,960
Gross Unrealized Losses	1,868	98	—	1,966
Held-To-Maturity Securities, Pledged as Collateral				318,622

Securities in a Continuous

Loss Position, at Fair Value:

Less than 12 Months	\$ 55,648	\$ 13,764	\$	—\$69,412
12 Months or Longer	65,152	3,257	—	68,409
Total	\$ 120,800	\$ 17,021	\$	—\$137,821
Number of Securities in a Continuous Loss Position	352	14	—	366

Unrealized Losses on

Securities in a Continuous

Loss Position:

Less than 12 Months	\$ 442	\$ 56	\$	—\$498
12 Months or Longer	1,425	43	—	1,468
Total	\$ 1,867	\$ 99	\$	—\$1,966

Disaggregated Details:

US Government Agency Securities, at Amortized Cost		\$ 2,680		
US Government Agency Securities, at Fair Value		2,661		
Government Sponsored Entity Securities, at Amortized Cost		57,697		
Government Sponsored Entity Securities, at Fair Value		57,887		

March 31, 2017

Held-To-Maturity Securities, at Amortized Cost	\$ 263,642	\$ 71,569	\$	—\$335,211
Held-To-Maturity Securities, at Fair Value	263,255	71,850	—	335,105
Gross Unrealized Gains	2,410	298	—	2,708
Gross Unrealized Losses	2,796	17	—	2,813
Held-To-Maturity Securities, Pledged as Collateral				316,966

Securities in a Continuous
Loss Position, at Fair Value:

Less than 12 Months	\$ 95,450	\$ 7,682	\$	—\$103,132
12 Months or Longer	657	—	—	657
Total	\$ 96,107	\$ 7,682	\$	—\$103,789
Number of Securities in a Continuous Loss Position	251	8	—	259

Unrealized Losses on
Securities in a Continuous
Loss Position:

Less than 12 Months	\$ 2,793	\$ 17	\$	—\$2,810
12 Months or Longer	3	—	—	3
Total	\$ 2,796	\$ 17	\$	—\$2,813

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Held-To-Maturity Securities

	State and Municipal Obligations	Mortgage- Backed Securities	Corporate and Other Debt Securities	Total Held-To Maturity Securities
March 31, 2017				
Disaggregated Details:				
US Government Agency Securities, at Amortized Cost		\$ 3,106		
US Government Agency Securities, at Fair Value		3,121		
Government Sponsored Entity Securities, at Amortized Cost		68,463		
Government Sponsored Entity Securities, at Fair Value		68,729		

The following table is the schedule of Equity Securities at March 31, 2018. Upon the adoption of ASU 2016-01 effective January 1, 2018, Equity Securities are not included in Securities Available-For-Sale since unrealized gains and losses are now recorded in the Consolidated Statements of Income. Prior to January 1, 2018, Equity Securities were included in Securities Available-For-Sale.

Equity Securities

March 31, 2018
Equity Securities, at Fair Value \$1,579

In the tables above, maturities of mortgage-backed securities are included based on their expected average lives.

Actual maturities will differ from the table above because issuers may have the right to call or prepay obligations with, or without, prepayment penalties.

Securities in a continuous loss position, in the tables above for March 31, 2018, December 31, 2017 and March 31, 2017, do not reflect any deterioration of the credit worthiness of the issuing entities. U.S. Government and Agency issues, including agency-backed collateralized mortgage obligations and mortgage-backed securities, are all rated at least Aaa by Moody's or AA+ by Standard and Poor's.

The state and municipal obligations are general obligations supported by the general taxing authority of the issuer, and in some cases are insured. Obligations issued by school districts are supported by state aid. For any non-rated municipal securities, credit analysis is performed in-house based upon data that has been submitted by the issuers to the New York State Comptroller. That analysis reflects satisfactory credit worthiness of the municipalities. Corporate and other debt securities continue to be rated above investment grade according to Moody's and Standard and Poor's. Subsequent to March 31, 2018, and through the date of the filing of this Quarterly Report on Form 10-Q Arrow held no securities downgraded below investment grade.

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

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Note 3. LOANS (In Thousands)

Loan Categories and Past Due Loans

The following table presents loan balances outstanding as of March 31, 2018, December 31, 2017 and March 31, 2017 and an analysis of the recorded investment in loans that are past due at these dates. Generally, Arrow considers an amortizing loan past due 30 or more days when the borrower is two payments past due. Loans held-for-sale of \$171, \$327 and \$896 as of March 31, 2018, December 31, 2017 and March 31, 2017, respectively, are included in the residential real estate balances for current loans.

	Commercial	Commercial Real Estate	Consumer Residential	Total	
March 31, 2018					
Loans Past Due 30-59 Days	\$ 45	\$ 156	\$ 3,673	\$ 1,711	\$ 5,585
Loans Past Due 60-89 Days	60	—	751	481	1,292
Loans Past Due 90 or more Days	41	807	252	321	1,421
Total Loans Past Due	146	963	4,676	2,513	8,298
Current Loans	127,528	454,095	621,964	781,152	1,984,739
Total Loans	\$ 127,674	\$ 455,058	\$ 626,640	\$ 783,665	\$ 1,993,037
Loans 90 or More Days Past Due and Still Accruing Interest					
Nonaccrual Loans	\$ —	\$ —	\$ —	\$ —	\$ —
	652	807	441	2,570	4,470
December 31, 2017					
Loans Past Due 30-59 Days	\$ 139	\$ —	\$ 5,891	\$ 2,094	\$ 8,124
Loans Past Due 60-89 Days	19	—	1,215	509	1,743
Loans Past Due 90 or more Days	99	807	513	1,422	2,841
Total Loans Past Due	257	807	7,619	4,025	12,708
Current Loans	128,992	443,441	595,208	770,421	1,938,062
Total Loans	\$ 129,249	\$ 444,248	\$ 602,827	\$ 774,446	\$ 1,950,770
Loans 90 or More Days Past Due and Still Accruing Interest					
Nonaccrual Loans	\$ —	\$ —	\$ 6	\$ 313	\$ 319
	\$ 588	\$ 1,530	\$ 653	\$ 2,755	5,526
March 31, 2017					
Loans Past Due 30-59 Days	\$ 189	\$ —	\$ 3,882	\$ 2,021	\$ 6,092
Loans Past Due 60-89 Days	9	—	1,145	684	1,838
Loans Past Due 90 or more Days	120	—	335	835	1,290
Total Loans Past Due	318	—	5,362	3,540	9,220
Current Loans	118,524	435,316	546,601	701,144	1,801,585
Total Loans	\$ 118,842	\$ 435,316	\$ 551,963	\$ 704,684	\$ 1,810,805
Loans 90 or More Days Past Due and Still Accruing Interest					
Nonaccrual Loans	\$ —	\$ —	\$ —	\$ —	\$ —
	\$ 144	\$ 870	\$ 656	\$ 2,603	4,273

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

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

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Commercial Real Estate - The Company offers commercial real estate loans to finance real estate purchases, refinancings, expansions and improvements to commercial properties. Commercial real estate loans are made to finance the purchases of real property which generally consists of real estate with completed structures. These commercial real estate loans are secured by first liens on the real estate, which may include apartments, commercial structures, housing businesses, healthcare facilities, and both owner- and non-owner-occupied facilities. These loans are typically less risky than commercial loans, since they are secured by real estate and buildings, and are generally originated in amounts of no more than 80% of the appraised value of the property. However, the Company also offers commercial construction and land development loans to finance projects, primarily within the communities that we serve. Many projects will ultimately be used by the borrowers' businesses, while others are developed for resale. These real estate loans are also secured by first liens on the real estate, which may include apartments, commercial structures, housing business, healthcare facilities and both owner-occupied and non-owner-occupied facilities. There is enhanced risk during the construction period, since the loan is secured by an incomplete project.

Consumer Loans - The Company offers a variety of consumer installment loans to finance personal expenditures. Most of these loans carry a fixed rate of interest with principal repayment terms typically ranging from one to five years, based upon the nature of the collateral and the size of the loan. In addition to installment loans, the Company also offers personal lines of credit and overdraft protection. Several loans are unsecured, which carry a higher risk of loss. Also included in this category are automobile loans. The Company primarily finances the purchases of automobiles indirectly through dealer relationships located throughout upstate New York and Vermont. Most of these loans carry a fixed rate of interest with principal repayment terms typically ranging from three to seven years. Indirect consumer loans are underwritten on a secured basis using the underlying collateral being financed.

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

Allowance for Loan Losses

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

Allowance for Loan Losses

	Commercial	Commercial Real Estate	Consumer Residential	Total
Roll-forward of the Allowance for Loan Losses for the Quarterly Periods:				

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December 31, 2017	\$ 1,873	\$ 4,504	\$ 7,604	\$ 4,605	\$ 18,586
Charge-offs	(16)	1	(347)	(8)	(370)
Recoveries	—	9	86	—	95
Provision	311	(151)	676	(90)	746
March 31, 2018	\$ 2,168	\$ 4,363	\$ 8,019	\$ 4,507	\$ 19,057
December 31, 2016	\$ 1,017	\$ 5,677	\$ 6,120	\$ 4,198	\$ 17,012
Charge-offs	(16)	—	(254)	—	(270)
Recoveries	7	—	109	—	116
Provision	(69)	(228)	727	(72)	358
March 31, 2017	\$ 939	\$ 5,449	\$ 6,702	\$ 4,126	\$ 17,216

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Allowance for Loan Losses

	Commercial				
	Commercial	Real Estate	Consumer	Residential	Total
March 31, 2018					
Allowance for loan losses - Loans Individually Evaluated for Impairment	\$ 92	\$ 42	\$ —	\$ 58	\$ 192
Allowance for loan losses - Loans Collectively Evaluated for Impairment	2,076	4,321	8,019	4,449	18,865
Ending Loan Balance - Individually Evaluated for Impairment	489	815	91	1,564	2,959
Ending Loan Balance - Collectively Evaluated for Impairment	\$ 127,185	\$ 454,243	\$ 626,549	\$ 782,101	\$ 1,990,078
December 31, 2017					
Allowance for loan losses - Loans Individually Evaluated for Impairment	\$ 94	\$ 2	\$ —	\$ 10	\$ 106
Allowance for loan losses - Loans Collectively Evaluated for Impairment	1,779	4,502	7,604	4,595	18,480
Ending Loan Balance - Individually Evaluated for Impairment	489	1,537	95	1,562	3,683
Ending Loan Balance - Collectively Evaluated for Impairment	\$ 128,760	\$ 442,711	\$ 602,732	\$ 772,884	\$ 1,947,087
March 31, 2017					
Allowance for loan losses - Loans Individually Evaluated for Impairment	\$ —	\$ 34	\$ —	\$ —	\$ 34
Allowance for loan losses - Loans Collectively Evaluated for Impairment	939	5,415	6,702	4,126	17,182
Ending Loan Balance - Individually Evaluated for Impairment	—	884	88	1,094	2,066
Ending Loan Balance - Collectively Evaluated for Impairment	\$ 118,841	\$ 434,432	\$ 551,876	\$ 703,590	\$ 1,808,739

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

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

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

The remainder of the portfolio is evaluated on a pooled basis, as described below. For each homogeneous loan pool, we estimate a total loss factor based on the historical net loss rates adjusted for applicable qualitative factors. We

update the total loss factors assigned to each loan category on a quarterly basis. For the commercial, commercial construction, and commercial real estate categories, we further segregate the loan categories by credit risk profile (pools of loans graded pass, special mention and accruing substandard). Additional description of the credit risk classifications is detailed in the Credit Quality Indicators section of this note.

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

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

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Credit Quality Indicators

The following table presents the credit quality indicators by loan category at March 31, 2018, December 31, 2017 and March 31, 2017:

Loan Credit Quality Indicators

	Commercial				
	Commercial	Real Estate	Consumer	Residential	Total
March 31, 2018					
Credit Risk Profile by Creditworthiness Category:					
Satisfactory	\$ 107,838	\$ 430,121	\$—	\$—	\$537,959
Special Mention	17,220	611	—	—	17,831
Substandard	2,615	23,521	—	—	26,136
Doubtful	—	807	—	—	807
Credit Risk Profile Based on Payment Activity:					
Performing	\$—	\$—	\$ 626,198	\$ 781,095	\$ 1,407,293
Nonperforming	—	—	441	2,570	3,011
December 31, 2017					
Credit Risk Profile by Creditworthiness Category:					
Satisfactory	\$ 124,961	\$ 417,362	\$—	\$—	\$542,323
Special Mention	1,341	177	—	—	1,518
Substandard	2,947	25,902	—	—	28,849
Doubtful	—	807	—	—	807
Credit Risk Profile Based on Payment Activity:					
Performing	\$—	\$—	\$ 602,168	\$ 771,584	\$ 1,373,752
Nonperforming	—	—	659	3,068	3,727
March 31, 2017					
Credit Risk Profile by Creditworthiness Category:					
Satisfactory	\$ 109,416	\$ 402,266	\$—	\$—	\$511,682
Special Mention	1,349	2,233	—	—	3,582
Substandard	8,077	30,817	—	—	38,894
Doubtful	—	—	—	—	—
Credit Risk Profile Based on Payment Activity:					
Performing	\$—	\$—	\$ 551,307	\$ 702,081	\$ 1,253,388
Nonperforming	—	—	656	2,603	3,259

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

For the allowance calculation, we use an internally developed system of five credit quality indicators to rate the credit worthiness of each commercial loan defined as follows:

1) Satisfactory - "Satisfactory" borrowers have acceptable financial condition with satisfactory record of earnings and sufficient historical and projected cash flow to service the debt. Borrowers have satisfactory repayment histories and primary and secondary sources of repayment can be clearly identified;

2) Special Mention - Loans in this category have potential weaknesses that deserve management's close attention. If left uncorrected, these potential weaknesses may result in deterioration of the repayment prospects for the asset or in

the institution's credit position at some future date. "Special mention" assets are not adversely classified and do not expose an institution to sufficient risk to warrant adverse classification. Loans which might be assigned this credit quality indicator include loans to borrowers with deteriorating financial strength and/or earnings record and loans with potential for problems due to weakening economic or market conditions;

3) Substandard - Loans classified as "substandard" are inadequately protected by the current sound net worth or paying capacity of the borrower or the collateral pledged, if any. Loans in this category have well defined weaknesses that jeopardize the

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repayment. They are characterized by the distinct possibility that the bank will sustain some loss if the deficiencies are not corrected. "Substandard" loans may include loans which are likely to require liquidation of collateral to effect repayment, and other loans where character or ability to repay has become suspect. Loss potential, while existing in the aggregate amount of substandard assets, does not have to exist in individual assets classified substandard;

4) Doubtful - Loans classified as "doubtful" have all of the weaknesses inherent in those classified as "substandard" with the added characteristic that the weaknesses make collection or liquidation in full, on the basis of current existing facts, conditions, and values highly questionable and improbable. Although possibility of loss is extremely high, classification of these loans as "loss" has been deferred due to specific pending factors or events which may strengthen the value (i.e. possibility of additional collateral, injection of capital, collateral liquidation, debt restructure, economic recovery, etc). Loans classified as "doubtful" need to be placed on non-accrual; and

5) Loss - Loans classified as "loss" are considered uncollectible and of such little value that their continuance as bankable assets is not warranted. As of the date of the balance sheet, all loans in this category have been charged-off to the allowance for loan losses.

Commercial loans are generally evaluated on an annual basis depending on the size and complexity of the loan relationship, unless the credit related quality indicator falls to a level of "special mention" or below, when the loan is evaluated quarterly. The credit quality indicator is one of the factors used in assessing the level of inherent risk of loss in our commercial related loan portfolios.

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Impaired Loans

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

Impaired Loans

		Commercial			
	Commercial	Real Estate	Consumer	Residential	Total
March 31, 2018					
Recorded Investment:					
With No Related Allowance	\$	—\$ 8	\$ 90	\$ 1,276	\$1,374
With a Related Allowance	483	783	—	356	1,622
Unpaid Principal Balance:					
With No Related Allowance	—	8	90	1,279	1,377
With a Related Allowance	489	807	—	286	1,582
December 31, 2017					
Recorded Investment:					
With No Related Allowance	\$	—\$ 781	\$ 94	\$ 1,269	\$2,144
With a Related Allowance	485	725	—	333	1,543
Unpaid Principal Balance:					
With No Related Allowance	—	816	95	1,274	2,185
With a Related Allowance	489	721	—	288	1,498
March 31, 2017					
Recorded Investment:					
With No Related Allowance	\$	—\$ 884	\$ 88	\$ 806	\$1,778
With a Related Allowance	—	—	—	288	288
Unpaid Principal Balance:					
With No Related Allowance	—	884	88	806	\$1,778
With a Related Allowance	—	—	—	288	288
For the Quarter Ended:					
March 31, 2018					
Average Recorded Balance:					
With No Related Allowance	\$	—\$ 395	\$ 92	\$ 1,273	\$1,760
With a Related Allowance	484	754	—	345	1,583
Interest Income Recognized:					
With No Related Allowance	—	—	—	16	16
With a Related Allowance	—	—	—	24	24
Cash Basis Income:					
With No Related Allowance	—	—	—	—	—
With a Related Allowance	—	—	—	—	—
March 31, 2017					
Average Recorded Balance:					
With No Related Allowance	\$	—\$ 887	\$ 90	\$ 952	\$1,929
With a Related Allowance	—	—	—	144	144
Interest Income Recognized:					
With No Related Allowance	—	—	1	—	1

With a Related Allowance	—	—	—	—	—
Cash Basis Income:					
With No Related Allowance	—	—	—	—	—
With a Related Allowance	—	—	—	—	—

At March 31, 2018, December 31, 2017 and March 31, 2017, all impaired loans were considered to be collateral dependent and were therefore evaluated for impairment based on the fair value of collateral less estimated cost to sell. Interest income recognized in the table above, represents income earned after the loans became impaired and includes restructured loans in compliance with their modified terms and nonaccrual loans where we have recognized interest income on a cash basis.

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Loans Modified in Trouble Debt Restructurings

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

	Commercial				Total
	Commercial	Real Estate	Consumer	Residential	
For the Quarter Ended:					
March 31, 2018					
Number of Loans	—	—	1	—	1
Pre-Modification Outstanding Recorded Investment	\$ —	\$ —	\$ 3	\$ —	\$ 3
Post-Modification Outstanding Recorded Investment	—	—	3	—	3
Subsequent Default, Number of Contracts	—	—	—	—	—
Subsequent Default, Recorded Investment	—	—	—	—	—
March 31, 2017					
Number of Loans	—	—	2	—	2
Pre-Modification Outstanding Recorded Investment	\$ —	\$ —	\$ 15	\$ —	\$ 15
Post-Modification Outstanding Recorded Investment	—	—	15	—	15
Subsequent Default, Number of Contracts	—	—	—	—	—
Subsequent Default, Recorded Investment	—	—	—	—	—

In general, loans requiring modification are restructured to accommodate the projected cash-flows of the borrower. Such modifications may involve a reduction of the interest rate, a significant deferral of payments or forgiveness of a portion of the outstanding principal balance. As indicated in the table above, no loans modified during the preceding twelve months subsequently defaulted as of March 31, 2018.

Note 4. GUARANTEES (In Thousands)

The following table presents the notional amount and fair value of Arrow's off-balance sheet commitments to extend credit and commitments under standby letters of credit as of March 31, 2018, December 31, 2017 and March 31, 2017:

	March 31, December 31, March 31,		
	2018	2017	2017
Commitments to Extend Credit and Letters of Credit			
Notional Amount:			
Commitments to Extend Credit	\$ 328,774	\$ 315,256	\$ 294,618
Standby Letters of Credit	3,584	3,526	3,371
Fair Value:			
Commitments to Extend Credit	\$ —	\$ —	\$ —
Standby Letters of Credit	24	23	28

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

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

Commitments to extend credit are agreements to lend to a customer as long as there is no violation of any condition established in the contract. Commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. Since many of the commitments are expected to expire without being drawn upon, the total commitment amounts do not necessarily represent future cash requirements. Arrow evaluates each customer's creditworthiness on a case-by-case basis. Home equity lines of credit are secured by residential real estate.

Construction commitments are secured by underlying real estate. For other lines of credit, the amount of collateral obtained, if deemed necessary by Arrow upon extension of credit, is based on management's credit evaluation of the counterparty. Collateral held varies, but may include accounts receivable, inventory, property, plant and equipment, and income-producing commercial properties. Most of the commitments are variable rate instruments.

Arrow does not issue any guarantees that would require liability-recognition or disclosure, other than its standby letters of credit.

Arrow has issued conditional commitments in the form of standby letters of credit to guarantee payment on behalf of a customer and guarantee the performance of a customer to a third party. Standby letters of credit generally arise in connection with lending relationships. The credit risk involved in issuing these instruments is essentially the same as that involved in extending loans to customers. Contingent obligations under standby letters of credit at March 31, 2018, December 31, 2017 and March 31, 2017 represent the maximum potential future payments Arrow could be required to make. Typically, these instruments have terms of 12 months or less and expire unused; therefore, the total amounts do not necessarily represent future cash requirements. Each customer is evaluated individually for creditworthiness under the same underwriting standards used for commitments to extend credit and on-balance sheet instruments. Company policies governing loan collateral apply to standby letters of credit at the time of credit extension. Loan-to-value ratios generally range from 50% for movable assets, such as inventory, to 100% for liquid assets, such as bank CD's. Fees for standby letters of credit typically range from 1% to 3% of the notional amount.

Fees are collected upfront and are amortized over the life of the commitment. The carrying amount and fair values of

Arrow's standby letters of credit at March 31, 2018, December 31, 2017 and March 31, 2017, were insignificant. The fair value of standby letters of credit is based on the fees currently charged for similar agreements or the cost to terminate the arrangement with the counterparties.

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

In the normal course of business, Arrow and its subsidiary banks become involved in a variety of routine legal proceedings. At present, there are no legal proceedings pending or threatened, which in the opinion of management and counsel, would result in a material loss to Arrow.

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Note 5. COMPREHENSIVE INCOME (In Thousands)

The following table presents the components of other comprehensive income for the three-month periods ended March 31, 2018 and 2017:

Schedule of Comprehensive Income

	Three Months Ended March 31,		
	Before-Tax Amount	Tax (Expense) Benefit	Net-of-Tax Amount
2018			
Net Unrealized Securities Holding Losses on Securities Available-for-Sale Arising During the Period	(3,332)	\$ 847	(2,485)
Amortization of Net Retirement Plan Actuarial Loss	60	(14)	46
Accretion of Net Retirement Plan Prior Service Credit	(1)	—	(1)
Other Comprehensive Loss	\$(3,273)	\$ 833	\$(2,440)
2017			
Net Unrealized Securities Holding Gains on Securities Available-for-Sale Arising During the Period	77	\$ (30)	47
Amortization of Net Retirement Plan Actuarial Loss	178	(69)	109
Accretion of Net Retirement Plan Prior Service Credit	(3)	1	(2)
Other Comprehensive Income	\$252	\$ (98)	\$ 154

The following table presents the changes in accumulated other comprehensive income by component:
 Changes in Accumulated Other Comprehensive Income (Loss) by Component ⁽¹⁾

	Unrealized Gains and Losses on Available-for- Sale Securities	Defined Benefit Plan Items Net Prior Service Gain (Cost) Credit	Total
For the Quarter-To-Date periods ended:			
December 31, 2017	\$ (1,250)	\$ (6,380) \$ (884)	\$ (8,514)
Other comprehensive income or loss before reclassifications	(2,485)	— —	(2,485)
Amounts reclassified from accumulated other comprehensive income	—	46 (1)	45
Net current-period other comprehensive income (loss)	(2,485)	46 (1)	(2,440)
Reclassification due to the adoption of ASU 2016-01	(331)		(331)
March 31, 2018	\$ (4,066)	\$ (6,334) \$ (885)	\$ (11,285)
December 31, 2016	\$ (382)	\$ (5,737) \$ (715)	\$ (6,834)
Other comprehensive income or loss before reclassifications	47	— —	47
Amounts reclassified from accumulated other comprehensive income	—	109 (2)	107
Net current-period other comprehensive income (loss)	47	109 (2)	154
March 31, 2017	\$ (335)	\$ (5,628) \$ (717)	\$ (6,680)

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

The following table presents the reclassifications out of accumulated other comprehensive income:
 Reclassifications Out of Accumulated Other Comprehensive Income ⁽¹⁾

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

For the Quarter-to-date periods ended:

March 31, 2018

Amortization of defined benefit pension items:

Prior-service costs	\$ 1	(2)	Salaries and Employee Benefits
Actuarial gains/(losses)	(60)	)	(2) Salaries and Employee Benefits
	(59)	)	Total before Tax
	14		Provision for Income Taxes
	\$ (45)	)	Net of Tax
Total reclassifications for the period	\$ (45)	)	Net of Tax

March 31, 2017

Amortization of defined benefit pension items:

Prior-service costs	\$ 3	(2)	Salaries and Employee Benefits
Actuarial gains/(losses)	(178)	)	(2) Salaries and Employee Benefits
	(175)	)	Total before Tax
	68		Provision for Income Taxes
	\$ (107)	)	Net of Tax
Total reclassifications for the period	\$ (107)	)	Net of Tax

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

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

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Note 6. STOCK BASED COMPENSATION (Dollars In Thousands, Except Share and Per Share Amounts)

Arrow has established three stock based compensation plans: an Incentive and Non-qualified Stock Option Plan (Long Term Incentive Plan), an Employee Stock Purchase Plan (ESPP) and an Employee Stock Ownership Plan (ESOP). All share and per share data have been adjusted for the September 28, 2017 3% stock dividend.

Long Term Incentive Plan

The Long Term Incentive Plan provides for the grant of incentive stock options, non-qualified stock options, restricted stock, restricted stock units, performance units and performance shares. The compensation committee of the Board of Directors administers the Long Term Incentive Plan.

Stock Options - Options may be granted at a price no less than the greater of the par value or fair market value of such shares on the date on which such option is granted, and generally expire ten years from the date of grant. The options usually vest over a four-year period.

The following table presents the roll forward of stock options issued pursuant to the Long Term Incentive Plan by Shares and Weighted Average Exercise Prices.

Roll-Forward of Shares Outstanding:

Outstanding at January 1, 2018	346,155
Granted	55,188
Exercised	(27,662)
Forfeited	—
Outstanding at March 31, 2018	373,681
Exercisable at Period-End	247,333
Vested and Expected to Vest	126,348

Roll-Forward of Shares Outstanding - Weighted Average Exercise Price:

Outstanding at January 1, 2018	\$24.12
Granted	30.85
Exercised	22.03
Forfeited	—
Outstanding at March 31, 2018	25.27
Exercisable at Period-End	22.57
Vested and Expected to Vest	30.54

Schedule of Other Long Term Incentive Plan Information

Grants Issued During 2018 - Weighted Average Information:

Fair Value	\$5.76
Fair Value Assumptions:	
Dividend Yield	2.98 %
Expected Volatility	21.55 %
Risk Free Interest Rate	2.68 %
Expected Lives (in years)	6.98

Restricted Stock Units - The Company grants restricted stock units which gives the recipient the right to receive shares of Company stock upon vesting. The fair value of each restricted stock unit is the market value of Company stock on the date of grant. 100% of the restricted stock unit awards vest three years from the grant date. Once vested,

the restricted stock units become vested units. Unvested restricted stock unit awards will generally be forfeited if the recipient ceases to be employed by the Company, with limited exceptions.

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The following table presents the roll forward of restricted stock units by units and weighted average grant-date fair value.

Roll-Forward of Restricted Stock Units	
Non-vested at January 1, 2018	—
Granted	3,279
Vested	—
Canceled	—
Non-vested at March 31, 2018	3,279
Roll-Forward of Non-vested Restricted Stock Units - Weighted Average Fair Value:	
Non-vested at January 1, 2018	\$ —
Granted	33.55
Vested	—
Canceled	—
Non-vested at March 31, 2018	33.55

The following table presents information on the amounts expensed for the periods ended March 31, 2018 and 2017:
Share-Based Compensation Expense

	For the Three Months Ended March 31, 2018	2017
Share-Based Compensation Expense	\$89	\$ 83

Employee Stock Purchase Plan

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

Employee Stock Ownership Plan

Arrow maintains an ESOP. Substantially all employees of Arrow and its subsidiaries are eligible to participate upon satisfaction of applicable service requirements. The ESOP borrowed funds from one of Arrow's subsidiary banks to purchase outstanding shares of Arrow's common stock. The notes require annual payments of principal and interest through 2018. As the debt is repaid, shares are released from collateral based on the proportion of debt paid to total debt outstanding for the year and allocated to active employees. In addition, the Company makes additional cash contributions to the Plan each year.

Shares pledged as collateral are reported as unallocated ESOP shares in stockholders' equity. As shares are released from collateral, Arrow reports compensation expense equal to the current average market price of the shares, and the shares become outstanding for earnings per share computations.

Note 7. RETIREMENT PLANS (Dollars in Thousands)

Arrow sponsors qualified and nonqualified defined benefit pension plans and other postretirement benefit plans for its employees. Arrow maintains a non-contributory pension plan, which covers substantially all employees. Effective December 1, 2002, all active participants in the qualified defined benefit pension plan were given a one-time irrevocable election to continue participating in the traditional plan design, for which benefits were based on years of service and the participant's final compensation (as defined), or to begin participating in the new cash balance plan design. All employees who participate in the plan after December 1, 2002 automatically participate in the cash balance plan design. The interest credits under the cash balance plan are based on the 30-year U.S. Treasury rate in effect for November of the prior year. The service credits under the cash balance plan are equal to 6.0% of eligible salaries for employees who become participants on or after January 1, 2003. For employees in the plan prior to January 1, 2003, the service credits are scaled based on the age of the participant, and range from 6.0% to 12.0%. The funding policy is to contribute up to the maximum amount that can be deducted for federal income tax purposes and to make all payments required under ERISA. Arrow also maintains a supplemental non-qualified unfunded retirement plan to provide eligible employees of Arrow and its subsidiaries with benefits in excess of qualified plan limits imposed by federal tax law.

Arrow has multiple non-pension postretirement benefit plans. The health care, dental and life insurance plans are contributory, with participants' contributions adjusted annually. Arrow's policy is to fund the cost of postretirement benefits based on the current cost of the underlying policies. However, the health care plan provision for automatic increases of Company contributions each year is based on the increase in inflation and is limited to a maximum of 5%.

As of December 31, 2016, Arrow updated its mortality assumption to the RP-2014 Mortality Table for annuitants and non-annuitants with projected generational mortality improvements using Scale MP-2016. The revised assumption resulted in a decrease in postretirement liabilities.

The following tables provide the components of net periodic benefit costs for the three month periods ended March 31, 2018 and 2017.

	Employees' Pension Plan	Select Executive Retirement Plan	Postretirement Benefit Plans
Net Periodic Benefit Cost			
For the Three Months Ended March 31, 2018:			
Service Cost ¹	\$ 348	\$ 11	\$ 33
Interest Cost ²	525	50	99
Expected Return on Plan Assets ²	(785)	—	—
Amortization of Prior Service (Credit) Cost ²	(12)	14	(3)
Amortization of Net Loss ²	33	33	(6)
Net Periodic Benefit Cost	\$ 109	\$ 108	\$ 123
Plan Contributions During the Period	\$ —	\$ 116	\$ 17
For the Three Months Ended March 31, 2017:			
Service Cost ¹	\$ 350	\$ 10	\$ 37
Interest Cost ²	350	50	86
Expected Return on Plan Assets ²	(800)	—	—
Amortization of Prior Service (Credit) Cost ²	(14)	14	(3)
Amortization of Net Loss ²	148	30	—
Net Periodic Benefit Cost	\$ 34	\$ 104	\$ 120

Plan Contributions During the Period	\$ —	\$ 113	\$ 53
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Footnotes:

1. Included in Salaries and Employee Benefits on the Consolidated Statements of Income
2. Included in Other Operating Expense on the Consolidated Statements of Income

We are not required to make a contribution to the qualified pension plan in 2018, and currently, we do not expect to make additional contributions in 2018. Arrow makes contributions to its other post-retirement benefit plans in an amount equal to benefit payments for the year.

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

The following table presents a reconciliation of the numerator and denominator used in the calculation of basic and diluted earnings per common share ("EPS") for periods ended March 31, 2018 and 2017. All share and per share amounts have been adjusted for the September 28, 2017 3% stock dividend.

Earnings Per Share

	Quarterly Period Ended:	
	March 31, 2018	March 31, 2017
Earnings Per Share - Basic:		
Net Income	\$8,531	\$ 6,631
Weighted Average Shares - Basic	13,936	13,889
Earnings Per Share - Basic	\$0.61	\$ 0.48
Earnings Per Share - Diluted:		
Net Income	\$8,531	\$ 6,631
Weighted Average Shares - Basic	13,936	13,889
Dilutive Average Shares Attributable to Stock Options	80	112
Weighted Average Shares - Diluted	14,016	14,001
Earnings Per Share - Diluted	\$0.61	\$ 0.47

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

FASB ASC Subtopic 820-10 defines fair value, establishes a framework for measuring fair value in GAAP and requires certain disclosures about fair value measurements. We do not have any nonfinancial assets or liabilities measured at fair value on a recurring basis. The only assets or liabilities that Arrow measured at fair value on a recurring basis at March 31, 2018 were securities available-for-sale and equity securities and for December 31, 2017 and March 31, 2017 securities available-for-sale. Arrow held no securities or liabilities for trading on such dates. The table below presents the financial instrument's fair value and the amounts within the fair value hierarchy based on the lowest level of input that is significant to the fair value measurement:

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

	Fair Value	Fair Value Measurements at Reporting Date Using:			Life-to-Date Gains (Losses)
		Quoted Prices In Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	
Fair Value of Assets and Liabilities Measured on a Recurring Basis:					
March 31, 2018					
Securities Available-for Sale:					
U.S. Government & Agency Obligations	\$59,657	\$59,657	\$ —	\$ —	
State and Municipal Obligations	9,743	—	9,743	—	
Mortgage-Backed Securities	235,389	—	235,389	—	
Corporate and Other Debt Securities	800	—	800	—	
Total Securities Available-for-Sale	305,589	59,657	245,932	—	
Equity Securities	1,579	—	1,579	—	
Total Securities Measured on a Recurring Basis	\$307,168	\$59,657	\$247,511	\$ —	
December 31, 2017					
Securities Available-for Sale:					
U.S. Government & Agency Obligations	\$59,894	\$59,894	\$ —	\$ —	
State and Municipal Obligations	10,349	—	10,349	—	
Mortgage-Backed Securities	227,596	—	227,596	—	
Corporate and Other Debt Securities	800	—	800	—	
Equity Securities	1,561	—	1,561	—	
Total Securities Available-for Sale	\$300,200	\$59,894	\$240,306	\$ —	
March 31, 2017					
Securities Available-for Sale:					
U.S. Government & Agency Obligations	\$147,231	\$54,695	\$92,536	\$ —	
State and Municipal Obligations	25,507	—	25,507	—	
Mortgage-Backed Securities	169,728	—	169,728	—	
Corporate and Other Debt Securities	3,298	—	3,298	—	
Equity Securities	1,395	—	1,395	—	
Total Securities Available-for Sale	\$347,159	\$54,695	\$292,464	\$ —	

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

March 31, 2018

Collateral Dependent Impaired Loans	\$1,295	\$—	\$—	\$ 1,295	\$ (58)
Other Real Estate Owned and Repossessed Assets, Net	1,647	—	—	1,647	(582)

December 31, 2017

Collateral Dependent Impaired Loans	\$—	\$—	\$—	\$ —	\$ —
Other Real Estate Owned and Repossessed Assets, Net	\$1,847	\$—	—	1,847	\$ (569)

March 31, 2017

Collateral Dependent Impaired Loans	\$288	\$—	\$—	\$ 288	\$ (34)
Other Real Estate Owned and Repossessed Assets, Net	1,734	—	—	1,734	(500)

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

Level 1 - Unadjusted quoted prices in active markets that are accessible at the measurement date for identical, unrestricted assets or liabilities;

Level 2 - Quoted prices for similar assets or liabilities in active markets, quoted prices for identical or similar assets or liabilities in markets that are not active, or inputs that are observable, either directly or indirectly, for substantially the full term of the asset or liability;

Level 3 - Prices or valuation techniques that require inputs that are both significant to the fair value measurement and unobservable (i.e., supported by little or no market activity).

There were no transfers between Levels 1, 2 and 3 for the three months ended March 31, 2018, December 31, 2017 and March 31, 2017.

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

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

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

The fair value of collateral dependent impaired loans and other real estate owned was based on third-party appraisals less estimated cost to sell. The appraisals may be adjusted by management for qualitative factors such as economic conditions and estimated liquidation expenses. Other assets which might have been included in this table include mortgage servicing rights, goodwill and other intangible assets. Arrow evaluates each of these assets for impairment on an annual basis, with no impairment recognized for these assets at March 31, 2018, December 31, 2017 and March 31, 2017.

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

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

ASU 2016-01 "Recognition and Measurement of Financial Assets and Financial Liabilities" requires that, effective for the first quarter of 2018, the fair value for loans must be disclosed using the "exit price" notion which is a reasonable estimate of what another party might pay in an orderly transaction. Fair values for loans are calculated for portfolios of loans with similar financial characteristics. Loans are segregated by type such as commercial, commercial real estate, residential mortgage, indirect auto and other consumer loans. Each loan category is further segmented into fixed and adjustable interest rate terms and by performing and nonperforming categories. The fair value of performing loans is calculated by determining the estimated future cash flow, which is the contractual cash flow adjusted for estimated prepayments. The discount rate is determined by starting with current market yields, and first adjusting for a liquidity premium. This premium is separately determined for residential real estate loans vs. other loans. Then a credit loss component is determined utilizing the credit loss assumptions used in the allowance for loan and lease loss model. Finally, a discount spread is applied separately for consumer loans vs. commercial loans based on market information and utilization of the Swap Curve. Fair value for nonperforming loans is generally based on recent external appraisals. If appraisals are not available, estimated cash flows are discounted using a rate commensurate with the risk associated with the estimated cash flows. Assumptions regarding credit risk, cash flows and discount rates are judgmentally determined using available market information and specific borrower information.

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

The fair value of FHLBNY advances is estimated based on the discounted value of contractual cash flows. The discount rate is estimated using current rates on FHLBNY advances with similar maturities and call features. The book value of the outstanding trust preferred securities (Junior Subordinated Obligations Issued to Unconsolidated Subsidiary Trusts) are considered to approximate fair value since the interest rates are variable (indexed to LIBOR) and Arrow is well-capitalized.

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Fair Value by Balance Sheet Grouping

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

Schedule of Fair Values by Balance Sheet Grouping

	Book Value	Fair Value	Fair Value Hierarchy		
			Level 1	Level 2	Level 3
March 31, 2018					
Cash and Cash Equivalents	\$ 100,272	\$ 100,272	\$ 100,272	\$ —	—
Securities Available-for-Sale	305,589	305,589	—	305,589	—
Securities Held-to-Maturity	330,124	324,938	—	324,938	—
Equity Securities	1,579	1,579	—	1,579	—
Federal Home Loan Bank and Federal Reserve Bank Stock	4,780	4,780	—	4,780	—
Net Loans	1,973,980	1,915,978	—	—	1,915,978
Accrued Interest Receivable	7,662	7,662	—	7,662	—
Deposits	2,411,273	2,402,122	—	2,402,122	—
Federal Funds Purchased and Securities Sold Under Agreements to Repurchase	74,957	74,957	—	74,957	—
Federal Home Loan Bank Term Advances	45,000	44,484	—	44,484	—
Junior Subordinated Obligations Issued to Unconsolidated Subsidiary Trusts	20,000	20,000	—	20,000	—
Accrued Interest Payable	361	361	—	361	—
December 31, 2017					
Cash and Cash Equivalents	\$ 72,838	\$ 72,838	\$ 72,838	\$ —	—
Securities Available-for-Sale	300,200	300,200	59,894	240,306	—
Securities Held-to-Maturity	335,907	335,901	—	335,901	—
Federal Home Loan Bank and Federal Reserve Bank Stock	9,949	9,949	—	9,949	—
Net Loans	1,932,184	1,901,046	—	—	1,901,046
Accrued Interest Receivable	6,753	6,753	—	6,753	—
Deposits	2,245,116	2,236,548	—	2,236,548	—
Federal Funds Purchased and Securities Sold Under Agreements to Repurchase	64,966	64,966	—	64,966	—
Federal Home Loan Bank Overnight Advances	105,000	105,000	—	105,000	—
Federal Home Loan Bank Term Advances	55,000	54,781	—	54,781	—
Junior Subordinated Obligations Issued to Unconsolidated Subsidiary Trusts	20,000	20,000	—	20,000	—
Accrued Interest Payable	410	410	—	410	—
March 31, 2017					
Cash and Cash Equivalents	\$ 64,803	\$ 64,803	\$ 64,803	\$ —	—
Securities Available-for-Sale	347,159	347,159	54,695	292,464	—
Securities Held-to-Maturity	335,211	335,105	—	335,105	—
Federal Home Loan Bank and Federal Reserve Bank Stock	6,826	6,826	—	6,826	—
Net Loans	1,793,589	1,773,895	—	—	1,773,895
Accrued Interest Receivable	7,530	7,530	—	7,530	—

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Deposits	2,256,536	2,248,066	—	2,248,066	—
Federal Funds Purchased and Securities Sold Under Agreements to Repurchase	32,035	32,035	—	32,035	—
Federal Home Loan Bank Overnight Advances	32,000	32,000	—	32,000	—
Federal Home Loan Bank Term Advances	55,000	55,130	—	55,130	—
Junior Subordinated Obligations Issued to Unconsolidated Subsidiary Trusts	20,000	20,000	—	20,000	—
Accrued Interest Payable	240	240	—	240	—

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Report of Independent Registered Public Accounting Firm

To the Stockholders and Board of Directors

Arrow Financial Corporation:

Results of Review of Interim Financial Information

We have reviewed the consolidated balance sheet of Arrow Financial Corporation and subsidiaries (the Company) as of March 31, 2018 and 2017, the related consolidated statements of income, comprehensive income, changes in stockholders' equity and cash flows for the three-month periods ended March 31, 2018 and 2017, and the related notes (collectively, the consolidated interim financial information). Based on our reviews, we are not aware of any material modifications that should be made to the consolidated interim financial information for it to be in conformity with U.S. generally accepted accounting principles.

We have previously audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States) (PCAOB), the consolidated balance sheet of the Company as of December 31, 2017, and the related consolidated statements of income, comprehensive income, changes in stockholders' equity, and cash flows for the year then ended (not presented herein); and in our report dated March 12, 2018, we expressed an unqualified opinion on those consolidated financial statements. In our opinion, the information set forth in the accompanying consolidated balance sheet as of December 31, 2017, is fairly stated, in all material respects, in relation to the consolidated balance sheet from which it has been derived.

Basis for Review Results

This consolidated interim financial information is the responsibility of the Company's management. We are a public accounting firm registered with the PCAOB and are required to be independent with respect to the Company in accordance with the U.S. federal securities laws and the applicable rules and regulations of the Securities and Exchange Commission and the PCAOB.

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

/s/ KPMG LLP

Albany, New York

May 9, 2018

Item 2.

ARROW FINANCIAL CORPORATION AND SUBSIDIARIES
MANAGEMENT'S DISCUSSION AND ANALYSIS OF
FINANCIAL CONDITION AND RESULTS OF OPERATIONS
March 31, 2018

Note on Terminology - In this Quarterly Report on Form 10-Q, the terms "Arrow," "the registrant," "the company," "we," "us," and "our" generally refer to Arrow Financial Corporation and its subsidiaries as a group, except where the context indicates otherwise. At certain points in this Form 10-Q, our performance is compared with that of our "peer group" of financial institutions. Unless otherwise specifically stated, the peer group for the purposes of this Form 10-Q is comprised of the group of 320 domestic bank holding companies with \$1 to \$3 billion in total consolidated assets as identified in the Federal Reserve Board's "Bank Holding Company Performance Report" for December 31, 2017 (the most recent such Report currently available), and peer group data contained herein has been derived from such 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. Our non-bank subsidiaries include Capital Financial Group, Inc. (an insurance agency specializing in selling and servicing group health care policies); Upstate Agency, LLC (an insurance agency specializing in property and casualty insurance); North Country Investment Advisers, Inc. (a registered investment adviser that provides investment advice to our proprietary mutual funds); Glens Falls National Community Development Corporation (which invests in qualifying community development projects); and Arrow Properties, Inc. (a real estate investment trust, or REIT). 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 - This Quarterly Report on Form 10-Q contains statements that are not historical in nature but rather are based on our beliefs, assumptions, expectations, estimates and projections about the future. These statements are "forward-looking statements" within the meaning of Section 21E of the Securities Exchange Act of 1934, as amended, and involve a degree of uncertainty and attendant risk. Words such as "may," "will," "expect," "believe," "anticipate," "estimate," "continue," and variations of such words and similar expressions are intended to identify such forward-looking statements. Examples of forward-looking statements include statements regarding the Company's asset quality, the level of allowance for loan losses, the sufficiency of liquidity sources, interest rate change exposure, changes in accounting standards, and the Company's tax plans and strategies. Some of these statements, such as those included in the interest rate sensitivity analysis in Part I, Item 3, entitled "Quantitative and Qualitative Disclosures About Market Risk," are merely presentations of what future performance or changes in future performance would look like based on hypothetical assumptions and on simulation models. Other forward-looking statements are based on our general perceptions of market conditions and trends in business activity, both our own and in the banking industry generally, as well as current management strategies for future operations and development.

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
- 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 Wall Street Reform and Consumer Protection Act ("Dodd-Frank") and the Tax Cuts

- and Jobs Act of 2017 (the "Tax Act")) or the modification or elimination of pre-existing measures;
- significant changes in U.S. monetary or fiscal policy, including new or revised monetary programs or targets
- e. 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. competition from other sources (e.g., so-called Fintech enterprises);
- g. similar uncertainties inherent in banking operations or business generally, including technological developments and changes; and
- h. other risks detailed from time to time within our filings with the Securities and Exchange Commission ("SEC").

Readers are cautioned not to place undue reliance on forward-looking statements in this Report, which speak only as of the date hereof. We undertake no general obligation to revise or update the forward-looking statements contained in this Report to reflect the occurrence of unanticipated events at any point in the future. This Quarterly Report should be read in conjunction with our Annual Report on Form 10-K for the year ended December 31, 2017 and our other filings with the SEC.

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 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. Historically, this adjustment has been considered helpful in comparing the financial institution’s net interest income (before tax) to that of another institution or in analyzing the 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, or 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 (before tax) 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/or to better demonstrate a single institution’s performance over time. Arrow follows these practices. As a result of the reduced federal corporate tax rates enacted by the Tax Act, tax-equivalent net interest income and the resulting net interest margin on a tax-equivalent basis have become less comparable to prior period levels when analyzing a financial institution’s performance over time. While Arrow continues to calculate, publish, and monitor these tax-equivalent financial performance measures, all users of this information should be aware of the non-comparative nature of post-Tax Act period results. Arrow presents net interest income and net interest margin on a GAAP basis in the relative sections of this Report in order to provide a consistently comparable performance measure over time as these measures are not effected by federal income tax rates.

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 be excluded therefrom 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 excluded therefrom 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.

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 provision 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.

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Arrow Financial Corporation
Selected Quarterly Information

(Dollars In Thousands, Except Per Share Amounts - Unaudited)

Quarter Ended	3/31/2018	12/31/2017	9/30/2017	6/30/2017	3/31/2017
Net Income	\$8,531	\$8,071	\$7,416	\$7,208	\$6,631
Transactions Recorded in Net Income (Net of Tax):					
Net Gain (Loss) on Securities Transactions	—	(278	) 6	—	—
Tax Benefit from Net Deferred Tax Liability Revaluation	—	1,116	—	—	—

Share and Per Share Data:⁽¹⁾

Period End Shares Outstanding	13,950	13,930	13,891	13,900	13,886
Basic Average Shares Outstanding	13,936	13,905	13,889	13,890	13,889
Diluted Average Shares Outstanding	14,016	14,006	13,966	13,975	14,001
Basic Earnings Per Share	\$0.61	\$0.58	\$0.53	\$0.52	\$0.48
Diluted Earnings Per Share	0.61	0.58	0.53	0.52	0.47
Cash Dividend Per Share	0.250	0.250	0.243	0.243	0.243

Selected Quarterly Average Balances:

Interest-Bearing Deposits at Banks	27,978	27,047	27,143	24,480	23,565	
Investment Securities	642,442	660,043	677,368	684,570	695,615	
Loans	1,971,240	1,930,590	1,892,766	1,842,543	1,781,113	
Deposits	2,305,736	2,284,206	2,193,778	2,206,365	2,161,798	
Other Borrowed Funds	184,613	187,366	262,864	207,270	205,436	
Stockholders' Equity	251,109	247,253	243,801	239,396	235,257	
Total Assets	2,763,706	2,744,180	2,725,653	2,677,843	2,626,470	
Return on Average Assets, annualized	1.25	% 1.17	% 1.08	% 1.08	% 1.02	%
Return on Average Equity, annualized	13.78	% 12.95	% 12.07	% 12.08	% 11.43	%
Return on Tangible Equity, annualized ⁽²⁾	15.24	% 14.36	% 13.40	% 13.45	% 12.76	%
Average Earning Assets	2,641,660	2,617,680	2,597,277	2,551,593	2,500,293	
Average Paying Liabilities	2,050,661	2,029,811	2,012,802	2,005,421	1,977,628	
Net Interest Income (GAAP)	20,402	20,314	19,650	19,227	18,461	
Net Interest Margin, annualized (GAAP)	3.13	% 3.08	% 3.00	% 3.02	% 2.99	%
Net Interest Income, Tax-Equivalent (Non-GAAP) ⁽³⁾	20,893	21,294	20,616	20,176	19,409	
Tax-Equivalent Adjustment (Non-GAAP) ⁽³⁾	491	980	966	949	948	
Net Interest Margin, annualized (Non-GAAP) ⁽³⁾	3.21	% 3.23	% 3.15	% 3.17	% 3.15	%

Efficiency Ratio Calculation: ⁽⁴⁾

Noninterest Expense	\$ 15,955	\$ 16,045	\$ 15,548	\$ 15,637	\$ 15,475
Less: Intangible Asset Amortization	67	69	69	70	71
Net Noninterest Expense	15,888	15,976	15,479	15,567	15,404
Net Interest Income, Tax-Equivalent (Non-GAAP) ⁽³⁾	20,893	21,294	20,616	20,176	19,409
Noninterest Income	6,888	6,752	7,141	7,057	6,695
Less: Net Securities Gain (Loss)	—	(458) 10	—	—

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Less: Net Unrealized Gain on Equity Securities	18	—	—	—	—	
Net Gross Income	27,763	28,504	27,747	27,233	26,104	
Efficiency Ratio (Non-GAAP)	57.23	% 56.05	% 55.79	% 57.16	% 59.01	%
Period-End Capital Information:						
Total Stockholders' Equity (i.e. Book Value)	\$252,734	\$249,603	\$244,648	\$240,752	\$236,111	
Book Value per Share ⁽¹⁾	18.12	17.92	17.61	17.32	17.00	
Goodwill and Other Intangible Assets, net	24,045	24,162	24,268	24,355	24,448	
Tangible Book Value per Share ^(1,2)	16.39	16.18	15.86	15.57	15.24	
Capital Ratios: ⁽⁵⁾						
Tier 1 Leverage Ratio	9.62	% 9.49	% 9.30	% 9.35	% 9.37	%
Common Equity Tier 1 Capital Ratio	12.97	% 12.89	% 12.70	% 12.68	% 12.84	%
Tier 1 Risk-Based Capital Ratio	14.03	% 13.97	% 13.79	% 13.79	% 13.99	%
Total Risk-Based Capital Ratio	15.04	% 14.99	% 14.77	% 14.77	% 14.98	%
Assets Under Trust Administration and Investment Management	\$1,470,191	\$1,452,994	\$1,411,608	\$1,356,262	\$1,333,690	

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Arrow Financial Corporation
 Selected Quarterly Information - Continued
 (Dollars In Thousands, Except Per Share Amounts - Unaudited)

Footnotes:

1. Share and Per Share Data have been restated for the September 28, 2017, 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. See "Use of Non-GAAP Financial Measures" on page 37.

	3/31/2018	12/31/2017	9/30/2017	6/30/2017	3/31/2017	
Total Stockholders' Equity (GAAP)	\$252,734	\$249,603	\$244,648	\$240,752	\$236,111	
Less: Goodwill and Other Intangible assets, net	24,045	24,162	24,268	24,355	24,448	
Tangible Equity (Non-GAAP)	\$228,689	\$225,441	\$220,380	\$216,397	\$211,663	
Period End Shares Outstanding	13,950	13,930	13,891	13,900	13,886	
Tangible Book Value per Share (Non-GAAP)	\$16.39	\$16.18	\$15.86	\$15.57	\$15.24	
Net Income	8,531	8,071	7,416	7,208	6,631	
Return on Tangible Equity (Net Income/Tangible Equity - Annualized)	15.24	% 14.36	% 13.40	% 13.45	% 12.76	%

3. Net Interest Margin is the ratio of our annualized tax-equivalent net interest income to average earning assets. This is also a non-GAAP financial measure which we believe provides investors with information that is useful in understanding our financial performance. See "Use of Non-GAAP Financial Measures" on page 37.

	3/31/2018	12/31/2017	9/30/2017	6/30/2017	3/31/2017	
Interest Income (GAAP)	\$22,418	\$22,135	\$21,599	\$20,926	\$19,997	
Add: Tax-Equivalent adjustment (Non-GAAP)	491	980	966	949	948	
Interest Income - Tax Equivalent (Non-GAAP)	\$22,909	\$23,115	\$22,565	\$21,875	\$20,945	
Net Interest Income (GAAP)	\$20,402	\$20,314	\$19,650	\$19,227	\$18,461	
Add: Tax-Equivalent adjustment (Non-GAAP)	491	980	966	949	948	
Net Interest Income - Tax Equivalent (Non-GAAP)	\$20,893	\$21,294	\$20,616	\$20,176	\$19,409	
Average Earning Assets	\$2,641,660	\$2,617,680	\$2,597,277	\$2,551,593	\$2,500,293	
Net Interest Margin (Non-GAAP)*	3.21	% 3.23	% 3.15	% 3.17	% 3.15	%

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). There is no GAAP financial measure that is closely comparable to the efficiency ratio. See "Use of Non-GAAP Financial Measures" on page 37.

5.

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For the recently-completed quarter, all of the regulatory capital ratios in the table on page 40 and the table in this Note 5, below, 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. The Common Equity Tier 1 Capital Ratio (CET1 Ratio) of Arrow as of March 31, 2018 that is listed in the tables (i.e., 12.97%) not only exceeds the currently required minimum CET1 Ratio (including Conservation Buffer) of 6.375%, but also exceeds the minimum CET1 Ratio that will be required when the Conservation Buffer is fully phased-in, on January 1, 2019, of 7.00% (including the ultimate required Conservation Buffer of 2.50%).

	3/31/2018	12/31/2017	9/30/2017	6/30/2017	3/31/2017
Total Risk Weighted Assets	\$1,889,719	\$1,856,242	\$1,830,730	\$1,802,455	\$1,747,318
Common Equity Tier 1 Capital	265,066	259,378	232,473	228,586	224,369
Common Equity Tier 1 Capital Ratio	12.97	% 12.89	% 12.70	% 12.68	% 12.84

* Quarterly ratios have been annualized.

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Average Consolidated Balance Sheets and Net Interest Income Analysis

(see "Use of Non-GAAP Financial Measures" on page 38)

(Fully Taxable Basis using a marginal federal tax rate of 35% for 2017, 21% for 2018)

(Dollars In Thousands)

Quarter Ended March 31:	2018			2017		
	Average Balance	Interest Income/Expense	Rate Earned/Paid	Average Balance	Interest Income/Expense	Rate Earned/Paid
Interest-Bearing Deposits at Banks	\$27,978	\$134	1.94 %	\$23,565	\$60	1.03 %
Investment Securities:						
Fully Taxable	359,908	1,895	2.14	403,930	1,994	2.00
Exempt from Federal Taxes	282,534	1,947	2.79	291,685	2,361	3.28
Loans	1,971,240	18,933	3.90	1,781,113	16,530	3.76
Total Earning Assets	2,641,660	22,909	3.52	2,500,293	20,945	3.40
Allowance for Loan Losses	(18,523)			(16,976)		
Cash and Due From Banks	35,608			35,525		
Other Assets	104,961			107,628		
Total Assets	\$2,763,706			\$2,626,470		
Deposits:						
Interest-Bearing Checking Accounts	\$914,116	387	0.17	\$894,911	331	0.15
Savings Deposits	723,660	522	0.29	677,662	291	0.17
Time Deposits of \$250,000 or More	63,406	204	1.30	33,758	55	0.66
Other Time Deposits	164,866	259	0.64	165,861	228	0.56
Total Interest-Bearing Deposits	1,866,048	1,372	0.30	1,772,192	905	0.21
Short-Term Borrowings	111,835	197	0.71	130,436	211	0.66
FHLB/BNY Term Advances and Other Long-Term Debt	72,778	447	2.49	75,000	420	2.27
Total Interest-Bearing Liabilities	2,050,661	2,016	0.40	1,977,628	1,536	0.31
Demand Deposits	439,688			389,606		
Other Liabilities	22,248			23,979		
Total Liabilities	2,512,597			2,391,213		
Stockholders' Equity	251,109			235,257		
Total Liabilities and Stockholders' Equity	\$2,763,706			\$2,626,470		
Net Interest Income (Tax-equivalent Basis)		20,893			19,409	
(Non-GAAP) ⁽¹⁾						
Reversal of Tax Equivalent Adjustment		(491)	(0.08)%		(948)	(0.15)%
Net Interest Income		\$20,402			\$18,461	
Net Interest Spread (Non-GAAP) ⁽¹⁾			3.12 %			3.09 %
Net Interest Margin (Non-GAAP) ⁽¹⁾			3.21 %			3.15 %

¹ See Note 3 on p. 39.

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OVERVIEW

We reported net income for the first quarter of 2018 of \$8.5 million, an increase of \$1.9 million, or 28.7%, over our net income for the first quarter of 2017. Diluted earnings per share (EPS) for the quarter was \$0.61, an increase of 29.8% from the EPS of \$0.47 reported for the first quarter of 2017. Return on average equity (ROE) for the first quarter of 2018 continued to be strong at 13.78%, up from an ROE of 11.43% for the first quarter ended March 31, 2017. Return on average assets (ROA) for the 2018 first quarter was 1.25%, an increase from an ROA of 1.02% for the first quarter ended March 31, 2017. Net interest income on a GAAP basis increased to \$20.4 million, up 10.5% over the \$18.5 million total in the comparable quarter of 2017. Net interest margin for the first quarter of 2018 was 3.13%, up from 2.99% for the first quarter of 2017. Tax-equivalent net interest income (a non-GAAP measure) also increased by approximately 7.6%, mainly due to the 5.7% increase in average earning assets from the first quarter of 2017, and a 6 basis point increase in the tax-equivalent net interest margin, increasing from 3.15% from the first quarter of 2017 to 3.21% for the first quarter 2018. The composition of average earning assets changed in the current quarter through a 10.7% increase in higher relative yielding average loans and a 7.6% decrease in lower relative yielding average investment securities. In addition to the composition of the balance sheet, a significant factor contributing to increased profitability was reduced tax rates resulting from the Tax Act. The provision for income taxes for the first quarter of 2018 decreased to \$2.1 million as compared to \$2.7 million for the first quarter of 2017. Total loans increased between the respective period ends by \$182.2 million, or 10.1%, while investment securities decreased by \$394 thousand, or 0.1%. On the funding side, average interest-bearing deposits increased 5.3% and average non-interest bearing demand deposits increased 12.9% in the first quarter of 2018 as compared to the same quarter in 2017. The provision for loan losses increased \$388 thousand during the first quarter of 2018 as compared to the first quarter of 2017, mainly due to total loan growth and the mix of the loan portfolio. Noninterest income increased \$194 thousand or 2.9% while noninterest expense increased \$480 thousand or 3.1%.

The changes in net income, net interest income and net interest margin between the three month periods are discussed in detail under the heading "RESULTS OF OPERATIONS," beginning on page 54.

Regulatory Capital and Increase in Stockholders' Equity: At March 31, 2018, we continued to exceed by a substantial amount all required minimum capital ratios under the bank regulatory capital rules at both the holding company and bank levels. At that date, both of our banks, as well as our holding company, continued to qualify as "well-capitalized" under the capital classification guidelines as defined by the current bank regulatory capital rules. Because of our continued profitability and strong asset quality, our regulatory capital levels throughout recent years have consistently remained well in excess of the various required regulatory minimums in effect from time to time, as they do at present. As a result of the Dodd-Frank Act, however, required minimum regulatory capital levels for insured banks and their parent holding companies will continue to increase, as a percentage of risk-based assets in 2019.

Stockholders' equity was \$252.7 million at March 31, 2018, an increase of \$3.1 million, or 1.3%, from the December 31, 2017 level of \$249.6 million, and an increase of \$16.6 million, or 7.0%, from the prior-year level. The components of the change in stockholders' equity since year-end 2017 are presented in the Consolidated Statement of Changes in Stockholders' Equity on page 6, and are discussed in more detail in the next section

At March 31, 2018, our book value per share was \$18.12, up by 6.6% over the prior-year level, and our tangible book value per share (a non-GAAP measure that deducts intangible assets from stockholders' equity) was \$16.39, an increase of \$1.15, or 7.5%, over the level as of March 31, 2017. See the disclosure on page 37 related to our use of non-GAAP financial measures generally, and tangible book value, specifically. In the first three months of 2018, total stockholders' equity increased by 1.3% (not annualized) and our total book value per share also increased by 8.1%. The increase in stockholders' equity over the first three months of 2018 principally reflected the following factors: (i) \$8.5 million of net income for the period and (ii) issuance of \$2.7 million of common stock through our employee benefit and dividend reinvestment plans; reduced by (iii) cash dividends of \$3.5 million; and (iv) repurchases of our own common stock, primarily in connection with our approved treasury stock repurchase plan, of \$0.6 million. On March 31, 2018, our closing stock price was \$33.95, representing a trading multiple of 2.07 to our tangible book value. As adjusted for a 3.0% stock dividend distributed September 28, 2017, the Company paid a quarterly cash dividend of \$0.243 per share for the first quarter of 2017, and a cash dividend of \$0.25 per share for the last quarter of

2017 and the first quarter of 2018.

Loan Quality: Our net charge-offs for the first quarter of 2018 were \$275 thousand as compared to \$153 thousand for the comparable 2017 quarter. Our ratio of net charge-offs to average loans (annualized) was 0.06% for the first quarter of 2018 compared to 0.03% for the first quarter of 2017. At March 31, 2018, our allowance for loan losses was \$19.1 million representing 0.96% of total loans, up 1 basis point from the December 31, 2017 ratio. We believe this allowance is appropriate and reflects the continuing strong credit quality in the loan portfolio.

Nonperforming loans were \$4.6 million at March 31, 2018, representing 0.23% of period-end loans, a decrease of 1 basis point from our prior year comparable quarter ratio, which compares favorably with the weighted average ratio of our peer group of 0.67% at December 31, 2017.

Loan Segments: During the first quarter of 2018, we experienced increases in outstanding balances in all three segments of our loan portfolio, without any significant deterioration in our credit quality. During the quarter, our total loans grew by \$42.3 million, or 2.2% as compared to the balance at December 31, 2017. The largest increase was in consumer loans which increased during the quarter by \$23.8 million, or 4.0%. In addition, our total commercial loan portfolio increased by \$9.2 million, or 1.6%, and our residential real estate loans expanded by \$9.2 million, or 1.2%.

Commercial Loans: These loans comprised 6.4% of our loan portfolio at period-end. 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.

Commercial Real Estate Loans: These loans comprised 22.8% of our loan portfolio at period-end. Commercial property values in our region have remained stable in recent periods. We update the appraisals on our nonperforming and watched CRE

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loan properties as deemed necessary, usually when the loan is downgraded or when we perceive significant market deterioration since our last appraisal.

Consumer Loans: These loans (primarily automobile loans) comprised 31.4% of our loan portfolio at period-end. Consumer automobile loans at March 31, 2018, were \$620 million, or 99.0% of this portfolio segment. In the first three months of 2018, we did not experience any significant increase in our delinquency rate or in the percentage of nonperforming loans in this segment.

Residential Real Estate Loans: These loans, including home equity loans, made up 39.3% of our portfolio at period-end. The residential real estate market in our service area has been stable in recent periods. We originated nearly all of the residential real estate loans currently held in our portfolio and apply conservative underwriting standards to our originations. We typically sell a portion of our residential real estate mortgage originations into the secondary market. The ratio of our sales of originations to total originations tends to fluctuate from period to period, although this ratio has generally declined somewhat in recent periods.

Liquidity and Access to Credit Markets: We have not experienced any liquidity problems or special concerns thus far in 2018, nor did we in any prior years back to and during the financial crisis. The terms of our lines of credit with our correspondent banks, the FHLB NY and the Federal Reserve Bank have not changed significantly in recent periods (see our general liquidity discussion on page 53). Historically, we have principally relied 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 of funds (our main liability-based sources are overnight borrowing arrangements with our correspondent banks, an arrangement for overnight borrowing and term credit advances from the FHLB NY, 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 direct liability arising out of certain antitrust claims involving merchant discounts to the extent that Visa's liability might exceed the remaining litigation escrow account amount. In light of the current state of covered litigation at Visa, 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 March 31, 2018, the Company held 27,771 shares of Visa Class B common stock. A potential future conversion of these shares into Visa Class A common stock could result in our receiving approximately 46 thousand shares of Visa Class A 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.

CHANGE IN FINANCIAL CONDITION

Summary of Selected Consolidated Balance Sheet Data

(Dollars in Thousands)

	At Period-End			\$ Change From December	\$ Change From March	% Change From December (not annualized)	% Change From March		
	March 31, 2018	December 31, 2017	March 31, 2017						
Interest-Bearing Bank Balances	\$70,747	\$30,276	\$14,645	\$40,471	\$56,102	133.7	%	383.1	%
Securities Available-for-Sale	305,589	300,200	347,159	5,389	(41,570)	1.8	%	(12.0)	%
Securities Held-to-Maturity	330,124	335,907	335,211	(5,783)	(5,087)	(1.7)	%	(1.5)	%
Equity Securities ⁽¹⁾	1,579	—	—	1,579	1,579				
Loans ⁽²⁾	1,993,037	1,950,770	1,810,805	42,267	182,232	2.2	%	10.1	%
Allowance for Loan Losses	19,057	18,586	17,216	471	1,841	2.5	%	10.7	%
Earning Assets ⁽²⁾	2,705,856	2,627,102	2,514,646	78,754	191,210	3.0	%	7.6	%
Total Assets	\$2,826,687	\$2,760,465	\$2,656,386	\$66,222	\$170,301	2.4	%	6.4	%
Demand Deposits	\$452,347	\$441,945	\$402,506	\$10,402	\$49,841	2.4	%	12.4	%
Interest-Bearing Checking Accounts	944,161	907,315	959,170	36,846	(15,009)	4.1	%	(1.6)	%
Savings Deposits	762,220	694,573	696,625	67,647	65,595	9.7	%	9.4	%
Time Deposits over \$250,000	85,403	38,147	30,993	47,256	54,410	123.9	%	175.6	%
Other Time Deposits	167,142	163,136	167,242	4,006	(100)	2.5	%	(0.1)	%
Total Deposits	\$2,411,273	\$2,245,116	\$2,256,536	\$166,157	\$154,737	7.4	%	6.9	%
Federal Funds Purchased and Securities Sold Under Agreements to Repurchase	\$74,957	\$64,966	\$32,035	\$9,991	\$42,922	15.4	%	134.0	%
FHLB NY Advances - Overnight	—	105,000	32,000	(105,000)	(32,000)	(100.0)	%	(100.0)	%
FHLB NY Advances - Term	45,000	55,000	55,000	(10,000)	(10,000)	(18.2)	%	(18.2)	%
Stockholders' Equity	252,734	249,603	236,111	3,131	16,623	1.3	%	7.0	%

(1) Equity Securities were included in Securities Available-for-Sale prior to the January 1, 2018 adoption of ASU 2016-01

(2) Includes Nonaccrual Loans

Municipal Deposits: Fluctuations in balances of our interest-bearing checking accounts are largely the result of municipal deposit fluctuations. Municipal deposits on average represent 27% to 33% of our total deposits. Municipal deposits are typically placed in interest-bearing checking and savings accounts, as well as various time deposits. In general, there is a seasonal pattern to municipal deposits which dip to a low point in August each year. Account balances tend to increase throughout the fall and into early winter from tax deposits, flatten out after the beginning of the ensuing calendar year, and increase again at the end of March from the electronic deposit of NYS Aid payments to school districts. In addition to these seasonal fluctuations within types of accounts, the overall level of municipal deposit balances fluctuates from year-to-year as some municipalities move their accounts in and out of our banks due to competitive factors. Often, the balances of municipal deposits at the end of a quarter are not representative of the average balances for that quarter.

If in the future, interest rates begin to rise significantly or the competition for municipal deposits otherwise becomes more intense, we may experience an elevation in the rates we are forced to pay on such deposits above our normal rates or, if we decline to pay such rates, we may experience a decrease in municipal deposit levels.

Changes in Sources of Funds: Our total deposits increased \$166.2 million, or 7.4%, from December 31, 2017 to March 31, 2018. Our municipal deposits increased by 15.2% during the period, mainly due to the receipt of NYS Aid payments to school districts in March 2018, while our consumer and business deposit balances increased by 4.3%. Due to this deposit growth along with the 15.4% increase in our securities sold under agreements to repurchase, we were able to pay off our FHLBNY Advances-Overnight at March 31, 2018. The first quarter increase in deposit balances also included seasonal municipal deposit growth and the use of brokered deposits to diversify balance sheet funding. At March 31, 2018, our term advances from the FHLBNY were \$45 million, reflecting the non-renewal of a \$10 million advance that matured during the quarter.

Changes in Earning Assets: Our loan portfolio at March 31, 2018, was \$1.99 billion, up by \$42.3 million, or 2.2%, from the December 31, 2017 level and up by \$182.2 million, or 10.1%, from the March 31, 2017 level. We experienced the following trends in our four largest segments:

1. Commercial loans. This segment of our portfolio decreased slightly by \$1.6 million, or 1.2%, during the first three months of 2018, representing a slight softening of demand for such loans during the period.
2. Commercial real estate loans. This segment of our portfolio increased by \$10.8 million, or 2.4%, during the first three months of 2018, representing the continued strong demand for such loans.

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Consumer loans (primarily automobile loans through indirect lending). As of March 31, 2018, these loans, primarily auto loans, had increased by \$23.8 million, or 4.0%, from the December 31, 2017 balance, reflecting a continuation of strong demand for new and used vehicles region-wide and an expansion of our dealer network for indirect lending.

4. Residential real estate loans. This segment increased during the first three months of 2018, by \$9.2 million, or 1.2%. As in prior periods, we elected to sell a portion of the residential mortgage loans we originated during the period to Freddie Mac. Gross originations were down during the period, compared to the comparable 2017 period reflecting lower housing inventory levels and a rising rate environment.

Deposit Trends

The following two tables provide information on trends in the balance and mix of our deposit portfolio by presenting, for each of the last five quarters, the quarterly average balances by deposit type and the percentage of total deposits represented by each deposit type. The principal change in deposit balances from March 31, 2017 was the steady and significant increase in demand deposits and savings deposits as well as an increase in time deposits over \$250,000 as of March 31, 2018 due to the increase in market rates. In addition, first quarter increase in deposit balances also included \$45 million of floating rate brokered deposits, based on the one-month LIBOR rate, which were acquired to diversify balance sheet funding. As mentioned previously, the volatility in interest-bearing checking deposit account balances is mainly due to seasonal fluctuations in municipal deposits. If and to the extent that interest rates, and corresponding deposit rates, across all maturities, begin to increase in future periods, even if such increases are very gradual, we would expect to see further growth in time deposits.

Quarterly Average Deposit Balances

(Dollars in Thousands)

	Quarter Ended				
	3/31/2018	12/31/2017	9/30/2017	6/30/2017	3/31/2017
Demand Deposits	\$439,688	\$441,761	\$443,840	\$408,214	