

ARROW FINANCIAL CORP
Form 10-K
March 06, 2009

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-K

Annual Report Pursuant to Section 13 or 15(d) of
The Securities Exchange Act of 1934

For the Fiscal Year Ended December 31, 2008

Commission File Number: 0-12507

ARROW FINANCIAL CORPORATION

(Exact name of registrant as specified in its charter)

New York

(State or other jurisdiction of
incorporation or organization)

22-2448962

(IRS Employer Identification
Number)

250 GLEN STREET, GLENS FALLS, NEW YORK 12801

(Address of principal executive offices) (Zip Code)

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

SECURITIES REGISTERED PURSUANT TO SECTION 12(b) OF THE ACT - NONE

SECURITIES REGISTERED PURSUANT TO SECTION 12(g) OF THE ACT

Common Stock, Par Value \$1.00

(Title of Class)

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act.

Yes ☒

No

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act.

Yes ☒

No

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such

reports), and (2) has been subject to such filing requirements for the past 90 days.

☒ Yes

No

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Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III

of this Form 10-K or any amendment to this Form 10-K:

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

Large accelerated
filer

Accelerated filer ☒

Non-accelerated filer

Smaller reporting
company

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

State the aggregate market value of the voting and non-voting common equity held by non-affiliates computed by reference to the price at which the common equity was last sold, or the average bid and asked price of such common equity, as of the last business day of the registrant's most recently completed second fiscal quarter: \$191,016,000

Indicate the number of shares outstanding of each of the registrant's classes of common stock.

<u>Class</u>	<u>Outstanding as of February 27, 2009</u>
Common Stock, par value \$1.00 per share	10,578,411

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the Registrant's Proxy Statement for the Annual Meeting of Shareholders to be held April 29, 2009 (Part III)

ARROW FINANCIAL CORPORATION

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*These items are incorporated by reference to the Corporation's Proxy Statement for the Annual Meeting of Shareholders to be held April 29, 2009.

NOTE ON TERMINOLOGY

In this Annual Report on Form 10-K, the terms Arrow, the registrant, the company, we, us, and our general refer to Arrow Financial Corporation and its subsidiaries as a group, except where the context indicates otherwise. Arrow is a two-bank holding company headquartered in Glens Falls, New York. Our banking subsidiaries are Glens Falls National Bank and Trust Company (Glens Falls National) whose main office is located in Glens Falls, New York, and Saratoga National Bank and Trust Company (Saratoga National) whose main office is located in Saratoga Springs, New York. Subsidiaries of Glens Falls National include Capital Financial Group, Inc. (an insurance agency specializing in selling and servicing group health care policies), North Country Investment Advisers, Inc. (a registered investment adviser that provides investment advice to our proprietary mutual funds), U.S. Benefits, Inc. (a provider of administrative and recordkeeping services for more complex retirement plans) and Arrow Properties, Inc., a real estate investment trust (REIT).

At certain points in this Report, our performance is compared with that of our peer group of financial institutions. Unless otherwise specifically stated, this peer group is comprised of the group of 286 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, 2008, and peer group data has been derived from such Report. This peer group is not, however, identical to either of the peer groups comprising the two bank indices included in the stock performance graphs on pages 13 and 14 of this Report.

FORWARD-LOOKING STATEMENTS

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

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

<u>Topic</u>	<u>Section</u>	<u>Page</u>	<u>Location</u>
Impact of Legislative Developments	Part I, Item 1.D.	8	Last paragraph in Section D
Impact of Legal Claims	Part I, Item 3	11	Paragraph under Item 3. Legal Proceedings

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Impact of Changing Interest Rates on	Part II,	24	3 rd paragraph under
Earnings	Item 7.B.I.		Impact of Interest Rate Changes 2003- 2008
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	Part II,	34	1 st paragraph under Residential
	Item 7.C.II.a.		Real Estate Loans
	Part II,	34	Last paragraph under Indirect Loans
	Item 7.C.II.a.		
	Part II,	35	1 st paragraph under table
	Item 7.C.II.a.		
	Part II,	38	Last paragraph
	Item 7.C.IV.		
	Part II,	43	Last three paragraphs
	Item 7A.		
Adequacy of the Allowance for Loan	Part II,	26	1 st and 2 nd paragraphs under II. Provision For Loan Losses and Allowance For Loan Losses
Losses	Item 7.B.II.		
Expected Level of Real Estate Loans	Part II,	34	1 st paragraph under Residential
	Item 7.C.II.a.		Real Estate Loans
Liquidity	Part II,	40	Last paragraph in Section D Liquidity
	Item 7.D.		
Dividend Capacity	Part I,	6	Next to last paragraph under Section C
	Item 1.C.		Supervision and Regulation
	Part II,	41	3 rd paragraph
	Item 7.E.		

These statements are not guarantees of future performance and involve certain risks and uncertainties that are difficult to quantify or, in some cases, to identify. In the case of all forward-looking statements, actual outcomes and results may differ materially from what the statements predict or forecast.

Factors that could cause or contribute to such differences include, but are not limited to; unexpected changes in economic and market conditions, including unanticipated fluctuations in interest rates and changes in the values of real estate and motor vehicles; severe changes in credit markets, including credit insurance markets; unforeseen

developments in state and federal regulation of financial institutions; enhanced competition from unexpected sources, including governmental operation of previously private large banking organizations; new emerging technologies; unexpected loss of key personnel; and similar risks of major upheavals in financial operations and markets. Readers are cautioned not to place undue reliance on these forward-looking statements, which speak only as of the date hereof.

We undertake no obligation to revise or update these forward-looking statements to reflect the occurrence of unanticipated events.

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. As a parallel measure with Regulation G, the SEC has provided in Item 10 of its Regulation S-K, that public companies must make the same types of supplemental disclosures whenever they include non-GAAP financial measures in their filings with the SEC. 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 or SEC filings, supplemental information is not required. The following measures used in this Report, which although commonly utilized by financial institutions have not been specifically exempted by the SEC, 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, 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 back to the net interest income total. This adjustment is considered helpful in comparing one financial institution's net interest income to that of another institution, to correct any distortion that might otherwise arise from the fact that the two institutions typically will have different proportions of tax-exempt items in their portfolios. Moreover, net interest income is itself a component of a second financial measure commonly used by financial institutions, net interest margin, which is the ratio of net interest income to average earning assets. For purposes of this measure as well, tax-equivalent net interest income is generally used by financial institutions, again to provide a better basis of comparison from institution to institution. We follow these practices.

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

Tangible Book Value per Share: Tangible equity is total shareholders' equity (as calculated under GAAP) 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 shareholders' equity including intangible assets divided by total shares issued and outstanding. Intangible assets, as a category of assets, includes many items, such as goodwill.

PART I

Item 1. Business

A. GENERAL

Our holding company, Arrow Financial Corporation, a New York corporation, was incorporated on March 21, 1983 and is registered as a bank holding company within the meaning of the Bank Holding Company Act of 1956. Arrow owns (directly or indirectly) two nationally chartered banks in New York (Glens Falls National and Saratoga National), an insurance agency (Capital Financial Group, Inc.), a registered investment adviser that advises our proprietary mutual funds (North Country Investment Advisers, Inc.), a Real Estate Investment Trust (Arrow Properties, Inc.) and four other non-bank subsidiaries whose operations are insignificant.

Subsidiary Banks (dollars in thousands)

	<u>Glens Falls National</u>	<u>Saratoga National</u>
Total Assets at Year-End	\$1,425,044	\$239,215
Trust Assets Under Administration and Investment Management at Year-End		
(Not Included in Total Assets)	\$724,464	\$30,914
Date Organized	1851	1988
Employees (full-time equivalent)	436	41
Offices	27	6
Counties of Operation	Warren, Washington, Saratoga, Essex & Clinton	Saratoga
Main Office	250 Glen Street Glens Falls, NY	171 So. Broadway Saratoga Springs, NY

The holding company's business consists primarily of the ownership, supervision and control of our two banks. The holding company provides various advisory and administrative services and coordinates the general policies and operation of the banks. There were 477 full-time equivalent employees at December 31, 2008.

We offer a full range of commercial and consumer banking and financial products. Our deposit base consists of

deposits derived principally from the communities we serve. We target our lending activities to consumers and small and mid-sized companies in our immediate geographic areas. Through our banks' trust operations, we provide retirement planning, trust and estate administration services for individuals, and pension, profit-sharing and employee benefit plan administration for corporations.

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

In April 2005, Arrow's subsidiary banks acquired from HSBC Bank USA, N.A. (HSBC) three bank branches located within the banks' service areas. Glens Falls National acquired two HSBC branches located in Argyle and Salem, New York, and Saratoga National acquired a branch located in Corinth, New York. The banks acquired substantially all deposit liabilities, the physical facilities and certain loans related to the branches. At the closing of the acquisitions, total deposits of the three branches were approximately \$62 million and the related loans were approximately \$8 million. The acquisition resulted in total intangible assets, including goodwill, of approximately \$5.9 million.

In November 2004, Glens Falls National acquired all of the outstanding shares of common stock of Capital Financial Group, Inc. (CFG), an insurance agency headquartered in South Glens Falls, New York, which specializes in group health and life insurance products. The acquisition was structured as a tax-free exchange of Arrow's common stock for CFG's common stock. CFG's president and staff continued with CFG after the acquisition. As adjusted for cumulative contingent payments, we recorded the following intangible assets as a result of the acquisition (none of which are deductible for income tax purposes): goodwill (\$1.735 million), covenant not to compete (\$117 thousand) and portfolio expirations (\$686 thousand). The value of the covenant is being amortized over five years and the value of the expirations is being amortized over twenty years. Under the acquisition agreement, we issued 66,630 shares of Arrow's common stock at the closing. The agreement also provided for annual contingent post-closing payments of Arrow common stock, based upon earnings of CFG, adjusted as provided in the agreement, over the five-year period following the closing. We concluded that under criteria established by Statement of Financial Accounting Standards (SFAS) No. 141 Business Combinations, these contingent payments would be recorded as additional goodwill at the time of payment. The maximum contingent payment over the five-year period is \$3.0 million of Arrow stock, valued at the market price on the date of payment. Through December 31, 2008, total contingent payments amounted to \$356 thousand (14,509 shares).

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

B. LENDING ACTIVITIES

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

agencies, while normally retaining the servicing rights.

In addition to sales of loans into the secondary market, we have periodically securitized some of the mortgage loans in our portfolio. In the securitized transactions, we sold mortgage loans and concurrently purchased an equivalent amount of guaranteed mortgage-backed securities issued by Freddie Mac, with the sold loans representing the underlying collateral for the pooled securities. We have no contingent liability to unrelated parties under these securitization arrangements. At December 31, 2008, the balance of these securitized loans remaining in our securities portfolio was approximately \$2.7 million. In addition to interest earned on loans, we receive facility fees for various types of commercial and industrial credits, and commitment fees for extension of letters of credit and certain types of loans.

Generally, we continue to implement lending strategies and policies that are intended to protect the quality of the loan portfolio, including strong underwriting and collateral control procedures and credit review systems. It is our policy to discontinue the accrual of interest on loans when the payment of interest and/or principal is due and unpaid for a designated period (generally 90 days) or when the likelihood of repayment is, in the opinion of management, uncertain (see Part II, Item 7.C.II.c. Risk Elements). Future cash payments on nonaccrual loans may be applied all to principal, although income in some cases may be recognized on a cash basis.

We lend primarily to borrowers within our geographic area. The loan portfolio does not include any foreign loans or any other significant risk concentrations. We do not participate in loan syndications, either as originator or as a participant. Most of the portfolio, in general, is fully collateralized, and many commercial loans are further secured by personal guarantees.

We do not engage in subprime mortgage lending as a business line and we do not extend or purchase so-called Alt A, negative amortization, option ARM s or negative equity mortgage loans.

C. SUPERVISION AND REGULATION

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

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

An important area of banking regulation is the federal banking system's promulgation and enforcement of minimum capitalization standards for banks and bank holding companies. The FRB has adopted various "capital adequacy guidelines" for its use in the examination and supervision of bank holding companies. The FRB's risk-based capital guidelines assign risk weightings to all assets and certain off-balance sheet items and establish an 8% minimum ratio of qualified total capital to the aggregate dollar amount of risk-weighted assets (which is almost always less than the dollar amount of such assets without risk weighting). Under the risk-based guidelines, at least half of total capital must consist of "Tier 1" capital, which comprises common equity, retained earnings and a limited amount of permanent preferred stock, less goodwill. Under the FRB's guidelines, trust preferred securities may also qualify as Tier 1 capital, in an amount not to exceed 25% of Tier 1 capital. The final rule limits restricted core capital elements to a percentage of the sum of core capital elements, net of goodwill less any associated deferred tax liability. We issued trust preferred securities in 2003 and 2004 to serve as part of our core capital. Up to half of total capital may consist of so-called "Tier 2" capital, comprising a limited amount of subordinated debt, preferred stock not qualifying as Tier 1 capital, certain other instruments and a limited amount of the allowance for loan losses. The FRB's other important guideline for measuring a bank holding company's capital is the leverage ratio standard, which establishes minimum limits on the ratio of a bank holding company's "Tier 1" capital to total tangible assets (not risk-weighted). For top-rated holding companies, the minimum leverage ratio is 3%, but lower-rated companies may be required to meet substantially greater minimum ratios. Our subsidiary banks are subject to capital requirements similar to the capital requirements applicable at the holding company level described above. Our banks' capital requirements have been promulgated by their primary federal regulator, the OCC.

Under applicable law, federal banking regulators are required to take prompt corrective action with respect to depository institutions that do not meet minimum capital requirements. The regulators have established five capital classifications for banking institutions, the highest being "well-capitalized." Our holding company and both of our

subsidiary banks currently qualify as well-capitalized. Under regulations adopted by the federal bank regulators, a banking institution is considered "well-capitalized" if it has a total risk-adjusted capital ratio of 10% or greater, a Tier 1 risk-adjusted capital ratio of 6% or greater and a leverage ratio of 5% or greater and is not subject to any regulatory order or written directive regarding capital maintenance. The year-end 2008 capital ratios of our holding company and our banks are set forth in Part II, Item 7.E. "Capital Resources and Dividends" and in Note 15 Regulatory Matters to the audited financial statements under Part II, Item 8 of this Report.

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

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

The Emergency Economic Stabilization Act of 2008 (EESA), which includes the Troubled Asset Relief Program (TARP), and the American Recovery and Reinvestment Act of 2009 (the ARRA) were recently enacted in response to the financial crises currently affecting the banking system and financial markets. The EESA, the ARRA and related government programs include a variety of regulatory initiatives aimed at providing stability to the financial services industry and financial markets; however, many of these laws and programs are and will continue to impact the supervision and regulation of the banking industry. The impact of certain of these laws and programs are addressed in the following section regarding Recent Legislative Developments.

D. RECENT LEGISLATIVE DEVELOPMENTS

The EESA, the ARRA and related recently established governmental programs, such as the FDIC's Temporary Liquidity Guarantee Program (TLGP) and the U.S. Treasury's Capital Purchase Program (CPP), a component of TARP, are discussed at the end of this section.

The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 became effective October 17, 2005. The Act addressed many areas of bankruptcy practice, including consumer bankruptcy, general and small business bankruptcy, treatment of tax claims in bankruptcy, ancillary and cross-border cases, financial contract protection amendments to Chapter 12 governing family farmer reorganization, and special protection for patients of a health care business filing for bankruptcy. This Act did not have a significant impact on our earnings or on our efforts to recover collateral on secured loans. In January of 2009, Congress began to consider a bill that would give bankruptcy judges the power to alter rates, terms, balances and maturities of home mortgage loans.

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

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

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

In November 1999, Congress enacted the Gramm-Leach-Bliley Act (GLBA), which permitted bank holding companies to engage in a wider range of financial activities. For example, under GLBA bank holding companies may underwrite all types of insurance and annuity products and all types of securities products and mutual funds, and may engage in merchant banking activities. Bank holding companies that wish to engage in these or other financial activities generally must do so through separate financial subsidiaries and may themselves be required to register (and qualify to register) as so-called financial holding companies. A bank holding company that does not register as a financial holding company remains a bank holding company subject to substantially the same regulatory restrictions

and permitted activities as applied to bank holding companies prior to GLBA (See Item I.C., Supervision and Regulation, above). We have not as yet elected to become a financial holding company. Also under GLBA, financial institutions have become subject to stringent customer privacy regulations, in addition to the privacy provisions under the Fair Credit Reporting Act Amendment of 2003.

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

The FICO was established by the Competitive Equality Banking Act of 1987, and is a mixed-ownership government corporation whose sole purpose was to issue bonds to insure thrift institutions. Outstanding FICO bonds, which are 30-year noncallable bonds with a principal amount of approximately \$8.1 billion, mature in 2017 through 2019. FICO has assessment authority, separate from the FDIC's authority to assess risk-based premiums for deposit insurance, to collect funds from all FDIC-insured institutions sufficient to pay interest on FICO bonds. The FDIC acts as collection agent for the FICO. Since the first quarter of 2000, all FDIC-insured deposits have been assessed at the same rate by FICO. For 2008, our FICO assessment was approximately \$141,000.

In 2007 the FDIC resumed charging financial institutions a premium under the new risk-based assessment system. Under this system, institutions in Risk Category I (the lowest of four risk categories) will pay a rate (based on a formula) of 5 to 7 cents per \$100 of assessable deposits. Both of our banks qualified for the 5 cent per \$100 assessment rate during 2008.

The Federal Deposit Insurance Reform Act of 2005 allowed "eligible insured depository institutions" to share a one-time assessment credit pool of approximately \$4.7 billion. Our credit amounted to \$747,000. The credit was available to offset FDIC insurance premiums beginning in 2007, but not to offset the FICO bond assessment, which will continue through 2019. The one-time credit fully offset our FDIC insurance premiums for 2007 and offset approximately \$134,000 of our \$637,000 2008 FDIC premiums.

In 2008, in response to the level of claims against the Bank Insurance Fund, the FDIC announced that it would raise the lowest rate from 5 cents to 12 cents per \$100 of assessable deposits beginning with the first quarter of 2009. In addition, beginning with the second quarter of 2009, the FDIC will add four new factors to the assessment rate calculation, including factors for brokered deposits, secured liabilities and unsecured liabilities. These changes will dramatically increase FDIC insurance expenses for all insured institutions.

On February 27, 2009, the FDIC adopted an interim rule, with request for comment, which would institute a one-time special assessment of 20 cents per \$100 of domestic deposits on FDIC insured institutions. The assessment would be payable on September 30, 2009. If the 20 cent assessment is approved, we estimate that our assessment would total approximately \$2.6 million. This rule would also allow the FDIC to impose additional special assessments of up to 10 cents per \$100 of domestic deposits at the end of any calendar quarter after June 30, 2009, to restore the Deposit Insurance Fund.

Also in late 2008, the FDIC adopted the TLGP to boost consumer confidence in their funds deposited with insured institutions. The TLGP allowed insured institutions to participate in two areas of additional insurance: 1) full coverage of noninterest-bearing accounts through December 31, 2009 at a cost of an additional 10 cents per \$100 of additional insured deposits, and 2) a guarantee of certain newly-issued unsecured short-term senior debt issued by a bank holding company or bank on or before June 30, 2009, at a cost ranging from 50 to 100 basis points. We elected to participate in both components of the TLGP, but, as of the filing date of this report, we have not issued any unsecured debt. We estimate that the cost for the additional insurance will only be \$18,000 for 2009.

Arrow was preliminarily approved by the U.S. Treasury Department to participate in the CPP; however, in January 2009, we announced that we would not participate in the CPP due to our strong financial and liquidity positions. See Item 7, Management's Discussion and Analysis of Financial Condition and Results of Operations, page 17. Under the CPP, the U.S. Treasury purchased preferred stock in participating publicly traded financial institutions. The dividend rate on the stock was 5%, increasing to 9% in year 6 and later years. The purchase also included the issuance of stock warrants at 15% of the amount of the investment.

The EESA, the ARRA, and the related governmental programs include a variety of initiatives that could have a significant impact on the banking industry and on Arrow; however, the actual impact that these new laws and programs will have on the financial markets, the financial services industry and Arrow cannot be determined at this time. In addition, various federal bills that would significantly affect banks are introduced in Congress and the New York State Legislature from time-to-time. We cannot estimate the likelihood of any currently proposed banking bills being enacted into law, or the ultimate effect that any such potential legislation, if enacted, would have upon our financial condition or operations.

E. STATISTICAL DISCLOSURE (GUIDE 3)

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

<u>Required Information</u>	<u>Location in Report</u>
Distribution of Assets, Liabilities and Stockholders' Equity; Interest Rates and Interest Differential	Part II, Item 7.B.I.
Investment Portfolio	Part II, Item 7.C.I.
Loan Portfolio	Part II, Item 7.C.II.
Summary of Loan Loss Experience	Part II, Item 7.C.III.
Deposits	Part II, Item 7.C.IV.
Return on Equity and Assets	Part II, Item 6.
Short-Term Borrowings	Part II, Item 8. Note 10.

F. COMPETITION

We face intense competition in all markets we serve. Traditional competitors are other local commercial banks, savings banks, savings and loan institutions and credit unions, as well as local offices of major regional and money center banks. We also encounter strong competition from the failed government sponsored enterprises Fannie Mae and Freddie Mac in the area of mortgage loans. Additionally, non-banking financial organizations, such as consumer finance companies, insurance companies, securities firms, money market and mutual funds and credit card companies offer substantive equivalents of the various loan and financial products and transactional accounts that we offer, even though these non-banking organizations are not subject to the same regulatory restrictions and capital requirements that apply to us. Under federal banking laws, such non-banking financial organizations not only may offer products comparable to those offered by commercial banks, but also may establish or acquire their own commercial banks.

G. EXECUTIVE OFFICERS OF THE REGISTRANT

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

<u>Name</u>	<u>Age</u>	<u>Positions Held and Years from Which Held</u>
Thomas L. Hoy	60	Chairman, President and CEO since 2004. Prior to 2004, Mr. Hoy served as President and CEO. Mr. Hoy has been with the company since 1974.
Terry R. Goodemote	45	Senior Vice President, Treasurer and CFO since January 1, 2007. Prior to 2007, Mr. Goodemote was Senior Vice President and head of the Accounting Division. Mr. Goodemote has been with the company since 1992.
John C. Van Leeuwen	65	Senior Vice President and Chief Credit Officer since 1995. Mr. Van Leeuwen retired as an officer of the company on June 30, 2008 and since that date has served the Company under a consulting agreement. Prior to 1995, Mr. Van Leeuwen served as Vice President and Loan Review Officer. Mr. Van Leeuwen has been with the company since 1985.
Gerard R. Bilodeau	62	Senior Vice President and Secretary since 1994. Mr. Bilodeau was Vice President and Secretary from 1993 to 1994 and was Director of Personnel prior to 1993. Mr. Bilodeau has been with the company since 1969.

H. AVAILABLE INFORMATION

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

Item 1A. Risk Factors

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

factors will develop, but to acknowledge the possible impact that could occur if the factors do develop.)

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

If economic conditions continue to deteriorate and the U.S. experiences a prolonged nationwide recession, the company's allowance for loan losses may not be adequate to cover actual losses. Like all financial institutions, we maintain an allowance for loan losses to provide for probable loan losses at the balance sheet date. Our allowance for loan losses is based on our historical loss experience as well as an evaluation of the risks associated with our loan portfolio, including the size and composition of the portfolio, current economic conditions and geographic concentrations within the portfolio and other factors. For a variety of reasons, including falling home prices nationwide, declining collateral values of used low-mileage vehicles and a general deterioration in U.S. credit markets since 2007, the rate of growth in the national economy slowed dramatically in 2008 and available data suggests that economic conditions may continue to deteriorate in upcoming periods. If the economy in our geographic market area, Northeastern New York State, should deteriorate or enter into a prolonged state of recession, this may have an additional adverse impact on our loan portfolio. If the quality of our portfolio should weaken due to this impact, our allowance for loan losses may not be adequate to cover actual loan losses, and future provisions for loan losses could materially and adversely affect financial results. Moreover, loan portfolio difficulties often accompany difficulties in other areas of our business, including growth of our business generally, thereby compounding the negative effects on earnings.

If economic conditions worsen and the U.S. financial markets continue to experience difficulties, the company may experience limited access to credit markets. As discussed under Part I, Item 7.D. Liquidity, the company has relationships with various third parties to provide overnight and longer-term credit arrangements. As these third parties themselves have difficulty in accessing their own credit markets then we may, in turn, experience a decrease in our capacity to borrow funds.

If the value of real estate in our market area were to decline materially, a significant portion of our loan portfolio could become under-collateralized, which might have a material adverse effect on us. In addition to considering the financial strength and cash flow characteristics of borrowers, we often secure loans with real estate collateral, which in

each case provides an alternate source of repayment in the event of default by the borrower. This real property may deteriorate in value during the time the credit is outstanding. If we are required to liquidate the collateral securing a loan to satisfy the debt during a period of reduced real estate values, our earnings and capital could be adversely affected. Our geographic market area experienced real estate price appreciation in the period 2002-2007 but property values in our region have leveled off in 2008 and have recently declined, similar to what is being experienced elsewhere in the U.S. Furthermore, proposed foreclosure legislation, if enacted, may allow courts to alter the terms of mortgages in foreclosure, resulting in an adverse impact on financial institutions.

If securities prices continue to significantly decline, we likely will experience a continuing reduction in income from fiduciary activities. A portion of the income we earn from managing assets in our fiduciary capacity is tied to the market value of those assets.

We are subject to the local economies where we operate, and unfavorable economic conditions in these areas could have a material adverse effect on our financial condition and results of operations. Our success depends upon the growth in population, income levels and deposits in our geographic market area. Unpredictable and unfavorable economic conditions unique to our market area may have an adverse effect on the quality of our loan portfolio and financial performance. As a community bank, we are less able than our larger regional competitors to spread the risk of unfavorable local economic conditions over a larger market area. Moreover, we cannot give any assurances that we will benefit from any unique and favorable economic conditions in our market area, even if they do occur.

The domestic interest rate environment could negatively affect the company's net interest income. An institution's net interest income is significantly affected by market rates of interest, including short-term and long-term rates and the relationship between the two. Interest rates are highly sensitive to many factors, which are beyond our control, including general economic conditions, policies of various governmental and regulatory agencies such as the Federal Reserve Board, and actions taken by foreign central banks. Like all financial institutions, the Company's balance sheet is affected by fluctuations in interest rates. Volatility in interest rates can also result in the flow of funds away from financial institutions. See the discussion under "Changes in Net Interest Income Due to Rate," on page 24 of this Report.

Current levels of market volatility are unprecedented. The market for certain investment securities has become highly volatile or inactive, and may not stabilize or resume in the near future. This volatility can result in significant fluctuation in the prices of those securities, which could affect the results of our operations.

Changes in accounting standards may materially impact the company's financial statements. From time to time, the Financial Accounting Standards Board (FASB) changes the financial accounting and reporting standards that govern the preparation of our financial statements. These changes can be hard to predict and can materially impact how we record and report our financial condition and results of operations. In some cases, we may be required to apply a new or revised standard retroactively, resulting in changes to previously reported financial statements.

The company's business could suffer if it loses key personnel unexpectedly or fails to provide for an orderly management succession. Our success depends, in large part, on our ability to retain our key personnel for the duration of their expected terms of service, and to arrange for an orderly succession of other, equally skilled personnel. Competition for the best people in our business can be intense. While our Board of Directors actively reviews succession plans, any sudden change at the senior management level may adversely affect our business.

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

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

Significant legal or regulatory enforcement actions could subject the company to substantial uninsured liabilities. From time to time we are subject to claims related to our operations. These claims and legal actions, including supervisory actions by our regulators, could involve large monetary claims and significant defense costs. To protect ourselves from the cost of these claims, we maintain insurance coverage in amounts and with deductibles that we believe are appropriate for our operations, but this insurance coverage may not cover all claims against us or may increase substantially in cost. As a result, we may be exposed to significant uninsured liabilities, which could adversely affect our results of operations and financial condition.

The company faces continuing and growing security risks to its own information base and to information on its customers. The computer systems and network infrastructure that we use are always vulnerable to unforeseen problems, including theft of confidential customer information (identity theft) and interruption of service as a result of fire, natural disasters, explosion or general infrastructure failure. These problems may arise in both our internally developed systems and the systems of our third-party service providers. We constantly assess and attempt to improve our security systems and disaster preparedness, but the risks in these areas are substantially escalating.

The company's stock price may begin to reflect market volatility. Our stock price can fluctuate widely in response to a variety of factors, including: actual or anticipated variations in our operating results; recommendations by securities analysts; significant acquisitions or business combinations; operating and stock price performance of other companies that investors deem comparable to us; new technology used or services offered by our competitors; news reports relating to trends, concerns and other issues in the financial services industry; and changes in government regulations. Many of these factors that may adversely affect our stock price do not directly pertain to our operating results, including general market fluctuations, industry-wide factors and economic and general political conditions and events, including terrorist attacks, economic slowdowns or recessions, interest rate changes, credit loss trends or currency fluctuations.

We may be adversely affected by government regulation. We are subject to extensive federal and state banking regulations and supervision. Banking regulations are intended primarily to protect our depositors' funds and the federal deposit insurance funds, not the company's shareholders. Regulatory requirements affect our lending practices, capital structure, investment practices, dividend policy and growth. Failure to meet minimum capital requirements could result in the imposition of limitations on our operations that would adversely impact our operations and could, if capital levels dropped significantly, result in our being required to cease or scale back our operations. Changes in governing law, regulations or regulatory practices could impose additional costs on us or adversely affect our ability to obtain deposits or make loans and thereby hurt our revenues and profitability.

There can be no assurance that recently enacted legislation will stabilize the U.S. financial markets. The EESA, ARRA and related federal government programs, such as the FDIC's TLGP, are intended to stabilize and provide liquidity to the U.S. financial markets. However, there can be no assurance that the EESA, the ARRA, the implementing regulations for the EESA and ARRA, the TLGP, or any other governmental program will have a positive impact on the financial markets. The failure of these laws and programs to stabilize the financial markets and a continuation or worsening of current financial market conditions could materially and adversely affect Arrow's business, financial condition, results of operations, access to credit or the trading price of Arrow's common stock.

Arrow may be adversely affected by the recently enacted legislation and related programs. The EESA, ARRA and related programs may adversely affect Arrow. Arrow may face increased regulation of our business and increased costs associated with these laws and programs. Programs established by the FDIC, whether or not Arrow participates, may have an adverse effect on Arrow. For example, participation in the FDIC's TLGP will require the payment of additional insurance premiums to the FDIC, but Arrow may also be required to pay significantly higher FDIC premiums caused by FDIC actions not involving Arrow (such as FDIC bank receiverships) that significantly deplete the insurance funds of the FDIC and reduce the ratio of reserves to insured deposits.

Item 1.B. Unresolved Staff Comments - None

Item 2. Properties

Our main office is at 250 Glen Street, Glens Falls, New York. The building is owned by us and serves as the main office for Glens Falls National Bank, our principal subsidiary. We own twenty-seven branch offices and lease six others at market rates.

In the opinion of management, the physical properties of our holding company and our subsidiary banks are suitable and adequate. For more information on our properties, see Notes 1, 6 and 21 to the Consolidated Financial Statements contained in Part II, Item 8 of this Report.

Item 3. Legal Proceedings

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

Item 4. Submission of Matters to a Vote of Security Holders

None in the fourth quarter of 2008.

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

The common stock of Arrow Financial Corporation is traded on The Nasdaq Stock MarketSM under the symbol AROW.

The high and low prices listed below represent actual sales transactions, as reported by Nasdaq. All stock prices and cash dividends per share have been restated to reflect subsequent stock dividends. On September 28, 2007, we distributed a 3% stock dividend on our outstanding shares of common stock.

	2008			2007		
	<u>Sales Price</u>		<u>Cash Dividends</u>	<u>Sales Price</u>		<u>Cash Dividends</u>
	<u>Low</u>	<u>High</u>	<u>Declared</u>	<u>Low</u>	<u>High</u>	<u>Declared</u>
First Quarter	\$18.500	\$23.690	\$.240	\$20.583	\$24.553	\$.233
Second Quarter	18.000	24.350	.240	20.825	22.990	.233
Third Quarter	17.790	32.720	.250	19.417	25.810	.233
Fourth Quarter	21.500	29.980	.250	20.490	25.000	.240

The payment of cash dividends by Arrow is at the discretion of its Board of Directors and is dependent upon, among other things, our earnings, financial condition and other factors, including applicable legal and regulatory restrictions. See "Capital Resources and Dividends" in Part II, Item 7.E. of this report.

There were approximately 5,709 holders of record of Arrow's common stock at December 31, 2008. Arrow has no other class of stock outstanding.

Equity Compensation Plan Information

The following table sets forth certain information regarding Arrow's equity compensation plans as of December 31, 2008. These equity compensation plans were our 1998 and 2008 Long Term Incentive Plans ("Stock Plans"), our 2000 Director, Officer and Employee Stock Purchase Plan ("ESPP") and our Directors' Stock Plan. Consistent with applicable law and regulation, the Stock Plans were approved by Arrow's shareholders, while the ESPP and the Directors' Stock Plan were not shareholder approved upon adoption. However, shareholders approved the Directors' Stock Plan at their 2008 annual meeting when the plan was amended to add shares.

<u>Plan Category</u>	(a) Number of Securities to be Issued Upon Exercise of Outstanding Options, <u>Warrants and Rights</u>	(b) Weighted-Average Exercise Price of Outstanding Options, <u>Warrants and Rights</u>	(c) Number of Securities Remaining Available for Future Issuance Under Equity Compensation Plans (Excluding Securities <u>Reflected in Column (a))</u>
Equity Compensation Plans Approved by Security Holders	434,532 (1)	\$21.83	326,909 (2)
Equity Compensation Plans Not Approved by Security Holders	<u>0</u>	0	<u>540,385</u> (3)
Total	<u>434,532</u>	\$21.83	<u>867,294</u>

(1) Includes 434,532 shares of common stock issuable pursuant to outstanding stock options granted under the Stock Plans.

(2) At the 2008 annual meeting of shareholders, shareholders approved the 2008 Stock Plan, which authorizes grants of options or awards for 300,000 shares. No options or awards were issued from that plan during the remainder of 2008. No additional awards may be made under the 1998 Stock Plan. Also included are 26,909 shares of common stock available for future issuance under the Directors' Stock Plan.

(3) All 540,385 shares of common stock are available for future issuance under the ESPP.

Description of Non-Shareholder Approved Plans.

Director, Officer and Employee Stock Purchase Plan. The Director, Officer and Employee Stock Purchase Plan was adopted by the Board of Directors in 2000. Under the plan, eligible participants (currently directors, officers, full-time employees and certain retirees) are permitted to acquire shares of common stock at a price that represents a small

discount from the current market price of the stock by authorizing regular withholding from their paychecks or, in the case of directors or retirees, regular withdrawals from their bank deposit accounts. Participants may also purchase shares on an ad hoc basis through optional cash contributions. The discount on shares acquired through regular withholdings or withdrawals is 5%. The discounted price only applies to the first \$1,000 of a participant's monthly contribution; after that threshold is reached, shares are purchased at 100% of market price. The total number of shares originally authorized for purchase under the Plan, as adjusted, was 775,546 shares. There are maximum and minimum levels for participant contributions, which the Board of Directors may change from time to time.

Directors' Stock Plan. The Directors' Stock Plan was originally adopted by the Board of Directors in 1999, and amended in 2008 with the approval of the shareholders. It provides for the automatic issuance of shares of Common Stock to directors of Arrow and its subsidiary banks in lieu of cash director fees otherwise payable to them. The portion of directors' fees payable in stock (as opposed to in cash) is fixed each year in advance by the Board of Directors. The total number of shares authorized for issuance under the Plan, as adjusted through December 31, 2008, is 62,736 shares.

STOCK PERFORMANCE GRAPHS

The following two graphs provide a comparison of the total cumulative return (assuming reinvestment of dividends) for the common stock of Arrow as compared to the Russell 2000 Index, the NASDAQ Banks Index, the SNL \$1B-\$5B Bank Assets Index, and the Zacks \$1B-\$5B Bank Assets Index. The Company has determined, however, that the SNL \$1B-\$5B Bank Assets Index, the industry index used in previous years, is not the best indicator of stockholder return among the Company's peers and will replace it with the Zacks \$1B-\$5B Bank Assets Index for this purpose going forward. The Zacks index was chosen as the industry index because of the large base of our peer group included in the index, which the Company believes represents a better indicator of stockholder return. Please note that the SNL \$1B-\$5B Bank Assets Index is also represented on the following graphs, because the applicable regulations require that both the new and old index be shown if the graph uses a different index from that used for the performance graph in the preceding year. We will not include the SNL \$1B-\$5B Bank Assets Index in next year's graphs.

The historical information set forth below may not be indicative of the future results. The first graph presents the five-year period from December 31, 2003 to December 31, 2008 and the second graph presents the ten-year period from December 31, 1998 to December 31, 2008.

TOTAL RETURN PERFORMANCE

Period Ending

<u>Index</u>	<u>12/31/03</u>	<u>12/31/04</u>	<u>12/31/05</u>	<u>12/31/06</u>	<u>12/31/07</u>	<u>12/31/08</u>
Arrow Financial Corporation ¹	100.00	118.56	106.50	107.88	100.54	122.50
Russell 2000 Index ¹	100.00	118.32	123.72	146.42	144.16	95.44
NASDAQ Banks Index ¹	100.00	114.45	111.80	125.48	99.46	72.51
Zacks \$1B - \$5B Bank Assets Index ¹	100.00	119.63	115.86	131.63	98.23	83.66
SNL \$1B - \$5B Bank Assets Index ²	100.00	123.42	121.31	140.38	102.26	84.81

Sources:

¹ Zacks Investment Research, Inc., Chicago, IL. Copyright 2009. All rights reserved. Used with permission.

² SNL Financial LC, Charlottesville, VA Copyright 2009. All rights reserved. Used with permission.

TOTAL RETURN PERFORMANCE**Period Ending**

<u>Index</u>	<u>12/31/98</u>	<u>12/31/99</u>	<u>12/31/00</u>	<u>12/31/01</u>	<u>12/31/02</u>	<u>12/31/03</u>	<u>12/31/04</u>	<u>12/31/05</u>	<u>12/31/06</u>	<u>12/31/07</u>	<u>12/31/08</u>
Arrow Financial Corporation 1	100.00	100.11	105.92	173.80	198.63	231.32	274.26	246.36	249.54	232.57	283.37
Russell 2000 Index ¹	100.00	121.26	117.59	120.51	95.84	141.12	166.97	174.59	206.62	203.43	134.68
NASDAQ Banks Index ¹	100.00	96.15	109.84	118.92	121.74	156.61	179.25	175.10	196.52	155.77	113.56
Zacks \$1B - \$5B Bank Assets Index ¹	100.00	87.65	89.77	111.48	131.63	177.63	212.50	205.79	233.80	174.49	148.60
SNL \$1B - \$5B Bank Assets Index ²	100.00	91.91	104.29	126.72	146.28	198.92	245.50	241.31	279.24	203.41	168.70

Sources:

¹ Zacks Investment Research, Inc., Chicago, IL. Copyright 2009. All rights reserved. Used with permission.

² SNL Financial LC, Charlottesville, VA Copyright 2009. All rights reserved. Used with permission.

The preceding stock performance graphs shall not be deemed incorporated by reference by any general statement incorporating by reference this Annual Report on Form 10-K into any filing under the Securities Act of 1933, as amended, or under the Securities Exchange Act of 1934, as amended, except to the extent the company specifically incorporates this information by reference, and shall not otherwise be deemed filed under such future filings.

Unregistered Sales of Equity Securities

In connection with Arrow's acquisition in 2004 of Capital Financial Group, Inc. (CFG), an insurance agency specializing in the sale of group health and life insurance products, Arrow issued 66,630 shares, as adjusted, of its common stock to the former sole shareholder of CFG, in exchange for his CFG shares. The terms of the acquisition included a post-closing purchase price adjustment provision, under which Arrow would also pay to the sole

shareholder, over the 5-year period following closing, additional consideration in the form of additional shares of Arrow's common stock, depending on the financial performance of CFG as a subsidiary of Arrow during such period. Under this provision, Arrow has issued an additional 14,509 shares to the sole shareholder through year-end 2008. All shares issued to the sole shareholder at the original closing and in post-closing adjustments have been issued without registration under the Securities Act of 1933, as amended, in reliance upon the exemption for such registration set forth in Section 3(a)(11) of the Act and Rule 147 promulgated by the Securities and Exchange Commission thereunder. This exemption has been available because the sole shareholder was and remains a New York resident, and CFG was and remains a New York corporation having substantially all of its assets and business operations in the State of New York.

Issuer Purchases of Equity Securities

The following table presents information about repurchases by us during the three months ended December 31, 2008 of our common stock (our only class of equity securities registered pursuant to Section 12 of the Securities Exchange Act of 1934):

Fourth Quarter	Total Number of	Average Price	Total Number of	Maximum
			Shares Purchased as	Approximate Dollar
<u>Calendar Month</u>	<u>Shares Purchased</u> ¹	<u>Paid Per Share</u> ¹	Part of Publicly	Value of Shares that
			Announced	May Yet be
				Purchased Under the
			<u>Plans or Programs</u> ²	<u>Plans or Programs</u> ²
October	5,551	\$24.57	---	2,657,379
November	11,295	26.47	---	2,657,379
December	<u>20,167</u>	24.88	---	2,657,379
Total	<u>37,013</u>	25.32	---	

¹The total number of shares purchased and the average price paid per share include shares purchased in open market transactions under the Arrow Financial Corporation Automatic Dividend Reinvestment Plan (the "DRIP") by the administrator of the DRIP and shares surrendered or deemed surrendered to Arrow by holders of options to acquire Arrow common stock in connection with the exercise of such options. In the months indicated, the listed number of shares purchased included the following numbers of shares purchased through such methods: October 2008 - DRIP purchases (968 shares), stock options (4,583 shares); November 2008 - DRIP purchases (2,048 shares), stock options (9,247 shares); December 2008 - DRIP purchases (18,456 shares), stock options (1,711 shares). DRIP purchases do not reflect so-called "netting" transactions, that is, purchases effected within the DRIP itself by the DRIP administrator consisting of monthly acquisitions of shares on behalf of purchasing participants who are investing funds in the plan from selling participants who are withdrawing funds from the plan.

²Includes only those shares acquired by Arrow pursuant to publicly-announced stock repurchase programs. It does not include shares purchased or subject to purchase under the DRIP or shares surrendered to Arrow upon exercise of options granted under any compensatory stock plans. Our only current publicly-announced stock repurchase program is the program approved by the Board of Directors and announced in April 2008 under which the Board authorized a twelve-month maximum cumulative purchase of \$5,000,000 in stock.

Item 6. Selected Financial Data**FIVE YEAR SUMMARY OF SELECTED DATA**

Arrow Financial Corporation and Subsidiaries

(Dollars In Thousands, Except Per Share Data)

Consolidated Statements of Income Data:	<u>2008</u>	<u>2007</u>	<u>2006</u>	<u>2005</u>	<u>2004</u>
Interest and Dividend Income	\$89,508	\$86,577	\$80,611	\$72,127	\$68,443
Interest Expense	<u>32,277</u>	<u>40,283</u>	<u>34,743</u>	<u>24,114</u>	<u>19,206</u>
Net Interest Income	57,231	46,294	45,868	48,013	49,237
Provision for Loan Losses	<u>1,671</u>	<u>513</u>	<u>826</u>	<u>1,030</u>	<u>1,020</u>
Net Interest Income After Provision					
for Loan Losses	55,560	45,781	45,042	46,983	48,217
Noninterest Income	15,886	16,288	15,883	14,584	12,830
Net (Losses) Gains on Securities Transactions	383	---	(102)	364	362
Noninterest Expense	<u>42,393</u>	<u>37,930</u>	<u>36,807</u>	<u>35,189</u>	<u>32,972</u>
Income Before Provision for Income Taxes	29,436	24,139	24,016	26,742	28,437
Provision for Income Taxes	<u>8,999</u>	<u>6,807</u>	<u>7,124</u>	<u>8,103</u>	<u>8,959</u>
Net Income	<u>\$20,437</u>	<u>\$17,332</u>	<u>\$16,892</u>	<u>\$18,639</u>	<u>\$19,478</u>
Per Common Share: ¹					
Basic Earnings	\$ 1.93	\$ 1.62	\$ 1.55	\$ 1.69	\$ 1.76
Diluted Earnings	1.92	1.61	1.53	1.66	1.72
Per Common Share: ¹					
Cash Dividends	\$.98	\$.94	\$.91	\$.87	\$.81
Book Value	11.93	11.50	10.83	10.68	10.59
Tangible Book Value ²	10.38	9.94	9.28	9.10	9.54
Consolidated Year-End Balance Sheet Data:					
Total Assets	\$1,665,086	\$1,584,846	\$1,520,217	\$1,519,603	\$1,377,949
Securities Available-for-Sale	325,090	338,070	315,886	326,363	325,248

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Securities Held-to-Maturity	133,976	114,611	108,498	118,123	108,117
Loans	1,109,812	1,038,844	1,008,999	996,545	875,311
Nonperforming Assets	4,971	2,336	3,169	2,372	2,245
Deposits	1,275,063	1,204,200	1,186,397	1,165,763	1,032,280
Federal Home Loan Bank Advances	160,000	160,000	125,000	157,000	150,000
Other Borrowed Funds	79,956	73,719	68,324	63,054	63,976
Shareholders' Equity	125,802	122,256	118,130	117,421	118,034

Selected Key Ratios:

Return on Average Assets	1.24%	1.11%	1.11%	1.28%	1.40%
Return on Average Equity	16.26	14.68	14.38	15.94	17.54
Dividend Payout ³	51.04	58.39	59.87	52.27	47.25

¹Share and per share amounts have been adjusted for subsequent stock splits and dividends, including the most recent September

2007 3% stock dividend.

²Tangible book value excludes intangible assets from total equity.

³Dividend Payout Ratio = cash dividends per share to fully diluted earnings per share.

Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations

The following table presents selected quarterly information for the fourth quarter of 2008 and the preceding four quarters:

Selected Quarterly Information:

(Dollars In Thousands, Except Per Share Amounts)

	<u>Dec 2008</u>	<u>Sep 2008</u>	<u>Jun 2008</u>	<u>Mar 2008</u>	<u>Dec 2007</u>
Net Income	\$5,012	\$5,008	\$5,436	\$4,981	\$4,481
<u>Transactions Recorded in Net Income (Net of Tax):</u>					
Visa Litigation (see page 21)	\$ ---	\$ ---	\$ ---	\$185	\$(362)
Gain on Redemption of Visa Inc. Class B Shares	---	---	---	452	---
Other-Than-Temporary Impairment (OTTI) (see page 20)	(242)	(731)	---	---	---
Net Securities Gains (Losses)	249	4	(21)	---	---
Net Gain on the Sale of Premises (see page 29)	---	---	---	69	---
Net Gains on Sales of Loans	31	8	19	5	5
Net Gains (Losses) on the Sale of Other Real Estate Owned	18	---	---	---	(5)
Period End Shares Outstanding	10,546	10,509	10,516	10,637	10,627
Basic Average Shares Outstanding	10,524	10,497	10,593	10,645	10,619
Diluted Average Shares Outstanding	10,588	10,559	10,650	10,694	10,682
Basic Earnings Per Share	\$.48	\$.48	\$.51	\$.47	\$.42
Diluted Earnings Per Share	.47	.47	.51	.47	.42
Cash Dividends Per Share	.25	.25	.24	.24	.24
Average Assets	\$1,687,366	\$1,657,666	\$1,625,093	\$1,606,082	\$1,601,053
Average Equity	127,136	124,601	126,177	124,686	120,433
Return on Average Assets	1.18%	1.20%	1.35%	1.25%	1.11%

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Return on Average Equity	15.68	15.99	17.33	16.07	14.76
Average Earning Assets	\$1,615,240	\$1,580,408	\$1,548,365	\$1,530,061	\$1,526,148
Average Paying Liabilities	1,345,344	1,308,191	1,288,047	1,272,871	1,265,765
Interest Income, Tax-Equivalent ¹	23,446	23,302	22,861	22,832	23,171
Interest Expense	7,541	7,690	7,751	9,295	10,413
Net Interest Income, Tax-Equivalent ¹	15,905	15,612	15,110	13,537	12,758
Tax-Equivalent Adjustment	727	710	746	750	740
Net Interest Margin ¹	3.92%	3.93%	3.92%	3.56%	3.32%

Efficiency Ratio Calculation:¹

Noninterest Expense	\$11,273	\$10,532	\$10,409	\$10,179	\$ 9,773
Less: Intangible Asset Amortization	<u>(89)</u>	<u>(89)</u>	<u>(86)</u>	<u>(96)</u>	<u>(96)</u>
Net Noninterest Expense	<u>\$11,184</u>	<u>\$10,443</u>	<u>\$10,323</u>	<u>\$10,083</u>	<u>\$ 9,677</u>
Net Interest Income, Tax-Equivalent ¹	\$15,905	\$15,612	\$15,110	\$13,537	\$12,758
Noninterest Income	4,152	3,089	4,181	4,847	4,016
Less: Net Securities (Gains) Losses	<u>(12)</u>	<u>1,204</u>	<u>35</u>	<u>(749)</u>	<u>---</u>
Net Gross Income	<u>\$20,045</u>	<u>\$19,905</u>	<u>\$19,326</u>	<u>\$17,635</u>	<u>\$16,774</u>
Efficiency Ratio ¹	55.79%	52.46%	53.42%	57.18%	57.69%

Period-End Capital Information:

Tier 1 Leverage Ratio	8.39%	8.32%	8.45%	8.54%	8.37%
Total Shareholders' Equity (i.e. Book Value)	\$125,802	\$125,397	\$124,080	\$127,051	\$122,256
Book Value per Share	11.93	11.93	11.80	11.94	11.50
Intangible Assets	16,378	16,457	16,495	16,593	16,590
Tangible Book Value per Share	10.38	10.36	10.23	10.38	9.94

Net Loans Charged-off as a

Percentage of Average Loans, Annualized	.14%	.07%	.00%	.08%	.05%
---	------	------	------	------	------

Provision for Loan Losses as a

Percentage of Average Loans, Annualized	.32	.09	.09	.11	.07
---	-----	-----	-----	-----	-----

Allowance for Loan Losses as a

Percentage of Loans, Period-end	1.20	1.16	1.20	1.20	1.19
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Allowance for Loan Losses as a

Percentage of Nonperforming Loans, Period-end	338.05	444.08	502.17	407.05	567.81
---	--------	--------	--------	--------	--------

Nonperforming Loans as a	.35	.26	.24	.29	.21
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Percentage of Loans, Period-end
Nonperforming Assets as a

Percentage of Total Assets, Period-end	.30	.24	.17	.20	.15
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¹ See Use of Non-GAAP Financial Measures on page 4.

Selected Twelve-Month Information:

(Dollars In Thousands, Except Per Share Amounts)

Share and per share amounts have been adjusted for subsequent stock dividends, including the most recent September 2007 3% stock dividend.

	<u>Dec 2008</u>	<u>Dec 2007</u>	<u>Dec 2006</u>
Net Income	\$20,437	\$17,332	\$16,892
<u>Transactions Recorded in Net Income (Net of Tax):</u>			
Visa Litigation (see page 21)	\$185	\$(362)	\$ ---
Gain on Redemption of Visa Inc. Class B Shares (see page 21)	452	---	---
Other-Than-Temporary Impairment (OTTI) (see page 20)	(971)	---	---
Net Securities Gains (Losses)	231	---	(61)
Net Gain on the Sale of Premises (see page 29)	69	---	136
Net Gains on Sales of Loans	64	25	44
Net Gains (Losses) on the Sale of Other Real Estate Owned	18	(2)	---
Period End Shares Outstanding	10,546	10,627	10,905
Basic Average Shares Outstanding	10,565	10,714	10,922
Diluted Average Shares Outstanding	10,622	10,786	11,067
Basic Earnings Per Share	\$1.93	\$1.62	\$1.55
Diluted Earnings Per Share	1.92	1.61	1.53
Cash Dividends Per Share	.98	.94	.91
Average Assets	\$1,644,210	\$1,558,251	\$1,522,327
Average Equity	125,653	118,082	117,466
Return on Average Assets	1.24%	1.11%	1.11%
Return on Average Equity	16.26	14.68	14.38
Average Earning Assets	\$1,568,677	\$1,486,707	\$1,451,655
Average Paying Liabilities	1,303,740	1,229,882	1,201,612
Interest Income, Tax-Equivalent ¹	92,441	89,498	82,999
Interest Expense	32,277	40,283	34,743
Net Interest Income, Tax-Equivalent ¹	60,164	49,215	48,256
Tax-Equivalent Adjustment	2,933	2,921	2,388

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Net Interest Margin ¹	3.84%	3.31%	3.32%
<u>Efficiency Ratio Calculation</u> ¹			
Noninterest Expense	\$42,393	\$37,930	\$36,807
Less: Intangible Asset Amortization	<u>(360)</u>	<u>(394)</u>	<u>(436)</u>
Net Noninterest Expense	<u>\$42,033</u>	<u>\$37,536</u>	<u>\$36,371</u>
Net Interest Income, Tax-Equivalent ¹	\$60,164	\$49,215	\$48,256
Noninterest Income	16,269	16,288	15,781
Less: Net Securities Losses (Gains)	<u>478</u>	<u>---</u>	<u>102</u>
Net Gross Income	<u>\$76,911</u>	<u>\$65,503</u>	<u>\$64,139</u>
Efficiency Ratio ¹	54.65%	57.30%	56.71%
<u>Period-End Capital Information:</u>			
Tier 1 Leverage Ratio (Period-end)	8.39%	8.37%	8.63%
Total Shareholders' Equity (i.e. Book Value)	\$125,802	\$122,256	\$118,130
Book Value per Share	11.93	11.50	10.83
Intangible Assets	16,378	16,590	16,925
Tangible Book Value per Share	10.38	9.94	9.28
Net Loans Charged-off as a			
Percentage of Average Loans	.07%	.04%	.08%
Provision for Loan Losses as a			
Percentage of Average Loans	.16	.05	.08
Allowance for Loan Losses as a			
Percentage of Loans, Period-end	1.20	1.19	1.22
Allowance for Loan Losses as a			
Percentage of Nonperforming Loans, Period-end	338.05	567.81	442.12
Nonperforming Loans as a			
Percentage of Loans, Period-end	.35	.21	.28
Nonperforming Assets as a			
Percentage of Total Assets, Period-end	.30	.15	.21

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

CRITICAL ACCOUNTING POLICIES

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

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

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

Valuation allowance for deferred tax assets: SFAS No. 109 Accounting for Income Taxes, requires a reduction in the carrying amount of deferred tax assets by a valuation allowance if, based on the weight of available evidence, it is more likely than not (a likelihood of more than 50 percent) that some portion or all of the deferred tax assets will not be realized. The valuation allowance should be sufficient to reduce the deferred tax asset to the amount that is more likely than not to be realized. Our analysis of the need for a valuation allowance for deferred tax assets is, in part, based on an estimate of future taxable income.

Goodwill: SFAS No. 142 Goodwill and Other Intangible Assets, requires that goodwill be tested for impairment at a level of reporting referred to as a reporting unit. Impairment is the condition that exists when the carrying amount of goodwill exceeds its implied fair value. The first step of the goodwill impairment test, used to identify potential impairment, compares the fair value of a reporting unit with its carrying amount, including goodwill. The second step of the goodwill impairment test, used to measure the amount of impairment loss, compares the implied fair value of a reporting unit's goodwill with the carrying amount of that goodwill.

Other than temporary decline in the value of debt and equity securities: SFAS No. 115 Accounting for Certain Investments in Debt and Equity Securities, requires that, for individual securities classified as either available-for-sale or held-to-maturity, an enterprise shall determine whether a decline in fair value below the amortized cost basis is other than temporary. For example, if it is probable that the investor will be unable to collect all amounts due according to the contractual terms of a debt security not impaired at acquisition, an other-than-temporary impairment shall be considered to have occurred. If the decline in fair value is judged to be other than temporary, the cost basis of the individual security shall be written down to fair value as a new cost basis and the amount of the write-down shall be included in current period earnings. Any significant economic downturn might result, and historically have on occasion resulted, in an other-than-temporary impairment in securities held in our portfolio.

Valuation methods for securities available-for-sale measured at fair value on a recurring basis: We account for securities available-for-sale in accordance with SFAS No. 115, with changes to fair value recorded in other comprehensive income. Most of the portfolio, which includes U.S. Treasury and agency securities, mortgage-backed securities, collateralized mortgage obligations, municipal securities, corporate debt and equity securities are priced using industry-standard models that consider various assumptions that include time value, yield curves, volatility factors, prepayment speeds, default rates, loss severity, current market and contractual prices for the underlying financial instruments, as well as other relevant economic measures. Substantially all of these assumptions are either observable in the marketplace, derived from observable data or are supported by observable levels at which transactions are executed in the marketplace. Municipal and corporate securities are valued using a type of matrix, or grid, pricing in which securities are benchmarked against the treasury rate based on credit rating. These model and matrix measurements are classified as Level 2 in the fair value hierarchy.

The following discussion and analysis focuses on and reviews our results of operations for each of the years in the three-year period ended December 31, 2008 and our financial condition as of December 31, 2008 and 2007. The discussion below should be read in conjunction with the selected quarterly and annual information set forth above and the consolidated financial statements and other financial data presented elsewhere in this Report. When necessary, prior-year financial information has been reclassified to conform to the current-year presentation.

A. OVERVIEW

Summary of 2008 Financial Results

We reported net income of \$20.4 million for 2008, an increase of \$3.1 million, or 17.9%, compared to 2007. Diluted earnings per share of \$1.92 represented an increase of \$.31, or 19.3%, from 2007. During 2008, both our net interest margin and net interest income increased due to a combination of falling short-term interest rates (which has a proportionately larger impact on the cost of our deposits than on our earnings from our assets) combined with a market-wide return of a positively-sloped yield curve (which has a proportionately larger impact on our earning assets than on our liabilities). A 5.5% increase in average earning assets also had a positive impact on the growth in our net interest income. Unlike many financial institutions, we did not experience significant deterioration in our loan and asset quality during 2008 despite the onset of a worldwide economic recession and severe disruption in the financial markets generally.

Earnings in all quarters of 2008 were higher than the respective 2007 quarters; in spite of the worsening economy late in 2008, annual earnings for 2008 represented a record high for the company.

Financial Market Turmoil: Over the past fifteen months, the Dow Jones Industrial Average (Dow Jones) slid from a high of over 14,000 to a low of under 8,000, with the most dramatic change occurring during the fourth quarter of 2008. The financial markets and particularly the banking sector have felt the impact of losses on subprime mortgages and other credit portfolios and loss of short-term liquidity, resulting in the September 2008 failure of Lehman Brothers Holdings (Lehman) and the distressed sales of Bear Stearns and Merrill Lynch. In addition, the number of bank failures, while not at historic highs, has risen to levels not seen for several years. Many community banks that were not underwriting subprime residential real estate loans and were not investing significant amounts in private issue collateralized debt obligations, like our company, have not experienced the significant losses in their loan or investment portfolios or the liquidity concerns that many of our larger contemporaries have experienced. However, the magnitude of turmoil in the markets did have an impact on our operations during 2008 and may continue to influence our financial condition and results of operations in forthcoming periods.

Decision Not to Participate in U.S. Treasury TARP CCP: As previously disclosed in our Current Report in Form 8-K filed with the SEC on January 27, 2009, our Board of Directors determined in late January 2009, after we had applied to the U.S. Treasury Department and federal bank regulators for participation by the Company in the U.S. Government's Capital Purchase Plan (CPP), an element of the larger Troubled Assets Relief Program (TARP), and after we had been preliminarily approved by the Department of Treasury for participation, that we would not proceed ahead and sell shares of our preferred stock to the Treasury Department but would decline to participate. The basic reason for the Board's decision, as discussed in the Form 8-K, was that the Company's financial and liquidity positions remained sufficiently strong at year-end such that the potential loss of Board and management flexibility entailed in CPP participation was deemed too high a cost to warrant participation.

Economic recession and loan quality: As the economic recession got underway in late 2007, our market area of northeastern New York was relatively sheltered from falling real estate values and increasing unemployment. As the recession became stronger and deeper in late 2008, even northeastern New York began to feel the impact of the worsening national economy reflected in a slow-down in real estate sales and increasing unemployment rates. By year-end 2008, we had experienced a decline in the credit quality of our loan portfolio, although by standard measures our portfolio continued to appear stronger than the average for our peer group. Nonperforming loans amounted to \$3.9 million at December 31, 2008, an increase of \$1.7 million from the prior year-end. The ratio of nonperforming loans to period-end loans was .35% at December 31, 2008, an increase from .21% one year earlier. By way of comparison, this ratio for our peer group increased by 128 basis points from 1.08% at December 31, 2007 to 2.36% at December 31, 2008. Our loans charged-off (net of recoveries) against our allowance for loan losses were \$800 thousand for 2008, as compared to \$390 thousand for the prior year. At year-end 2008, the allowance for loan losses was \$13.3 million, representing 1.20% of total loans, essentially the same as at the prior year-end. To date, we have not experienced significant deterioration in any of our three major loan portfolio segments:

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Commercial Loans: We lend to small and medium size businesses, which typically do not encounter liquidity problems, since we may often also provide support for their supplementary liquidity needs. However, current unemployment rates in our region are higher than in the past few years and the number of total jobs has decreased, although these trends are largely attributable to a few changes in the local operations of a small number of larger corporations.

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Residential Real Estate Loans: We have not experienced a notable increase in our foreclosure rates, primarily due to the fact that we did not originate or participate in underwriting subprime loans.

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Indirect Automobile Loans: These loans comprise over 30% of our loan portfolio. We have not experienced any significant change in our delinquency rate or level of charge-offs, although both delinquencies and charge-offs did increase moderately in the fourth quarter of 2008.

Investment securities and other-than-temporary impairment: We hold a \$2.0 million par value senior unsecured bond issued by Lehman. On September 15, 2008, Lehman declared bankruptcy resulting in a significant decline in the market value of the bond. We deemed the decline to be other-than-temporary in the third quarter 2008, and, accordingly, recognized a non-cash other-than-temporary impairment charge to earnings of \$731 thousand net of tax (a \$.07 reduction in diluted earnings per share). After further deterioration, we recognized an additional charge to earnings of \$241 thousand net of tax (a \$.02 reduction in diluted earnings per share) in the fourth quarter of 2008. The remaining estimated value of our Lehman bond of \$400 thousand has been included in non-performing assets as of December 31, 2008. The Lehman bankruptcy proceedings are ongoing and the ultimate value of our bond is subject to further change. Corporate bonds and other debt securities represented only \$7.4 million, or 1.6%, of our \$459.1 million investment securities portfolio at December 31, 2008. We did not hold any preferred or common stock of Fannie Mae or Freddie Mac. As of year-end, we had not experienced any impairment issues with our holdings of mortgage-backed securities or CMO s.

Liquidity and access to credit markets: We have not experienced any liquidity issues during 2008 and through the date of this report. The terms of our lines of credit with our correspondent banks, the FHLBNY and the Federal Reserve Bank, have not changed, except for some increases in the maximum borrowing capacity (see our general liquidity discussion on page 40). In general, we rely on asset-based liquidity (i.e. funds in overnight investments and cash flow from maturing investments and loans) with liability-based liquidity as a secondary source (overnight lending arrangements with our correspondent banks, FHLBNY overnight and term advances and the Federal Reserve Bank discount window, as primary sources). During the recent period of bank failures, some institutions experienced a run on deposits, even though there was no reasonable expectation that depositors would lose any of their insured deposits. We maintain, and periodically test, a contingent liquidity plan whose purpose is to ensure that we can generate an adequate amount of cash to meet a wide variety of potential liquidity crises.

Effect of VISA public offering, stock redemption and litigation reserves: In December 2007, we recorded a \$600 thousand liability for our proportional share, as a member bank of the Visa credit card organization, of certain estimated litigation costs incurred by Visa U.S.A., Inc., as further described in our Form 10-K for December 31, 2007. On March 28, 2008, VISA Inc. distributed to member banks, in a mandatory redemption of 38.7% of its Class B shares held by the member banks, some of the proceeds realized by Visa from the IPO of its Class A shares on March 19, 2008. With another portion of the IPO proceeds, Visa established a \$3 billion escrow to cover certain, but not all, of its continuing litigation liabilities. During the first quarter of 2008, we recorded the following transactions:

A gain of \$749 thousand from the mandatory redemption by Visa of 38.7% of our Class B Visa Inc. shares, reflected in noninterest income, and

A reversal of \$306 thousand of the \$600 thousand accrual at December 31, 2007 representing our proportional share of Visa litigation costs, reflected as a reduction in 2008 other operating expense.

Accordingly, we have a remaining liability of \$294 thousand included as a component of **Other Liabilities** in the consolidated balance sheet as of December 31, 2008, representing our estimate of the fair value of potential losses related to the remaining covered Visa litigation. Class B shares which were not redeemed will be converted to Class A shares, at a conversion ratio to be determined based on member banks' actual liability for litigation expenses, on the later of three years or the settlement of litigation indemnified by member banks. These remaining Class B shares are available to fund future Visa litigation liabilities indemnified by the member banks until that time. In accordance with Generally Accepted Accounting Principles (GAAP) and consistent with the Securities and Exchange Commission (SEC) guidance, the Company has not recognized any value for its remaining Visa Class B shares.

In October 2008, Visa announced that it had settled the lawsuit with Discover Financial Services, which was part of the covered litigation for which the Visa member banks are contingently liable. In December 2008, Visa deposited an additional \$1.1 billion into the litigation escrow fund, thereby reducing the ratio for the conversion of Class B to Class A shares and effectively repurchasing approximately 12% of the remaining Class B shares held by member banks to fund its settlement of the Discover litigation. The Company had not previously recognized the value of the Class B shares in accordance with the SEC guidance discussed above, nor did the Company recognize any income or expense as a result of Visa's redemption of its Class B shares or settlement of the litigation in the fourth quarter. The estimation of the Company's proportionate share of any potential losses related to certain covered litigation is extremely difficult and involves a high degree of judgment. Management has determined the remaining \$294 thousand liability included in **Other Liabilities** on our year-end consolidated balance sheet is the fair value of our proportionate share of the remaining covered Visa litigation as of December 31, 2008, but this value is subject to change depending upon future developments in the Visa litigation.

Change in Shareholder Equity: At December 31, 2008, our tangible book value per share (calculated based on shareholders' equity reduced by intangible assets including goodwill and other intangible assets) amounted to \$10.38, an increase of \$.44, or 4.4%, from year-end 2007. Our total shareholders' equity at year-end 2008 increased 2.9% over the year-end 2007 level. Major changes to shareholders' equity included: i) \$20.4 million of net income for the year; ii) a \$2.5 million net unrealized gain in securities available-for-sale, offset by; iii) cash dividends of \$10.3 million, iv) losses on our pension plan (reflected as other comprehensive income) of \$6.9 million; and v) repurchases of our own common stock of \$4.3 million. As of the last trading day of 2008, the average of our closing stock price was \$21.43, resulting in a trading multiple of 2.42 to our tangible book value. We also continue to remain classified as well-capitalized under regulatory guidelines. As mentioned above, due to our strong capital, financial and liquidity positions at year-end, we did not participate in the U.S. Treasury's Capital Purchase Program (a component of TARP).

The Board of Directors declared a quarterly cash dividend of \$.25 per share for the fourth quarter of 2008. For the year, total cash dividends (as adjusted for stock dividends) were \$.98 compared to \$.94 for 2007, an increase of \$.04, or 4.3%.

Other Recent Transactions: In accordance with our Current Report in Form 8-K filed with the SEC on March 2, 2009, Arrow and its bank subsidiaries have transferred their merchant bank card processing business for a cash payment of \$3 million to TransFirst LLC and a bank designated by TransFirst. In connection with this transfer, TransFirst will provide merchant bank card processing to our merchant customers, and our organization will have the opportunity to develop new business through referrals, while eliminating the cost, responsibility and associated risks of administering a highly specialized processing service. As we also announced in our March 2 Form 8-K, Arrow and Glens Falls National have terminated discussions to acquire Upstate Agency, Inc., an independent property and casualty insurance agency, as the parties were unable to reach agreement on certain terms of the proposed transaction. As we also announced in our March 2, 2009 Form 8-K, Arrow and Glens Falls National have terminated discussions to acquire Upstate Agency, Inc., an independent property and casualty insurance agency, as the parties were unable to reach agreement on certain terms of the proposed transaction. The potential acquisition of Upstate had been previously disclosed in a Current Report in Form 8-K filed with the SEC on October 14, 2008.

B. RESULTS OF OPERATIONS

The following analysis of net interest income, the provision for loan losses, noninterest income, noninterest expense and income taxes, highlights the factors that had the greatest impact on our results of operations for 2008 and the prior two years.

I. NET INTEREST INCOME (Tax-equivalent Basis)

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

CHANGE IN NET INTEREST INCOME

(Dollars In Thousands) (Tax-equivalent Basis)

	<u>Years Ended December 31,</u>			<u>Change From Prior Year</u>			
	<u>2008</u>	<u>2007</u>	<u>2006</u>	<u>2007 to 2008</u>		<u>2006 to 2007</u>	
				<u>Amount</u>	<u>%</u>	<u>Amount</u>	<u>%</u>
Interest and Dividend Income	\$92,441	\$89,498	\$82,999	\$ 2,943	3.3 %	\$6,499	7.8 %
Interest Expense	<u>32,277</u>	<u>40,283</u>	<u>34,743</u>	<u>(8,006)</u>	(19.9)	<u>5,540</u>	16.0
Net Interest Income	<u>\$60,164</u>	<u>\$49,215</u>	<u>\$48,256</u>	<u>\$10,949</u>	22.3	<u>\$ 959</u>	2.0

On a tax-equivalent basis, net interest income was \$60.2 million in 2008, an increase of \$10.9 million, or 22.2%, from \$49.2 million in 2007. This compared to an increase of \$959 thousand, or 2.0%, from 2006 to 2007. Factors contributing to the increase in net interest income over the three-year period are discussed in the following portions of this Section B.I.

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

	<u>2008 Compared to 2007</u>			<u>2007 Compared to 2006</u>		
	Change in Net Interest Income Due to:			Change in Net Interest Income Due to:		
Interest and Dividend Income:	<u>Volume</u>	<u>Rate</u>	<u>Total</u>	<u>Volume</u>	<u>Rate</u>	<u>Total</u>
Federal Funds Sold	\$ (195)	\$ (439)	\$ (634)	\$ 656	\$ (12)	\$ 644
Interest-Bearing Bank Balances	57	---	57	---	---	---

Securities Available-for-Sale:

Taxable	1,154	666	1,820	(674)	862	188
Non-Taxable	(154)	(97)	(251)	295	262	557

Securities Held-to-Maturity:

Taxable	(2)	(1)	(3)	(2)	1	(1)
Non-Taxable	478	(231)	247	416	24	440

Loans	<u>3,229</u>	<u>(1,522)</u>	<u>1,707</u>	<u>1,523</u>	<u>3,148</u>	<u>4,671</u>
Total Interest and Dividend Income	<u>4,567</u>	<u>(1,624)</u>	<u>2,943</u>	<u>2,214</u>	<u>4,285</u>	<u>6,499</u>

Interest Expense:

Deposits:

Interest-Bearing NOW Deposits	1,001	(2,696)	(1,695)	461	1,313	1,774
Regular and Money Market Savings	217	(792)	(575)	(229)	607	378
Time Deposits of \$100,000 or More	(392)	(2,645)	(3,037)	876	594	1,470
Other Time Deposits	<u>(625)</u>	<u>(2,140)</u>	<u>(2,765)</u>	<u>370</u>	<u>1,448</u>	<u>1,818</u>
Total Deposits	201	(8,273)	(8,072)	1,478	3,962	5,440

Short-Term Borrowings	221	(821)	(600)	85	154	239
Long-Term Debt	<u>1,025</u>	<u>(359)</u>	<u>666</u>	<u>(528)</u>	<u>389</u>	<u>(139)</u>
Total Interest Expense	<u>1,447</u>	<u>(9,453)</u>	<u>(8,006)</u>	<u>1,035</u>	<u>4,505</u>	<u>5,540</u>
Net Interest Income	<u>\$3,120</u>	<u>\$7,829</u>	<u>\$10,949</u>	<u>\$1,179</u>	<u>\$ (220)</u>	<u>\$ 959</u>

The following table reflects the components of our net interest income, setting forth, for years ended December 31, 2008, 2007 and 2006 (i) average balances of assets, liabilities and shareholders' equity, (ii) interest and dividend income earned on earning assets and interest expense incurred on interest-bearing liabilities, (iii) average yields earned on earning assets and average rates paid on interest-bearing liabilities, (iv) the net interest spread (average yield less average cost) and (v) the net interest margin (yield) on earning assets. Interest income and interest rate information is presented on a tax-equivalent basis (see the discussion under "Use of Non-GAAP Financial Measures" on page 4 of this Report). The yield on securities available-for-sale is based on the amortized cost of the securities. Nonaccrual loans are included in average loans.

Average Consolidated Balance Sheets and Net Interest Income Analysis

(Tax-equivalent basis using a marginal tax rate of 35%)

(Dollars in Thousands)

Years Ended:	2008			2007			2006		
	Average	Interest Income or <u>Expense</u>	Rate Earned or Paid	Average	Interest Income or <u>Expense</u>	Rate Earned or Paid	Average	Interest Income or <u>Expense</u>	Rate Earned or Paid
Federal Funds Sold	\$ 17,472	\$ 464	2.66%	\$ 22,022	\$ 1,098	4.99%	\$ 8,875	\$ 454	5.12%
Int.-Bearing Bank Balances	5,997	57	0.95	---	---	---	---	---	---
S e c u r i t i e s Available-for- Sale:									
Taxable	332,256	16,169	4.87	308,172	14,349	4.66	323,162	14,161	4.38
Non-Taxable	21,360	1,204	5.64	24,015	1,455	6.06	18,627	898	4.82
S e c u r i t i e s Held-to-Maturity:									
Taxable	274	13	4.74	310	16	5.16	356	17	4.78
Non-Taxable	119,934	6,597	5.50	111,332	6,350	5.70	104,024	5,910	5.68
Loans	<u>1,071,384</u>	<u>67,937</u>	6.34	<u>1,020,856</u>	<u>66,230</u>	6.49	<u>996,611</u>	<u>61,559</u>	6.18
Total Earning Assets	<u>1,568,677</u>	<u>92,441</u>	5.89	<u>1,486,707</u>	<u>89,498</u>	6.02	<u>1,451,655</u>	<u>82,999</u>	5.72
Allowance for Loan Losses	(12,658)			(12,323)			(12,263)		
Cash and Due From Banks	32,505			33,180			33,853		
Other Assets	<u>55,686</u>			<u>50,687</u>			<u>49,082</u>		
Total Assets	<u>\$1,644,210</u>			<u>\$1,558,251</u>			<u>\$1,522,327</u>		
Deposits:									
Interest-Bearing NOW	\$ 367,351	5,173	1.41	\$ 315,614	6,868	2.18	\$ 290,860	5,094	1.75
Regular and Money Market	281,208	3,398	1.21	266,007	3,973	1.49	283,253	3,595	1.27

Savings									
Time Deposits of									
\$100,000									
Or More	172,055	5,591	3.25	180,606	8,628	4.78	161,729	7,158	4.43
Other Time									
Deposits	<u>243,247</u>	<u>8,628</u>	3.55	<u>258,042</u>	<u>11,393</u>	4.42	<u>248,706</u>	<u>9,575</u>	3.85
Total Interest-									
Bearing									
Deposits	1,063,861	22,790	2.14	1,020,269	30,862	3.02	984,548	25,422	2.58
Short-Term									
Borrowings	58,473	789	1.35	49,355	1,389	2.81	46,044	1,150	2.50
F H L B N Y									
Advances and									
Long-Term Debt	<u>181,406</u>	<u>8,698</u>	4.79	<u>160,258</u>	<u>8,032</u>	5.01	<u>171,020</u>	<u>8,171</u>	4.78
Total Interest-									
Bearing Funds	1,303,740	<u>32,277</u>	2.48	1,229,882	<u>40,283</u>	3.28	1,201,612	<u>34,743</u>	2.89
Demand Deposits	189,999			186,474			182,706		
Other Liabilities	<u>24,818</u>			<u>23,813</u>			<u>20,543</u>		
Total Liabilities	1,518,557			1,440,169			1,404,861		
Shareholders									
Equity	<u>125,653</u>			<u>118,082</u>			<u>117,466</u>		
Total Liabilities									
and									
Shareholders									
Equity	<u>\$1,644,210</u>			<u>\$1,558,251</u>			<u>\$1,522,327</u>		
Net Interest Income									
(Tax-equivalent									
Basis)		60,164			49,215			48,256	
Reversal of Tax									
Equivalent									
Adjustment		<u>(2,933)</u>			<u>(2,921)</u>			<u>(2,388)</u>	
Net Interest Income		<u>\$57,231</u>			<u>\$46,294</u>			<u>\$45,868</u>	
Net Interest Spread			3.41%			2.74%			2.83%
Net Interest Margin			3.84%			3.31%			3.32%

CHANGES IN NET INTEREST INCOME DUE TO RATE

YIELD ANALYSIS (Tax-equivalent basis)	December 31,		
	<u>2008</u>	<u>2007</u>	<u>2006</u>
Yield on Earning Assets	5.89%	6.02%	5.72%
Cost of Interest-Bearing Liabilities	<u>2.48</u>	<u>3.28</u>	<u>2.89</u>
Net Interest Spread	<u>3.41%</u>	<u>2.74%</u>	<u>2.83%</u>
Net Interest Margin	<u>3.84%</u>	<u>3.31%</u>	<u>3.32%</u>

Following two years of decreases in net interest income (2006 and 2005), we experienced a modest increase in net interest income in 2007 and a significant increase in 2008. The increase was \$959 thousand (or 2.0%) from 2006 to 2007, but \$10.9 million (or 22.2%) from 2007 to 2008. In 2008, an increase in average earning assets (i.e., changes in volume) had a \$3.1 million positive impact on net interest income, but the greater influence was a significant increase in net interest margin (i.e., changes in rates), which provided a \$7.8 million positive impact on our net interest income for the year.

Generally, the following items have a major impact on changes in net interest income due to rate: general interest rate changes, the ratio of our rate sensitive assets to rate sensitive liabilities (interest rate sensitivity gap) during periods of interest rate changes, and changes in the level of nonperforming loans.

Impact of Interest Rate Changes 2003 2008

Our profitability is affected by the prevailing interest rate environment, both short-term rates and long-term rates, by changes in those rates, and by the relationship between short- and long-term rates (i.e., the yield curve).

Changes in Rates 2003 2008. In mid-2003, due to actions by the Federal Reserve Bank (Fed), the target rate on federal funds (funds which banks loan to one another on an overnight basis) decreased to a (then) almost unprecedented low of 1.00%, and rates paid by banks on short-term deposits similarly decreased to historically low levels. The resulting lower rates on credit provoked a substantial expansion of lending across all sectors of the U.S. economy, especially mortgage and consumer lending. In mid-2004, the Fed reversed course and began to increase short-term rates with a series of 25 basis point increases in the targeted federal funds rate, reaching 5.25% by mid-2006. Rates paid by banks on short-term deposits similarly increased during this period, although rates paid on long-term deposits (and yields earned on long-term loans and assets) did not increase proportionately, as lending, particularly mortgage lending, continued to expand nationwide at a rapid rate.

From mid-2006 to fall 2007, the Fed did not take any actions to change short-term rates. In September 2007, however, in response to a weakening economy and a loss of liquidity in the short-term credit market, precipitated in large part by the collapse in the housing market and resulting problems in subprime residential real estate lending, the Fed began lowering the federal funds target rate, rapidly and by significant amounts.

By the December 2007 meeting of the Board of Governors, the rate had decreased 100 basis points, to 4.25%, and throughout 2008, the Fed, in response to continuing liquidity concerns in the credit markets, further lowered the targeted federal funds rate by an additional 400 basis points, to an unprecedented low range of 0% to .25%. We began to see an immediate impact in the reduced cost of our deposits, which we expect will continue but at a more gradual pace as maturing time deposits reprice. We also expect that our loan and investment securities yields will decline, but that we may not realize a sizable reduction in our cost of deposits, since short-term rates are not expected to decrease significantly.

Changes in the Yield Curve 2005 – 2008. An important development with regard to the effect of rate changes on our profitability in the mid-2004 to mid-2007 period was the flattening of the yield curve, especially during 2006 and the first half of 2007. After the Fed began increasing short-term interest rates in June 2004, the yield curve did not maintain its traditional upward slope but flattened; that is, as short-term rates increased, longer-term rates stayed unchanged or even decreased. Therefore, the traditional spread between short-term rates and long-term rates (the upward yield curve) essentially disappeared, i.e., the curve flattened. In late 2006 and in early 2007, the yield curve actually inverted, with short-term rates exceeding long-term rates. The flattening of the yield curve was the most significant factor in reducing our net interest income from 2005 through 2007.

At the end of the second quarter of 2007, however, the yield on longer-term securities began to increase over short-term investments. This increase in rate spread was further enhanced when long-term rates held steady after the Fed lowered short-term rates in September 2007. Because market perceptions and expectations are now changing regarding the need to price more risk into long-term debt, long-term rates may be expected to remain steady, or perhaps even rise, even though short-term rates have dropped sharply in recent quarters. Therefore, the yield curve may continue to reflect its more traditional shape for some time. However, even lending institutions such as ours that have avoided subprime lending problems and have enjoyed continued high credit quality in recent periods may nevertheless experience some increasing pressure on credit quality in recent periods, especially if the national or regional economy continues to weaken. Any credit or asset quality erosion will reduce or possibly outweigh the benefit we may experience from the return of a positively-sloped yield curve. Thus, no assurances can be given on future improvements in our net interest margins, net interest income or net income generally, particularly as consumer mortgage related borrowings diminish across the U.S. economy and the redeployment of funds by bankers from maturing loans and assets into other high-quality assets becomes progressively more difficult.

Effect of Rate Changes on Our Margin; Changes in Our Margins 2002 – Late 2007. In addition to the shape of the yield curve, our net interest margin has traditionally been sensitive to and impacted by changes in prevailing market interest rates. Generally, there has been a negative correlation between changes in prevailing interest rates and our net interest margin, especially when rates begin to move in a different direction. Typically, when prevailing rates begin to decline, our net interest margin generally increases in immediately ensuing periods, and vice versa, when prevailing rates begin to increase as in each case earning assets reprice more slowly than interest-bearing sources of funds. This was the case for our net interest margin during the 2002 to mid-2003 period, when prevailing short-term market rates began to decline and our margin increased, and during the mid-2003 to 2004 period, when rates began to increase and our margins experienced a negative effect. In 2005 through mid-2007, however, even as the Fed held rates steady, our net interest margin continued to suffer as a result of the flattening yield curve. Our margin reached a low point in the fourth quarter of 2006, at 3.24%, and then increased slightly to 3.32% for each of the first two quarters of 2007. In the third quarter of 2007 the margin decreased once again, to 3.29%.

Improvement in Our Margins Late 2007 – 2008. Since September 30, 2007 our margin has steadily improved, principally due to the fact the rates we paid on our interest-bearing liabilities began to reprice downward rapidly. The dramatic reduction in short-term interest rates since September 2007 has had a significant positive impact on our net interest income and net interest margins. In the fourth quarter of 2007, our margin expanded by three basis points, to 3.32%, and our margin for the 2008 first quarter was 3.56%, an increase of 24 basis points. The margin increased by another 36 basis points to 3.92% for the second quarter of 2008, and then held steady at 3.93% and 3.92% for the respective third and fourth quarters of 2008.

We expect that our margin may contract in future periods as volume of repricing in the investment and loan portfolios exceeds the volume of repricing in our deposit and wholesale funding portfolios.

Moreover, our ability to reduce the rates paid on some of our non-maturity deposit products, even if short-term funding rates continue to decline in upcoming periods, is limited due to the already low levels for those products, whereas rates earned on our earning assets will likely index downwards to the full extent of the decrease in prevailing rates. A discussion of the models we use in projecting the impact on net interest income resulting from possible changes in interest rates vis-à-vis the repricing patterns of our earning assets and interest-bearing liabilities is included later in this report under Item 7.A., Quantitative and Qualitative Disclosures About Market Risk.

CHANGES IN NET INTEREST INCOME DUE TO VOLUME

AVERAGE BALANCES

(Dollars In Thousands)

<u>Years Ended December 31,</u>			<u>Change From Prior Year</u>			
			<u>2007 to 2008</u>		<u>2006 to 2007</u>	
<u>2008</u>	<u>2007</u>	<u>2006</u>	<u>Amount</u>	<u>%</u>	<u>Amount</u>	<u>%</u>

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Earning Assets	\$1,568,677	\$1,486,707	\$1,451,655	\$81,970	5.5%	\$35,052	2.4%
Interest-Bearing Liabilities	1,303,740	1,229,882	1,201,612	73,858	6.0	28,270	2.4
Demand Deposits	189,999	186,474	182,706	3,525	1.9	3,768	2.1
Total Assets	1,644,210	1,558,251	1,522,327	85,959	5.5	35,924	2.4
Earning Assets to Total Assets	95.41%	95.41%	95.36%				

2007 to 2008:

In general, an increase in average earning assets has a positive impact on net interest income. For 2008, average earning assets increased \$82.0 million over 2007, while average interest-bearing liabilities only increased \$73.9 million. This combination led to a \$3.1 million increase in net interest income. (This positive effect was in addition to the \$7.8 million positive impact on net interest income resulting from the changes in rates during the year, discussed above.)

The \$82.0 million increase in average earning assets from 2007 to 2008 reflected an increase in average loans of \$50.5 million, or 5.0%, and an increase of \$30.0 million, or 6.8%, in investment securities, while the level of overnight funds purchased remained relatively unchanged. We experienced increases in all major categories within the loan portfolio during 2008, although the average balance of indirect loans (which represented the second largest segment of the loan portfolio) increased only 1.3% from 2007. Indirect loans are primarily auto loans financed through local dealerships where we acquire the dealer paper. Increases in the average balances of our other two large segments were an increase of \$29.5 million, or 10.0%, in our commercial and commercial real estate loans and an increase of \$18.2 million, or 5.5%, in our residential real estate loans.

The \$73.9 million increase in average interest-bearing liabilities resulted from a \$47.1 million increase in average deposit balances and a \$30.3 million increase in the average balance of other borrowed funds.

The fact that average earning assets grew at a faster pace than average interest-bearing liabilities was primarily due to a \$3.5 million, or 1.9%, increase in the average balance of non-interest bearing demand deposits and from retained earnings.

2006 to 2007:

In general, an increase in average earning assets has a positive impact on net interest income. For 2007, average earning assets increased \$35.1 million over 2006, while average interest-bearing liabilities only increased \$28.3 million. This combination led to a \$1.2 million increase in net interest income. (This positive effect was partially offset by the \$220 thousand negative effect on net interest income resulting from the changes in rates during the year, discussed above.)

The \$35.1 million increase in average earning assets from 2006 to 2007 reflected an increase in average loans of \$24.2 million, or 2.4%, a decrease of \$2.3 million, or 0.5%, in investment securities and an increase of \$13.1 million in the average balance of federal funds purchased. We experienced increases in all major categories within the loan portfolio during 2007, although the average balance of indirect loans (which represented the second largest segment of the loan portfolio) decreased slightly. Indirect loans are primarily auto loans financed through local dealerships where we acquire the dealer paper. Increases in the average balances of other loan categories included: i) for commercial and commercial real estate loans, an increase of \$11.6 million, or 4.4%, ii) for residential real estate loans, an increase of \$8.0 million, or 2.5%, and iii) for other consumer loans, an increase of \$5.5 million, or 10.1%. Although average loans increased by 2.4% in 2007, this was a lower rate of increase than the 5.8% rate experienced in 2006.

The \$28.3 million increase in average interest-bearing liabilities resulted from a \$28.2 million increase in time deposits and a \$7.5 million increase in non-maturity deposit balances. These increases were offset in part by a decrease of \$7.5 million in the average balance of borrowed funds.

The fact that average earning assets grew at a faster pace than average interest-bearing liabilities was primarily due to a \$3.8 million, or 2.1%, increase in the average balance of non-interest bearing demand deposits.

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

II. PROVISION FOR LOAN LOSSES AND ALLOWANCE FOR LOAN LOSSES

We consider our accounting policy relating to the allowance for loan losses to be a critical accounting policy, given the uncertainty involved in evaluating the level of the allowance required to cover credit losses inherent in the loan portfolio, and the material effect that such judgments may have on our results of operations. In addition to the following discussion, see Notes 1 and 5 to the consolidated financial statements, included in Item 8 of this Report.

Through the provision for loan losses, an allowance is maintained that reflects our best estimate of probable incurred loan losses related to specifically identified loans and losses for categories of loans in the remaining portfolio. Actual loan losses are charged against this allowance when loans are deemed uncollectible.

We use a two-step process to determine the provision for loans losses and the amount of the allowance for loan losses.

We evaluate impaired commercial and commercial real estate loans over \$250,000 under SFAS No. 114, Accounting for Creditors for Impairment of a Loan. We evaluate the remainder of the portfolio under SFAS No. 5 Accounting for Contingencies.

At December 31, 2008 we had three loans considered impaired that were evaluated under SFAS No. 114. Those loans had sufficient collateral and required no specific reserve. See Note 5 to the consolidated financial statements, included in Item 8 of this Report.

Homogenous Loan Pools: Under our SFAS No. 5 analysis, we group homogeneous loans as follows, each with its own estimated loss-rate:

i)

Unsecured commercial loans,

ii)

Secured construction and development loans,

iii)

Secured commercial loans non-owner occupied,

iv)

Secured commercial loans owner occupied,

v)

One to four family residential real estate loans,

vi)

Home equity loans,

vii)

Indirect loans low risk tiers (based on credit scores),

viii)

Indirect loans high risk tiers, and

ix)

Other consumer loans.

Within the group of other commercial and commercial real estate loans, we sub-group loans based on our internal system of risk-rating, which is applied to all commercial and commercial real estate loans. We establish loss rates for each of these pools.

Estimated losses, under our SFAS No. 5 evaluation, reflect consideration of all significant factors that affect the collectibility of the portfolio as of December 31, 2008. In our evaluation, we do both a quantitative and qualitative analysis of the homogeneous pools.

Quantitative Analysis: Quantitatively, we determine the historical loss rate for each homogeneous loan pool.

During the past five years we have had little charge-off activity on loans secured by residential real estate. Indirect consumer lending (principally automobile loans) represents a significant component of our total loan portfolio and is the only category of loans that has a history of losses that lends itself to a trend analysis. We have had two losses on commercial real estate loans in the past five years. Losses on commercial loans (other than those secured by real estate) are also historically low, but can vary widely from year-to-year; this is the most complex category of loans in our loss analysis.

Our net charge-offs for the past five years have been at historical lows for our company, although charge-offs increased in 2008, particularly in the fourth quarter (see the table on page 28). Annualized net charge-offs have ranged from .04% to .09% of average loans during this period. In prior years this ratio was significantly higher. For example, in the mid-to-late 1990's, the charge-off ratio ranged from .16% to .32% for our company. The ratio for bank holding companies in our peer group was .65% for the years ended December 31, 2008, the most recent reporting period. The change in this peer group ratio represents a significant increase from the prior five years when the peer ratio ranged from .13% to .25%.

Qualitative Analysis: While historical loss experience provides a reasonable starting point for our analysis, historical losses, or even recent trends in losses, do not by themselves form a sufficient basis to determine the appropriate level for the allowance. Therefore, we have also considered and adjusted historical loss factors for qualitative and environmental factors that are likely to cause credit losses associated with our existing portfolio. These included:

.

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

For each homogeneous loan pool, we estimate a loss factor expressed in basis points for each of the qualitative factors above, and for historical credit losses. We update and change, if necessary, the loss-rates assigned to various pools based on the analysis of loss trends and the change in qualitative and environmental factors.

From June 2004 to June 2006, the Federal Reserve Bank increased prevailing short-term rates in an effort to slow down national economic growth and check potential increases in the inflation rate. However, from August 2007 through December 2008, the Federal Reserve Bank began to cut rates in response to the growing liquidity crisis in credit markets and evidence of a significant economic recession. In our market area there was little impact from these developments in credit markets and the national economy on unemployment rates, job growth and business failures until the last quarter of 2008; overall, our market area has not experienced in the past five quarters the degree of negative impact on lending, credit and property values that the U.S. as a whole has experienced, although this may change in upcoming periods.

Due to the imprecise nature of the loan loss estimation process and ever changing economic conditions, the risk attributes of our portfolio may not be adequately captured in data related to the formula-based loan loss components used to determine allocations in our analysis of the adequacy of the allowance for loan losses. Management, therefore, has established and held an unallocated portion within the allowance for loan losses reflecting the uncertainty of future economic conditions within our market area. This unallocated portion of the allowance was \$500 thousand at December 31, 2008.

SUMMARY OF THE ALLOWANCE AND PROVISION FOR LOAN LOSSES

(Dollars In Thousands) (Loans, Net of Unearned Income)

Years-Ended December 31,	<u>2008</u>	<u>2007</u>	<u>2006</u>	<u>2005</u>	<u>2004</u>
Loans at End of Period	\$1,109,812	\$1,038,844	\$1,008,999	\$ 996,545	\$ 875,311
Average Loans	1,071,384	1,020,856	996,611	942,286	866,690
Total Assets at End of Period	1,665,086	1,584,846	1,520,217	1,519,603	1,377,949
Nonperforming Assets:					
Nonaccrual Loans:					
Commercial Real Estate	\$2,263	\$ 758	\$ 708	\$ 597	\$ 512
Commercial Loans	50	73	56	26	7
Residential Real Estate Loans	100	253	452	59	603
Consumer Loans	<u>1,056</u>	<u>855</u>	<u>822</u>	<u>1,193</u>	<u>981</u>
Total Nonaccrual Loans	3,469	1,939	2,038	1,875	2,103
Loans Past Due 90 or More Days and					
Still Accruing Interest	<u>457</u>	<u>245</u>	<u>739</u>	<u>373</u>	<u>6</u>
Total Nonperforming Loans	3,926	2,184	2,777	2,248	2,109
Reposessed Assets	64	63	144	124	136
Other Real Estate Owned	581	89	248	---	---
Nonaccrual Investments	<u>400</u>	<u>---</u>	<u>---</u>	<u>---</u>	<u>---</u>
Total Nonperforming Assets	<u>\$4,971</u>	<u>\$2,336</u>	<u>\$3,169</u>	<u>\$2,372</u>	<u>\$2,245</u>
Allowance for Loan Losses:					
Balance at Beginning of Period	\$12,401	\$12,278	\$12,241	\$12,046	\$11,842
Loans Charged-off:					
Commercial, Financial and Agricultural	(83)	(27)	(32)	(134)	(22)
Real Estate - Commercial	---	(6)	---	---	---
Real Estate - Residential	(25)	---	---	(30)	---
Installment Loans to Individuals	<u>(1,184)</u>	<u>(797)</u>	<u>(1,105)</u>	<u>(964)</u>	<u>(1,040)</u>
Total Loans Charged-off	(1,292)	(830)	(1,137)	(1,128)	(1,062)

Recoveries of Loans Previously Charged-off:

Commercial, Financial and Agricultural	38	13	27	18	6
Real Estate - Commercial	197	17	17	17	17
Real Estate - Residential	2	2	2	2	3
Installment Loans to Individuals	<u>255</u>	<u>408</u>	<u>302</u>	<u>256</u>	<u>220</u>
Total Recoveries of Loans					
Previously Charged-off	<u>492</u>	<u>440</u>	<u>348</u>	<u>293</u>	<u>246</u>
Net Loans Charged-off	(800)	(390)	(789)	(835)	(816)
Provision for Loan Losses Charged to Expense	<u>1,671</u>	<u>513</u>	<u>826</u>	<u>1,030</u>	<u>1,020</u>
Balance at End of Period	<u>\$13,272</u>	<u>\$12,401</u>	<u>\$12,278</u>	<u>\$12,241</u>	<u>\$12,046</u>

Nonperforming Asset Ratio Analysis:

Net Loans Charged-off as a Percentage of

Average Loans	.07%	.04%	.08%	.09%	.09%
Provision for Loan Losses as a					
Percentage of Average Loans	.16	.05	.08	.11	.12
Allowance for Loan Losses as a					
Percentage of Loans, Period-end	1.20	1.19	1.22	1.23	1.38
Allowance for Loan Losses as a					
Percentage of Nonperforming Loans	338.05	567.81	442.12	544.55	571.18
Nonperforming Loans as a					
Percentage of Loans, Period-end	.35	.21	.28	.23	.24
Nonperforming Assets as a Percentage of					
Total Assets, Period-end	.30	.15	.21	.16	.16

ALLOCATION OF THE ALLOWANCE FOR LOAN LOSSES

(Dollars in Thousands)

	<u>2008</u>	<u>2007</u>	<u>2006</u>	<u>2005</u>	<u>2004</u>
Commercial, Financial and Agricultural	\$ 1,735	\$ 1,634	\$ 1,691	\$ 1,574	\$ 1,430

Real Estate-Commercial	3,568	3,247	3,348	3,160	2,632
Real Estate-Residential Mortgage	2,610	2,320	1,714	1,569	1,411
Indirect and Other Installment Loans to Individuals	4,859	4,369	4,517	5,294	4,392
Unallocated	<u>500</u>	<u>831</u>	<u>1,008</u>	<u>644</u>	<u>2,181</u>
Total	<u>\$13,272</u>	<u>\$12,401</u>	<u>\$12,278</u>	<u>\$12,241</u>	<u>\$12,046</u>

III. NONINTEREST INCOME

The majority of our noninterest income constitutes fee income from services, principally fees and commissions from fiduciary services, deposit account service charges, insurance commissions, computer processing fees and other recurring fee income. Net gains or losses on the sale of securities available-for-sale is another category of noninterest income.

ANALYSIS OF NONINTEREST INCOME

(Dollars In Thousands)

	<u>Years Ended December 31,</u>			<u>Change From Prior Year</u>			
	<u>2008</u>	<u>2007</u>	<u>2006</u>	<u>2007 to 2008</u>		<u>2006 to 2007</u>	
				<u>Amount</u>	<u>%</u>	<u>Amount</u>	<u>%</u>
Income from Fiduciary Activities	\$ 5,463	\$ 5,572	\$ 5,082	\$ (109)	(2.0)%	\$490	9.6%
Fees for Other Services to Customers	8,562	8,130	7,954	432	5.3	176	2.2
Net Gains (Losses) on Securities Transactions	383	---	(102)	383	---	102	100.0
Other Than Temporary Impairment	(1,610)	---	---	(1,610)	---	---	---
Gain on Visa Stock Redemption	749	---	---	749	---	---	---
Gain on the Sale of Premises	115	---	227	115	---	(227)	(100.0)
Insurance Commissions	2,066	1,869	1,768	197	10.5	101	5.7
Other Operating Income	<u>541</u>	<u>717</u>	<u>852</u>	<u>(176)</u>	(24.5)	<u>(135)</u>	(15.9)
Total Noninterest Income	<u>\$16,269</u>	<u>\$16,288</u>	<u>\$15,781</u>	<u>\$ (19)</u>	(0.1)%	<u>\$507</u>	3.2%

2008 compared to 2007: Although total noninterest income was relatively unchanged from 2007 to 2008 there were several significant transactions during 2008, most notably the two items discussed in the Overview beginning on page 20: 1) the write-down of our Lehman bond, and 2) the gain from the Visa stock redemption.

For 2008, income from fiduciary activities decreased \$109 thousand, or 2.0%, from 2007. The decrease followed the significant decrease in assets under administration and management following the severe decline in the stock markets in the last three months of 2008. At year-end 2008, the market value of assets under trust administration and investment management amounted to \$755.4 million, a decrease of \$205.8 million, or 21.4%, from year-end 2007. By comparison, the Dow Jones Industrial Average was 8,776 at December 31, 2008 a 33.8% decrease from 13,264 at December 31, 2007. With a significant portion of our fiduciary fees indexed to assets under administration we would normally expect this income to decrease proportionately. However, since the market decline occurred primarily in the second half of the year our total income from fiduciary activities did not fall to the full extent of the decrease in the market value of assets under administration.

Income from fiduciary activities includes income from funds under investment management in The North Country Funds, specifically the North Country Equity Growth Fund (NCEGX) and the North Country Intermediate Bond Fund (NCBDX), both of which are advised by our registered investment adviser subsidiary, North Country Investment Advisers, Inc. On a combined basis, these funds had a market value of \$180.0 million and \$207.1 million at December 31, 2008 and 2007, respectively. The funds were introduced in March 2001. Most of the dollars invested in these funds are derived from retirement and pension plan accounts of which our banks serve as trustee, but our North Country Funds also are offered on a retail basis through an arrangement with UVEST Financial Services Group, Inc., a third-party registered broker/dealer that provides securities brokerage services to our customers from several of our bank branches. Our company's pension plan is included as an investor in the North Country Funds, which owned shares in the funds with a market value of approximately \$14.5 million at December 31, 2008 and \$17.5 million at 2007.

Fees for other services to customers include deposit account service charges, debit card processing fees, merchant bankcard processing fees, safe deposit box fees and loan servicing fees. These fees amounted to \$8.6 million in 2008, an increase of \$432 thousand, or 5.3%, from 2007. The increase was primarily attributable to debit card activity fee income and increases in income from our third-party provider of securities brokerage services.

During 2008 we recognized a net gain of \$383 thousand on the sale of \$29.1 million of investment securities available-for-sale, whereas no securities were sold during 2007.

During 2008 we sold a building which we were using for storage and for administrative purposes to a developer. After renovation, we agreed to lease back office space which amounted to less than 10 percent of the total building space. We recognized a gain of \$115 thousand in 2008 on this sale.

In November 2004, we acquired Capital Financial Group, Inc., a local insurance agency specializing in the sale of group health and life insurance. See the more detailed discussion of the acquisition on page 5 of this Report. Insurance commission income increased from \$1.9 million in 2007 to \$2.1 million in 2008.

Other operating income includes net gains on the sale of loans and other real estate owned as well as other miscellaneous revenues. For 2008, other operating income decreased \$176 thousand, or 24.5%, from 2007. In years prior to 2008, other operating income included data processing servicing fee income received from one unaffiliated upstate New York bank. However, this arrangement came to an end in the second quarter of 2007, following the acquisition of that institution by an unrelated company. Termination of the arrangement resulted in a reduction in fee income of \$135 thousand in 2008 compared to 2007.

2007 compared to 2006: Total noninterest income increased \$507 thousand, or 3.2%, from 2006 to 2007.

For 2007, income from fiduciary activities increased \$490 thousand, or 9.6%, from 2006. Most of the increase resulted from an increase in assets under administration and management. At year-end 2007, the market value of assets under trust administration and investment management amounted to \$961.2 million, an increase of \$54.7 million, or 6.0%, from year-end 2006.

Fees for other services to customers in 2007 included deposit account service charges, debit card processing fees, merchant bankcard processing fees, safe deposit box fees and loan servicing fees. These fees amounted to \$8.1 million in 2007, an increase of \$176 thousand, or 2.2%, from 2006. The increase was primarily attributable to increases in rental income from our third-party provider of securities brokerage services and increases in our merchant bankcard and debit card activity fee income.

Insurance commission income from our Capital Financial insurance agency subsidiary was \$1.7 million for 2005, the first full year of income from this business. The total increased to \$1.8 million in 2006 and \$1.9 million in 2007.

Other operating income includes net gains on the sale of loans and other real estate owned as well as other miscellaneous revenues. For 2007, other operating income decreased \$135 thousand, or 15.9%, from 2006. In 2006, we sold, at market price, a parcel of land that we had earlier purchased to serve as premises for a new branch. The sale of land resulted in a gain of \$227 thousand. We subsequently entered into an agreement with the buyer to lease from them a portion of the building they constructed on the parcel of land to serve as a bank branch. In years prior to 2007, other operating income included data processing servicing fee income received from one unaffiliated upstate New York bank. However, this arrangement came to an end in the second quarter of 2007, following the acquisition of that institution by an unrelated company. The termination of this arrangement in mid-2007 resulted in a reduction in fee income between 2006 and 2007 of \$56 thousand.

IV. NONINTEREST EXPENSE

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

ANALYSIS OF NONINTEREST EXPENSE

(Dollars In Thousands)

	<u>Years Ended December 31,</u>			<u>Change From Prior Year</u>			
	<u>2008</u>	<u>2007</u>	<u>2006</u>	<u>2007 to 2008</u>		<u>2006 to 2007</u>	
				<u>Amount</u>	<u>%</u>	<u>Amount</u>	<u>%</u>
Salaries and Employee Benefits	\$24,551	\$21,424	\$22,096	\$3,127	14.6%	\$ (672)	(3.0)%
Occupancy Expense of Premises, Net	3,479	3,198	3,058	281	8.8	140	4.6
Furniture and Equipment Expense	3,211	3,015	2,971	196	6.5	44	1.5
Other Operating Expense	<u>11,152</u>	<u>10,293</u>	<u>8,682</u>	<u>859</u>	8.3	<u>1,611</u>	18.6
Total Noninterest Expense	<u>\$42,393</u>	<u>\$37,930</u>	<u>\$36,807</u>	<u>\$4,463</u>	11.8	<u>\$1,123</u>	3.1

2008 compared to 2007: Noninterest expense for 2008 amounted to \$42.4 million, an increase of \$4.5 million, or 11.8%, from 2007. One comparative measure of operating expenses for financial institutions is the efficiency ratio. The efficiency ratio (a ratio where lower is better) is calculated as the ratio of noninterest expense to the sum of tax equivalent net interest income and other income. Excluded from the calculation are intangible asset amortization and any net securities gains or losses. The efficiency ratio might be considered a non-GAAP financial measure but is generally utilized by banks and bank analysts to assess an institution's performance. See the discussion on Use of Non-GAAP Financial Measures on page 4 of this Report. For 2008, the efficiency ratio for Arrow was 54.7%, a decrease from the 2007 ratio of 57.3%. Our 2008 ratio compared favorably to the ratio for our peer group of 68.95% as of December 31, 2008. For information on the calculation of our efficiency ratios on a quarterly and annual basis, see pages 17 and 18 of this Report.

Salaries and employee benefits expense increased \$3.1 million, or 14.6%, from 2007 to 2008. Salary expense increased \$1.13 million, or 6.9%, from 2007, due primarily to staff increases and to normal merit increases. Employee benefits increased \$2.0 million, or 39.2% from 2007 to 2008. This was primarily attributable to increases in incentive compensation expenses. The ratio of total personnel expense (salaries and employee benefits) to average assets was 1.49% for 2008, which was still 4 basis points less than the annualized ratio for our peer group of 1.53% at December 31, 2008.

Occupancy expense increased \$281 thousand, or 8.8%, from 2007 to 2008. The increase was primarily attributable to increased heating costs, maintenance and real estate taxes. Furniture and equipment expense increased by \$196 thousand, or 6.5%, from 2007 to 2008. The increase was primarily attributable to increases in data processing expenses.

Other operating expense increased from 2007 to 2008, by \$859 thousand, or 8.3%. The most significant component of the increase was an increase in our FDIC assessment of \$505 thousand. In 2007, the FDIC resumed charging an assessment for insured deposits. All of our 2007 assessment was offset by a one time credit provided to bank by the FDIC. The small dollar amount of credit remaining after 2007 was used up in its entirety to offset the assessment for the first quarter of 2008. Other increases were spread among a variety of categories, including legal and marketing expenses. These increases were offset in part by a \$306 thousand reversal of the \$600 thousand reserve for the Visa U.S.A. litigation costs recognized in the fourth quarter of 2007 (see page 21).

2007 compared to 2006: Noninterest expense for 2007 amounted to \$37.9 million, an increase of \$1.1 million, or 3.1%, from 2006. For 2007, the efficiency ratio for Arrow was 57.3%, an increase from the 2006 ratio of 56.7%. Our 2007 ratio, however, still compared favorably to the ratio for our peer group of 64.6% as of December 31, 2007. For information on the calculation of our efficiency ratios on a quarterly and annual basis, see pages 17 and 18 of this Report.

Salaries and employee benefits expense decreased \$672 thousand, or 3.0%, from 2006 to 2007. Salary expense increased \$246 thousand, or 1.5%, from 2006, due primarily to normal merit increases and to staff increases at our new branches. Employee benefits, however, decreased \$918 thousand, or 15.2% from 2006 to 2007. This was primarily attributable to decreases in post-retirement benefits and incentive compensation expenses. The ratio of total personnel expense (salaries and employee benefits) to average assets was 1.37% for 2007, 22 basis points less than the annualized ratio for our peer group of 1.59% at December 31, 2007.

Occupancy expense increased \$140 thousand, or 4.6%, from 2006 to 2007. A portion of the increase was attributable to increased costs for two new branches. Furniture and equipment expense increased by \$44 thousand, or 1.5%, from 2006 to 2007.

Other operating expense increased from 2006 to 2007, by \$1.6 million, or 18.6%. The most significant component of the increase was the \$600 thousand reserve for the Visa U.S.A. litigation costs (see page 21). Other increases were spread among a variety of categories, including marketing and third party computer processing fees.

V. INCOME TAXES

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

INCOME TAXES AND EFFECTIVE RATES

(Dollars in Thousands)

	<u>Years Ended December 31,</u>			<u>Change From Prior Year</u>			
	<u>2008</u>	<u>2007</u>	<u>2006</u>	<u>2007 to 2008</u>		<u>2006 to 2007</u>	
				<u>Amount</u>	<u>%</u>	<u>Amount</u>	<u>%</u>
Provision for Income Taxes	\$8,999	\$6,807	\$7,124	\$2,192	32.2%	\$(317)	(4.4)%
Effective Tax Rate	30.6%	28.2%	29.7%	2.4%	8.5	(1.5)%	(5.1)

The provisions for federal and state income taxes amounted to \$9.0 million, \$6.8 million and \$7.1 million for 2008, 2007 and 2006, respectively. The effective income tax rates for 2008, 2007 and 2006 were 30.6%, 28.2% and 29.7%, respectively, with the increase in the effective rate between 2007 and 2008 reflecting a decrease in the ratio of tax-exempt income to total income before taxes.

C. FINANCIAL CONDITION

I. INVESTMENT PORTFOLIO

Investment securities are classified as held-to-maturity, trading, or available-for-sale, depending on the purposes for which such securities were acquired and are being held. Securities held-to-maturity are debt securities that the company has both the positive intent and ability to hold to maturity; such securities are stated at amortized cost. Debt and equity securities that are bought and held principally for the purpose of sale in the near term are classified as

trading securities and are reported at fair value with unrealized gains and losses included in earnings. Debt and equity securities not classified as either held-to-maturity or trading securities are classified as available-for-sale and are reported at fair value with unrealized gains and losses excluded from earnings and reported net of taxes in accumulated other comprehensive income or loss. At December 31, 2008, 2007 and 2006, we held no trading securities. Set forth below is certain information about our securities available-for-sale portfolio and securities held-to-maturity portfolio at such date.

Securities Available-for-Sale:

The following table sets forth the carrying value of our securities available-for-sale portfolio at year-end 2008, 2007 and 2006.

SECURITIES AVAILABLE-FOR-SALE

(In Thousands)

	December 31,		
	<u>2008</u>	<u>2007</u>	<u>2006</u>
U.S. Treasury and Agency Obligations	\$ 11,528	\$ 39,497	\$ 55,077
State and Municipal Obligations	15,446	24,206	23,189
Collateralized Mortgage Obligations	185,830	138,971	126,315
Other Mortgage-Backed Securities	93,849	112,458	90,051
Corporate and Other Debt Securities	7,433	11,574	11,613
Mutual Funds and Equity Securities	<u>11,004</u>	<u>11,364</u>	<u>9,641</u>
Total	<u>\$325,090</u>	<u>\$338,070</u>	<u>\$315,886</u>

In all periods, other mortgage-backed securities consisted solely of agency mortgage pass-through securities. Pass-through securities provide to the investor monthly portions of principal and interest pursuant to the contractual obligations of the underlying mortgages. Collateralized mortgage obligations (CMOs) separate the repayments into two or more components (tranches), where each tranche has a separate estimated life and yield. Our practice has been to purchase pass-through securities and CMOs that are guaranteed by federal agencies and tranches of CMOs with shorter maturities. Included in corporate and other debt securities are corporate bonds and commercial paper, which were highly rated at the time of purchase, although some have been downgraded recently, including our Lehman bond. At year-end 2008, approximately \$9.7 million, or 87.9%, of the listed amount of mutual funds and equity securities consisted of required holdings of stock of the Federal Reserve Bank of New York and the Federal Home Loan Bank of New York.

The following table sets forth the maturities of our securities available-for-sale portfolio as of December 31, 2008. CMOs and other mortgage-backed securities are included in the table based on their expected average lives. Mutual funds and equity securities, which have no stated maturity, are included in the after 10-years category.

MATURITIES OF SECURITIES AVAILABLE-FOR-SALE

(In Thousands)

		After	After		
	Within	1 But	5 But		
	One	Within	Within	After	
	<u>Year</u>	<u>5 Years</u>	<u>10 Years</u>	<u>10 Years</u>	<u>Total</u>
U.S. Treasury and Agency Obligations	\$11,528	\$ ---	\$ ---	\$ ---	\$ 11,528
State and Municipal Obligations	7,591	3,828	985	3,042	15,446
Collateralized Mortgage Obligations	21,811	66,793	86,204	11,022	185,830
Other Mortgage-Backed Securities	2,903	57,662	15,470	17,814	93,849
Corporate and Other Debt Securities	2,936	4,342	---	155	7,433
Mutual Funds and Equity Securities	---	---	---	<u>11,004</u>	<u>11,004</u>
Total	<u>\$46,769</u>	<u>\$132,625</u>	<u>\$102,659</u>	<u>\$43,037</u>	<u>\$325,090</u>

The following table sets forth the tax-equivalent yields of our securities available-for-sale portfolio at December 31, 2008.

YIELDS ON SECURITIES AVAILABLE-FOR-SALE

(Fully Tax-Equivalent Basis)

		After	After		
	Within	1 But	5 But		
	One	Within	Within	After	
	<u>Year</u>	<u>5 Years</u>	<u>10 Years</u>	<u>10 Years</u>	<u>Total</u>
U.S. Treasury and Agency Obligations	4.20%	---%	---%	---%	4.20%
State and Municipal Obligations	3.95	5.20	6.65	7.59	5.15
Collateralized Mortgage Obligations	4.47	4.64	5.22	5.27	4.93
Other Mortgage-Backed Securities	2.95	4.54	5.03	5.57	4.77
Corporate and Other Debt Securities	5.62 ¹	5.02	---	4.52	5.22
Mutual Funds and Equity Securities	4.48	5.30	---	5.06	5.06

Total	4.09	4.58	5.18	5.32	4.50
-------	------	------	------	------	------

¹ Includes the Lehman bond on a nonaccrual basis.

The yields on corporate and other debt securities shown in the table above are calculated by dividing annual interest, including accretion of discounts and amortization of premiums, by the amortized cost of the securities at December 31, 2008. Yields on obligations of states and municipalities exempt from federal taxation were computed on a fully tax-equivalent basis using a marginal tax rate of 35%. Dividend earnings derived from equity securities were adjusted to reflect applicable federal income tax exclusions.

At December 31, 2008 and 2007, the weighted average maturity was 5.1 and 3.3 years, respectively, for debt securities in the available-for-sale portfolio. At December 31, 2008, the net unrealized gains on securities available-for-sale amounted to \$4.0 million. The net unrealized gain or loss on such securities, net of tax, is reflected in accumulated other comprehensive income/loss.

The unrealized loss on available-for-sale securities was \$61 thousand at December 31, 2007. For both periods, the unrealized gain or loss was primarily attributable to a change in market rates between the date of purchase and market yields at the balance sheet date.

For further information regarding our portfolio of securities available-for-sale, see Note 3 to the Consolidated Financial Statements contained in Part II, Item 8 of this Report.

Securities Held-to-Maturity:

The following table sets forth the carrying value of our portfolio of securities held-to-maturity (consisting exclusively of state and municipal obligations) at December 31 of each of the last three years.

SECURITIES HELD-TO-MATURITY

(In Thousands)

	December 31,		
	<u>2008</u>	<u>2007</u>	<u>2006</u>
State and Municipal Obligations	<u>\$133,976</u>	<u>\$114,611</u>	<u>\$108,498</u>

For information regarding the fair value of our portfolio of securities held-to-maturity at December 31, 2008, see Note 3 to the Consolidated Financial Statements contained in Part II, Item 8 of this Report.

The following table sets forth the maturities of our portfolio of securities held-to-maturity as of December 31, 2008.

MATURITIES OF SECURITIES HELD-TO-MATURITY

(In Thousands)

	Within One Year	After 1 But Within 5 Years	After 5 But Within 10 Years	After 10 Years	Total
State and Municipal Obligations	<u>\$51,970</u>	<u>\$37,655</u>	<u>\$30,073</u>	<u>\$14,278</u>	<u>\$133,976</u>

The following table sets forth the tax-equivalent yields of our portfolio of securities held-to-maturity at December 31, 2008.

YIELDS ON SECURITIES HELD-TO-MATURITY

(Fully Tax-Equivalent Basis)

	Within <u>One Year</u>	After 1 But Within 5 <u>Years</u>	After 5 But Within 10 <u>Years</u>	After <u>10 Years</u>	<u>Total</u>
State and Municipal Obligations	4.48%	5.30%	5.52%	6.03%	5.11%

The yields shown in the table above are calculated by dividing annual interest, including accretion of discounts and amortization of premiums, by the carrying value of the securities at December 31, 2008. Yields on obligations of states and municipalities exempt from federal taxation (which constituted the entire portfolio) were computed on a fully tax-equivalent basis using a marginal tax rate of 35%.

During 2008, 2007 and 2006, we sold no securities from the held-to-maturity portfolio. The weighted-average maturity of the held-to-maturity portfolio was 4.0 years and 4.8 years at December 31, 2008 and 2007, respectively.

II. LOAN PORTFOLIO

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

a. Types of Loans

(Dollars In Thousands)

	<u>2008</u>		<u>2007</u>		<u>2006</u>		<u>2005</u>		<u>2004</u>	
	<u>Amount</u>	<u>%</u>	<u>Amount</u>	<u>%</u>	<u>Amount</u>	<u>%</u>	<u>Amount</u>	<u>%</u>	<u>Amount</u>	<u>%</u>
Commercial, Financial	\$ 86,872	8	\$ 79,128	8	\$ 79,581	8	\$ 79,917	8	\$ 76,379	9

and Agricultural

Real Estate -

Commercial	183,676	17	160,787	15	161,443	16	152,447	15	137,107	15
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Real Estate -

Construction	34,428	3	39,265	4	31,319	3	25,736	3	7,868	1
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Real Estate -

Residential	444,655	40	417,092	40	399,446	40	376,820	38	342,957	39
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Indirect and

Other Installment

Loans to

Individuals	<u>360,181</u>	<u>32</u>	<u>342,572</u>	<u>33</u>	<u>337,210</u>	<u>33</u>	<u>361,625</u>	<u>36</u>	<u>311,000</u>	<u>36</u>
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Total Loans	1,109,812	<u>100</u>	1,038,844	<u>100</u>	1,008,999	<u>100</u>	996,545	<u>100</u>	875,311	<u>100</u>
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Allowance for

Loan

Losses	<u>(13,272)</u>	<u>(12,401)</u>	<u>(12,278)</u>	<u>(12,241)</u>	<u>(12,046)</u>
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Total Loans, Net	<u>\$1,096,540</u>	<u>\$1,026,443</u>	<u>\$ 996,721</u>	<u>\$984,304</u>	<u>\$863,265</u>
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Maintenance of High Quality in the Loan Portfolio: During the second half of 2007 and throughout 2008, the U.S. experienced significant disruption and volatility in its financial and capital markets. A major cause of the disruption was a significant decline in residential real estate values across much of the U.S., which in turn triggered widespread defaults on subprime mortgage loans and steep devaluations of portfolios containing these loans and securities collateralized by them. In recent months, as real estate values have continued to fall in most areas of the U.S., problems have spread from subprime loans to better quality mortgage portfolios, and in some cases prime mortgage loans, as well as home equity and credit card loans. Recently, commercial real estate values have begun to decline substantially and commercial real estate mortgage portfolios have begun to experience the same problems that have beset residential mortgage portfolios over the prior 18 months. Many lending institutions have suffered sizable charge-offs and losses in their loan and investment securities portfolios in the past six quarters as a result of their origination or investment in these kinds of loans or securities.

Through December 2008, we have not experienced a significant deterioration in our loan or investment portfolios, except for the impaired Lehman bond cited earlier in this Report. We have never engaged in subprime mortgage lending as a business line and we do not extend or purchase any so-called Alt-A, negative amortization, option ARM, or negative equity mortgage loans. On occasion we have made loans to borrowers having a FICO score of 660 or below or have had extensions of credit outstanding to borrowers who have developed credit problems after origination resulting in deterioration of their FICO scores. We also on occasion have extended community development loans to borrowers whose creditworthiness is below our normal standards as part of the community support program we have developed in fulfillment of our statutorily-mandated duty to support low- and moderate-income borrower within our service area. However, we are a prime lender and apply prime lending standards and this, together with the fact that the service area in which we make most of our loans has not experienced as severe a decline in property values as other parts of the U.S., are the principal reasons that we have not to date experienced significant deterioration in our loan portfolio.

If, however, the current downturn in the U.S. real estate markets should continue and the U.S. and/or our local economy should continue to weaken substantially, we can give no assurances about the continuing high quality of our loan portfolio. In such an event we may experience elevated charge-offs, higher provisions to our loan loss reserve, and increasing expense related to asset maintenance and supervision.

Residential Real Estate Loans: In recent years, residential real estate and home equity loans have represented the largest segment of our loan portfolio. Residential mortgage demand has been moderate since 2004, after a several year period when demand was high. However, during 2004 and 2005 and the first quarter of 2006, we sold many of our 30-year, fixed-rate mortgage originations, while retaining the servicing rights. By the end of the first quarter of 2006, as yields on longer-term residential real estate loans began to rise, we stopped selling our 30-year mortgage originations and decided to retain them in our portfolio. However, during the last quarter of 2008, as the government support entities (GSEs) Fannie Mae and Freddie Mac began to dominate the stressed home mortgage market and to offer lower-rate mortgages that the non-GSI market was hard-pressed to match, we began to sell most of our originations to Freddie Mac. During 2008, the \$66.2 million of our new residential real estate loan originations offset normal principal amortization, prepayments on pre-existing loans and fourth quarter sales of newly originated loans. If we continue in the current GSE-subsidized low-rate environment for newly originated residential real estate loans, we may experience a decrease in our outstanding balances in this segment of our portfolio. Moreover, if our local economy or real estate market suffers a major downturn, the demand for residential real estate loans in our service area may decrease, which also may negatively impact our real estate portfolio and our financial performance.

Indirect Loans: In the early years of the current decade, indirect consumer loans (consisting principally of auto loans financed through local dealerships where we acquire the dealer paper) was the largest segment of our loan portfolio. For much of this period, indirect consumer loans were the fastest growing segment of our loan portfolio, both in terms of absolute dollar amount and as a percentage of the overall portfolio. Since 2003, however, this segment of the portfolio has fluctuated in size, with periods of expansion followed by contraction. Generally, over the period the segment experienced little growth in absolute terms and decreased as a percentage of the overall portfolio. This change in indirect loan totals was largely the result of aggressive campaigns of zero rate and other subsidized financing by auto manufacturers, commencing late 2001 and recurring periodically in the years since then.

At the end of the first quarter of 2006, we experienced an increase in indirect loans, which continued throughout the second and third quarters of 2006, for a variety of factors, including the decision by the automobile manufacturers to be less aggressive with their subsidized financing programs. In the fourth quarter of 2006, however, indirect loan balances declined by 4.3%, measured at quarter-end (although the average balance for the fourth quarter was slightly higher than the average balance for the third quarter).

In the last quarter of 2007 and the first two quarters of 2008, we encountered enhanced rate competition on indirect (auto) loans from other lenders, including finance affiliates of the auto manufacturers who increased their offerings of heavily subsidized, low- or zero-rate loans. This increasingly competitive environment, combined with softening demand for vehicles, especially for SUVs and light trucks, had a negative effect on our indirect originations, and we experienced decreases in indirect balances in the first two quarters of 2008. However during the last two quarters of 2008, as some of the major lenders in the indirect market pulled back, including the auto companies' financing affiliates, our share of the indirect loan market increased and our portfolio at December 31, 2008 exceeded the balance at December 31, 2007 by \$19.5 million, or 5.7%.

Originations of indirect loans for 2008 were approximately \$

174.8 million. At December 31, 2008, indirect loans represented the second largest category of loans in our portfolio and a significant component of our business. However, if the recent dramatic reduction in auto demand continues, our indirect loan portfolio is likely to experience limited, if any, overall growth, either in real terms or as a percentage of the total portfolio, regardless of whether the auto company affiliates resume their offering of highly-subsidized vehicle

loans. Such weakened demand for indirect loans could negatively impact our financial performance.

Commercial, Commercial Real Estate and Construction and Land Development Loans: We have experienced moderate to strong demand for commercial loans for the past several years, and thus commercial and commercial real estate loan balances have grown significantly, both in dollar amount and as a percentage of the overall loan portfolio. This pattern continued during 2008 as the outstanding balance in this category grew \$21.3 million, or 8.0%, from year-end 2007 on originations of approximately \$114.9 million. Substantially all commercial and commercial real estate loans in our portfolio are extended to businesses or borrowers located in our regional market. Many of the loans in the commercial portfolio have variable rates tied to prime, FHLBNY or U.S. Treasury indices. We have not experienced any significant weakening in our commercial loan portfolio in recent quarters, although in the last few months on a national scale, the commercial real estate market has recently begun to give signs of substantial weakness. It is entirely possible that we may experience a reduction in the demand for such loans and/or a weakening in the quality of our commercial and commercial real estate loan portfolio in upcoming periods.

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

LOAN PORTFOLIO

Quarterly Average Loan Balances

(Dollars In Thousands)

	Quarter Ending				
	<u>Dec 2008</u>	<u>Sep 2008</u>	<u>Jun 2008</u>	<u>Mar 2008</u>	<u>Dec 2007</u>
Commercial and Commercial Real Estate	\$ 308,232	\$ 306,160	\$ 292,869	\$ 277,003	\$ 273,068
Residential Real Estate	340,486	334,489	326,003	322,819	318,883
Home Equity	51,887	48,358	47,895	46,535	46,152
Indirect Consumer Loans	358,945	342,526	332,458	337,060	342,595
Other Consumer Loans ¹	<u>50,428</u>	<u>51,758</u>	<u>53,578</u>	<u>55,493</u>	<u>55,963</u>
Total Loans	<u>\$1,109,978</u>	<u>\$1,083,291</u>	<u>\$1,052,803</u>	<u>\$1,038,910</u>	<u>\$1,036,661</u>

Percentage of Total Quarterly Average Loans

	Quarter Ending				
	<u>Dec 2008</u>	<u>Sep 2008</u>	<u>Jun 2008</u>	<u>Mar 2008</u>	<u>Dec 2007</u>
Commercial and Commercial Real Estate	27.8%	28.3%	27.8%	26.7%	26.3%
Residential Real Estate	30.7	30.9	31.0	31.1	30.8
Home Equity	4.7	4.4	4.5	4.5	4.4
Indirect Consumer Loans	32.3	31.6	31.6	32.4	33.1
Other Consumer Loans ¹	<u>4.5</u>	<u>4.8</u>	<u>5.1</u>	<u>5.3</u>	<u>5.4</u>
Total Loans	<u>100.0%</u>	<u>100.0%</u>	<u>100.0%</u>	<u>100.0%</u>	<u>100.0%</u>

Quarterly Tax-Equivalent Yield on Loans

	Quarter Ending				
	<u>Dec 2008</u>	<u>Sep 2008</u>	<u>Jun 2008</u>	<u>Mar 2008</u>	<u>Dec 2007</u>
Commercial and Commercial Real Estate	6.48%	6.61%	6.74%	7.13%	7.15%
Residential Real Estate	6.00	6.00	6.07	6.08	6.01
Home Equity	4.74	4.91	5.24	6.84	7.33
Indirect Consumer Loans	6.36	6.35	6.22	6.20	6.20
Other Consumer Loans ¹	7.34	7.36	7.30	7.33	7.35
Total Loans	6.25	6.30	6.33	6.50	6.50

¹ Other Consumer Loans includes certain home improvement loans secured by mortgages. However, these same loan balances are reported as

Real Estate Residential in the table of period-end balances on page 33, captioned Types of Loans.

In general, the yield (tax-equivalent interest income divided by average loans) on our loan portfolio and other earning assets is ultimately impacted by changes in prevailing interest rates, as previously discussed on in this Report on page 24 under the heading "Impact of Interest Rate Changes 2003 - 2008." We expect that loan yields will continue to rise and fall with changes in prevailing market rates, although the timing and degree of responsiveness will be influenced by a variety of other factors, including the makeup of the loan portfolio, the shape of the yield curve, consumer expectations and preferences and the rate at which the portfolio expands. Additionally, there is a significant amount of cash flow from normal amortization and prepayments in all loan categories, and this cash flow reprices at current rates as new loans are generated at the current yields.

As noted in the earlier discussion, during a period of change in prevailing rates, we generally experience a time lag between the impact of the change on our deposit portfolio (which is felt relatively quickly) and the impact of the

change on our loan portfolio (which occurs more slowly). The consequence of this time lag is a positive impact on the net interest margin during the beginning of a rate decline period, and a negative impact on the margin at the beginning of a rate increase period.

As we discussed in our review of net interest income above, during the period from mid-2004 to mid-2006, the Federal Reserve Bank increased the targeted federal funds rate from 1.00% to 5.25%, in an effort to dampen inflationary pressures and unrestrained borrowing. During this period of rate increase, the time-lag between repricing of our deposits and the repricing of loan balances was especially lengthy; in some sectors of the portfolio, the upward repricing of loan rates never occurred, at least not before the Fed reversed course and began decreasing rates in the last four months of 2007 and all of 2008.

The following table indicates the respective maturities and interest rate structure of our commercial, financial and agricultural loans and real estate - construction loans at December 31, 2008. For purposes of determining relevant maturities, loans are assumed to mature at (but not before) their scheduled repayment dates as required by contractual terms. Demand loans and overdrafts are included in the Within 1 Year maturity category. Most of the real estate - construction loans are made with a commitment for permanent financing, whether extended by us or unrelated third parties. The maturity distribution below reflects the final maturity of the permanent financing.

b. Maturities and Sensitivities of Loans to Changes in Interest Rates

(In Thousands)

	After 1			
	Within	But Within	After	
	<u>1 Year</u>	<u>5 Years</u>	<u>5 Years</u>	<u>Total</u>
Commercial, Financial and Agricultural	\$30,850	\$35,206	\$20,816	\$ 86,872
Real Estate - Construction	<u>5,435</u>	<u>4,707</u>	<u>24,286</u>	<u>34,428</u>
Total	<u>\$36,285</u>	<u>\$39,913</u>	<u>\$45,102</u>	<u>\$121,300</u>
Fixed Interest Rates	\$ 6,420	\$32,878	\$17,843	\$ 57,141
Variable Interest Rates	<u>29,865</u>	<u>7,035</u>	<u>27,259</u>	<u>64,159</u>
Total	<u>\$36,285</u>	<u>\$39,913</u>	<u>\$45,102</u>	<u>\$121,300</u>

COMMITMENTS AND LINES OF CREDIT

Stand-by letters of credit represent extensions of credit granted in the normal course of business, which are not reflected in the financial statements at a given date because the commitments are not funded at that time. As of December 31, 2008, our total contingent liability for standby letters of credit amounted to \$15.1 million. In addition to these instruments, we also have issued lines of credit to customers, including home equity lines of credit, commitments for residential and commercial construction loans and other personal and commercial lines of credit, which also may be unfunded or only partially funded from time to time. Commercial lines, generally issued for a period of one year, are usually extended to provide for the working capital requirements of the borrower. At December 31, 2008, we had outstanding unfunded loan commitments in the aggregate amount of approximately \$160.6 million.

c. Risk Elements

1. Nonaccrual, Past Due and Restructured Loans

The amounts of nonaccrual, past due and restructured loans for the past five years are presented in the table on page 28 under the heading Summary of the Allowance and Provision for Loan Losses.

We designate loans as nonaccrual when the payment of interest and/or principal is due and unpaid for a designated period (generally 90 days) or when the likelihood of the full repayment of principal and interest is, in the opinion of management, uncertain. Under the Uniform Retail Credit Classification and Account Management Policy established by banking regulators, fixed-maturity consumer loans must generally be charged-off no later than when 120 days past due. Loans secured with non-real estate collateral in the process of collection are charged-down to the value of the collateral, less cost to sell. Open-end credits, residential real estate loans and commercial loans are evaluated for charge-off on a loan-by-loan basis when placed on nonaccrual status. We had no material commitments to lend additional funds on outstanding nonaccrual loans at December 31, 2008. Loans past due 90 days or more and still accruing interest are those loans which were contractually past due 90 days or more but because of expected repayments, were still accruing interest.

The balance of loans 30-89 days past due totaled \$7.8 million at December 31, 2008 and represented 0.71% of loans outstanding at that date, as compared to approximately \$8.5 million, or 0.82% of loans at December 31, 2007. These non-current loans at December 31, 2008 were composed of approximately \$6.0 million of consumer loans, principally indirect motor vehicle loans, \$1.2 million of residential real estate loans and \$0.6 million of commercial loans.

SFAS No. 114 requires that all impaired loans, except for large groups of smaller-balance homogeneous loans, be measured based on (i) the present value of expected future cash flows discounted at the loan's effective interest rate, (ii) the loan's observable market price or (iii) the fair value of the collateral, less cost to sell, if the loan is collateral dependent. We apply the provisions of SFAS No. 114 to all impaired commercial and commercial real estate loans over \$250 thousand, and to all restructured loans. Allowances for losses for the remaining smaller-balance loans are evaluated under SFAS No. 5. Under the provisions of SFAS No. 114, we determine impairment for collateralized loans based on fair value of the collateral less estimated cost to sell. For other loans, impairment is determined by comparing the recorded value of the loan to the present value of the expected cash flows, discounted at the loan's

effective interest rate. We determine the interest income recognition method for impaired loans on a loan-by-loan basis. Based upon the borrowers' payment histories and cash flow projections, interest recognition methods include full accrual or cash basis.

During 2008, four commercial loans were considered impaired under SFAS No. 114 with an average recorded investment of \$1.1 million. At year-end 2008, the balance of impaired loans consisted of three loans with a combined balance of \$2.2 million which had no related reserve.

At December 31, 2008, nonperforming loans amounted to \$3.9 million, an increase of \$1.7 million from the balance at year-end 2007. Total nonperforming loans at year-end 2008 represented .35% of period-end loans, an increase from .21% at year-end 2007. By way of comparison, the ratio of nonperforming loans to average loans for our peer group at December 31, 2008 was 2.36%, up from 1.08% at December 31, 2007.

During 2008, income recognized on year-end balances of nonaccrual loans was \$208 thousand. Income that would have been recognized during that period on nonaccrual loans, if such loans had been current in accordance with their original terms and had been outstanding throughout the period (or since origination if held for part of the period) was \$295 thousand.

During 2007, one commercial loan was considered impaired under SFAS No. 114 with an average recorded investment of \$733 thousand. At year-end 2007, the balance of impaired loans consisted of that one loan with a balance of \$759 thousand which had no related reserve.

At December 31, 2007, nonperforming loans amounted to \$2.2 million, a decrease of \$593 thousand, or 21.4%, from the balance at year-end 2006. Total nonperforming loans at year-end 2007 represented .21% of period-end loans, a decrease from .28% at year-end 2006. The ratio of nonperforming loans to average loans for our peer group at December 31, 2007 was 1.08%, up from .56% at December 31, 2006.

During 2007, income recognized on year-end balances of nonaccrual loans was \$70 thousand. Income that would have been recognized during that period on nonaccrual loans, if such loans had been current in accordance with their original terms and had been outstanding throughout the period (or since origination if held for part of the period) was \$162 thousand.

During 2006, two commercial loans were considered impaired under SFAS No. 114 with an average recorded investment of \$341 thousand. At year-end 2006, the balance of impaired loans consisted of one loan with a balance of \$708 thousand which had no related reserve.

At December 31, 2006, nonperforming loans amounted to \$2.8 million, an increase of \$529 thousand, or 23.5%, from the balance at year-end 2005. Total nonperforming loans at year-end 2006 represented .28% of period-end loans, an increase from .23% at year-end 2005. The ratio of nonperforming loans to average loans for our peer group at December 31, 2006 was .56%.

During 2006, income recognized on year-end balances of nonaccrual loans was \$126 thousand. Income that would have been recognized during that period on nonaccrual loans, if such loans had been current in accordance with their original terms and had been outstanding throughout the period (or since origination if held for part of the period) was \$160 thousand.

2. Potential Problem Loans

On at least a quarterly basis, we apply an internal credit quality rating system to commercial loans that are either past due or fully performing but exhibit certain characteristics that could reflect a potential weakness. Loans are placed on nonaccrual status when the likely amount of future principal and interest payments are expected to be less than the contractual amounts, even if such loans are not 90 days past due.

Periodically we review the loan portfolio for evidence of potential problem loans. Potential problem loans are loans that are currently performing in accordance with contractual terms, but where known information about possible credit problems of the borrower causes doubt about the ability of the borrower to comply with the loan payment terms and may result in disclosure of such loans as nonperforming at some time in the future. Through our on-going credit monitoring, we consider loans which, in our internal classification system, are classified as substandard but continue to accrue interest to be potential problem loans. At December 31, 2008, we identified 46 commercial relationships totaling \$34.4 million as potential problem loans. At December 31, 2007, we identified 35 commercial relationships totaling \$25.3 million as potential problem loans. Factors such as payment history, value of supporting collateral, and personal or government guarantees led us to conclude that the current risk exposure on these loans did not warrant accounting for the loans as nonperforming. Although in a performing status as of year-end, these loans exhibited certain risk factors, which have the potential to cause them to become nonperforming at some point in the future.

The overall level of our performing loans that demonstrate characteristics of potential weakness from time-to-time is for the most part dependent on economic conditions in northeastern New York State, which in turn are impacted at least in part by economic conditions in the U.S. generally.

3. Foreign Outstandings - None

4. Loan Concentrations

The loan portfolio is well diversified. There are no concentrations of credit that exceed 10% of the portfolio, other than the general categories reported in the preceding Section C.II.a. of this Item 7. For further discussion, see Note 24 to the Consolidated Financial Statements in Part II, Item 8 of this Report.

5. Other Real Estate Owned and Repossessed Assets

Other real estate owned (OREO) consists of real property acquired in foreclosure. OREO is carried at the lower of (i) fair value less estimated cost to sell or (ii) the recorded investment in the loan at the date of foreclosure, or cost. We establish allowances for OREO losses, which are established and monitored on a property-by-property basis and reflect our ongoing estimate of the property's estimated fair value less costs to sell (when such amount is less than cost). For all periods, all OREO was held for sale. Repossessed assets for each of the five years in the table below consist almost entirely of motor vehicles.

Distribution of OREO and Repossessed Assets

(In Thousands)

	December 31,				
	<u>2008</u>	<u>2007</u>	<u>2006</u>	<u>2005</u>	<u>2004</u>
Single Family 1 - 4 Units	\$581	\$ 89	\$ 48	\$ ---	\$ ---
Commercial Real Estate	<u>---</u>	<u>---</u>	<u>200</u>	<u>---</u>	<u>---</u>
Other Real Estate Owned, Net	581	89	248	---	---
Reposessed Assets	<u>64</u>	<u>63</u>	<u>144</u>	<u>124</u>	<u>136</u>
Total OREO and Repossessed Assets	<u>\$645</u>	<u>\$152</u>	<u>\$392</u>	<u>\$124</u>	<u>\$136</u>

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

Schedule of Changes in OREO

(In Thousands)

	<u>2008</u>	<u>2007</u>	<u>2006</u>	<u>2005</u>	<u>2004</u>
Balance at Beginning of Year	\$ 89	\$248	\$ ---	\$ ---	\$ ---
Properties Acquired Through Foreclosure	581	115	248	295	---
Sales	<u>(89)</u>	<u>(274)</u>	<u>---</u>	<u>(295)</u>	<u>---</u>
Balance at End of Year	<u>\$581</u>	<u>\$ 89</u>	<u>\$248</u>	<u>\$ ---</u>	<u>\$ ---</u>

There was no allowance for OREO losses at year-end 2008, 2007 or 2006. We started 2008 with one property in OREO. During the year we acquired four more and sold one, ending the year with four properties. We started 2007 with two properties in OREO. During the year we acquired two more and sold three, ending the year with just one property. We started 2006 with no properties in OREO. During the year we acquired two properties, which remained unsold at year-end. We started 2005 with no properties in OREO. During the year we acquired and sold four properties, ending the year with no properties in OREO. We started 2004 with no properties in OREO. During 2004, we did not acquire or sell any real estate acquired through foreclosure.

III. SUMMARY OF LOAN LOSS EXPERIENCE

The information required in this section is presented in the discussion of the Provision for Loan Losses and Allowance for Loan Losses in Part II Item 7.B.II. beginning on page 26 of this Report, including:

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Charge-offs and Recoveries by loan type

.

Factors that led to the amount of the Provision for Loan Losses

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Allocation of the Allowance for Loan Losses by loan type

The percent of loans in each loan category is presented in the table of loan types in the preceding section on page 33 of this report.

IV. DEPOSITS

The following table sets forth the average balances of and average rates paid on deposits for the periods indicated.

AVERAGE DEPOSIT BALANCES

Years Ended December 31,

(Dollars In Thousands)

	<u>2008</u>		<u>2007</u>		<u>2006</u>	
	Average		Average		Average	
	<u>Balance</u>	<u>Rate</u>	<u>Balance</u>	<u>Rate</u>	<u>Balance</u>	<u>Rate</u>
Demand Deposits	\$ 189,999	--%	\$ 186,474	--%	\$ 182,706	--%
Interest-Bearing Demand Deposits	367,351	1.41	315,614	2.18	290,860	1.75
Regular and Money Market Savings	281,208	1.21	266,007	1.49	283,253	1.27
Time Deposits of \$100,000 or More	172,055	3.25	180,606	4.78	161,729	4.43
Other Time Deposits	<u>243,247</u>	3.55	<u>258,042</u>	4.42	<u>248,706</u>	3.85
Total Deposits	<u>\$1,253,860</u>	1.82	<u>\$1,206,743</u>	2.56	<u>\$1,167,254</u>	2.18

During 2008, average deposit balances increased by \$47.1 million, or 3.9%, over the average for 2007. The increase was generated from our branch network.

During 2007, average deposit balances increased by \$39.5 million, or 3.4%, over the average for 2006. The increase was generated from our branch network, including a new branch in Plattsburgh in the beginning of 2007 and another in the Saratoga Springs area in April of 2007.

We did not sell or close any branches during the covered period, 2006-2008.

The following table presents the quarterly average balance by deposit type for each of the most recent five quarters.

DEPOSIT PORTFOLIO

Quarterly Average Deposit Balances (Dollars In Thousands)

	Quarter Ending				
	<u>Dec 2008</u>	<u>Sep 2008</u>	<u>Jun 2008</u>	<u>Mar 2008</u>	<u>Dec 2007</u>
Demand Deposits	\$ 188,638	\$ 200,193	\$ 188,949	\$ 182,118	\$ 190,002
Interest-Bearing Demand Deposits	406,206	353,171	370,458	339,296	353,655
Regular and Money Market Savings	285,986	288,307	284,695	265,712	263,784
Time Deposits of \$100,000 or More	165,725	178,041	156,850	187,610	174,915
Other Time Deposits	<u>244,155</u>	<u>242,069</u>	<u>238,297</u>	<u>248,471</u>	<u>250,260</u>
Total Deposits	<u>\$1,290,710</u>	<u>\$1,261,781</u>	<u>\$1,239,249</u>	<u>\$1,223,207</u>	<u>\$1,232,616</u>

Fluctuations in balances of our NOW accounts and time deposits of \$100,000 or more are largely the result of municipal deposit fluctuations. Municipal deposits on average represent 15% to 20% of our total deposits. Municipal deposits are typically placed in NOW accounts and time deposits of short duration. Many of our municipal deposit relationships are subject to annual renewal, by formal or informal agreements.

In general, there is a seasonal pattern to municipal deposits starting with a low point during July and August. Account balances tend to increase throughout the fall and into the winter months from tax deposits and receive an additional boost at the end of March from the electronic deposit of state funds. 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.

For a variety of reasons, including the seasonality of municipal deposits, we typically experience little net growth or a small contraction in average deposit balances in the first quarter of each calendar year, versus significant growth in the second quarter. Deposit balances followed this pattern for the first two quarters of 2008 as the average balance decreased \$9.4 million, or 0.8%, in the first quarter of 2008, from the fourth quarter of 2007, while the average deposit balance for the second quarter of 2008 increased \$16.0 million, or 1.3%, from the first quarter of 2008. During the third quarter of 2008, the average balance of our municipal deposits decreased by \$11.4 million, but this decrease was more than offset by a \$33.9 million increase in the average balance of our non-municipal accounts. During the fourth quarter of 2008, average deposit balances increased by \$28.9 million, nearly all of which was attributable to a seasonal increase in municipal balances.

We typically experience a shift within the mix of deposit categories during periods of significant interest rate increases or decreases. During periods of falling rates, like the period from mid-2007 through the end of 2008, depositors tend to transfer maturing time deposits to nonmaturity interest-bearing deposit products. This has been the case for the past four quarters. At December 31, 2008 time deposits represented 31.7% of total deposits, down from 34.5% at December 31, 2007. This compares to recent historical lows and highs of 22.5% at June 30, 2004 and 40.8% at June 30, 2000. We expect this shift from time deposits to nonmaturity deposit products to continue if rates remain at their current low levels.

The total quarterly average balances as a percentage of total deposits are illustrated in the table below.

Percentage of Total Quarterly Average Deposits	Quarter Ending				
	<u>Dec 2008</u>	<u>Sep 2008</u>	<u>Jun 2008</u>	<u>Mar 2008</u>	<u>Dec 2007</u>
Demand Deposits	14.6%	15.9%	15.2%	14.9%	15.4%
Interest-Bearing Demand Deposits	31.5	28.0	29.9	27.8	28.7
Regular and Money Market Savings	22.2	22.8	23.0	21.7	21.4
Time Deposits of \$100,000 or More	12.8	14.1	12.7	15.3	14.2
Other Time Deposits	<u>18.9</u>	<u>19.2</u>	<u>19.2</u>	<u>20.3</u>	<u>20.3</u>
Total Deposits	<u>100.0%</u>	<u>100.0%</u>	<u>100.0%</u>	<u>100.0%</u>	<u>100.0%</u>

Time deposits of \$100,000 or more are to a large extent comprised of municipal deposits and are obtained on a competitive bid basis.

Quarterly Cost of Deposits	Quarter Ending				
	<u>Dec 2008</u>	<u>Sep 2008</u>	<u>Jun 2008</u>	<u>Mar 2008</u>	<u>Dec 2007</u>
Demand Deposits	---%	---%	---%	---%	---%
Interest-Bearing Demand Deposits	1.28	1.31	1.38	1.69	2.34
Regular and Money Market Savings	1.02	1.19	1.25	1.39	1.52
Time Deposits of \$100,000 or More	2.87	2.88	3.11	4.05	4.60
Other Time Deposits	3.25	3.23	3.46	4.23	4.42
Total Deposits (Including Non-Interest-Bearing)	1.61	1.67	1.76	2.25	2.55

In general, rates paid by us on various types of deposit accounts are influenced by the rates being offered or paid by our competitors, which in turn are influenced by prevailing interest rates in the economy as impacted from time to time by the actions of the Federal Reserve Bank. There typically is a time lag between the Federal Reserve's actions undertaken to influence rates and the actual repricing of our deposit liabilities, although this lag is normally shorter than the lag between Federal Reserve actions and the repricing of our loans and other earning assets.

As demonstrated in the table above, we experienced a steady decrease in the cost of our deposits in each of the past 5 quarters during the period of falling interest rates from mid-2007 through the end of 2008. Although maturing time deposits will reprice at lower rates in forthcoming periods, most of our nonmaturity deposit products have already been reduced to (or nearly to) the lowest sustainable levels.

We do not use brokered deposits as a regular funding source and there were not any such balances carried during 2008, 2007 or 2006.

V. TIME DEPOSITS OF \$100,000 OR MORE

The maturities of time deposits of \$100,000 or more at December 31, 2008 are presented below. (In Thousands)

Maturing in:	
Under Three Months	\$56,115
Three to Six Months	33,566
Six to Twelve Months	35,346
2010	10,605
2011	1,268
2012	16,657
2013	<u>3,630</u>
Total	<u>\$157,187</u>

D. LIQUIDITY

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

Overnight investments in federal funds sold, interest bearing bank balances at the Federal Reserve Bank in addition to cash flow from investment securities and loans, both from normal repayment cash-flows and the ability to quickly pledge marketable investment securities and loans to obtain funds, represent our primary sources of available liquidity. Certain investment securities are selected at purchase as available-for-sale based on their marketability and collateral value, as well as their yield and maturity. Our securities available-for-sale portfolio was \$325.1 million at year-end 2008. Due to the volatility in market values, we are not able to assume that large quantities of such securities could be sold at short notice at their carrying value to provide needed liquidity. But, if market conditions are favorable resulting in unrealized gains in the available-for-sale portfolio, we may pursue modest sales of such securities conducted in an orderly fashion to provide needed liquidity.

In addition to liquidity from short-term investments, investment securities and loans, we have supplemented available liquidity with additional off-balance sheet sources such as federal funds lines of credit and credit lines with the Federal Home Loan Bank of New York (FHLBNY). We have established federal funds lines of credit with three correspondent banks totaling \$30 million. The average balance throughout 2008 was only \$369 thousand and there was no period-end balance. We have established overnight and 30 day term lines of credit with the FHLBNY; each of these lines provided for a maximum borrowing line of \$124.0 million at December 31, 2008. We borrowed only occasionally from the overnight line of credit with the FHLBNY during 2008. The average balance throughout 2008 was \$1.4 million and there was no period-end balance. If advanced, such lines of credit are collateralized by mortgage-backed securities, loans and FHLBNY stock. The balance in other short-term borrowings at December 31, 2008 consisted entirely of treasury, tax and loan balances at the Federal Reserve Bank of New York.

In addition, we have identified brokered certificates of deposit as an appropriate off-balance sheet source of funding accessible in a relatively short time period. Also, Glens Falls National has established a borrowing facility with the Federal Reserve Bank of New York, pledging certain consumer loans as collateral for potential discount window advances. At December 31, 2008, the amount available under this facility was \$223.0 million, but there were no advances then outstanding. We measure and monitor our basic liquidity as a ratio of liquid assets to short-term liabilities, both with and without the availability of borrowing arrangements. Based on the level of overnight funds investments, available liquidity from our investment securities portfolio, cash flow from our loan portfolio, our stable core deposit base and our significant borrowing capacity, we believe that our liquidity is sufficient to meet any reasonably likely events or occurrences.

During the past several quarters, the financial markets have been challenging for many financial institutions. As a result of these market conditions, liquidity premiums have widened and many banks have experienced certain liquidity constraints, substantially increased pricing to retain deposit balances or utilized the Federal Reserve System discount window to secure adequate funding. Because of Arrow's favorable credit quality and strong balance sheet, Arrow has not experienced any significant liquidity constraints through the end of 2008. During the past several quarters, Arrow's liquidity position has been strong, as depositors and investors in the wholesale funding markets seek strong financial institutions.

E. CAPITAL RESOURCES AND DIVIDENDS

Shareholders' equity was \$125.8 million at December 31, 2008, an increase of \$3.5 million, or 2.9%, from the prior year-end. The most significant positive changes to shareholders' equity included (a) net income of \$20.4 million and (b) net unrealized gains in the valuation allowance for available-for-sale securities (\$2.5 million, net of tax) which were only partially offset by: (i) cash dividends (\$10.3 million), (ii) a net retirement plan loss reflected as a component of other comprehensive loss (\$6.9 million) (iii) purchases of our own common stock (\$4.3 million) and, (iv) our guarantee of a \$1.0 million loan to our Employee Stock Ownership Plan (ESOP) which requires a reduction in shareholders' equity for the shares acquired with loan proceeds that have not yet been allocated to employees.

In each of 2004 and 2003, we enhanced our regulatory capital by issuing \$10 million of capital securities in private placements with institutional investors, utilizing a subsidiary Delaware business trust for that purpose. These trust preferred securities were reflected as Junior Subordinated Obligations Issued to Unconsolidated Subsidiary Trusts on our consolidated balance sheets as of December 31, 2008 and 2007. These securities have certain features that make them an attractive funding vehicle. Under the Federal Reserve's regulatory capital guidelines discussed below, trust preferred securities may qualify as Tier 1 capital, in an amount not to exceed 25% of Tier 1 capital, net of goodwill less any associated deferred tax liability. Both of our issues of trust preferred securities qualify in their entirety as Tier 1 regulatory capital.

The maintenance of appropriate capital levels is a management priority. Overall capital adequacy is monitored on an ongoing basis by management and reviewed regularly by the Board of Directors. Our principal capital planning goal is to provide an adequate return to shareholders while retaining a sufficient base to provide for future expansion and comply with all regulatory standards.

Our continuing strong capital base and financial condition were key factors in our decision in January of 2009, to decline a capital investment by the U.S. Treasury under their CPP (see page 8).

One set of regulatory capital guidelines applicable to our holding company and subsidiary banks are the so-called risk-based capital measures. Under these measures, as established by federal bank regulators, the minimum ratio of "Tier 1" capital to risk-weighted assets is 4.0% and the minimum ratio of total capital to risk-weighted assets is 8.0%. For Arrow, Tier 1 capital is comprised of common shareholders' equity and the trust preferred securities issued by our two unconsolidated subsidiaries (see the second previous paragraph), less intangible assets. Total capital for the risk-based capital guidelines includes Tier 1 capital plus other qualifying regulatory capital, including a portion of our allowance for loan losses.

In addition to the risk-based capital measures, the federal bank regulatory agencies require banks and bank holding companies to satisfy another capital guideline, the Tier 1 leverage ratio (Tier 1 capital to quarterly average assets less intangible assets). The minimum Tier 1 leverage ratio is 3.0% for the most highly rated institutions. The guidelines provide that other institutions should maintain a Tier 1 leverage ratio that is at least 1.0% to 2.0% higher than the 3.0% minimum level for top-rated institutions.

The table below sets forth the capital ratios of our holding company and subsidiary banks, Glens Falls National and Saratoga National, as of December 31, 2008:

<u>Capital Ratios:</u>	<u>Arrow</u>	<u>GFNB</u>	<u>SNB</u>
Risk-Based Tier 1 Ratio	13.1%	13.3%	12.1%

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Total Risk-Based Capital Ratio	14.3	14.5	13.4
Tier 1 Leverage Ratio	8.5	8.4	9.1

At December 31, 2008 our holding company and both banks exceeded the minimum capital ratios established by the regulatory guidelines, and qualified as "well-capitalized", the highest category, in the capital classification scheme set by federal bank regulatory agencies (see the further discussion under "Supervision and Regulation" in Part I Item 1.C. of this Report).

The source of funds for the payment of shareholder dividends by our holding company consists primarily of dividends declared and paid to the holding company by our bank subsidiaries. In addition to regulatory constrictions on payments of dividends, there are statutory limitations applicable to the payment of dividends by our bank subsidiaries.

As of December 31, 2008, under this statutory limitation, the maximum amount that could have been paid by the bank subsidiaries to the holding company, without special regulatory approval, was approximately \$13.2 million. The ability of our holding company and our banks to pay dividends in the future is and will continue to be influenced by regulatory policies, capital guidelines and applicable laws.

See Part II, Item 5, "Market for the Registrant's Common Equity and Related Stockholder Matters and Issuer Purchases of Equity Securities" for a recent history of our cash dividend payments.

F. OFF-BALANCE SHEET ARRANGEMENTS

In the normal course of operations, we may engage in a variety of financial transactions that, in accordance with generally accepted accounting principles, are not recorded in the financial statements, or are recorded in amounts that differ from the notional amounts. These transactions involve, to varying degrees, elements of credit, interest rate, and liquidity risk. Such transactions may be used by us for general corporate purposes or for customer needs. Corporate purpose transactions may be used to help manage credit, interest rate, and liquidity risk or to optimize capital. Customer transactions may be used to manage customers' requests for funding.

We have no off-balance sheet arrangements that are reasonably likely to have a material current or future effect on our financial condition, revenues or expenses, results of operations, liquidity or capital expenditures.

G. CONTRACTUAL OBLIGATIONS (In Thousands)

<u>Contractual Obligation</u>	<u>Total</u>	<u>Payments Due by Period</u>			
		Less Than			More Than 5
		<u>1 Year</u>	<u>1-3 Years</u>	<u>3-5 Years</u>	<u>Years</u>
Long-Term Debt Obligations:					
Federal Home Loan Bank Advances ¹	\$160,000	\$20,000	\$80,000	\$50,000	\$10,000
Junior Subordinated Obligations	20,000	---	---	---	20,000

Issued to Unconsolidated

Subsidiary Trusts²

Operating Lease Obligations ³	3,229	398	689	706	1,436
Obligations under Retirement Plans ⁴	<u>29,542</u>	<u>2,698</u>	<u>5,569</u>	<u>6,052</u>	<u>15,223</u>
Total	<u>\$212,771</u>	<u>\$23,096</u>	<u>\$86,258</u>	<u>\$56,758</u>	<u>\$46,659</u>

¹ See Note 11 to the Consolidated Financial Statements in Item 8 of this Report for additional information on Federal Home Loan Bank Advances, including call provisions.

² See Note 12 to the Consolidated Financial Statements in Item 8 of this Report for additional information on Junior Subordinated Obligations Issued to Unconsolidated Subsidiary Trusts (trust preferred securities).

³ See Note 21 to the Consolidated Financial Statements in Item 8 of this Report for additional information on our Operating Lease Obligations.

⁴ See Note 16 to the Consolidated Financial Statements in Item 8 of this Report for additional information on our Retirement Plans.

H. FOURTH QUARTER RESULTS

We reported net income of \$5.0 million for the fourth quarter of 2008, an increase of \$531 thousand, or 11.9%, from the fourth quarter of 2007. Diluted earnings per common share for the fourth quarter of 2008 were \$.47, an increase of \$.05, or 11.9%, from the \$.42 amount for the fourth quarter of 2007. The net change in earnings was primarily affected by the following: (a) a \$3.1 million increase in tax-equivalent net interest income, (b) a \$136 thousand increase in noninterest income, offset by (i) a \$689 thousand increase in the provision for loan losses, (ii) a \$1.5 million increase in noninterest expense, and (iii) a \$576 thousand increase in the provision for income taxes. The factors contributing to these quarter-to-quarter changes are included in the discussion of the year-to-year changes elsewhere in this Report.

SELECTED FOURTH QUARTER FINANCIAL INFORMATION

(Dollars In Thousands, Except Per Share Amounts)

	For the Quarters Ended	
	December 31,	
	<u>2008</u>	<u>2007</u>
Interest and Dividend Income	\$22,719	\$22,431
Interest Expense	<u>7,541</u>	<u>10,413</u>
Net Interest Income	15,178	12,018
Provision for Loan Losses	<u>880</u>	<u>191</u>
Net Interest Income after Provision for Loan Losses	14,298	11,827
Noninterest Income	4,152	4,016
Noninterest Expense	<u>11,273</u>	<u>9,773</u>
Income Before Provision for Income Taxes	7,177	6,070
Provision for Income Taxes	<u>2,165</u>	<u>1,589</u>
Net Income	<u>\$ 5,012</u>	<u>\$ 4,481</u>

SHARE AND PER SHARE DATA:**Weighted Average Number of Shares Outstanding:**

Basic	10,524	10,619
Diluted	10,588	10,682
Basic Earnings Per Common Share	\$.48	\$.42
Diluted Earnings Per Common Share	.47	.42
Cash Dividends Per Common Share	.25	.24

AVERAGE BALANCES:

Assets	\$1,687,366	\$1,601,053
Earning Assets	1,615,240	1,526,148
Loans	1,109,978	1,036,661
Deposits	1,290,710	1,232,616
Shareholders' Equity	127,136	120,433

SELECTED RATIOS (Annualized):

Return on Average Assets	1.18%	1.11%
Return on Average Equity	15.68%	14.76%
Net Interest Margin ¹	3.92%	3.32%
Net Charge-offs to Average Loans	.14%	.05%
Provision for Loan Losses to Average Loans	.32%	.07%

¹Net Interest Margin is the ratio of tax-equivalent net interest income to average earning assets. (See Use of Non-GAAP Financial

Measures on page 4).

Item 7A. Quantitative and Qualitative Disclosures About Market Risk

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

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

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

The simulation model attempts to capture the impact of changing interest rates on the interest income received and interest expense paid on all interest-sensitive assets and liabilities reflected on our consolidated balance sheet. This sensitivity analysis is compared to ALCO policy limits which specify a maximum tolerance level for net interest income exposure over a one year horizon, assuming no balance sheet growth and a 200 basis point upward and a 100 basis point downward shift in interest rates, and a repricing of interest-bearing assets and liabilities at their earliest reasonably predictable repricing date. We normally apply a parallel and pro rata shift in rates over a 12 month period. However, at year-end 2008 the targeted federal funds rate was a range of 0 to .25%. For the decreasing rate simulation we applied a 100 basis point downward shift in interest rates for the long end of the yield curve with short-term rate decreases limited at zero.

Applying the simulation model analysis as of December 31, 2008, a 200 basis point increase in interest rates demonstrated a 0.7% increase in net interest income, and a 100 basis point decrease in interest rates demonstrated a 1.6% decrease in net interest income. These amounts were well within our ALCO policy limits. Historically there has existed an inverse relationship between changes in prevailing rates and our net interest income, reflecting the fact that our liabilities and sources of funds generally reprice more quickly than our earning assets.

The preceding sensitivity analysis does not represent a forecast on our part and should not be relied upon as being indicative of expected operating results. As noted elsewhere in this Report, the Federal Reserve Board took certain actions from September 2007 through December 2008 that resulted in a 500 basis point decrease in prevailing rates. We believe that decreases in prevailing interest rates will generally have a short-term positive impact on our net interest margin and net interest income, which would be mitigated or perhaps reversed over the mid- to longer-term. We believe that increases in prevailing rates will generally have a negative impact on our margin and net interest income in the short-term, which would be mitigated or perhaps reversed over the long-term. In each case, that is, in the case of increasing or decreasing rates, the slope of the yield curve and changes in the slope of the yield curve will

also affect net interest income and the net interest margin. We are not able to predict with certainty what the magnitude of these effects would be.

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

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

Item 8. Financial Statements and Supplementary Data

The following audited consolidated financial statements and unaudited supplementary data are submitted herewith:

Reports of Independent Registered Public Accounting Firm

Financial Statements:

Consolidated Balance Sheets

as of December 31, 2008 and 2007

Consolidated Statements of Income

for the Years Ended December 31, 2008, 2007 and 2006

Consolidated Statements of Changes in Shareholders' Equity

for the Years Ended December 31, 2008, 2007 and 2006

Consolidated Statements of Cash Flows

for the Years Ended December 31, 2008, 2007 and 2006

Notes to Consolidated Financial Statements

Supplementary Data: (Unaudited)

Summary of Quarterly Financial Data for the Years Ended December 31, 2008 and 2007

Report of Independent Registered Public Accounting Firm

The Board of Directors and Stockholders

of Arrow Financial Corporation:

We have audited the accompanying consolidated balance sheets of Arrow Financial Corporation and subsidiaries (the Company) as of December 31, 2008 and 2007, and the related consolidated statements of income, changes in shareholders' equity and cash flows for each of the years in the three-year period ended December 31, 2008. These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Arrow Financial Corporation and subsidiaries as of December 31, 2008 and 2007, and the results of their operations and their cash flows for each of the years in the three-year period ended December 31, 2008, in conformity with U.S. generally accepted accounting principles.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the Company's internal control over financial reporting as of December 31, 2008, based on criteria established in Internal Control - Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO), and our report dated March 5, 2009, expressed an unqualified opinion on the effectiveness of the Company's internal control over financial reporting.

Albany, New York

March 5, 2009

Report of Independent Registered Public Accounting Firm

The Board of Directors and Stockholders

of Arrow Financial Corporation:

We have audited Arrow Financial Corporation's (the Company) internal control over financial reporting as of December 31, 2008, based on criteria established in Internal Control - Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). The Company's management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting, included in the accompanying Management's Report. Our responsibility is to express an opinion on the Company's internal control over financial reporting based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, and testing and evaluating the design and operating effectiveness of internal control based on the assessed risk. Our audit also included performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, Arrow Financial Corporation maintained, in all material respects, effective internal control over financial reporting as of December 31, 2008, based on criteria established in Internal Control Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO).

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheets of Arrow Financial Corporation and subsidiaries as of December 31, 2008 and 2007, and the related consolidated statements of income, changes in shareholders' equity, and cash flows for each of the years in the three-year period ended December 31, 2008, and our report dated March 5, 2009 expressed an unqualified opinion on those consolidated financial statements.

Albany, New York

March 5, 2009

ARROW FINANCIAL CORPORATION AND SUBSIDIARIES

CONSOLIDATED BALANCE SHEETS

(Dollars in Thousands)

	December 31,	
	<u>2008</u>	<u>2007</u>
ASSETS		
Cash and Due from Banks	\$ 37,239	\$ 35,289
Interest-Bearing Bank Balances	21,099	---
Federal Funds Sold	<u>---</u>	<u>16,000</u>
Cash and Cash Equivalents	<u>58,338</u>	<u>51,289</u>
Securities Available-for-Sale	325,090	338,070
Securities Held-to-Maturity (Approximate Fair Value of \$134,331 in 2008 and \$114,977 in 2007)	133,976	114,611
Loans	1,109,812	1,038,844
Allowance for Loan Losses	<u>(13,272)</u>	<u>(12,401)</u>
Net Loans	1,096,540	1,026,443
Premises and Equipment, Net	17,602	16,728
Other Real Estate and Repossessed Assets, Net	645	152
Goodwill	14,726	14,614
Other Intangible Assets, Net	1,652	1,976
Other Assets	<u>16,517</u>	<u>20,963</u>
Total Assets	<u>\$1,665,086</u>	<u>\$1,584,846</u>
LIABILITIES		
Deposits:		
Demand	\$ 182,613	\$ 184,273
Regular Savings, N.O.W. & Money Market Deposit Accounts	688,752	590,383
Time Deposits of \$100,000 or More	157,187	180,334
Other Time Deposits	<u>246,511</u>	<u>249,210</u>
Total Deposits	<u>1,275,063</u>	<u>1,204,200</u>
Short-Term Borrowings:		
Federal Funds Purchased and Securities Sold Under Agreements to Repurchase	59,339	52,630

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Other Short-Term Borrowings	617	1,089
Federal Home Loan Bank Advances	160,000	160,000
Junior Subordinated Obligations Issued to Unconsolidated Subsidiary Trusts		
(Junior Subordinated Obligations)	20,000	20,000
Other Liabilities	<u>24,265</u>	<u>24,671</u>
Total Liabilities	<u>1,539,284</u>	<u>1,462,590</u>

Commitments and Contingent Liabilities (Notes 21 and 22)

SHAREHOLDERS EQUITY

Preferred Stock, \$5 Par Value; 1,000,000 Shares Authorized	---	---
Common Stock, \$1 Par Value; 20,000,000 Shares Authorized		
(14,728,543 Shares Issued at December 31, 2008 and		
at December 31, 2007)	14,729	14,729
Surplus	163,215	161,476
Retained Earnings	25,454	15,347
Unallocated ESOP Shares (122,207 Shares at December 31, 2008		
and 109,885 Shares at December 31, 2007)	(2,572)	(2,042)
Accumulated Other Comprehensive Loss	(9,404)	(4,890)
Treasury Stock, at Cost (4,060,209 Shares at December 31,		
2008 and 3,991,399 Shares at December 31, 2007)	<u>(65,620)</u>	<u>(62,364)</u>
Total Shareholders Equity	<u>125,802</u>	<u>122,256</u>
Total Liabilities and Shareholders Equity	<u>\$1,665,086</u>	<u>\$1,584,846</u>

See Notes to Consolidated Financial Statements.

ARROW FINANCIAL CORPORATION AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF INCOME

(In Thousands, Except Per Share Amounts)

	Years Ended December 31,		
	<u>2008</u>	<u>2007</u>	<u>2006</u>
INTEREST AND DIVIDEND INCOME			
Interest and Fees on Loans	\$67,638	\$65,904	\$61,244
Interest-Bearing Bank Balances	57	---	---
Interest on Federal Funds Sold	464	1,098	454
Interest and Dividends on Securities Available-for-Sale	16,956	15,317	14,917
Interest on Securities Held-to-Maturity	<u>4,393</u>	<u>4,258</u>	<u>3,996</u>
Total Interest and Dividend Income	<u>89,508</u>	<u>86,577</u>	<u>80,611</u>
INTEREST EXPENSE			
Interest on Deposits:			
Time Deposits of \$100,000 or More	5,591	8,628	7,158
Other Deposits	17,199	22,234	18,264
Interest on Short-Term Borrowings:			
Federal Funds Purchased and Securities Sold			
Under Agreements to Repurchase	779	1,367	1,119
Other Short-Term Borrowings	10	22	31
Federal Home Loan Bank Advances	7,462	6,627	6,789
Junior Subordinated Obligations Issued to Unconsolidated Subsidiary Trusts	<u>1,236</u>	<u>1,405</u>	<u>1,382</u>
Total Interest Expense	<u>32,277</u>	<u>40,283</u>	<u>34,743</u>
NET INTEREST INCOME	57,231	46,294	45,868
Provision for Loan Losses	<u>1,671</u>	<u>513</u>	<u>826</u>
NET INTEREST INCOME AFTER PROVISION FOR LOAN LOSSES	<u>55,560</u>	<u>45,781</u>	<u>45,042</u>
NONINTEREST INCOME			
Income from Fiduciary Activities	5,463	5,572	5,082
Fees for Other Services to Customers	8,562	8,130	7,954
Net Gains (Losses) on Securities Transactions	383	---	(102)
Other-Than-Temporary Impairment on Investment Securities	(1,610)	---	---
Gain on Visa Stock Redemption	749	---	---
Gain on Sale of Premises	115	---	227

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Insurance Commissions	2,066	1,869	1,768
Other Operating Income	<u>541</u>	<u>717</u>	<u>852</u>
Total Noninterest Income	<u>16,269</u>	<u>16,288</u>	<u>15,781</u>
NONINTEREST EXPENSE			
Salaries and Employee Benefits	24,551	21,424	22,096
Occupancy Expense of Premises, Net	3,479	3,198	3,058
Furniture and Equipment Expense	3,211	3,015	2,971
Other Operating Expense	<u>11,152</u>	<u>10,293</u>	<u>8,682</u>
Total Noninterest Expense	<u>42,393</u>	<u>37,930</u>	<u>36,807</u>
INCOME BEFORE PROVISION FOR INCOME TAXES	29,436	24,139	24,016
Provision for Income Taxes	<u>8,999</u>	<u>6,807</u>	<u>7,124</u>
NET INCOME	<u>\$20,437</u>	<u>\$17,332</u>	<u>\$16,892</u>
Average Shares Outstanding:			
Basic	10,565	10,714	10,922
Diluted	10,622	10,786	11,067
Per Common Share:			
Basic Earnings	\$ 1.93	\$ 1.62	\$ 1.55
Diluted Earnings	1.92	1.61	1.53

All share and per share amounts have been adjusted for the 2008 3% stock dividend.

See Notes to Consolidated Financial Statements.

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

(In Thousands, Except Share and Per Share Amounts)

	Common Shares <u>Issued</u>	Common <u>Stock</u>	<u>Surplus</u>	Retained <u>Earnings</u>	Unallo- cated ESOP <u>Shares</u>	Accumulated Other Com- prehensive Income <u>(Loss)</u>	Treasury <u>Stock</u>	<u>Total</u>
Balance at December 31, 2005	13,883,064	\$13,883	\$139,442	\$21,402	\$(1,163)	\$ (4,563)	\$(51,580)	\$117,421
Comprehensive Income, Net of Tax:								
Net Income	---	---	---	16,892	---	---	---	<u>16,892</u>
Net Unrealized Securities Holding								
Losses Arising During the Period,								
Net of Tax (Pre-tax \$36)	---	---	---	---	---	(21)	---	(21)
Reclassification Adjustment for								
Net Securities Losses Included								
in Net Income, Net of Tax								
(Pre-tax \$102)	---	---	---	---	---	61	---	<u>61</u>
Other Comprehensive Income								<u>40</u>
Comprehensive Income								<u>16,932</u>

Adjustment to Initially
Apply FASBStatement No. 158, Net
of Tax

(Pre-tax \$5,725)	---	---	---	---	---	(3,442)	---	(3,442)
3% Stock Dividend	416,492	417	10,329	(10,746)	---	---	---	---
Cash Dividends Paid, \$.91 per Share	---	---	---	(9,929)	---	---	---	(9,929)
Stock Options Exercised								
(63,415 Shares)	---	---	144	---	---	---	580	724
Shares Issued Under the Directors' Stock								
Plan (5,370 Shares)	---	---	82	---	---	---	48	130
Shares Issued Under the Employee Stock								
Purchase Plan (20,642 Shares)	---	---	315	---	---	---	185	500
Stock-Based Compensation Expense	---	---	5	---	---	---	---	5
Tax Benefit for Disposition of								
Stock Options	---	---	315	---	---	---	---	315
Purchase of Treasury Stock								
(202,335 Shares)	---	---	---	---	---	---	(5,127)	(5,127)
Acquisition of Subsidiary (1,466 Shares)	---	---	28	---	---	---	13	41
Allocation of ESOP Stock (21,969 Shares)	---	---	259	---	301	---	---	560
Balance at December 31, 2006	<u>14,299,556</u>	<u>\$14,300</u>	<u>\$150,919</u>	<u>\$17,619</u>	<u>\$ (862)</u>	<u>\$ (7,965)</u>	<u>\$(55,881)</u>	<u>\$118,130</u>

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ARROW FINANCIAL CORPORATION AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY, Continued

(In Thousands, Except Share and Per Share Amounts)

	Common Shares <u>Issued</u>	Common Stock	Surplus	Retained Earnings	Unallo- cated ESOP Shares	Accumulated Other Com- prehensive Income <u>(Loss)</u>	Treasury Stock	Total
Balance at December 31, 2006	14,299,556	\$14,300	\$150,919	\$17,619	\$ (862)	\$ (7,965)	\$(55,881)	\$118,130
Comprehensive Income, Net of Tax:								
Net Income	---	---	---	17,332	---	---	---	<u>17,332</u>
Net Unrealized Securities Holding Gains								
Arising During the Period, Net of Tax								
(Pre-tax \$6,137)	---	---	---	---	---	3,691	---	3,691
Net Retirement Plan Loss (Pre-tax \$1,524)	---	---	---	---	---	(939)	---	(939)
Net Retirement Plan Prior Service Credit								
(Pre-tax \$329)	---	---	---	---	---	199	---	199
Amortization of Net Retirement Plan								
Actuarial Loss (Pre-tax \$444)	---	---	---	---	---	268	---	268
Accretion of Net	---	---	---	---	---	(144)	---	<u>(144)</u>

Retirement Plan
PriorService Credit
(Pre-tax \$239)Other
Comprehensive
Income3,075Comprehensive
Income20,407

3% Stock Dividend	428,987	429	9,148	(9,577)	---	---	---	---
Cash Dividends Paid, \$.94 per Share	---	---	---	(10,027)	---	---	---	(10,027)
Stock Options Exercised								
(69,236 Shares)	---	---	498	---	---	---	557	1,055
Shares Issued Under the Directors' Stock								
Plan (6,354 Shares)	---	---	90	---	---	---	50	140
Shares Issued Under the Employee Stock								
Purchase Plan (22,749 Shares)	---	---	308	---	---	---	181	489
Stock-Based Compensation Expense	---	---	70	---	---	---	---	70
Tax Benefit for Disposition of								
Stock Options	---	---	164	---	---	---	---	164
Purchase of Treasury Stock								
(327,562 Shares)	---	---	---	---	---	---	(7,303)	(7,303)
Acquisition of Subsidiary (4,317 Shares)	---	---	79	---	---	---	32	111
Acquisition of Shares by ESOP								
(67,190 Shares)	---	---	---	---	(1,500)	---	---	(1,500)
	<u>---</u>	<u>---</u>	<u>200</u>	<u>---</u>	<u>320</u>	<u>---</u>	<u>---</u>	<u>520</u>

Allocation of ESOP

Stock (23,317

Shares)

Balance at December
31, 2007

<u>14,728,543</u>	<u>\$14,729</u>	<u>\$161,476</u>	<u>\$15,347</u>	<u>\$(2,042)</u>	<u>\$ (4,890)</u>	<u>\$(62,364)</u>	<u>\$122,256</u>
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ARROW FINANCIAL CORPORATION AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY, Continued

(In Thousands, Except Share and Per Share Amounts)

	Common Shares Issued	Common Stock	Surplus	Retained Earnings	Unallo- cated ESOP Shares	Accumulated Other Com- prehensive Income (Loss)	Treasury Stock	Total
Balance at December 31, 2007	14,728,543	\$14,729	\$161,476	\$15,347	\$(2,042)	\$(4,890)	\$(62,364)	\$122,256
Comprehensive Income, Net of Tax:								
Net Income	---	---	---	20,437	---	---	---	<u>20,437</u>
Net Unrealized Securities Holding Gains								
Arising During the Period, Net of Tax								
(Pre-tax \$2,860)	---	---	---	---	---	1,727	---	1,727
Reclassification Adjustment for								
Net Securities Gains Included								
in Net Income, Net of Tax								
(Pre-tax \$383)	---	---	---	---	---	(230)	---	(230)
Reclassification Adjustment for Other-Than-	---	---	---	---	---	972	---	972

Temporary Impairment, Net of Tax (Pre-tax \$1,610)								
Net Retirement Plan Loss (Pre-tax \$11,471)	---	---	---	---	---	(6,928)	---	(6,928)
Net Retirement Plan Prior Service Cost (Pre-tax \$336)	---	---	---	---	---	(202)	---	(202)
Amortization of Net Retirement Plan Actuarial Loss (Pre-tax \$443)	---	---	---	---	---	268	---	268
Accretion of Net Retirement Plan Prior Service Credit (Pre-tax \$200)	---	---	---	---	---	(121)	---	<u>(121)</u>
Other Comprehensive Loss								<u>(4,514)</u>
Comprehensive Income								<u>15,923</u>
Cash Dividends Paid, \$.98 per Share	---	---	---	(10,330)	---	---	---	(10,330)
Stock Options Exercised (79,823 Shares)	---	---	503	---	---	---	673	1,176
Shares Issued Under the Directors' Stock Plan (5,185 Shares)	---	---	78	---	---	---	43	121
Shares Issued Under the Employee Stock Purchase Plan (19,286 Shares)	---	---	266	---	---	---	162	428
Shares Issued for Dividend Reinvestment	---	---	282	---	---	---	148	430

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Plans (17,568 Shares)								
Stock-Based Compensation Expense	---	---	115	---	---	---	---	115
Tax Benefit for Disposition of								
Stock Options	---	---	176	---	---	---	---	176
Purchase of Treasury Stock								
(195,801 Shares)	---	---	---	---	---	---	(4,325)	(4,325)
Acquisition of Subsidiary (5,129 Shares)	---	---	69	---	---	---	43	112
Acquisition of Shares by ESOP								
(43,262 Shares)	---	---	---	---	(1,000)	---	---	(1,000)
Allocation of ESOP Stock (30,940 Shares)	---	---	250	---	470	---	---	720
Balance at December 31, 2008	<u>14,728,543</u>	<u>\$14,729</u>	<u>\$163,215</u>	<u>\$25,454</u>	<u>\$(2,572)</u>	<u>\$(9,404)</u>	<u>\$(65,620)</u>	<u>\$125,802</u>

See Notes to Consolidated Financial Statements.

ARROW FINANCIAL CORPORATION AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CASH FLOWS

(Dollars in Thousands)

	Years Ended December 31,		
	<u>2008</u>	<u>2007</u>	<u>2006</u>
Operating Activities:			
Net Income	\$20,437	\$17,332	\$16,892
Adjustments to Reconcile Net Income to Net Cash Provided by Operating Activities:			
Provision for Loan Losses	1,671	513	826
Depreciation and Amortization	2,571	2,868	3,025
Compensation Expense for Allocated ESOP Shares	250	200	259
Gains on the Sale of Securities Available-for-Sale	(422)	---	(94)
Losses on the Sale of Securities Available-for-Sale	39	---	196
Other-Than-Temporary Impairment	1,610	---	---
Loans Originated and Held-for-Sale	(2,311)	(4,627)	(5,077)
Proceeds from the Sale of Loans Held-for-Sale	6,830	4,680	5,436
Net Gains on the Sale of Loans	(106)	(42)	(74)
Net (Gains) Losses on the Sale of Premises and			
Equipment, Other Real Estate Owned and Repossessed Assets	(133)	19	(234)
Contributions to Pension Plans	(6,810)	(2,288)	(2,386)
Deferred Income Tax Expense	2,203	1,021	344
Shares Issued Under the Directors' Stock Plan	121	140	130
Stock-Based Compensation Expense	115	70	5
Net (Increase) Decrease in Other Assets	(374)	(653)	1,118
Net (Decrease) Increase in Other Liabilities	<u>(96)</u>	<u>1,977</u>	<u>2,812</u>
Net Cash Provided By Operating Activities	<u>25,595</u>	<u>21,210</u>	<u>23,178</u>
Investing Activities:			
Proceeds from the Sale of Securities Available-for-Sale	29,079	2,228	43,988
Proceeds from the Maturities and Calls of Securities Available-for-Sale	106,671	63,189	33,061
Purchases of Securities Available-for-Sale	(120,234)	(81,970)	(67,336)
Proceeds from the Maturities of Securities Held-to-Maturity	21,944	10,085	30,234
Purchases of Securities Held-to-Maturity	(41,493)	(16,419)	(20,832)
Net Increase in Loans	(77,333)	(30,975)	(14,527)
Proceeds from the Sales of Premises and Equipment, Other	1,164	953	1,331

Real Estate Owned and Repossessed Assets			
Purchase of Premises and Equipment	<u>(2,469)</u>	<u>(2,403)</u>	<u>(1,348)</u>
Net Cash (Used In) Provided By Investing Activities	<u>(82,671)</u>	<u>(55,312)</u>	<u>4,571</u>

Financing Activities:

Net Increase in Deposits	70,863	17,803	20,634
Net Increase in Short-Term Borrowings	6,237	5,395	5,270
Federal Home Loan Bank Advances	---	40,000	60,000
Federal Home Loan Bank Repayments	---	(5,000)	(92,000)
Purchase of Treasury Stock	(4,325)	(7,303)	(5,127)
Treasury Stock Issued for Stock-Based Plans	1,604	1,544	1,224
Tax Benefit from Exercise of Stock Options	176	164	315
Treasury Stock Issued for Dividend Reinvestment Plans	430	---	---
Acquisition of Unallocated Common Stock by the ESOP	(1,000)	(1,500)	---
Allocation of Common Stock Purchased by the ESOP	470	320	301
Cash Dividends Paid	<u>(10,330)</u>	<u>(10,027)</u>	<u>(9,929)</u>
Net Cash Provided By (Used In) Financing Activities	<u>64,125</u>	<u>41,396</u>	<u>(19,312)</u>
Net Increase in Cash and Cash Equivalents	7,049	7,294	8,437
Cash and Cash Equivalents at Beginning of Year	<u>51,289</u>	<u>43,995</u>	<u>35,558</u>
Cash and Cash Equivalents at End of Year	<u>\$58,338</u>	<u>\$51,289</u>	<u>\$43,995</u>

Supplemental Disclosures to Statements of Cash Flow Information:

Cash Paid During the Year for:

Interest on Deposits and Borrowings	\$34,415	\$38,892	\$33,656
Income Taxes	6,235	5,902	3,296

Non-cash Investing and Financing Activity:

Transfer of Loans to Other Real Estate Owned and Repossessed Assets	1,152	729	1,000
Changes in Retirement Plans Net Loss and Prior Service Cost, Net of Tax	2,468	3,691	40
Shares Issued for CFG Acquisition	112	111	41
Change in Retirement Plans Net Loss and Prior Service Cost, Net of Tax	(6,983)	(616)	---
Adjustment to Initially Apply SFAS No. 158, Net of Tax	---	---	(3,442)

See Notes to Consolidated Financial Statements.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 1:

SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (In Thousands, Except Per Share Amounts)

Arrow Financial Corporation (Arrow) is a bank holding company organized in 1983 under the laws of New York and registered under the Bank Holding Company Act of 1956. The accounting and reporting policies of Arrow Financial Corporation and its subsidiaries conform to accounting principles generally accepted in the United States of America and general practices within the banking industry in all material respects.

Principles of Consolidation - The financial statements of Arrow and its wholly owned subsidiaries are consolidated and all material inter-company transactions have been eliminated. In the Parent Company Only financial statements in Note 25, the investment in wholly owned subsidiaries is carried under the equity method of accounting. When necessary, prior years consolidated financial statements have been reclassified to conform to the current-year financial statement presentation.

Cash and Cash Equivalents - Cash and cash equivalents include the following items: cash at branches, due from bank balances, cash items in the process of collection, interest-bearing bank balances and federal funds sold. Beginning in the fourth quarter of 2008, the Federal Reserve Bank began paying interest on both required reserve balances and excess reserve balances. Required reserve balances at December 31, 2008 were approximately \$6,590 and excess reserve balances were approximately \$14,509. Excess reserve balances would have been maintained as federal funds sold or overnight Federal Home Loan Bank deposits in prior periods.

Securities - 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. Realized gains and losses are based upon the amortized cost of the specific security sold. Any unrealized losses on securities which reflect a decline in value which is other than temporary are charged to income. The cost of securities is adjusted for amortization of premium and accretion of discount, which is calculated on an effective interest rate method.

Loans and Allowance for Loan Losses - Interest income on loans is accrued and credited to income based upon the principal amount outstanding. Loan fees and costs directly associated with loan originations are deferred and amortized as an adjustment to yield over the lives of the loans originated.

From time-to-time, Arrow has sold (some with servicing retained) residential real estate loans at or shortly after origination. At any point, the amount of loans pending settlement are not material, as well as any loan commitments on loans intended for sale (which under Statement of Financial Accounting Standards (SFAS) No. 133 Accounting for Derivative Instruments and Hedging Activities are considered derivatives). All student loans are sold to Sallie Mae (along with servicing) at origination. Any gain or loss on the sale of loans, along with the value of the servicing right, is recognized at the time of sale as the difference between the recorded basis in the loan and net proceeds from the sale. The balance of loans serviced for others was \$46,402 at December 31, 2008.

Loans are placed on nonaccrual status either due to the delinquency status of principal and/or interest (generally when past due 90 or more days) or a judgment by management that the full repayment of principal and interest is unlikely.

The allowance for loan losses is maintained by charges to operations based upon our best estimate of the probable amount of loans that we will be unable to collect based on current information and events. Provisions to the allowance for loan losses are offset by actual loan charge-offs (net of any recoveries). In general, when consumer loans are 120 days past due, an evaluation of estimated proceeds from the liquidation of the loan's collateral is compared to the loan carrying amount and a charge to the allowance for loan losses is taken for any deficiency. While management uses available information to recognize losses on loans, future additions to the allowance may be necessary based on changes in economic conditions in Arrow's market area. In addition, various Federal and State regulatory agencies, as an integral part of their examination process, review Arrow's allowance for loan losses. Such agencies may require Arrow to recognize additions to the allowance in future periods, based on their judgments about information available to them at the time of their examination, which may not be currently available to management.

Arrow accounts for impaired loans under SFAS No. 114, "Accounting by Creditors for Impairment of a Loan." SFAS No. 114, as amended, which requires that impaired loans, except for large groups of smaller-balance homogeneous loans, be measured based on either the present value of expected future cash flows discounted at the loan's effective interest rate, the loan's observable market price or the fair value of the collateral if the loan is collateral dependent. If the measurement of the impaired loan is less than the recorded investment in the loan, an impairment reserve is recognized as part of the allowance for loan losses.

Arrow applies the provisions of SFAS No. 114 to all impaired commercial and commercial real estate loans over \$250, and to all loans restructured subsequent to the adoption of SFAS No. 114. Allowances for loan losses for the remaining loans are recognized in accordance with SFAS No. 5. Under the provisions of SFAS No. 114, Arrow determines impairment for collateral dependent loans based on the fair value of the collateral less estimated costs to sell. For other loans, impairment is determined by comparing the recorded investment in the loan to the present value of the expected cash flows, discounted at the loan's effective interest rate. Arrow determines the interest income recognition method on a loan-by-loan basis. Based upon the borrowers' payment histories and cash flow projections, interest recognition methods include full accrual or cash basis.

In management's opinion, the balance of the allowance for loan losses, at each balance sheet date, is sufficient to provide for probable loan losses.

NOTE 1:

SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Other Real Estate Owned and Repossessed Assets - Real estate acquired by foreclosure and assets acquired by repossession are recorded at the lower of the recorded investment in the loan or the fair value of the property less estimated costs to sell. Subsequent declines in fair value, after transfer to other real estate owned and repossessed assets are recognized through a valuation allowance. Such declines in fair value along with related operating expenses to administer such properties or assets are charged directly to operating expense.

Premises and Equipment - Premises and equipment are stated at cost, less accumulated depreciation and amortization. Depreciation and amortization included in operating expenses are computed largely on the straight-line method. The provision is based

on the estimated useful lives of the assets (buildings and improvements 20-40 years; furniture and equipment 7-10 years; data processing equipment 5-7 years) and, in the case of leasehold improvements, amortization is computed over the terms of the respective leases or their estimated useful lives, whichever is shorter. Gains or losses on disposition are reflected in earnings.

Income Taxes - Arrow accounts for income taxes under the asset and liability method required by SFAS No. 109

Accounting for Income Taxes. Deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in income tax expense in the period that includes the enactment date. Arrow's policy is that deferred tax assets are reduced by a valuation allowance if, based on the weight of available evidence, it is more likely than not that some or all of the deferred tax assets will not be realized.

On January 1, 2007 Arrow adopted FASB Interpretation No. 48, Accounting for Uncertainty in Income Taxes an interpretation of FASB Statement No. 109 (FIN 48), in 2008. FIN 48 clarified the accounting for uncertainty in income taxes recognized in an enterprise's financial statements in accordance with FASB Statement No. 109,

Accounting for Income Taxes. FIN 48 prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. FIN 48 also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure, and transition. Interest and penalties are recorded as a component of the provision for income taxes, if any. The adoption of this interpretation did not have a material effect on Arrow's results of operations or financial position for the fiscal year ending December 31, 2007.

Goodwill and Other Intangible Assets Under SFAS No. 142 Goodwill and Other Intangible Assets, identifiable intangible assets acquired in a business combination are capitalized and amortized. Any remaining unidentifiable intangible asset is classified as goodwill, for which amortization is not required but which must be evaluated annually for impairment. Annually, Arrow tests for any impairment of goodwill and other intangible assets by comparing the carrying amount of those assets to the fair value of each reporting unit's intangible assets, applying rates derived from recent actual transactions.

In April 2005, Arrow completed the cash purchase of three branches from HSBC Bank USA, N.A. Arrow recorded the following intangible assets as a result of the acquisition: goodwill (\$3,690) and core deposit intangible asset (\$2,247). The value of the core deposit intangible asset is being amortized over ten years.

In November 2004, Arrow acquired all of the outstanding shares of common stock of Capital Financial Group, Inc. in a tax-free exchange for Arrow's common stock (66,630 shares, as restated for stock dividends). As adjusted for subsequent contingency payments, Arrow recorded the following intangible assets as a result of the acquisition (none of which are deductible for income tax purposes): goodwill (\$1,735), covenant (\$117) and expirations (\$686). The value of the covenant is being amortized over five years and the value of the expirations is being amortized over twenty years. The agreement provides for annual contingent future payments of Company stock, based upon earnings, over a five-year period. Management has concluded that, under criteria established by SFAS No. 141, these payments will be recorded as additional goodwill at the time of payment. The amount of additional goodwill recorded in 2008 and 2007 was \$112 (5,129 shares) and \$111 (4,317 shares), respectively.

The carrying amounts of other recognized intangible assets that meet the recognition criteria of SFAS No. 141 Business Combinations and for which separate accounting records have been maintained (core deposit intangibles and mortgage servicing rights), have been included in the consolidated balance sheet as Other Intangible Assets, Net. Core deposit intangibles are being amortized on a straight-line basis over a period of ten to fifteen years.

Arrow has sold residential real estate loans (primarily to Freddie Mac) with servicing retained. Arrow accounts for mortgage servicing rights under SFAS No. 156 Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities. Mortgage servicing rights are recognized as an asset when loans are sold with servicing retained, by allocating the cost of an originated mortgage loan between the loan and servicing right based on estimated relative fair values. The cost allocated to the servicing right is capitalized as a separate asset and amortized in proportion to, and over the period of, estimated net servicing income. Capitalized mortgage servicing rights are evaluated for impairment by comparing the asset's carrying value to its current estimated fair value. Fair values are estimated using a discounted cash flow approach, which considers future servicing income and costs, current market interest rates, and anticipated prepayment, and default rates. Impairment losses are recognized through a valuation allowance for servicing rights having a current fair value that is less than amortized cost. Adjustments to increase (decrease) the valuation allowance are charged (credited) to income as a component of other operating income. There was no allowance for impairment losses at December 31, 2008 or 2007.

NOTE 1:

SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Pension and Postretirement Benefits - Arrow maintains a non-contributory, defined benefit pension plan covering substantially all employees, as well as a supplemental pension plan covering certain executive officers selected by the Board of Directors. The costs of these plans, based on actuarial computations of current and future benefits for employees, are charged to current operating expenses. Arrow also provides certain post-retirement medical, dental and life insurance benefits to substantially all employees and retirees. The cost of post-retirement benefits other than pensions is recognized on an accrual basis as employees perform services to earn the benefits.

On December 31, 2006, Arrow adopted SFAS Statement No. 158, Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans (an amendment of FASB Statements No. 87, 88, 106, and 132R). Issued in September 2006, SFAS No. 158 completed the first phase of FASB's comprehensive project to improve the accounting and reporting for defined benefit pension and other postretirement plans. FAS No. 158 requires an employer to:

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Recognize the funded status of a benefit plan measured as the difference between plan assets at fair value (with limited exceptions) and the benefit obligation in its consolidated balance sheet. For a pension plan, the benefit obligation is the projected benefit obligation; for any other postretirement benefit plan, such as a retiree health care plan, the benefit obligation is the accumulated postretirement benefit obligation.

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Recognize as a component of other comprehensive income (loss), net of tax, the gains or losses and prior service costs or credits that arise during the period but are not recognized as components of net periodic benefit cost pursuant to FASB Statement No. 87, Employers' Accounting for Pensions, or No. 106, Employers' Accounting for Postretirement Benefits Other Than Pensions. Amounts recognized in accumulated other comprehensive income, including the gains or losses, prior service costs or credits, and the transition asset or obligation remaining from the initial application of Statements 87 and 106, are adjusted as they are subsequently recognized as components of net periodic benefit cost pursuant to the recognition and amortization provisions of those Statements.

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Measure defined benefit plan assets and obligations as of the date of the employer's fiscal year-end consolidated balance sheet (with limited exceptions).

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Disclose in the notes to financial statements additional information about certain effects on net periodic benefit cost for the next fiscal year that arise from delayed recognition of the gains or losses, prior service costs or credits, and

transition asset or obligation.

Effective December 31, 2006, SFAS No. 158 required Arrow to recognize the overfunded or underfunded status of our single employer defined benefit postretirement plan as an asset or liability on its consolidated balance sheet and to recognize changes in the funded status in comprehensive income in the year in which the change occurred. However, gains or losses, prior services costs or credits, and transition assets or obligations that have not yet been included in net periodic benefit cost as of the end of 2006, the fiscal year in which SFAS No. 158 was initially applied, were recognized as components of the ending balance of accumulated other comprehensive income (loss), net of tax.

Stock-Based Compensation Plans Arrow has two stock option plans, which are described more fully in Notes 17 and 18. In accordance with SFAS No. 123(R), the company expenses the grant date fair value of options granted. The expense is recognized over the four year vesting period of the grant.

Arrow sponsors an Employee Stock Purchase Plan (ESPP) under which employees purchased Arrow's common stock at a 5% discount below market price at the time of purchase. Under SFAS No. 123(R), a stock purchase plan with a discount of 5% or less is not considered a compensatory plan.

Arrow sponsors an Employee Stock Ownership Plan (ESOP), a qualified defined contribution plan. The ESOP has borrowed funds from one of Arrow's subsidiary banks to purchase Arrow common stock. These loans are accounted for under SOP 93-6, which requires that shares pledged as collateral be reported as a reduction of Arrow's shareholders equity. SOP 93-6 also requires the recognition of compensation expense as shares are released for allocation to individual employee accounts equal to the difference between the current average market price and the purchase price.

Securities Sold Under Agreements to Repurchase - In securities repurchase agreements, Arrow receives cash from a counterparty in exchange for the transfer of securities to a third party custodian's account that explicitly recognizes Arrow's interest in the securities. These agreements are accounted for by Arrow as secured financing transactions, since it maintains effective control over the transferred securities, and meets other criteria for such accounting as specified in SFAS No. 140. Accordingly, the cash proceeds are recorded as borrowed funds, and the underlying securities continue to be carried in Arrow's securities available-for-sale portfolio.

Earnings Per Share (EPS) - Basic EPS excludes dilution and is computed by dividing income available to common stockholders by the weighted average number of common shares outstanding for the period. Diluted EPS reflects the potential dilution that could occur if securities or other contracts to issue common stock were exercised or converted into common stock or resulted in the issuance of common stock that then shared in the earnings of the entity (such as Arrow's stock options), computed using the treasury stock method. Unallocated common shares held by Arrow's Employee Stock Ownership Plan are not included in the weighted average number of common shares outstanding for either the basic or diluted EPS calculation.

NOTE 1:

SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Financial Instruments - Arrow is a party to certain financial instruments with off-balance sheet risk, such as: commercial lines of credit, construction lines of credit, overdraft protection, home equity lines of credit and standby letters of credit. Arrow's policy is to record such instruments when funded. Fair value estimates are made at a specific point in time, based on relevant market information and information about the financial instrument. These estimates do not reflect any premium or discount that could result from offering for sale at one time Arrow's entire holdings of a particular financial instrument. Because no market exists for a significant portion of Arrow's financial instruments, fair value estimates are based on judgments regarding future expected loss experience, current economic conditions, risk characteristics of various financial instruments, and other factors. These estimates are subjective in nature and involve uncertainties and matters of significant judgment and therefore cannot be determined with precision. Changes in assumptions could significantly affect the estimates.

Fair value estimates are based on existing on- and off-balance sheet financial instruments without attempting to estimate the value of anticipated future business and the value of assets and liabilities that are not considered financial instruments. For example, Arrow has a substantial trust department that contributes net fee income annually. The value of trust department customer relationships is not considered a financial instrument, and therefore this value has not been incorporated into the fair value estimates. Other significant assets and liabilities that are not considered financial assets or liabilities include deferred taxes, premises and equipment, the value of low-cost, long-term core deposits and goodwill. In addition, the tax ramifications related to the realization of the unrealized gains and losses can have a significant effect on fair value estimates and have not been considered in any of the estimates.

The carrying amount of the following short-term assets and liabilities is a reasonable estimate of fair value: cash and due from banks, federal funds sold and purchased, securities sold under agreements to repurchase, demand deposits, savings, N.O.W. and money market deposits, other short-term borrowings, accrued interest receivable and accrued interest payable. The fair value estimates of other on- and off-balance sheet financial instruments, as well as the method of arriving at fair value estimates, are included in the related footnotes and summarized in Note 23. As of December 31, 2008 and 2007, and during 2008, 2007 and 2006, Arrow had no derivative instruments within the meaning of SFAS No. 133, Accounting for Derivative Instruments and Hedging Activities, as amended other than loans pending settlement and loan commitments on loans intended for sale, the amounts of which are not material.

Fair Value Measures - We adopted Statement of Financial Accounting Standards (SFAS) Statement No. 157, Fair Value Measurements (SFAS No. 157) on January 1, 2008. SFAS No. 157 defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles (GAAP) and expands disclosures about fair value measurements. SFAS No. 157 establishes a fair value hierarchy that prioritizes the inputs to valuation techniques used to measure fair value. The hierarchy gives the highest priority to unadjusted quoted prices in active markets for identical assets or liabilities (level 1 measurements) and the lowest priority to unobservable inputs (level 3 measurements).

The three levels of the fair value hierarchy under SFAS No. 157 are:

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

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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;

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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).

A financial instrument's level within the fair value hierarchy is based on the lowest level of input that is significant to the fair value measurement. SFAS Statement No. 159, "The Fair Value Option for Financial Assets and Financial Liabilities" became effective January 1, 2008 for the Company. We did not elect under SFAS No. 159 to measure any eligible items at fair value under SFAS No. 157 at that date.

Trust Assets and Fiduciary Income - Assets held by Arrow in a fiduciary or agency capacity for its customers are not included in the consolidated balance sheets since these assets are not assets of Arrow. Income from fiduciary activities is reported on the accrual basis.

Segment Reporting - Management evaluates the operations of Arrow based solely on one business segment - commercial banking, which constitutes Arrow's only segment for financial reporting purposes. Arrow operates primarily in northern New York State in Warren, Washington, Saratoga, Essex and Clinton counties and surrounding areas.

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. Actual results could differ from those estimates.

NOTE 1:

SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

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. In addition, various regulatory agencies, as an integral part of their examination process, periodically review Arrow's allowance for loan losses. Such agencies may require Arrow to recognize adjustments to the allowance for loan losses based on their judgments about information available to them at the time of their examination, which may not be currently available to management.

Recent Accounting Pronouncements

In December 2007, the Financial Accounting Standards Board (FASB) issued revised Statement of Financial Accounting Standards (SFAS) No. 141, "Business Combinations." SFAS No. 141(R) retains the fundamental requirements of SFAS No. 141 that the acquisition method of accounting (formerly the purchase method) be used for all business combinations; that an acquirer be identified for each business combination; and that intangible assets be identified and recognized separately from goodwill. SFAS No. 141(R) requires the acquiring entity in a business combination to recognize the assets acquired, the liabilities assumed and any noncontrolling interest in the acquiree at the acquisition date, measured at their fair values as of that date, with limited exceptions. Additionally, SFAS No. 141(R) changes the requirements for recognizing assets acquired and liabilities assumed arising from contingencies and recognizing and measuring contingent consideration. SFAS No. 141(R) also enhances the disclosure requirements for business combinations. SFAS No. 141(R) applies prospectively to business combinations for which the acquisition date is on or after the beginning of the first annual reporting period beginning on or after December 15, 2008 and may not be applied before that date. The impact that SFAS No. 141 is expected to have on our financial condition or results of operations is indeterminable as it is prospective in nature.

In December 2007, the FASB issued SFAS No. 160, "Noncontrolling Interests in Consolidated Financial Statements, an amendment of ARB No. 51," (SFAS No. 160). SFAS No. 160 amends Accounting Research Bulletin No. 51, "Consolidated Financial Statements" to establish accounting and reporting standards for the noncontrolling interest in a subsidiary and for the deconsolidation of a subsidiary. Among other things, SFAS No. 160 clarifies that a noncontrolling interest in a subsidiary is an ownership interest in the consolidated entity that should be reported as equity in the consolidated financial statements and requires consolidated net income to be reported at amounts that include the amounts attributable to both the parent and the noncontrolling interest. SFAS No. 160 also amends SFAS No. 128, "Earnings per Share," so that earnings per share calculations in consolidated financial statements will continue to be based on amounts attributable to the parent. SFAS No. 160 is effective for fiscal years, and interim

periods within those fiscal years, beginning on or after December 15, 2008 and is applied prospectively as of the beginning of the fiscal year in which it is initially applied, except for the presentation and disclosure requirements which are to be applied retrospectively for all periods presented. SFAS No. 160 is not expected to have a material impact on our financial condition or results of operations.

In March 2008, the FASB issued SFAS No. 161, Disclosures about Derivative Instruments and Hedging Activities, (SFAS No. 161). The new standard is intended to improve financial reporting about derivative instruments and hedging activities by requiring enhanced disclosures to enable investors to better understand their effects on an entity's financial position, financial performance, and cash flows. The new standard also improves transparency about the location and amounts of derivative instruments in an entity's financial statements; how derivative instruments and related hedged items are accounted for under Statement 133, Accounting for Derivative Instruments and Hedging Activities; and how derivative instruments and related hedged items affect its financial position, financial performance, and cash flows. SFAS No. 161 achieves these improvements by requiring disclosure of the fair values of derivative instruments and their gains and losses in a tabular format. It also provides more information about an entity's liquidity by requiring disclosure of derivative features that are credit risk related. Finally, it requires cross-referencing within footnotes to enable financial statement users to locate important information about derivative instruments. It is effective for financial statements issued for fiscal years and interim periods beginning after November 15, 2008, with early application encouraged. SFAS No. 161 is not expected to have a material impact on our financial condition or results of operations.

NOTE 1:

SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

In December 2008, the FASB issued FASB Staff Position FAS 132(R)1 which amends SFAS No 132(R), Employers Disclosures about Pensions and Other Postretirement Benefits (FSP FAS 132(R)1). Beginning with financial statements issued for December 31, 2009, FSP FAS 132(R)1 will require additional disclosures about our defined benefit pension plan:

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Objectives of the Disclosures about Postretirement Benefit Plan Assets

The objectives of the disclosures about plan assets in an employer's defined benefit pension or other postretirement plan are to provide users of financial statements with an understanding of:

- a. How investment allocation decisions are made, including the factors that are pertinent to an understanding of investment policies and strategies
- b. The major categories of plan assets
- c. The inputs and valuation techniques used to measure the fair value of plan assets
- d. The effect of fair value measurements using significant unobservable inputs (Level 3) on changes in plan assets for the period
- e. Significant concentrations of risk within plan assets.

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An employer shall disclose information about how investment allocation decisions are made, including factors that are pertinent to an understanding of investment policies and strategies.

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An employer shall disclose separately for pension plans and other postretirement benefit plans the fair value of each major category of plan assets as of each annual reporting date for which a statement of financial position is presented. Asset categories shall be based on the nature and risks of assets in an employer's plan.

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An employer shall disclose information that enables users of financial statements to assess the inputs and valuation techniques used to develop fair value measurements of plan assets at the annual reporting date. For fair value measurements using significant unobservable inputs (Level 3), an employer shall disclose the effect of the measurements on changes in plan assets for the period.

An employer shall provide users of financial statements with an understanding of significant concentrations of risk in plan assets.

The requirements of FSP FAS 132(R)1 are disclosure requirements and will not have an impact on our financial condition or results of operations.

NOTE 2:

CASH AND DUE FROM BANKS (In Thousands)

The bank subsidiaries are required to maintain certain reserves of vault cash and/or deposits with the Federal Reserve Bank. The total amount of the required reserves at December 31, 2008 and 2007 was approximately \$15,018 and \$14,687, respectively.

NOTE 3:**SECURITIES (In Thousands)**

The fair value of securities, except certain state and municipal securities, is estimated based on published prices or bid quotations received from securities dealers. The fair value of certain state and municipal securities is not readily available through market sources, so fair value estimates are based on the discounted contractual cash flows using estimated market discount rates that reflect the credit and interest rate risk inherent in the instrument. For short-term securities the estimated fair value is the carrying amount.

Included in mutual funds and equity securities are Federal Home Loan Bank of New York (FHLBNY) and Federal Reserve Bank (FRB) stock. FHLBNY and FRB stock are restricted investment securities and amounted to \$8,859 and \$817 at December 31, 2008, respectively and \$8,765 and \$809 at December 31, 2007, respectively. The required level of FHLBNY stock is based on the amount of FHLBNY borrowings (see Note 11) and is pledged to secure those borrowings. While some Federal Home Loan Banks have stopped paying dividends and repurchasing stock upon reductions in debt levels, the FHLBNY continues to pay dividends and repurchase its stock. Accordingly, we have not recognized any impairment on our holdings of FHLBNY common stock. However, the FHLBNY has reported impairment issues among its holdings of mortgage-backed securities.

Corporate and other debt securities included a corporate bond issued by Lehman Brothers Holdings (Lehman) that has been deemed to be other-than-temporarily impaired. This Lehman bond had a book value of \$2,010 prior to the recognition of \$1,610 in losses charged to earnings for the year ended December 31, 2008. The book value and approximate fair value for this security was \$400 at December 31, 2008.

A summary of the amortized costs and the approximate fair values of securities at December 31, 2008 and 2007 is presented below:

Securities Available-for-Sale:

	Amortized	Fair	Gross Unrealized	Gross Unrealized
	Cost	Value	<u>Gains</u>	<u>Losses</u>
December 31, 2008:				
U.S. Treasury and Agency Obligations	\$ 11,375	\$ 11,528	\$ 153	\$ ---
State and Municipal Obligations	15,410	15,446	36	---
Collateralized Mortgage Obligations	183,256	185,830	2,594	20
Other Mortgage-Backed Securities	91,900	93,849	2,038	89
Corporate and Other Debt Securities	7,911	7,433	---	478

Mutual Funds and Equity Securities	<u>11,210</u>	<u>11,004</u>	<u>4</u>	<u>210</u>
Total Securities Available-for-Sale	<u>\$321,062</u>	<u>\$325,090</u>	<u>\$4,825</u>	<u>\$797</u>

December 31, 2007:

U.S. Treasury and Agency Obligations	\$ 39,486	\$ 39,497	\$ 84	\$ 73
State and Municipal Obligations	24,216	24,206	---	10
Collateralized Mortgage Obligations	138,909	138,971	386	324
Other Mortgage-Backed Securities	112,456	112,458	803	801
Corporate and Other Debt Securities	11,566	11,574	115	107
Mutual Funds and Equity Securities	<u>11,498</u>	<u>11,364</u>	<u>1</u>	<u>135</u>
Total Securities Available-for-Sale	<u>\$338,131</u>	<u>\$338,070</u>	<u>\$1,389</u>	<u>\$1,450</u>

Securities Held-to-Maturity:

			Gross	Gross
	Amortized	Fair	Unrealized	Unrealized
	<u>Cost</u>	<u>Value</u>	<u>Gains</u>	<u>Losses</u>
December 31, 2008:				
State and Municipal Obligations	<u>\$133,976</u>	<u>\$134,331</u>	<u>\$1,146</u>	<u>\$ 791</u>

December 31, 2007:

State and Municipal Obligations	<u>\$114,611</u>	<u>\$114,977</u>	<u>\$ 991</u>	<u>\$ 625</u>
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NOTE 3:**SECURITIES (Continued)**

A summary of the maturities of securities as of December 31, 2008 is presented below. Mutual funds and equity securities, which have no stated maturity, are included in the over ten-year category. Collateralized mortgage obligations and other mortgage-backed securities are included in the schedule based on their expected average lives. Actual maturities may differ from the table below because issuers may have the right to call or prepay obligations with or without prepayment penalties.

Securities:	<u>Available-for-Sale</u>		<u>Held-to-Maturity</u>	
	<u>Amortized</u>	<u>Fair</u>	<u>Amortized</u>	<u>Fair</u>
	<u>Cost</u>	<u>Value</u>	<u>Cost</u>	<u>Value</u>
Within One Year:				
U.S. Treasury and Agency Obligations	\$ 11,375	\$ 11,528	\$ ---	\$ ---
State and Municipal Obligations	7,580	7,591	51,970	52,152
Collateralized Mortgage Obligations	21,698	21,811	---	---
Other Mortgage-Backed Securities	2,925	2,903	---	---
Corporate and Other Debt Securities	<u>3,026</u>	<u>2,936</u>	<u>---</u>	<u>---</u>
Total	<u>46,604</u>	<u>46,769</u>	<u>51,970</u>	<u>52,152</u>
From 1 - 5 Years:				
U.S. Treasury and Agency Obligations	---	---	---	---
State and Municipal Obligations	3,804	3,828	37,655	38,104
Collateralized Mortgage Obligations	65,835	66,793	---	---
Other Mortgage-Backed Securities	56,533	57,662	---	---
Corporate and Other Debt Securities	<u>4,477</u>	<u>4,342</u>	<u>---</u>	<u>---</u>
Total	<u>130,649</u>	<u>132,625</u>	<u>37,655</u>	<u>38,104</u>
From 5 - 10 Years:				
State and Municipal Obligations	985	985	30,073	29,975
Collateralized Mortgage Obligations	84,939	86,204		

Other Mortgage-Backed Securities	<u>15,147</u>	<u>15,470</u>	<u>---</u>	<u>---</u>
Total	<u>101,071</u>	<u>102,659</u>	<u>30,073</u>	<u>29,975</u>

Over 10 Years:

State and Municipal Obligations	3,041	3,042	14,278	14,100
Collateralized Mortgage Obligations	10,784	11,022		
Other Mortgage-Backed Securities	17,295	17,814	---	---
Corporate and Other Debt Securities	408	155	---	---
Mutual Funds and Equity Securities	<u>11,210</u>	<u>11,004</u>	<u>---</u>	<u>---</u>
Total	<u>42,738</u>	<u>43,037</u>	<u>14,278</u>	<u>14,100</u>
Total Securities	<u>\$321,062</u>	<u>\$325,090</u>	<u>\$133,976</u>	<u>\$134,331</u>

The following table sets forth the components of interest and dividend income on securities available-for-sale and securities held-to-maturity for the year ending December 31:

Components of Investment Securities Interest and Dividend Income	<u>2008</u>	<u>2007</u>	<u>2006</u>
Securities Available-for-Sale:			
Taxable Interest Income	\$15,490	\$13,589	\$13,612
Nontaxable Interest Income	805	982	765
Dividend Income	<u>661</u>	<u>746</u>	<u>540</u>
Total Interest and Dividend Income, on Securities Available-for-Sale	<u>\$16,956</u>	<u>\$15,317</u>	<u>\$14,917</u>
Securities Held-to-Maturity			
Taxable Interest Income	\$ 13	\$ 16	\$ 17
Nontaxable Interest Income	<u>4,380</u>	<u>4,242</u>	<u>3,979</u>
Total Interest Income, on Securities Held-to-Maturity	<u>\$4,393</u>	<u>\$4,258</u>	<u>\$3,996</u>

The fair value of securities pledged to secure repurchase agreements amounted to \$59,339 and \$52,630 at December 31, 2008 and 2007, respectively. The fair value of securities pledged to secure public and trust deposits and for other purposes totaled \$257,831 and \$253,417 at December 31, 2008 and 2007, respectively. Other mortgage-backed securities at December 31, 2008 and 2007 included \$2,742 and \$3,484, respectively, of loans previously securitized by Arrow, which it continues to service.

NOTE 3:**SECURITIES (Continued)**

Information on temporarily impaired securities at December 31, 2008 and 2007, segregated according to the length of time such securities had been in a continuous unrealized loss position, is summarized as follows:

December 31, 2008	<u>Less than 12 Months</u>		<u>12 Months or Longer</u>		<u>Total</u>	
	Fair	Unrealized	Fair	Unrealized	Fair	Unrealized
<u>Available-for-Sale Portfolio:</u>	<u>Value</u>	<u>Losses</u>	<u>Value</u>	<u>Losses</u>	<u>Value</u>	<u>Losses</u>
Collateralized Mortgage Obligations	\$4,597	\$ 20	\$ 102	\$ 0	\$ 4,699	\$ 20
Other Mortgage-Backed Securities	143	0	8,492	89	8,635	89
Corporate & Other Debt Securities	5,038	402	1,950	76	6,988	478
Mutual Funds and Equity Securities	<u>26</u>	<u>0</u>	<u>1,283</u>	<u>210</u>	<u>1,309</u>	<u>210</u>
Total Securities Available-for-Sale	<u>\$9,804</u>	<u>\$422</u>	<u>\$11,827</u>	<u>\$375</u>	<u>\$21,631</u>	<u>\$797</u>
<u>Held-to-Maturity Portfolio</u>						
State & Municipal Obligations	\$5,970	\$94	\$22,218	\$697	\$28,188	\$791

The table above for December 31, 2008 consists of 133 securities where the current fair value is less than the related amortized cost. These unrealized losses do not reflect any deterioration of the credit worthiness of the issuing entities. Agency-backed CMOs are all rated AAA, as are the mortgage-backed securities. The municipal obligations are partially insured, with the remainder supported by the general taxing authority of the municipality and, in the cases of school districts, are supported by state aid. For any non-rated municipal securities, third party credit analysis shows no deterioration in the credit worthiness of the municipalities. Corporate and other debt securities consist of three corporate bonds, one private placement trust preferred, and one trust preferred pool. The three corporate bond issues are rated investment grade, and are performing. The private placement trust preferred is rated AAA by Standard & Poor's; the trust preferred pool is rated investment grade, with the privately issued securities securing the note performing. Mutual funds and equity securities include four common stock holdings that show unrealized losses which are not deemed to be other-than-temporarily impaired. These unrealized losses do not reflect deterioration in the credit worthiness of the companies, since they have adequate capital positions. 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. Since we have the intent and ability to hold these investments until a recovery of fair value, which may be until maturity for the debt securities, we do not consider these investments to be other-than-temporarily impaired at December 31, 2008.

December 31, 2007	<u>Less than 12 Months</u>		<u>12 Months or Longer</u>		<u>Total</u>	
	Fair	Unrealized	Fair	Unrealized	Fair	Unrealized
<u>Available-for-Sale Portfolio:</u>	<u>Value</u>	<u>Losses</u>	<u>Value</u>	<u>Losses</u>	<u>Value</u>	<u>Losses</u>
U.S. Treasury and Agency Obligations	\$ ---	\$---	\$ 27,414	\$ 73	\$ 27,414	\$ 73
State & Municipal Obligations	---	---	3,822	10	3,822	10
Collateralized Mortgage Obligations	6,014	17	77,807	307	83,821	324
Other Mortgage-Backed Securities	195	1	47,722	800	47,917	801
Corporate & Other Debt Securities	---	---	3,963	107	3,963	107
Mutual Funds and Equity Securities	<u>59</u>	<u>4</u>	<u>1,043</u>	<u>131</u>	<u>1,102</u>	<u>135</u>
Total Securities Available-for-Sale	<u>\$6,268</u>	<u>\$22</u>	<u>\$161,771</u>	<u>\$1,428</u>	<u>\$168,039</u>	<u>\$1,450</u>
<u>Held-to-Maturity Portfolio</u>						
State & Municipal Obligations	\$10,858	\$121	\$35,362	\$504	\$46,220	\$625

The table above for December 31, 2007 consists of 253 securities where the current fair value is less than the related amortized cost. With the exception of one holding, these unrealized losses do not reflect any deterioration of the credit worthiness of the issuing entities. The U.S. government agency securities are all rated AAA, as are the agency-backed CMOs and the mortgage-backed securities. 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. The municipal obligations are partially insured, with the remainder supported by the general taxing authority of the municipality and, in the cases of school districts, are supported by state aid. For any non-rated municipal securities, third party credit analysis shows no deterioration in the credit worthiness of the municipalities. One corporate holding, General Motors Acceptance Corp. (GMAC), had experienced deterioration in credit worthiness. As of December 31, 2007, the bond had a fair value of \$1,902 and an amortized cost of \$2,007, resulting in an unrealized loss of \$105. The bond was sold during 2008 for a loss of \$39.

NOTE 4:**LOANS (In Thousands)**

Loans at December 31, 2008 and 2007 consisted of the following:

	<u>2008</u>	<u>2007</u>
Commercial, Financial and Agricultural	\$ 86,872	\$ 79,128
Real Estate - Commercial	183,676	160,787
Real Estate - Residential	444,655	417,092
Real Estate - Construction	34,428	39,265
Indirect and Other Consumer Loans	<u>360,181</u>	<u>342,572</u>
Total Loans	<u>\$1,109,812</u>	<u>\$1,038,844</u>

The carrying amount of net loans (i.e. net of the allowance for loan losses) at December 31, 2008 and 2007 was \$1,096,540 and \$1,026,443, respectively. The estimated fair value of net loans at December 31, 2008 and 2007 was \$1,111,411 and \$1,024,783, respectively. Included in the carrying amount of loans in the table above are unamortized deferred loan origination costs, net of deferred loan origination fees, of \$1,219 and \$1,429 at December 31, 2008 and 2007, respectively.

Fair values are estimated for portfolios of loans with similar financial characteristics. Loans are segregated by type such as commercial, commercial real estate, residential mortgage, indirect and other consumer loans. Each loan category is further segmented into fixed and adjustable rate interest terms and by performing and nonperforming categories.

The fair value of performing loans is calculated by discounting scheduled cash flows through the estimated maturity using estimated market discount rates that reflect the credit and interest rate risk inherent in the loan. The estimate of maturity is based on historical experience with repayments for each loan classification, modified, as required, by an estimate of the effect of current economic and lending conditions. Fair value for nonperforming loans is generally based on recent external appraisals. If appraisals are not available, estimated cash flows are discounted using a rate commensurate with the risk associated with the estimated cash flows. Assumptions regarding credit risk, cash flows and discount rates are judgmentally determined using available market information and specific borrower information.

Certain executive officers and directors, including their immediate families and organizations in which they are principals of Arrow or affiliates, have various loan, deposit and other transactions with Arrow. Such transactions are entered into on substantially the same terms, including interest rates and collateral, as those prevailing at the time for comparable transactions with others. The amount of such related party loans was \$13,351 at December 31, 2008 and \$13,563 at December 31, 2007. During 2008, the amount of new loans and renewals extended to such related parties was \$1,550 and the total of loan repayments was \$1,762.

Arrow has pledged certain loans secured by one-to-four family residential mortgages under a blanket collateral agreement to secure borrowings from the Federal Home Loan Bank of New York (see Note 11). As of December 31,

2008, the amount of such pledged loans amounted to \$232,399.

Arrow designates certain loans as nonaccrual and suspends the accrual of interest and the amortization of net deferred fees or costs when payment of interest and/or principal is due and unpaid for a period of, generally, ninety days or the likelihood of repayment is uncertain in the opinion of management. The following table presents information concerning nonperforming loans at December 31:

	<u>2008</u>	<u>2007</u>
Nonaccrual Loans	\$3,469	\$1,939
Loans Past Due 90 or More Days and Still Accruing Interest	<u>457</u>	<u>245</u>
Total Nonperforming Loans	<u>\$3,926</u>	<u>\$2,184</u>

Arrow has no material commitments to make additional advances to borrowers with nonperforming loans. The following table presents information with respect to interest on the nonaccrual loans shown in the table above for the years ended December 31:

	<u>2008</u>	<u>2007</u>	<u>2006</u>
Gross Interest That Would Have Been Earned Under Original Terms	\$295	\$162	\$160
Interest Included in Income	208	70	126

NOTE 5:**ALLOWANCE FOR LOAN LOSSES AND IMPAIRED LOANS (In Thousands)**

The following summarizes the changes in the allowance for loan losses during the years ended December 31:

	<u>2008</u>	<u>2007</u>	<u>2006</u>
Balance at Beginning of Year	\$12,401	\$12,278	\$12,241
Provision for Loan Losses	1,671	513	826
Recoveries	492	440	348
Charge-Offs	<u>(1,292)</u>	<u>(830)</u>	<u>(1,137)</u>
Balance at End of Year	<u>\$13,272</u>	<u>\$12,401</u>	<u>\$12,278</u>

The balance of impaired loans, within the scope of SFAS No. 114, was \$2,231 and \$759 at December 31, 2008 and 2007, respectively. The allowance for loan losses included no allocation for these impaired loans at either date. The average recorded investment in impaired loans for 2008, 2007 and 2006 was \$1,065, \$733 and \$341, respectively. For all years, no interest income was recorded on such loans during the period of impairment.

NOTE 6:**PREMISES AND EQUIPMENT (In Thousands)**

A summary of premises and equipment at December 31, 2008 and 2007 is presented below:

	<u>2008</u>	<u>2007</u>
Land and Bank Premises	\$22,423	\$21,122
Equipment, Furniture and Fixtures	15,828	15,252
Leasehold Improvements	<u>864</u>	<u>864</u>
Total Cost	39,115	37,238
Accumulated Depreciation and Amortization	<u>(21,513)</u>	<u>(20,510)</u>
Net Premises and Equipment	<u>\$17,602</u>	<u>\$16,728</u>

Amounts charged to expense for depreciation totaled \$1,224, \$1,280 and \$1,260 in 2008, 2007 and 2006, respectively. Amounts charged to expense for leasing office space totaled \$321, \$306 and \$271 in 2008, 2007 and 2006, respectively.

NOTE 7:

OTHER REAL ESTATE OWNED AND REPOSSESSED ASSETS (In Thousands)

The balance of other real estate owned was \$581 at December 31, 2008 and was comprised of four residential real estate properties. The balance of other real estate owned was \$89 at December 31, 2007 and was comprised of one residential real estate property. Repossessed assets totaled \$64 and \$63 at December 31, 2008 and 2007, respectively, and consisted solely of motor vehicles repossessed in satisfaction of loans.

NOTE 8:**OTHER INTANGIBLE ASSETS (In Thousands)**

The following table presents information on Arrow's intangible assets (other than goodwill) as of December 31, 2008, 2007 and 2006:

	Mortgage				
	Depositor	Servicing			
	<u>Intangibles¹</u>	<u>Rights²</u>	<u>Covenants³</u>	<u>Expirations⁴</u>	<u>Total</u>
Gross Carrying Amount, December 31, 2008	\$2,247	\$329	\$117	\$751	\$3,444
Accumulated Amortization	<u>(1,318)</u>	<u>(232)</u>	<u>(96)</u>	<u>(146)</u>	<u>(1,792)</u>
Net Carrying Amount, December 31, 2008	<u>\$ 929</u>	<u>\$ 97</u>	<u>\$ 21</u>	<u>\$605</u>	<u>\$1,652</u>
Gross Carrying Amount, December 31, 2007	\$2,247	\$306	\$117	\$686	\$3,356
Accumulated Amortization	<u>(1,021)</u>	<u>(181)</u>	<u>(73)</u>	<u>(105)</u>	<u>(1,380)</u>
Net Carrying Amount, December 31, 2007	<u>\$1,226</u>	<u>\$125</u>	<u>\$ 44</u>	<u>\$581</u>	<u>\$1,976</u>
Gross Carrying Amount, December 31, 2006	\$2,247	\$306	\$117	\$686	\$3,356
Accumulated Amortization	<u>(684)</u>	<u>(130)</u>	<u>(49)</u>	<u>(71)</u>	<u>(934)</u>
Net Carrying Amount, December 31, 2006	<u>\$1,563</u>	<u>\$176</u>	<u>\$ 68</u>	<u>\$615</u>	<u>\$2,422</u>
Amortization Expense:					
2008	\$297	\$51	\$23	\$41	\$412
2007	337	51	24	34	446
2006	377	51	24	34	486

Mortgage

	Depositor	Servicing	<u>Covenants</u> ³	<u>Expirations</u> ⁴	
	<u>Intangibles</u> ¹	<u>Rights</u> ²			<u>Total</u>
Estimated Annual Amortization Expense: ^{1,2,3,4}					
2009	\$255	\$44	\$21	\$ 48	\$368
2010	214	28		47	289
2011	175	13		47	235
2012	132	5		47	184
2013	92	4		41	137
Later Years	61	3		375	439

¹ Amortization of Depositor Intangibles is reported in the income statement as a component of other operating expense.

² Amortization of Mortgage Servicing Rights is reported in the income statement as a reduction of servicing fee income.

³ Amortization of Covenants is reported in the income statement as a component of other operating expense.

⁴ Amortization of Expirations is reported in the income statement as a component of other operating expense.

During 2008, no impairment losses were recognized with respect to Arrow's existing goodwill or intangible assets.

NOTE 9:**TIME DEPOSITS (In Thousands)**

The following summarizes the contractual maturities of time deposits during years subsequent to December 31, 2008:

	Time Deposits of \$100,000 or More	Other Time Deposits
2009	\$125,027	\$160,894
2010	10,605	26,816
2011	1,268	10,575
2012	16,657	39,728
2013	3,630	8,343
2014 and Beyond	<u>---</u>	<u>155</u>
Total	<u>\$157,187</u>	<u>\$246,511</u>

The carrying value of time deposits at December 31, 2008 and 2007 was \$403,698 and \$429,544, respectively. The estimated fair value of time deposits at December 31, 2008 and 2007 was \$411,853 and \$429,889, respectively. The fair value of time deposits is based on the discounted value of contractual cash flows, except that the fair value is limited to the extent that the customer could redeem the certificate after imposition of a premature withdrawal penalty. The discount rates are estimated using the FHLBNY yield curve, which is considered representative of Arrow's time deposit rates.

NOTE 10:**SHORT-TERM BORROWINGS (Dollars in Thousands)**

A summary of short-term borrowings is presented below:

Federal Funds Purchased and Securities Sold	<u>2008</u>	<u>2007</u>	<u>2006</u>
Under Agreements to Repurchase:			
Balance at December 31	\$59,339	\$52,630	\$47,566
Maximum Month-End Balance	69,547	55,926	53,967
Average Balance During the Year	57,711	48,851	45,381
Average Rate During the Year	1.35%	2.80%	2.47%
Rate at December 31	0.49%	2.53%	2.50%
Other Short-Term Borrowings:			
Balance at December 31	\$ 617	\$ 1,089	\$ 758
Maximum Month-End Balance	3,751	2,377	2,013
Average Balance During the Year	762	504	663
Average Rate During the Year	1.31%	4.37%	4.65%
Rate at December 31	0.02%	4.00%	5.01%
Average Aggregate Short-Term Borrowing Rate During the Year	1.35%	2.81%	2.50%

Securities sold under agreements to repurchase generally mature within ninety days. Arrow maintains effective control over the securities underlying the agreements. Federal funds purchased represent overnight transactions.

Other short-term borrowings primarily include demand notes issued to the U.S. Treasury. In addition, Arrow has in place federal funds lines of credit with three correspondent banks totaling \$30 million, the Federal Home Loan Bank of New York (FHLBNY) and the Federal Reserve Bank of New York.

NOTE 11:**FHLBNY ADVANCES (Dollars in Thousands)**

Arrow has established overnight and 30 day term lines of credit with the FHLBNY each in the amount of \$124,000. If advanced, such lines of credit will be collateralized by mortgage-backed securities, loans and FHLBNY stock. Participation in the FHLBNY program requires an investment in FHLBNY stock. The investment in FHLBNY stock, included in Securities Available-for-Sale on the Consolidated Balance Sheets, amounted to \$8,859 and \$8,765 at December 31, 2008 and 2007, respectively. Arrow also borrows longer-term funds from the FHLBNY. Certain borrowings are in the form of convertible advances. These advances have a set final maturity, but are callable by the FHLBNY at certain dates beginning no earlier than one year from the issuance date. If the advances are called, Arrow may elect to have the funds replaced by the FHLBNY at the then prevailing market rate of interest. The borrowings are secured by mortgage loans and/or mortgage-backed securities and/or FHLBNY stock held by Arrow. The total amount of assets pledged to the FHLBNY for borrowing arrangements at December 31, 2008 and 2007 amounted to \$232,399 and \$211,357, respectively.

The table below presents information applicable to FHLBNY advances as of December 31, 2008 and 2007:

<u>2008 Amount</u>	<u>2007 Amount</u>	<u>Effective Rate</u>	<u>Next Call Date</u>	<u>Call Frequency</u>	<u>Maturity Date</u>
\$ 10,000	\$ 10,000	3.88%	01/06/2009	Quarterly	10/06/2015
10,000	10,000	4.24%	01/06/2009	Quarterly	10/06/2010
10,000	10,000	4.70%	01/12/2009	Quarterly	01/12/2012
5,000	5,000	4.91%	01/28/2009	Quarterly	07/28/2011
5,000	5,000	4.82%	01/28/2009	Quarterly	07/28/2011
10,000	10,000	4.76%	02/27/2009	Quarterly	11/27/2009
10,000	10,000	4.53%	03/04/2009	Quarterly	12/04/2009
10,000	10,000	4.41%	03/19/2009	Quarterly	12/19/2010
10,000	10,000	5.20%	05/19/2009	One-Time	05/19/2011
10,000	10,000	4.72%	07/27/2009	Quarterly	07/27/2012
10,000	10,000	4.46%	08/28/2009	Quarterly	08/28/2012
10,000	10,000	3.73%	12/20/2010	Quarterly	12/20/2012
10,000	10,000	5.12%		One-Time	02/14/2011
10,000	10,000	5.18%		One-Time	02/23/2011
10,000	10,000	5.03%		One-Time	04/28/2011
10,000	10,000	5.07%		One-Time	05/19/2011

<u>10,000</u>	<u>10,000</u>	4.32%	One-Time	10/09/2012
<u>\$160,000</u>	<u>\$160,000</u>			

The estimated fair value of FHLBNY advances was \$171,287 and \$164,270 at December 31, 2008 and 2007, respectively. 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 table below presents the amounts of FHLBNY advances maturing in the next five years and beyond:

<u>Final Maturity</u>	<u>Amount</u>
2009	\$20,000
2010	20,000
2011	60,000
2012	50,000
2015	<u>10,000</u>
Total FHLBNY Advances	<u>\$160,000</u>

NOTE 12:**GUARANTEED PREFERRED BENEFICIAL INTERESTS IN CORPORATION S JUNIOR SUBORDINATED****DEBENTURES (In Thousands)**

During 2008, there were outstanding two classes of financial instruments issued by two separate subsidiary business trusts of Arrow, having an aggregate amount of \$20,000, identified as Junior Subordinated Obligations Issued to Unconsolidated Subsidiary Trusts on the Consolidated Balance Sheets and as Guaranteed Preferred Beneficial Interests in Corporation s Junior Subordinated Debentures on the Consolidated Income Statements.

The first of the two classes of trust-issued instruments outstanding at year-end was issued by Arrow Capital Statutory Trust II ("ACST II"), a Delaware business trust established on July 16, 2003, upon the filing of a certificate of trust with the Delaware Secretary of State. In July 2003, ACST II issued all of its voting (common) stock to Arrow and issued and sold to an unaffiliated purchaser 30-year guaranteed preferred beneficial interests in the trust's assets ("ACST II trust preferred securities") in the aggregate amount of \$10,000. The ACST II trust preferred securities bore a rate of 6.53% until September 30, 2008. After that date the rate became variable, adjusting quarterly to the 3-month LIBOR plus 3.15%. ACST II used the proceeds of the sale of its trust preferred securities to purchase an identical amount (\$10,000) of junior subordinated debentures issued by Arrow that bear an interest rate identical at all times to the rate payable on the ACST II trust preferred securities. The ACST II trust preferred securities became redeemable after July 23, 2008.

NOTE 12:

GUARANTEED PREFERRED BENEFICIAL INTERESTS IN CORPORATION S JUNIOR SUBORDINATED

DEBENTURES (Continued)

The second of the two classes of trust-issued instruments outstanding at year-end was issued by Arrow Capital Statutory Trust III ("ACST III"), a Delaware business trust established on December 23, 2004, upon the filing of a certificate of trust with the Delaware Secretary of State. On December 28, 2004, the ACST III issued all of its voting (common) stock to Arrow and issued and sold to an unaffiliated purchaser 30-year guaranteed preferred beneficial interests in the trust's assets ("ACST III trust preferred securities") in the aggregate amount of \$10,000. The rate on the ACST III trust preferred securities is a variable rate, adjusted quarterly, equal to the 3-month LIBOR plus 2.00%.

ACST III used the proceeds of the sale of its trust preferred securities to purchase an identical amount (\$10,000) of junior subordinated debentures issued by Arrow that bear an interest rate identical at all times to the rate payable on the ACST III trust preferred securities. The ACST III trust preferred securities are redeemable on or after March 31, 2010.

The primary assets of the two subsidiary trusts having trust preferred securities outstanding at year-end, ACST II and ACST III (the "Trusts"), are Arrow's junior subordinated debentures discussed above, and the sole revenues of the Trusts are payments received by them from Arrow with respect to the junior subordinated debentures. The trust preferred securities issued by the Trusts are non-voting. All common voting securities of the Trusts are owned by Arrow. Arrow used the net proceeds from its sale of junior subordinated debentures to the Trusts, facilitated by the Trusts' sale of their trust preferred securities to the purchasers thereof, for general corporate purposes. The trust preferred securities and underlying junior subordinated debentures, with associated expense that is tax deductible, qualify as Tier I capital under regulatory definitions.

Arrow's primary source of funds to pay interest on the debentures held by the Trusts are current dividends received by Arrow from its subsidiary banks. Accordingly, Arrow's ability to make payments on the debentures, and the ability of the Trusts to make payments on their trust preferred securities, are dependent upon the continuing ability of Arrow's subsidiary banks to pay dividends to Arrow. Since the trust preferred securities issued by the subsidiary trusts and the underlying junior subordinated debentures issued by Arrow at December 31, 2008, 2007 and 2006 are classified as debt for financial statement purposes, the expense associated with these securities is recorded as interest expense in the consolidated statements of income for the three years.

The estimated fair value of the outstanding trust preferred securities and underlying junior subordinated debentures was \$19,969 at December 31, 2007. Based on Arrow's capital adequacy, the fair value of the outstanding trust preferred securities are considered to approximate fair value since the rates are variable (indexed to LIBOR) and Arrow is well-capitalized.

NOTE 13:

ACCUMULATED OTHER COMPREHENSIVE LOSS (In Thousands)

The following table presents the components, net of tax, of accumulated other comprehensive loss as of December 31:

	<u>2008</u>	<u>2007</u>
Retirement Plan Net Loss	\$(12,495)	\$(5,836)
Retirement Plan Prior Service Cost	659	983
Net Unrealized Securities Holding Gains (Losses)	<u>2,432</u>	<u>(37)</u>
Total Accumulated Other Comprehensive Loss	<u>\$ (9,404)</u>	<u>\$(4,890)</u>

NOTE 14:**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 each of the years in the three-year period ended December 31, 2008. All share and per share amounts have been adjusted for the 2007 3% stock dividend.

	Net Income	Weighted-Average Shares	Per Share
	<u>(Numerator)</u>	<u>(Denominator)</u>	<u>Amount</u>
For the Year Ended December 31, 2008:			
Basic EPS	\$20,437	10,565	<u>\$1.93</u>
Dilutive Effect of Stock Options	<u>---</u>	<u>57</u>	
Diluted EPS	<u>\$20,437</u>	<u>10,622</u>	<u>\$1.92</u>
For the Year Ended December 31, 2007:			
Basic EPS	\$17,332	10,714	<u>\$1.62</u>
Dilutive Effect of Stock Options	<u>---</u>	<u>72</u>	
Diluted EPS	<u>\$17,332</u>	<u>10,786</u>	<u>\$1.61</u>
For the Year Ended December 31, 2006:			
Basic EPS	\$16,892	10,922	<u>\$1.55</u>
Dilutive Effect of Stock Options	<u>---</u>	<u>145</u>	
Diluted EPS	<u>\$16,892</u>	<u>11,067</u>	<u>\$1.53</u>

During a portion of 2008, options to purchase 240 shares of common stock at an average price of \$25.70 per share were outstanding but were not included in the computation of diluted EPS because the options' exercise price was greater than the average market price of the common shares during that period. Antidilutive shares for 2007 and 2006 were 252 shares at an average price of \$25.66 per share and 70 shares at an average price of \$29.30, for the respective

years.

NOTE 15:

REGULATORY MATTERS (Dollars in Thousands)

In the normal course of business, Arrow and its subsidiaries operate under certain regulatory restrictions, such as the extent and structure of covered intercompany borrowings and maintenance of reserve requirement balances.

The principal source of the funds for the payment of shareholder dividends by Arrow has been from dividends declared and paid to Arrow by its bank subsidiaries. As of December 31, 2008, the maximum amount that could have been paid by subsidiary banks to Arrow, without prior regulatory approval, was approximately \$13,226.

Under current Federal Reserve regulations, Arrow is prohibited from borrowing from the subsidiary banks unless such borrowings are secured by specific obligations. Additionally, the maximum of any such borrowing is limited to 10% of an affiliate's capital and surplus.

Arrow and its subsidiary banks are subject to various regulatory capital requirements administered by the federal banking agencies. Failure to meet minimum capital requirements can initiate certain mandatory--and possibly additional discretionary--actions by regulators that, if undertaken, could have a direct material effect on an institution's financial statements. Under capital adequacy guidelines and the regulatory framework for prompt corrective action, Arrow and its subsidiary banks must meet specific capital guidelines that involve quantitative measures of assets, liabilities, and certain off-balance sheet items as calculated under regulatory accounting practices. Capital amounts and classification are also subject to qualitative judgments by the regulators about components, risk weightings, and other factors.

Quantitative measures established by regulation to ensure capital adequacy require Arrow and its subsidiary banks to maintain minimum capital amounts and ratios (set forth in the table below) of total and Tier I capital (as defined in the regulations) to risk-weighted assets (as defined), and of Tier I capital (as defined) to average assets (as defined). Management believes, as of December 31, 2008 and 2007, that Arrow and both subsidiary banks meet all capital adequacy requirements to which they are subject.

As of December 31, 2008, Arrow and both subsidiary banks qualified as well-capitalized under the regulatory framework for prompt corrective action. To be categorized as well-capitalized, Arrow and its subsidiary banks must maintain minimum total risk-based, Tier I risk-based, and Tier I leverage ratios as set forth in the table below. There are no conditions or events that management believes have changed Arrow's or its subsidiary banks' categories.

Arrow's and its subsidiary banks, Glens Falls National Bank and Trust Company (Glens Falls National) and Saratoga National Bank and Trust Company (Saratoga National), actual capital amounts and ratios are presented in the table below as of December 31, 2008 and 2007:

Minimum Amounts	Minimum Amounts
For Capital	To Be

	<u>Actual</u>		<u>Adequacy Purposes</u>		<u>Well-Capitalized</u>	
	<u>Amount</u>	<u>Ratio</u>	<u>Amount</u>	<u>Ratio</u>	<u>Amount</u>	<u>Ratio</u>
As of December 31, 2008:						
Total Capital						
(to Risk Weighted Assets):						
Arrow	\$155,015	14.3%	\$86,722	8.0%	\$108,402	10.0%
Glens Falls National	131,825	14.5	72,731	8.0	90,914	10.0
Saratoga National	23,911	13.4	14,275	8.0	17,844	10.0
Tier I Capital						
(to Risk Weighted Assets):						
Arrow	141,743	13.1	43,280	4.0	64,920	6.0
Glens Falls National	120,968	13.3	36,381	4.0	54,572	6.0
Saratoga National	21,677	12.1	7,166	4.0	10,749	6.0
Tier I Capital						
(to Average Assets):						
Arrow	141,743	8.5	66,703	4.0	66,703	4.0
Glens Falls National	120,968	8.4	57,604	4.0	72,005	5.0
Saratoga National	21,677	9.1	9,528	4.0	11,910	5.0

NOTE 15:
REGULATORY MATTERS (Continued)

	Minimum Amounts				Minimum Amounts	
	For Capital				To Be	
	<u>Actual</u>		<u>Adequacy Purposes</u>		<u>Well-Capitalized</u>	
	<u>Amount</u>	<u>Ratio</u>	<u>Amount</u>	<u>Ratio</u>	<u>Amount</u>	<u>Ratio</u>
As of December 31, 2007:						
Total Capital						
(to Risk Weighted Assets):						
Arrow	\$145,475	14.1%	\$82,598	8.0%	\$103,247	10.0%
Glens Falls National	124,646	14.5	68,913	8.0	86,141	10.0
Saratoga National	21,949	12.7	13,622	8.0	17,028	10.0
Tier I Capital						
(to Risk Weighted Assets):						
Arrow	133,074	12.9	41,295	4.0	61,943	6.0
Glens Falls National	114,396	13.3	34,457	4.0	51,685	6.0
Saratoga National	19,799	11.5	6,917	4.0	10,375	6.0
Tier I Capital						
(to Average Assets):						
Arrow	133,074	8.4	63,596	4.0	63,596	4.0
Glens Falls National	114,396	8.4	54,735	4.0	68,419	5.0
Saratoga National	19,799	8.6	9,177	4.0	11,471	5.0

NOTE 16:
RETIREMENT PLANS (Dollars in Thousands)

Arrow sponsors qualified and nonqualified defined benefit pension plans and other postretirement benefit plans for its employees. For the qualified pension plan, the fair value of the plan's assets, at \$26,568, exceeded the projected benefit obligation by \$974 at December 31, 2008. 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%.

NOTE 16:**RETIREMENT PLANS (Continued)**

The following tables set forth changes in the plans' benefit obligations (projected benefit obligation for pension benefits and accumulated benefit obligation for postretirement benefits) and changes in the plans' assets and the funded status of the pension plans and other postretirement benefit plan at December 31:

	<u>2008</u>			<u>2007</u>		
	Select			Select		
	Executive	Total		Executive	Total	
	Employee Pension Plan	Retirement Plan	Pension Plan	Employee Pension Plan	Retirement Plan	Pension Plan
Change in Benefit Obligation:						
Benefit Obligation at January 1	\$25,181	\$ 3,547	\$28,728	\$24,506	\$ 3,162	\$27,668
Service Cost	980	45	1,025	950	44	994
Interest Cost	1,563	224	1,787	1,442	180	1,622
Amendments	184	---	184	150	180	330
Actuarial Loss	357	139	496	655	269	924
Benefits Paid	<u>(2,671)</u>	<u>(310)</u>	<u>(2,981)</u>	<u>(2,522)</u>	<u>(288)</u>	<u>(2,810)</u>
Benefit Obligation at December 31 ¹	<u>25,594</u>	<u>3,645</u>	<u>29,239</u>	<u>25,181</u>	<u>3,547</u>	<u>28,728</u>
Change in Plan Assets:						
Fair Value of Plan Assets at January 1	31,040	---	31,040	29,317	---	29,317
Actual Return on Plan Assets	(8,301)	---	(8,301)	2,245	---	2,245
Employer Contributions	6,500	310	6,810	2,000	288	2,288
Benefits Paid	<u>(2,671)</u>	<u>(310)</u>	<u>(2,981)</u>	<u>(2,522)</u>	<u>(288)</u>	<u>(2,810)</u>
Fair Value of Plan Assets at December 31	<u>26,568</u>	<u>---</u>	<u>26,568</u>	<u>31,040</u>	<u>---</u>	<u>31,040</u>
Funded Status	<u>\$ 974</u>	<u>\$(3,645)</u>	<u>\$ (2,671)</u>	<u>\$ 5,859</u>	<u>\$(3,547)</u>	<u>\$ 2,312</u>

Postretirement Benefits:

	<u>2008</u>	<u>2007</u>
Change in Benefit Obligation:		
Benefit Obligation at January 1	\$6,821	\$6,860
Service Cost	154	165
Interest Cost	423	384
Plan Participants' Contributions	236	209
Amendments	152	(659)
Actuarial Loss	70	357
Medicare Part D Prescription Drug Federal Subsidy	10	21
Benefits Paid	<u>(525)</u>	<u>(516)</u>
Benefit Obligation at December 31 ¹	<u>7,341</u>	<u>6,821</u>

Change in Plan Assets:

Employer Contributions	279	286
Plan Participants' Contributions	236	209
Medicare Part D Prescription Drug Federal Subsidy	10	21
Benefits Paid	<u>(525)</u>	<u>(516)</u>
Fair Value of Plan Assets at December 31	<u>---</u>	<u>---</u>

Funded Status **\$(7,341)** **\$(6,821)**

¹ Represents the projected benefit obligation for pension benefits and the accumulated benefit obligation for postretirement benefits.

NOTE 16:
RETIREMENT PLANS (Continued)

The following tables summarize the funded status of the pension and postretirement plans, reconciled to the amounts recognized in the consolidated balance sheets as of December 31, 2008 and 2007:

<u>Pension Plans:</u>	<u>2008</u>			<u>2007</u>		
	Select			Select		
	Executive	Total		Executive	Total	
	Employee s Retirement Pension Plan	Plan	Pension Plan	Employee s Retirement Pension Plan	Plan	Pension Plan
Prepaid Benefit Cost	\$974	\$ ---	\$ 974	\$5,859	\$ ---	\$ 5,859
Accrued Benefit Liability	---	(3,645)	(3,645)	---	(3,547)	(3,547)
Net Benefit Cost Recognized	\$974	\$(3,645)	\$(2,671)	\$5,859	\$(3,547)	\$ 2,312

<u>Postretirement Benefits:</u>	<u>2008</u>	<u>2007</u>
Prepaid Benefit Cost	\$ ---	\$ ---
Accrued Benefit Liability	(7,341)	(6,821)
Net Benefit Cost Recognized	\$(7,341)	\$(6,821)

The components of accumulated other comprehensive income related to pension plans and other postretirement benefits, on a pre-tax basis, at December 31 are summarized below.

<u>Pension Plans:</u>	<u>2008</u>			<u>2007</u>		
	Select			Select		
	Executive	Total		Executive	Total	
	Employee s Retirement Pension Plan	Plan	Pension Plan	Employee s Retirement Pension Plan	Plan	Pension Plan
Change in Benefit Obligation:						

		<u>Plan</u>			<u>Plan</u>	
Net Actuarial Loss	\$16,933	\$1,661	\$18,594	\$5,972	\$1,630	\$7,602
Prior Service Credit	<u>(279)</u>	<u>(20)</u>	<u>(299)</u>	<u>(452)</u>	<u>(123)</u>	<u>(575)</u>
Total Pre-tax Amounts Recognized in						
Accumulated Other Comprehensive Loss	\$16,654	\$1,641	\$18,295	\$5,520	\$1,507	\$7,027

<u>Postretirement Benefits:</u>	<u>2008</u>	<u>2007</u>
Net Actuarial Loss	\$2,099	\$2,063
Prior Service Credit	<u>(792)</u>	<u>(1,052)</u>
Total Pre-tax Amounts Recognized in		
Accumulated Other Comprehensive Loss	\$1,307	\$1,011

We expect that \$1,387 of net actuarial loss and \$184 of prior service credit, included in accumulated other comprehensive income at December 31, 2008, will be recognized as components of net periodic benefit cost in 2009.

At December 31, 2008 and 2007, the accumulated benefit obligation (the actuarial present value of benefits, vested and non-vested, earned by employees based on current and past compensation levels) for Arrow's qualified defined benefit pension plan totaled \$25,070 and \$24,607, respectively, which compared with total plan assets of \$26,567 and \$31,040, respectively. At December 31, 2008 and 2007, the accumulated benefit obligation for Arrow's non-qualified defined benefit pension plan was \$3,645 and \$3,547, respectively, which compared with no plan assets at December 31, 2008 and 2007.

NOTE 16:**RETIREMENT PLANS (Continued)**

The following table provides the components of net periodic benefit costs for the plans for the years ended December 31:

<u>Pension Plans:</u>	<u>2008</u>			<u>2007</u>			<u>2006</u>		
	Select			Select			Select		
	Executive	Total		Executive	Total		Executive	Total	
	Employee Pension Plan	Retirement Plan	Pension Plan	Employee Pension Plan	Retirement Plan	Pension Plan	Employee Pension Plan	Retirement Plan	Pension Plan
<u>Net Periodic Benefit Cost</u>									
Service Cost	\$980	\$45	\$1,025	\$ 950	\$ 44	\$ 994	\$1,033	\$87	\$1,120
Interest Cost	1,564	223	1,787	1,442	180	1,622	1,310	188	1,498
Expected Return on Plan Assets	(2,547)	---	(2,547)	(2,501)	---	(2,501)	(2,246)	---	(2,246)
Amortization of Prior Service Credit	10	(102)	(92)	(11)	(110)	(121)	(11)	(91)	(102)
Amortization of Net Loss	244	108	352	225	100	325	375	149	524
Net Periodic Benefit Cost	251	274	525	105	214	319	\$ 461	\$ 333	\$ 794
<u>Other Changes in Plan Assets and Benefit Obligations Recognized in Other Comprehensive Loss:</u>									
Net Loss	11,204	140	11,344	907	269	1,176			
Prior Service Cost (Credit)	184	---	184	150	180	330			
Amortization of Net Loss	(244)	(108)	(352)	(225)	(100)	(325)			
Amortization of Prior Service Credit	(10)	102	92	11	110	121			
Total Recognized in	11,134	134	11,268	843	459	1,302			

Other
Comprehensive

Loss
Total
Recognized in
Net

Periodic
Benefit Cost

And Other

Comprehensive Loss	<u>\$11.385</u>	<u>\$408</u>	<u>\$11.793</u>	<u>\$948</u>	<u>\$673</u>	<u>\$1.621</u>
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Postretirement Benefits:

<u>Net Periodic Benefit Cost</u>	<u>2008</u>	<u>2007</u>	<u>2006</u>
Service Cost	\$154	\$165	\$180
Interest Cost	423	384	428
Amortization of Prior Service Credit	(108)	(118)	(3)
Amortization of Transition Obligation	---	---	28
Amortization of Net Loss	<u>91</u>	<u>119</u>	<u>121</u>
Net Periodic Benefit Cost	<u>560</u>	<u>550</u>	<u>\$754</u>

Other Changes in Plan Assets and Benefit

<u>Obligations Recognized in Other Comprehensive Loss</u>		
Net Loss	127	348
Prior Service Cost (Credit)	152	(659)
Amortization of Net Loss	(91)	(119)
Amortization of Prior Service Credit	<u>108</u>	<u>118</u>
Total Recognized in Other Comprehensive Loss	<u>296</u>	<u>(312)</u>
Total Recognized in Net Periodic Benefit Cost and		
Other Comprehensive Loss	<u>\$856</u>	<u>\$238</u>

NOTE 16:**RETIREMENT PLANS (Continued)**

The prior service costs or credits are amortized on a straight-line basis over the average remaining service period of active participants. Gains and losses in excess of 10% of the greater of the benefit obligation or the fair value of assets are amortized over the average remaining service period of active participants.

Additional Information:	<u>Employee Pension Plan and Select Executive Retirement Plan</u>			<u>Postretirement Benefits</u>		
	<u>2008</u>	<u>2007</u>	<u>2006</u>	<u>2008</u>	<u>2007</u>	<u>2006</u>
Weighted-Average Assumptions Used						
To Determine Benefit Obligation at						
December 31:						
Discount Rate	6.15%	6.40%	5.85%	6.15%	6.40%	5.85%
Rate of Compensation Increase	3.50%	3.50%	3.50%	3.50%	3.50%	3.50%
Interest Rate Credit for Determining						
Projected Cash Balance Account	4.50%	4.75%	4.75%	---	---	---
Interest Rate to Annuitize Cash						
Balance Account	6.00%	6.00%	4.75%	---	---	---
Interest Rate to Convert Annuities						
To Actuarially Equivalent Lump						
Sum Amounts	6.00%	6.00%	4.75%	---	---	---

	<u>Employee Pension Plan and Select Executive Retirement Plan</u>			<u>Postretirement Benefits</u>		
	<u>2008</u>	<u>2007</u>	<u>2006</u>	<u>2008</u>	<u>2007</u>	<u>2006</u>
Weighted-Average Assumptions Used						
To Determine Net Periodic Benefit						

Cost for Years Ended December 31:

Discount Rate	6.40%	5.85%	5.50%	6.40%	5.85%	5.50%
Expected Long-Term Return on						
Plan Assets	8.00%	8.50%	8.75%	---	---	---
Rate of Compensation Increase	3.50%	3.50%	3.50%	3.50%	3.50%	3.50%
Interest Rate Credit for Determining						
Projected Cash Balance Account	4.75%	4.75%	4.75%	---	---	---
Interest Rate to Annuitize Cash						
Balance Account	6.00%	4.75%	4.75%	---	---	---
Interest Rate to Convert Annuities						
To Actuarially Equivalent Lump						
Sum Amounts	6.00%	4.75%	4.75%	---	---	---

The expected long-term rate of return on plan assets is based on the return of the portfolio as a whole and not the sum of the returns on individual asset categories. This expected return of 8.00% for the year ended December 31, 2008 was based principally on Arrow's fifteen-year time-weighted historical return of 7.15% with an adjustment for expected returns. This was reduced from the 8.50% and 8.75% expected ten-year returns utilized for the years ended December 31, 2007 and 2006, respectively.

The discount rate to determine the benefit obligation is based on the Citigroup Pension Discount Curve as adjusted to provide the necessary cash flows for the payment of benefits when due. This discount rate utilized for determining the benefit obligation for the year ended December 31, 2008 was 6.15%, compared to rates of 6.40% and 5.85% utilized for the years ended December 31, 2007 and 2006, respectively.

The following table presents management's estimated benefit payments for the next ten years:

<u>Payment Period</u>	<u>Employee Pension Plan</u>	<u>Select Executive Retirement Plan</u>	<u>Postretirement Plan</u>
2009	\$ 1,925	\$ 290	\$ 483
2010	1,781	283	507
2011	2,090	379	529
2012	2,153	373	547
2013	2,062	363	554
2014-2018	10,623	1,649	2,951

NOTE 16:**RETIREMENT PLANS (Continued)**

	Assumed Health Care Cost Trend Rates at December 31,					
	<u>Health Care Pre 65</u>		<u>Health Care Post 65</u>		<u>Drug Benefits</u>	
	<u>2008</u>	<u>2007</u>	<u>2008</u>	<u>2007</u>	<u>2008</u>	<u>2007</u>
Health Care Cost Trend						
Rate Assumed for Next Year	8.30%	9.00%	7.50%	8.00%	10.00%	11.00%
Rate to which the Cost Trend						
Rate is Assumed to Decline						
(the Ultimate Trend Rate)	5.00%	5.00%	5.00%	5.00%	5.00%	5.00%
Year that the Rate Reaches						
the Ultimate Trend Rate	2015	2015	2015	2015	2015	2015

Assumed health care cost trend rates have a significant effect on the amounts reported for the health care plans. A one-percentage-point change in assumed health care cost trend rates would have the following effects:

	<u>1-Percentage- Point Increase</u>	<u>1-Percentage- Point Decrease</u>
Effect on Total Service and Interest Cost Components of Net Periodic		
Postretirement Benefit Cost For the Year Ended December 31, 2008	\$ 53	\$(47)
Effect on the Accumulated Postretirement Benefit Obligation as of		
December 31, 2008	514	(471)

Arrow's pension plan weighted-average asset allocations at December 31, 2008, and 2007, by asset category are as follows:

Employee Pension

Plan Assets

At December 31,

<u>2008</u>	<u>2007</u>
16.3%	7.6%
0.1	0.1
12.3	10.1
53.6	65.4
<u>17.7</u>	<u>16.8</u>
<u>100.0%</u>	<u>100.0%</u>

Asset Category:

Cash		
Mortgages		
Company Stock		
Mutual Funds	Equity	
Mutual Funds	Fixed Income	
Total		

At December 31, 2008 and 2007, plan assets included shares of mutual funds advised by Arrow's subsidiary, North Country Investment Advisers, Inc., with a market value of \$14,453 and \$17,453, respectively. At December 31, 2008 and 2007, plan assets also included 130 and 146 shares, respectively, of Arrow Financial Corporation common stock with a market value of \$3,262 and \$3,137, respectively. During the respective years, the plan received \$141 and \$123 from cash dividends on Arrow's common stock. In accordance with ERISA guidelines, the Board authorized the purchase of Arrow common stock up to 10% of the fair market value of the plan's assets at the time of acquisition. During 2008, the market value of Arrow common stock increase while the market value of other plan assets declined.

NOTE 16:

RETIREMENT PLANS (Continued)

Pension Plan Investment Policies and Strategies:

Return Requirements:

The portfolio should achieve an inflation-protected rate of return at least equal to the actuarial assumption.

Risk Tolerance:

The Plan has the flexibility to accept an average to above-average degree of risk. Key factors to consider in reaching conclusions regarding risk tolerance are: (i) the pension plan must meet ERISA prudence requirements, which apply to the entire portfolio, not just its individual component securities, (ii) the expected long-term return on plan assets is reasonable relative to historic results over the last ten years, (iii) the salary progression rate is in line with past results, (iv) the plan is valued annually, (v) Arrow's average employee age is reasonably low (45), and the time horizon is long, and (vi) the Plan's operating results have been relatively strong and consistent.

Asset Allocation:

The Plan's limited liquidity requirements permit a low level of short-term reserves, which in any event do not meet the plan's 8.00% return requirement. All of the constraints suggest that moderate emphasis on common stocks is appropriate. With historically low interest rates, a lower weighting in bonds is appropriate. A separate asset allocation policy is reviewed by the Compensation Committee of the Board on a regular basis and documented.

Investment Strategy:

The equity portion of the plan will be invested in a diversified portfolio of equity securities of companies with small, mid, and large capitalizations. Both domestic and international equities are allowed. While the plan is allowed to invest in the common stock of Arrow Financial up to 10% of the fair market value of plan assets at purchase, the plan assets will not be concentrated in any particular industry. Both growth and value styles will be employed to increase the diversification and offer varying opportunities for appreciation.

The fixed income portion of the plan will be invested in U.S. dollar denominated investment grade bonds or debt securities and fixed income mutual funds. Individual fixed income securities shall be rated within the top four ratings categories by nationally recognized ratings agencies such as Moody's and Standard & Poor's. The individual fixed income portfolio will maintain a dollar-weighted average quality of A or better and an average dollar-weighted maturity between 1 and 10 years. The individual fixed income portion will be invested without regard to industry or sector based on analysis of each target security's structural and repayment features, current pricing and trading opportunities as well as credit quality of the issuer. Individual bonds with ratings that fall below the portfolio's rating requirements will be sold only when it is in the best interests of the plan.

Cash Flows

The expected 2009 contribution for the qualified pension plan is \$2,000 and the expected 2009 contribution for the nonqualified plan is \$290. Arrow makes contributions for its postretirement benefits in an amount equal to actual expenses for the year. The expected contribution is estimated to be \$300 for 2009.

NOTE 17:

OTHER EMPLOYEE BENEFIT PLANS (In Thousands)

Arrow maintains an employee stock ownership plan (ESOP). Substantially all employees of Arrow and its subsidiaries are eligible to participate upon satisfaction of applicable service requirements. The ESOP borrowed \$1,000, \$1,500, \$105, \$464 and \$853 in 2008, 2007, 2001, 2000 and 1999, respectively, 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. Arrow's ESOP expense amounted to \$549, \$168 and \$502 in 2008, 2007 and 2006, respectively. 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.

Shares pledged as collateral are reported as unallocated ESOP shares in shareholders' 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. The ESOP shares as of December 31, 2008 were as follows:

Allocated Shares	687
Shares Released for Allocation During 2008	31
Unallocated Shares	<u>122</u>
Total ESOP Shares	<u>840</u>
Market Value of Unallocated Shares	\$3,069

Under the employee stock purchase plan (ESPP), employees may purchase shares of Arrow s common stock, up to \$24 annually, at a discount to the prevailing market price (currently a 5% discount). Under the ESPP, shares are issued by Arrow without a charge to earnings in accordance with SFAS No. 123(R). Substantially all employees of Arrow and its subsidiaries are eligible to participate upon satisfaction of applicable service requirements. Arrow also sponsors a Long-Term Incentive Award Plan and a Short-Term Incentive Award Plan for senior management and a Profit Sharing Plan for substantially all employees. The combined cost of these plans was \$1,184, \$336 and \$250 for 2008, 2007 and 2006, respectively.

NOTE 18:**STOCK OPTION PLANS**

Arrow has established fixed Incentive Stock Option and Non-qualified Stock Option Plans. At December 31, 2008, approximately 300,000 shares remained available for grant under these plans. 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, however, in December 2005 Arrow's Compensation Committee of the Board of Directors accelerated the vesting for all the remaining unvested shares from stock options granted in 2002 through 2004. The action to accelerate the vesting of the stock options was made to eliminate the non-cash compensation expense that would otherwise have been recognized by the Company in the 2006-2008 period due to the required adoption of FASB Statement 123(R) on January 1, 2006.

For years ended December 31, 2008, 2007 and 2006, the amount expensed for grants issued under these plans was \$115, \$70 and \$5, respectively. Grants were issued in 2007 and 2006, but no grants were issued in 2008. The weighted-average fair value of options granted during 2007 and 2006 was \$4.37 and \$5.68, respectively. The fair value of each option grant is estimated on the date of grant using the Black-Scholes option-pricing model with the following weighted-average assumptions used for grants in 2007 and 2006, respectively: dividend yields of 4.34% and 3.86%; expected volatility of 27.3% and 27.2%; risk free interest rates of 3.77% and 4.81%; and expected lives of 8.09 and 7.42 years.

A summary of the status of Arrow's stock option plans as of December 31, 2008 and changes during the year then ended is presented below.

		Weighted		
		Average	Remaining	Aggregate
		Exercise	Contractual	Intrinsic
Options:	<u>Shares</u>	<u>Price</u>	<u>Life (in years)</u>	<u>Value</u>
Outstanding at January 1, 2008	519,557	\$20.77		
Granted	---	---		
Exercised	(79,823)	14.73		
Forfeited	<u>(5,202)</u>	25.00		
Outstanding at December 31, 2008	<u>434,532</u>	21.83	4.7	\$1,438
Exercisable at December 31, 2008	379,780	21.71	4.1	1,303
Expected to Vest	54,752	22.68	8.5	---

Cash proceeds, tax benefits and intrinsic value related to total stock options exercised were as follows:

	Years Ended		
	December 31,		
	<u>2008</u>	<u>2007</u>	<u>2006</u>
Proceeds From Stock Options Exercised	\$1,176	\$1,055	\$724
Tax Benefits Related to Stock Options Exercised	176	164	315
Intrinsic Value of Stock Options Exercised	874	485	855

The following table summarizes information about Arrow's stock options at December 31, 2008:

<u>Options Outstanding</u>			<u>Options Exercisable</u>		
		Weighted-			Weighted-
		Average			Average
Range of	Number	Remaining	Average	Number	Weighted-
Exercise	Outstanding	Contractual	Exercise	Exercisable	Exercise
<u>Prices</u>	<u>At 12/31/08</u>	<u>Life (Years)</u>	<u>Price</u>	<u>at 12/31/08</u>	<u>Price</u>
\$11.99-\$12.92	75,483	1.5	\$12.43	75,483	\$12.43
\$14.44	3,877	0.1	14.44	3,877	14.44
\$19.21	71,736	3.0	19.21	71,736	19.21
\$21.70	43,000	8.9	21.70	10,750	21.70
\$24.11-\$24.73	174,666	5.3	24.34	152,164	24.37
\$29.30	<u>65,770</u>	6.0	29.30	<u>65,770</u>	29.30
	<u>434,532</u>	4.7	21.83	<u>379,780</u>	21.71

NOTE 19:

OTHER OPERATING EXPENSE (In Thousands)

Other operating expenses included in the consolidated statements of income are as follows:

	<u>2008</u>	<u>2007</u>	<u>2006</u>
Computer Services	\$ 1,467	\$ 1,460	\$1,352
Legal and Other Professional Fees	1,835	1,369	1,365
Postage	1,335	1,332	1,258
Advertising and Promotion	977	758	658
Stationery and Printing	970	926	853
FDIC and Other Insurance	853	354	366
Telephone and Communications	839	751	679
Visa-Related Litigation Exposure	(306)	600	---
Intangible Asset Amortization	360	395	435
Charitable Contributions	124	145	153
All Other	<u>2,698</u>	<u>2,203</u>	<u>1,563</u>
Total Other Operating Expense	<u>\$11,152</u>	<u>\$10,293</u>	<u>\$8,682</u>

NOTE 20:

INCOME TAXES (In Thousands)

The provision for income taxes is summarized below:

	<u>2008</u>	<u>2007</u>	<u>2006</u>
Current Tax Expense:			
Federal	\$6,263	\$5,421	\$6,264
State	<u>533</u>	<u>365</u>	<u>516</u>
Total Current Tax Expense	<u>6,796</u>	<u>5,786</u>	<u>6,780</u>
Deferred Tax Expense			
Federal	1,852	867	236
			183

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State	<u>351</u>	<u>154</u>	<u>108</u>
Total Deferred Tax Expense	<u>2,203</u>	<u>1,021</u>	<u>344</u>
Total Provision for Income Taxes	<u>\$8,999</u>	<u>\$6,807</u>	<u>\$7,124</u>

The provisions for income taxes differed from the amounts computed by applying the U.S. Federal Income Tax Rate of 35% for 2008, 2007 and 2006 to pre-tax income as a result of the following:

	<u>2008</u>	<u>2007</u>	<u>2006</u>
Computed Tax Expense at Statutory Rate	\$10,303	\$8,449	\$8,406
Increase (Decrease) in Income Taxes Resulting From:			
Tax-Exempt Income	(2,026)	(2,068)	(1,730)
Nondeductible Interest Expense	199	258	193
State Taxes, Net of Federal Income Tax Benefit	575	338	406
Other Items, Net	<u>(52)</u>	<u>(170)</u>	<u>(151)</u>
Total Provision for Income Taxes	<u>\$8,999</u>	<u>\$6,807</u>	<u>\$7,124</u>

The tax effects of temporary differences that give rise to significant portions of the deferred tax assets and deferred tax liabilities at December 31, 2008 and 2007 are presented below:

Deferred Tax Assets:	<u>2008</u>	<u>2007</u>
Allowance for Loan Losses	\$ 5,144	\$ 4,799
Pension and Deferred Compensation Plans	3,631	3,510
Pension Liability (Included in Accumulated Other Comprehensive Income)	7,766	3,185
Net Unrealized Losses on Securities Available-for-Sale	---	24
Other	<u>980</u>	<u>440</u>
Total Gross Deferred Tax Assets	<u>17,521</u>	<u>11,958</u>
Deferred Tax Liabilities:		
Pension Plans	6,983	4,507
Depreciation	750	567
Deferred Income	2,639	2,469
Net Unrealized Gains on Securities Available-for-Sale	1,596	---
Goodwill	<u>2,757</u>	<u>2,377</u>
Total Gross Deferred Tax Liabilities	<u>14,725</u>	<u>9,920</u>
Net Deferred Tax Assets (Included in Other Assets)	<u>\$2,796</u>	<u>\$2,038</u>

NOTE 20:**INCOME TAXES (Continued)**

Management believes that the realization of the recognized net deferred tax assets at December 31, 2008 and 2007 is more likely than not, based on existing loss carryback ability, available tax planning strategies and expectations as to future taxable income. Accordingly, there was no valuation allowance for deferred tax assets as of December 31, 2008 and 2007.

At January 1, 2008 and for the period ended December 31, 2008, Arrow had no unrecognized tax benefits under FIN 48. Interest and penalties are recorded as a component of the provision for income taxes, if any. During 2008, the Internal Revenue Service completed an examination of our 2006 federal income tax return, which resulted in an additional payment of \$38. Tax years 2007 and 2008 are subject to examination. During 2007, the New York State Department of Taxation and Finance conducted an examination of our 2003, 2004 and 2005 bank franchise tax returns, which concluded with no adjustments. Tax years 2006 through 2008 are subject to New York State examination.

NOTE 21:**LEASE COMMITMENTS (In Thousands)**

At December 31, 2008, Arrow was obligated under a number of noncancellable operating leases for buildings and equipment. Certain of these leases provide for escalation clauses and contain renewal options calling for increased rentals if the lease is renewed.

Future minimum lease payments on operating leases at December 31, 2008 were as follows:

	Operating
	<u>Leases</u>
2009	\$ 398
2010	344
2011	345
2012	350
2013	356
Later Years	<u>1,436</u>
Total Minimum Lease Payments	<u>\$3,229</u>

Arrow leases three of its branch offices, at market rates, from Stewart's Shops Corp. Gary Dake, president of Stewart's Shops Corp., serves on both the boards of Arrow and Saratoga National Bank and Trust Company.

NOTE 22:

FINANCIAL INSTRUMENTS WITH OFF-BALANCE SHEET RISK AND CONTINGENT LIABILITIES

(In Thousands)

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

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

Commitments to extend credit were \$160,559 and \$175,744 at December 31, 2008 and 2007, respectively. These commitments 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 lines of credit 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.

FASB Interpretation No. 45 (FIN No. 45), "Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others; an Interpretation of FASB Statements No. 5, 57, and 107 and rescission of FASB Interpretation No. 34" requires certain disclosures and potential liability-recognition for the fair value at issuance of guarantees that fall within its scope. Arrow does not issue any guarantees that would require liability-recognition or disclosure, other than its standby letters of credit.

NOTE 22:

**FINANCIAL INSTRUMENTS WITH OFF-BALANCE SHEET RISK AND CONTINGENT LIABILITIES
(Continued)**

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 totaled \$15,095 and \$3,187 at December 31, 2008 and 2007, respectively, and 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 will 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 range from 1% to 3% of the notional amount. Fees are collected upfront and amortized over the life of the commitment. The carrying amount and fair value of Arrow's standby letters of credit at December 31, 2008 and 2007 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.

Under SFAS No. 107 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.

NOTE 23:

FAIR VALUE OF FINANCIAL INSTRUMENTS (In Thousands)

The only assets or liabilities that Arrow measured at fair value on a recurring basis at December 31, 2008 were securities available-for-sale. Arrow held no securities or liabilities for trading on such date. The fair value measurement of securities available-for-sale on such date was as follows:

Fair Value Measurements at Reporting Date Using:

<u>Description</u>	<u>12/31/2008</u>	Quoted Prices		
		In Active Markets for Identical Assets	Significant Other Observable Inputs	Significant Unobservable Inputs
		<u>(Level 1)</u>	<u>(Level 2)</u>	<u>(Level 3)</u>
Securities Available-for Sale	\$325,090	\$---	\$324,535	\$555

Securities available-for-sale are fair valued utilizing independent bond pricing services for identical assets or significantly similar securities. 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. Based on the inputs used by our independent pricing services, we identify the appropriate level within the fair value hierarchy to report these fair values in accordance with SFAS 157. We do not hold, nor have we ever invested in, any auction rate investment securities.

On October 10, 2008, the FASB issued FASB Staff Position (FSP) 157-3, an amendment of SFAS No. 157, to clarify the application of SFAS No. 157 in an inactive market by providing an illustrative example to demonstrate how the fair value of a financial asset is determined when the market for that financial asset is inactive. Application issues addressed by the FSP include: a. How management's internal assumptions (that is, expected cash flows and appropriately risk-adjusted discount rates) should be considered when measuring fair value when relevant observable data do not exist; b. How observable market information in a market that is not active should be considered when measuring fair value; c. How the use of market quotes (for example, broker quotes or pricing services for the same or similar financial assets) should be considered when assessing the relevance of observable and unobservable data available to measure fair value.

Effective for any unissued financial statements, we have applied the FSP to the valuation of two securities in our securities available-for-sale portfolio as of December 31, 2008: 1) our holding of a Lehman Brothers bond, and 2) our holding of a pooled trust preferred security. These securities are included in Fair Value Measurement Level 3 in the above table that Arrow measured at fair value on a recurring basis at December 31, 2008. We employed the following methods in our analysis of the fair values: a) Lehman bond - since Lehman Brothers declared bankruptcy on September 15, 2008, the market for this bond has been very illiquid. The price provided by our third-party pricing service reflected values from distressed sales that have occurred, which we have determined do not reflect the fair value of this security. We obtained additional value estimates from unobservable inputs including an estimated future recovery range of values, an estimated future recovery period and an estimated risk premium for securities with similar credit characteristics.

NOTE 23:**FAIR VALUE OF FINANCIAL INSTRUMENTS (Continued)**

Based on using the median price from the estimated recovery price range obtained, and a discount rate including the estimated risk premium obtained, we performed a discounted cash flow analysis to determine the fair value at December 31, 2008; b) trust preferred security - due to the fact that the market for this security is inactive, we performed a discounted cash flow analysis in addition to reviewing the price provided to us by our third-party pricing service in order to determine a fair value estimate for this security as of December 31, 2008. In performing the discounted cash flow analysis, we obtained additional value estimates from unobservable inputs including expected cash flows and a market based rate of return including an assumed risk premium for securities with similar credit characteristics plus a market price adjustment for the small size and lack of an established market for this type of security. We determined the fair value for this security at December 31, 2008 to be the lower of the fair value obtained from our third-party pricing service and our discounted cash flow analysis.

The following table is a reconciliation of the beginning and ending balances for 2008 of the Level 3 assets of Arrow, i.e., as to which fair value is measured using significant unobservable inputs, all of which are securities available-for-sale:

Beginning Balance, January 1, 2008	\$ ---
Transfers In	1,006
Principal payment received	(5)
Total net losses (realized/unrealized):	
Included in earnings, as a result of other-than-temporary impairment	(400)
Included in other comprehensive income	<u>(46)</u>
Ending Balance, December 31, 2008	<u>\$ 555</u>
The amount of total losses for the year 2008 included in earnings attributable to the change in unrealized gains or losses relating to assets still held at December 31, 2008, as a result of other-than-temporary impairment	<u>\$(1,610)</u>

The only asset or liability that Arrow measured at fair value on a nonrecurring basis was other real estate owned:

<u>Fair Value Measurements Using:</u>					
<u>Description</u>	Period	Quoted Prices	Significant	Significant	Total

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	Ended	In Active	Other	Unobservable	Gains
	<u>12/31/2008</u>	Markets for	Observable	Inputs	<u>(Losses)</u>
		Identical Assets	Inputs	<u>(Level 3)</u>	
		<u>(Level 1)</u>	<u>(Level 2)</u>		
Other Real Estate Owned	\$142	---	\$142	---	---

Other real estate owned, in the table above, consists of one property acquired during the first quarter of 2008. Fair value was obtained from an appraisal by an independent third party appraiser and was based on a comparison to recent sales of similar properties and the fact that we are improving the property, prior to sale. The charge to reduce the property to its fair value, less estimated cost to sell, was recorded as a loan charge-off, prior to the transfer to other real estate owned.

Other impaired assets which might have been included in this table include mortgage servicing rights, goodwill and other intangible assets. Arrow evaluates each of these assets for impairment on a quarterly basis, with no impairment recognized for these assets at December 31, 2008.

The following table presents a summary at December 31 of the carrying amount and fair value of Arrow's financial instruments not carried at fair value or an amount approximating fair value:

	<u>2008</u>		<u>2007</u>	
	Carrying	Fair	Carrying	Fair
	<u>Amount</u>	<u>Value</u>	<u>Amount</u>	<u>Value</u>
Securities Held-to-Maturity (Note 3)	\$ 133,976	\$ 134,331	\$ 114,611	\$ 114,977
Net Loans (Note 4)	1,096,540	1,111,411	1,026,443	1,024,783
Time Deposits (Note 9)	403,698	411,853	429,544	429,889
FHLBNY Advances (Note 11)	160,000	171,287	160,000	164,270
Junior Subordinated Obligations Issued to				
Unconsolidated Subsidiary Trusts (Note 12)	20,000	20,000	20,000	19,969

NOTE 24:

CONCENTRATIONS OF CREDIT RISK

Most of Arrow's loans are with customers in northeastern New York. Although the loan portfolios of the subsidiary banks are well diversified, tourism has a substantial impact on the northeastern New York economy. The commitments to extend credit are fairly consistent with the distribution of loans presented in Note 4. Generally, the loans are secured by assets and are expected to be repaid from cash flow or the sale of selected assets of the

borrowers. Arrow evaluates each customer's creditworthiness on a case-by-case basis. The amount of collateral obtained, if deemed necessary by Arrow upon extension of credit, is based upon management's credit evaluation of the counterparty. The nature of the collateral varies with the type of loan and may include: residential real estate, cash and securities, inventory, accounts receivable, property, plant and equipment, income producing commercial properties and automobiles.

NOTE 25:**PARENT ONLY FINANCIAL INFORMATION (In Thousands)**

Condensed financial information for Arrow Financial Corporation is as follows:

BALANCE SHEETS	December 31,	
	<u>2008</u>	<u>2007</u>
ASSETS		
Interest-Bearing Deposits with Subsidiary Banks	\$ 1,389	\$ 297
Securities Available-for-Sale	1,373	1,126
Investment in Subsidiaries at Equity	148,009	144,709
Other Assets	<u>3,069</u>	<u>3,417</u>
Total Assets	<u>\$153,840</u>	<u>\$149,549</u>
LIABILITIES		
Junior Subordinated Obligations Issued to Unconsolidated Subsidiary Trusts	\$ 20,000	\$ 20,000
Other Liabilities	<u>8,038</u>	<u>7,293</u>
Total Liabilities	28,038	27,293
SHAREHOLDERS' EQUITY		
Total Shareholders' Equity	<u>125,802</u>	<u>122,256</u>
Total Liabilities and Shareholders' Equity	<u>\$153,840</u>	<u>\$149,549</u>

STATEMENTS OF INCOME	Years Ended December 31,		
	<u>2008</u>	<u>2007</u>	<u>2006</u>
Income:			
Dividends from Bank Subsidiaries	\$13,919	\$15,850	\$14,250
Interest and Dividends on Securities Available-for-Sale	42	31	22
Other Income (Including Management Fees)	784	665	931
Net Gains on the Sale of Securities Available-for-Sale	<u>10</u>	<u>---</u>	<u>12</u>
Total Income	<u>14,755</u>	<u>16,546</u>	<u>15,215</u>

Expense:

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Interest Expense	1,356	1,547	1,450
Salaries and Benefits	199	138	249
Other Expense	<u>821</u>	<u>698</u>	<u>636</u>
Total Expense	<u>2,376</u>	<u>2,383</u>	<u>2,335</u>
Income Before Income Tax Benefit and Equity in Undistributed Net Income of Subsidiaries	12,379	14,163	12,880
Income Tax Benefit	<u>744</u>	<u>782</u>	<u>722</u>
Income Before Equity in Undistributed Net Income of Subsidiaries	13,123	14,945	13,602
Equity in Undistributed Net Income of Subsidiaries	<u>7,314</u>	<u>2,387</u>	<u>3,290</u>
Net Income	<u>\$20,437</u>	<u>\$17,332</u>	<u>\$16,892</u>

NOTE 25:**PARENT ONLY FINANCIAL INFORMATION (Continued)**

The Statement of Changes in Shareholders' Equity is not reported because it is identical to the Consolidated Statement of Changes in Shareholders' Equity.

STATEMENTS OF CASH FLOWS

	Years Ended December 31,		
	<u>2008</u>	<u>2007</u>	<u>2006</u>
Operating Activities:			
Net Income	\$20,437	\$17,332	\$16,892
Adjustments to Reconcile Net Income to Net Cash Provided by Operating Activities:			
Undistributed Net Income of Subsidiaries	(7,314)	(2,387)	(3,290)
Net Gains on the Sale of Securities Available-for-Sale	(10)	---	(12)
Gain of the Sale of Property	---	---	(148)
Shares Issued Under the Directors' Stock Plan	121	140	130
Stock-Based Compensation Expense	115	70	5
Compensation Expense for Allocated ESOP Shares	---	---	259
Changes in Other Assets and Other Liabilities	<u>498</u>	<u>659</u>	<u>(159)</u>
Net Cash Provided by Operating Activities	<u>13,847</u>	<u>15,814</u>	<u>13,677</u>
Investing Activities:			
Proceeds from the Sale of Securities Available-for-Sale	86	8	429
Purchases of Securities Available-for-Sale	(396)	(156)	(1,044)
Proceeds from the Sale of Property	<u>---</u>	<u>---</u>	<u>326</u>
Net Cash Used in Investing Activities	<u>(310)</u>	<u>(148)</u>	<u>(289)</u>
Financing Activities:			
Exercise of Stock Options, Shares Issued to the Employees			
Stock Purchase Plan and Shares Issued for the Dividend Reinvestment Plan	2,034	1,544	1,224
Tax Benefit for Disposition of Stock Options	176	164	315
Purchase of Treasury Stock	(4,325)	(7,303)	(5,127)
Cash Dividends Paid	<u>(10,330)</u>	<u>(10,027)</u>	<u>(9,929)</u>
Net Cash Used in Financing Activities	<u>(12,445)</u>	<u>(15,622)</u>	<u>(13,517)</u>
Net Increase (Decrease) in Cash and Cash Equivalents	1,092	44	(129)
Cash and Cash Equivalents at Beginning of the Year	<u>297</u>	<u>253</u>	<u>382</u>

Cash and Cash Equivalents at End of the Year	<u>\$ 1,389</u>	<u>\$ 297</u>	<u>\$ 253</u>
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Supplemental Disclosures to Statements of

Cash Flow Information:

Interest Paid	\$1,356	\$1,547	\$1,450
Non-cash Investing and Financing Activities:			
Changes in the Valuation Allowance for Securities Available-for-Sale, Net of Tax	(2,468)	3,707	40
Shares Issued for CFG Acquisition	112	111	41
ESOP Note	(1,000)	(1,500)	---
Surplus Adjustment for Allocated ESOP Shares	250	200	---
Common Stock Purchased by ESOP	470	320	301
Change in Retirement Plan Net Loss and Prior Service Cost, Net of Tax	(6,983)	(632)	---
Adjustment to Initially Apply SFAS No. 158, Net of Tax	---	---	(3,442)

SUMMARY OF QUARTERLY FINANCIAL DATA (Unaudited)

The following quarterly financial information for 2008 and 2007 is unaudited, but, in the opinion of management, fairly presents the results of Arrow.

SELECTED QUARTERLY FINANCIAL DATA

(In Thousands, Except Per Share Amounts)

	<u>2008</u>			
	First	Second	Third	Fourth
	<u>Quarter</u>	<u>Quarter</u>	<u>Quarter</u>	<u>Quarter</u>
Total Interest and Dividend Income	\$22,082	\$22,115	\$22,592	\$22,719
Net Interest Income	12,787	14,364	14,902	15,178
Provision for Loan Losses	290	248	253	880
Net Securities (Losses) Gains	---	(35)	6	412
Income Before Provision for Income Taxes	7,165	7,888	7,206	7,177
Net Income	4,981	5,436	5,008	5,012
Basic Earnings Per Common Share	.47	.51	.48	.48
Diluted Earnings Per Common Share	.47	.51	.47	.47

	<u>2007</u>			
	First	Second	Third	Fourth
	<u>Quarter</u>	<u>Quarter</u>	<u>Quarter</u>	<u>Quarter</u>
Total Interest and Dividend Income	\$20,816	\$21,409	\$21,921	\$22,431
Net Interest Income	11,202	11,425	11,649	12,018
Provision for Loan Losses	94	92	136	191
Net Securities (Losses) Gains	---	---	---	---
Income Before Provision for Income Taxes	5,759	5,931	6,379	6,070
Net Income	4,131	4,210	4,510	4,481

Basic Earnings Per Common Share	.38	.39	.42	.42
Diluted Earnings Per Common Share	.38	.39	.42	.42

Item 9. Changes in and Disagreements With Accountants on Accounting and Financial Disclosure - None.

Item 9A. Controls and Procedures

Senior management maintains disclosure controls and procedures that are designed to ensure that information required to be disclosed in our Exchange Act reports is recorded, processed, summarized and reported within the time periods provided in the SEC's rules and forms, and that such information is accumulated and communicated to our management, including the Chief Executive Officer and Chief Financial Officer, as appropriate, to allow timely decisions regarding required disclosure. In designing and evaluating the disclosure controls and procedures, senior management has recognized that any controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving the desired control objectives, and therefore has been required to apply its judgment in evaluating the cost-benefit relationship of possible controls and procedures.

Senior management, including the Chief Executive Officer and Chief Financial Officer, evaluated the effectiveness of the design and operation of our disclosure controls and procedures (as defined in Rule 13(a)-15(e) under the Exchange Act) as of December 31, 2008. Based upon that evaluation, senior management, including the Chief Executive Officer and Chief Financial Officer, concluded that our disclosure controls and procedures were effective on that date. There were no changes made in our internal controls or in other factors that could significantly affect these internal controls subsequent to the date of the evaluation performed by the Chief Executive Officer and Chief Financial Officer.

Management's Report on Internal Control Over Financial Reporting

Our management is responsible for establishing and maintaining adequate internal control over financial reporting, as such term is defined in Exchange Act Rules 13a-15(f). Under the supervision and with the participation of our management, including our chief executive officer and chief financial officer, we conducted an assessment of the effectiveness of our internal control over financial reporting. Our evaluation is based on the framework set forth in *Internal Control - Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission. Based on our assessment, our management concluded that our internal control over financial reporting was effective as of December 31, 2008.

Item 9B. Other Information - None.

PART III

Item 10. Directors, Executive Officers and Corporate Governance

The information required by this item is set forth under the captions Nominees for Director and Directors Continuing in Office and Board Committees of Arrow's Proxy Statement for its Annual Meeting of Shareholders to be held April 29, 2009 (the Proxy Statement), which sections are incorporated herein by reference. Certain required information regarding our Executive Officers is contained in Part I, Item 1.G., of this Report, Executive Officers of the Registrant. Arrow has adopted a Financial Code of Ethics applicable to our principal executive officer, principal financial officer and principal accounting officer, a copy of which can be found on our website at www.arrowfinancial.com under the link Corporate Governance.

Item 11. Executive Compensation

The information required by this item is set forth under the captions Executive Compensation, Summary Compensation Table, Grants of Plan-Based Awards Table, Outstanding Equity Awards at Fiscal Year-End Table, Option Exercises and Stock Vested Table, Pension Plans, Pension Benefits Table, Nonqualified Deferred Compensation Table, Potential Payments to Executives upon Termination or Change-in-Control, Agreements with Executive Officers, Compensation of Directors, and Director Compensation Table, of the Proxy Statement, which sections are incorporated herein by reference.

Item 12. Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters

Certain information required by this item is set forth under the captions Principal Shareholders of the Company and Nominees for Director and Directors Continuing in Office of the Proxy Statement, which sections are incorporated herein by reference, and in the section entitled Equity Compensation Plan Information in Part II of this Form 10-K on page 13.

Item 13. Certain Relationships and Related Transactions, and Director Independence

The information required by this item is set forth under the captions Transactions with Directors, Officers and Associated Persons, Corporate Governance and Board Independence, Audit Committee Independence and Financial Expert of the Proxy Statement, which sections are incorporated herein by reference.

Item 14. Principal Accounting Fees and Services

The information required by this item is set forth under the captions Ratification of the Independent Auditor and Independent Auditor's Fees of the Proxy Statement, which sections are incorporated herein by reference.

PART IV

Item 15. Exhibits, Financial Statement Schedules

1. Financial Statements

The following financial statements, the notes thereto, and the independent auditors' report thereon are filed in Part II, Item 8 of this report. See the index to such financial statements at the beginning of Item 8.

Reports of Independent Registered Public Accounting Firm

Consolidated Balance Sheets as of December 31, 2008 and 2007

Consolidated Statements of Income for the Years Ended December 31, 2008, 2007 and 2006

Consolidated Statements of Changes in Shareholders

Equity for the Years Ended December 31, 2008, 2007 and 2006

Consolidated Statements of Cash Flows for the Years Ended December 31, 2008, 2007 and 2006

Notes to Consolidated Financial Statements

2. Schedules

All schedules are omitted as the required information is either not applicable or not required or is contained in the respective financial statements or in the notes thereto.

3. Exhibits:

The following exhibits are incorporated by reference herein.

Exhibit

<u>Number</u>	<u>Exhibit</u>
3.(i)	Certificate of Incorporation of the Registrant, as amended, incorporated herein by reference from the Registrant's Annual Report filed on Form 10-K for the year ended December 31, 2007, Exhibit 3.(i)
3.(ii)	By-laws of the Registrant, as amended, incorporated herein by reference from the Registrant's Current Report on Form 8-K filed December 23, 2008, Exhibit 3.i
4.1	Amended and Restated Declaration of the Trust by and among U.S. Bank National Association, as Institutional Trustee, Arrow Financial Corporation, as Sponsor and certain Administrators named therein, dated as of July 23, 2003, relating to Arrow Capital Statutory Trust II, incorporated herein by reference from the Registrant's Quarterly Report on Form 10-Q for the quarter ended September 30, 2003, Exhibit 4.1
4.2	Indenture between Arrow Financial Corporation, as Issuer, and U.S. Bank National Association, as Trustee, dated as of July 23, 2003, incorporated herein by reference from the Registrant's Quarterly Report on Form 10-Q for the quarter ended September 30, 2003, Exhibit 4.2
4.3	Placement Agreement by and among Arrow Financial Corporation, Arrow Capital Statutory Trust II and SunTrust Capital Markets, Inc., dated July 23, 2003, incorporated herein by reference from the Registrant's Quarterly Report on Form 10-Q for the quarter ended September 30, 2003, Exhibit 4.3
4.4	Guarantee Agreement by and between Arrow Financial Corporation and U.S. Bank National Association, dated as of July 23, 2003, incorporated herein by reference from the Registrant's Quarterly Report on Form 10-Q for the quarter ended September 30, 2003, Exhibit 4.4
4.5	Amended and Restated Trust Agreement by and among Wilmington Trust Company, as Institutional Trustee, Arrow Financial Corporation, as Sponsor and certain Administrators named therein, dated as of December 28, 2004, relating to Arrow Capital Statutory Trust III, incorporated herein by reference from the Registrant's Annual Report on Form 10-K for the year ended December 31, 2004, Exhibit 4.6
4.6	Junior Subordinated Indenture between Arrow Financial Corporation, as Issuer, and Wilmington Trust Company, as Trustee, dated as of December 28, 2004, incorporated herein by reference from the Registrant's Annual Report on Form 10-K for the year ended December 31, 2004, Exhibit 4.7
4.7	Placement Agreement by and among Arrow Financial Corporation, Arrow Capital Statutory Trust III and SunTrust Capital Markets, Inc., dated December 28, 2004, incorporated herein by reference from the Registrant's Annual Report on Form 10-K for the year ended December 31, 2004, Exhibit 4.8
4.8	Guarantee Agreement by and between Arrow Financial Corporation and Wilmington Trust Company, dated as of December 28, 2004, incorporated herein by reference from the Registrant's Annual Report on Form 10-K for the year ended December 31, 2004, Exhibit 4.9
10.1	1993 Long Term Incentive Plan of the Registrant, incorporated herein by reference from Registrant's 1993 Act Registration Statement on Form S-8, Exhibit 4.1 (File number 33-66192; filed July 19, 1993).
10.2	1998 Long Term Incentive Plan of the Registrant, incorporated herein by reference from Registrant's

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1933 Act Registration Statement on Form S-8, Exhibit 4.1 (File number 333-62719; filed September 2, 1998)*

- 10.3 2008 Long Term Incentive Plan of the Registrant, incorporated herein by reference from the Registrant's Form 8-K filed on May 6, 2008, Exhibit 10.1*
- 10.4 2000 Employee Stock Purchase Plan of the Registrant, incorporated herein by reference from Registrant's 1933 Act Registration Statement on Form S-3 (File number 333-47912; filed on October 11, 2000)*
- 10.5 Award under Schedule A of Select Executive Retirement Plan to Thomas L. Hoy, dated May 2, 2001, incorporated herein by reference from the Registrant's Annual Report on Form 10-K for the year ended December 31, 2001, Exhibit 10.15*
- 14 Financial Code of Ethics, incorporated herein by reference from the Registrant's Annual Report on Form 10-K for the year ended December 31, 2003, Exhibit 14

* Management contracts or compensation plans required to be filed as an exhibit.

The following exhibits are submitted herewith:

Exhibit

<u>Number</u>	<u>Exhibit</u>
10.6	Profit Sharing Plan of the Registrant, as amended on November 19, 2008*
10.7	Directors' Deferred Compensation Plan of Registrant as amended on November 19, 2008*
10.8	Directors' Stock Plan of the Registrant as amended on November 19, 2008*
10.9	Select Executive Retirement Plan of the Registrant for benefits accrued or vested after December 31, 2004, as amended on December 17, 2008 *
10.10	Select Executive Retirement Plan of the Registrant for benefits accrued or vested on or before December 31, 2004, as amended on December 17, 2008 *
10.11	Senior Officers Deferred Compensation Plan of the Registrant, as amended on December 17, 2008*
10.12	Short Term Incentive Plan of the Registrant, as amended on December 17, 2008*
10.13	Employment Agreement among the Registrant, its subsidiary bank, Glens Falls National Bank and Trust Company, and Thomas L. Hoy dated December 29, 2008*
10.14	Change of Control Agreement among the Registrant, its subsidiary bank, Glens Falls National Bank and Trust Company, and Terry R. Goodemote dated December 31, 2008*
10.15	Consulting Agreement between the Registrant and John C. Van Leeuwen, dated December 29, 2008*
10.16	Consulting Agreement between the Registrant and John J. Murphy, dated December 29, 2008*
21	Subsidiaries of Arrow Financial Corporation
23	Consent of Independent Registered Public Accounting Firm
31.1	Certification of Chief Executive Officer under SEC Rule 13a-14(a)/15d-14(a)
31.2	Certification of Chief Financial Officer under SEC Rule 13a-14(a)/15d-14(a)
32	Certification of Chief Executive Officer under 18 U.S.C. Section 1350 and Certification of Chief Financial Officer under 18 U.S.C. Section 1350

* Management contracts or compensation plans required to be filed as an exhibit.

SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

ARROW FINANCIAL CORPORATION

Date: March 5, 2009

By /s/ Thomas L. Hoy

Thomas L. Hoy

Chairman, President and Chief Executive Officer

Date: March 5, 2009

By: /s/ Terry R. Goodemote

Terry R. Goodemote

Senior Vice President, Treasurer and

Chief Financial Officer

(Principal Financial and Accounting Officer)

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below on March 5, 2009 by the following persons in the capacities indicated.

/s/ Herbert O. Carpenter

Herbert O. Carpenter

/s/ Thomas L. Hoy

Thomas L. Hoy

Director

/s/ John J. Carusone, Jr.

John J. Carusone, Jr.

Director

/s/ Michael B. Clarke

Michael B. Clarke

Director

/s/ Gary C. Dake

Gary C. Dake

Director

/s/ Mary Elizabeth T. FitzGerald

Mary Elizabeth T. FitzGerald

Director

/s/ Kenneth C. Hopper, M.D.

Kenneth C. Hopper, M.D.

Director and Vice Chairman

Director and Chairman, President and CEO

/s/ David G. Kruczlnicki

David G. Kruczlnicki

Director

/s/ Elizabeth O. C. Little

Elizabeth O. C. Little

Director

/s/ David L. Moynehan

David L. Moynehan

Director

/s/ John J. Murphy

John J. Murphy

Director

/s/ Richard J. Reisman, D.M.D.

Richard J. Reisman, D.M.D.

Director

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