CITIZENS & NORTHERN CORP
Form 10-K
February 21, 2013

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-K

(Mark One)

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

For the fiscal year ended December 31, 2012

OR

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

For the transition period from _______________ to _________________________.

Commission file number: 0-16084

CITIZENS & NORTHERN CORPORATION

(Exact name of Registrant as specified in its charter)

PENNSYLVANIA	23-2451943
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)

90-92 MAIN STREET, WELLSBORO, PA 16901

(Address of principal executive offices) (Zip code)

570-724-3411

(Registrant's telephone number including area code)

Securities registered pursuant to Section 12(b) of the Act:

Title of Each Class	**Name of Exchange Where Registered**
Common Stock Par Value $1.00	The NASDAQ Stock Market LLC

Securities registered pursuant to section 12(g) of the Act: None

Indicate by check mark whether the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes ¨ No x

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 x

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 x No ¨

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

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 definitions of “large accelerated filer,” “accelerated filer “and “smaller reporting company” in Rule 12b-2 of the Exchange Act.

(Check one:) Large accelerated filer ¨ Accelerated filer x Non-accelerated filer ¨ Smaller reporting company ¨

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes ¨ No x

The aggregate market value of the registrant's common stock held by non-affiliates at June 30, 2012, the registrant's most recently completed second fiscal quarter, was $228,460,311.

The number of shares of common stock outstanding at February 19, 2013 was 12,331,554.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the registrant's proxy statement for the annual meeting of its shareholders to be held April 16, 2013 are incorporated by reference into Parts III and IV of this report.

PART I

ITEM 1. BUSINESS

Citizens & Northern Corporation ("Corporation") is a holding company whose principal activity is community banking. The Corporation's principal office is located in Wellsboro, Pennsylvania. The largest subsidiary is Citizens & Northern Bank ("C&N Bank" or the "Bank"). In 2005, the Corporation acquired Canisteo Valley Corporation and its subsidiary, First State Bank, a New York State chartered commercial bank with offices in Canisteo and South Hornell, NY. Management considers the New York State branches, which are located in the southern tier of New York State in close proximity to some of the Pennsylvania branches, to be part of the same community banking operating segment as the Pennsylvania locations. Effective September 1, 2010, the First State Bank operations were merged into C&N Bank, and later in September 2010, Canisteo Valley Corporation was merged into the Corporation. The Corporation's other wholly-owned subsidiaries are Citizens & Northern Investment Corporation and Bucktail Life Insurance Company ("Bucktail"). Citizens & Northern Investment Corporation was formed in 1999 to engage in investment activities. Bucktail reinsures credit and mortgage life and accident and health insurance on behalf of C&N Bank.

C&N Bank is a Pennsylvania banking institution that was formed by the consolidation of Northern National Bank of Wellsboro and Citizens National Bank of Towanda on October 1, 1971. Subsequent mergers included: First National Bank of Ralston in May 1972; Sullivan County National Bank in October 1977; Farmers National Bank of Athens in January 1984; and First National Bank of East Smithfield in May 1990. On May 1, 2007, the Corporation acquired Citizens Bancorp, Inc. ("Citizens"), with banking offices in Coudersport, Emporium and Port Allegany, Pennsylvania. Citizens Trust Company, the banking subsidiary of Citizens, was merged with and into C&N Bank as part of the transaction. C&N Bank has held its current name since May 6, 1975, at which time C&N Bank changed its charter from a national bank to a Pennsylvania bank.

C&N Bank provides an extensive range of banking services, including deposit and loan products for personal and commercial customers. The Bank also maintains a trust division that provides a wide range of financial services, such as 401(k) plans, retirement planning, estate planning, estate settlements and asset management. In January 2000, C&N Bank formed a subsidiary, C&N Financial Services Corporation ("C&NFSC"). C&NFSC is a licensed insurance agency that provides insurance products to individuals and businesses. In 2001, C&NFSC added a broker-dealer division, which offers mutual funds, annuities, educational savings accounts and other investment products through registered agents. C&NFSC's operations are not significant in relation to the total operations of the Corporation.

All phases of the Bank's business are competitive. The Bank primarily competes in Tioga, Bradford, Sullivan, Lycoming, Potter, Cameron and McKean counties in Pennsylvania, and Steuben and Allegany counties in New York. The Bank competes with local commercial banks headquartered in our market area as well as other commercial banks with branches in our market area. Some of the banks that have branches in our market area are larger in overall size. With respect to lending activities and attracting deposits, the Bank also competes with savings banks, savings and loan associations, insurance companies, regulated small loan companies and credit unions. Also, the Bank competes with mutual funds for deposits. C&N Bank competes with insurance companies, investment counseling firms, mutual funds and other business firms and individuals for trust, investment management, brokerage and insurance services. The Bank is generally competitive with all financial institutions in our service area with respect to interest rates paid on time and savings deposits, service charges on deposit accounts and interest rates charged on loans. The Bank serves a diverse customer base, and is not economically dependent on any small group of customers or on any individual industry.

Major initiatives within the last 5 years included the following:

- implemented an overdraft privilege program in 2008;
- underwent an operational process review in 2008, resulting in identification of opportunities for increases in revenue and decreases in expenses, including a net reduction in work force of 15.9%, to 297 full-time equivalent employees at December 31, 2008 from 353 at December 31, 2007;
- in 2009, raised capital of $26.440 million by issuing preferred stock and a warrant to sell 194,794 shares of common stock to the U.S. Department of the Treasury under the Troubled Asset Relief Program ("TARP") Capital Purchase Program;
- in 2009, issued common stock, which raised a total of $24.585 million of capital, net of offering costs;

- in 2009, began originating and selling residential mortgage loans to the secondary market through the MPF Xtra program administered by the Federal Home Loan Banks of Pittsburgh and Chicago, with significant growth in volume of activity under this program in 2010 through 2012, as evidenced by net gains from sales of loans of $1,925,000 in 2012, $1,107,000 in 2011 and $761,000 in 2010 and a total outstanding balance of residential mortgages sold and serviced of $100,631,000 at December 31, 2012;

- repurchased in 2010 all of the preferred stock and redeemed the warrant from the TARP Capital Purchase Program;

- merged the operations of First State Bank into C&N Bank and Canisteo Valley Corporation into Citizens & Northern Corporation in 2010;

- in 2011, sold the banking facility at 130 Court Street, Williamsport, PA, and entered into a leasing arrangement to continue to offer banking and trust services from the facility, resulting in an estimated $122,000 (pre-tax) reduction in operating expenses in 2012; and

- in April 2012, re-opened the Athens, PA, facility, which was damaged by flooding in September 2011.

Virtually all of the Corporation's banking offices are located in the "Marcellus Shale," an area extending across portions of New York State, Pennsylvania, Ohio, Maryland, West Virginia and Virginia. In 2009 through 2012, most of the Pennsylvania counties in which the Corporation operates have been significantly affected by an upsurge in natural gas exploration, as technological developments have made exploration of the Marcellus Shale commercially feasible. A significant portion of the Corporation's new business opportunities in lending, Trust and other services during this time frame have arisen either directly or indirectly from Marcellus Shale-related activity. Due in large part to a decline in the market price of natural gas, Marcellus Shale natural gas exploration activity slowed over the course of 2012, though it has not completely stalled, and the Corporation continues to find gas-related business development opportunities. Due to its pervasive nature, it is virtually impossible to quantify the aggregate impact of Marcellus Shale-related activity on the Corporation's financial position and results of operations in 2009 through 2012.

At December 31, 2012, C&N Bank had total assets of $1,274,880,000, total deposits of $1,008,356,000, net loans outstanding of $677,053,000 and 292 full-time equivalent employees.

Most activities of the Corporation and its subsidiaries are regulated by federal or state agencies. The primary regulatory relationships are described as follows:

- The Corporation is a bank holding company formed under the provisions of Section 3 of the Federal Reserve Act. The Corporation is under the direct supervision of the Federal Reserve and must comply with the reporting requirements of the Federal Bank Holding Company Act.

- C&N Bank is a state-chartered, nonmember bank, supervised by the Federal Deposit Insurance Corporation and the Pennsylvania Department of Banking.

- C&NFSC is a Pennsylvania corporation. The Pennsylvania Department of Insurance regulates C&NFSC's insurance activities. Brokerage products are offered through third party networking agreements.

- Bucktail is incorporated in the state of Arizona and supervised by the Arizona Department of Insurance.

A copy of the Corporation's annual report on Form 10-K, quarterly reports on Form 10-Q, current events reports on Form 8-K, and amendments to these reports, will be furnished without charge upon written request to the Corporation's Treasurer at P.O. Box 58, Wellsboro, PA 16901. Copies of these reports will be furnished as soon as reasonably possible, after they are filed electronically with the Securities and Exchange Commission. The information is also available through the Corporation's web site at www.cnbankpa.com.

ITEM 1A. RISK FACTORS

The Corporation is subject to the many risks and uncertainties applicable to all banking companies, as well as risks specific to the Corporation's geographic locations. Although the Corporation seeks to effectively manage risks, and maintains a level of equity that exceeds the banking regulatory agencies' thresholds for being considered "well capitalized" (see Note 18 to the consolidated financial statements), management cannot predict the future and cannot eliminate the possibility of credit, operational or other losses. Accordingly, actual results may differ materially from management's expectations. Some of the Corporation's significant risks and uncertainties are discussed below.

Credit Risk from Lending Activities - A significant source of risk is the possibility that losses will be sustained because borrowers, guarantors and related parties may fail to perform in accordance with the terms of their loan agreements. Most of the Corporation’s loans are secured, but some loans are unsecured. With respect to secured loans, the collateral securing the repayment of these loans may be insufficient to cover the obligations owed under such loans. Collateral values may be adversely affected by changes in economic, environmental and other conditions, including declines in the value of real estate, changes in interest rates, changes in monetary and fiscal policies of the federal government, wide-spread disease, terrorist activity, environmental contamination and other external events. In addition, collateral appraisals that are out of date or that do not meet industry recognized standards may create the impression that a loan is adequately collateralized when it is not. The Corporation has adopted underwriting and credit monitoring procedures and policies, including regular reviews of appraisals and borrower financial statements, that management believes are appropriate to mitigate the risk of loss. Also, as discussed further in the “Provision and Allowance for Loan Losses” section of Management’s Discussion and Analysis, the Corporation attempts to estimate the amount of losses that may be inherent in the portfolio through a quarterly evaluation process that includes several members of management and that addresses specifically identified problem loans, as well as other quantitative data and qualitative factors. Such risk management and accounting policies and procedures, however, may not prevent unexpected losses that could have a material adverse effect on the Corporation’s financial condition, results of operations or liquidity.

Interest Rate Risk - Business risk arising from changes in interest rates is an inherent factor in operating a banking organization. The Corporation’s assets are predominantly long-term, fixed-rate loans and debt securities. Funding for these assets comes principally from shorter-term deposits and borrowed funds. Accordingly, there is an inherent risk of lower future earnings or decline in fair value of the Corporation’s financial instruments when interest rates change. Significant fluctuations in interest rates could have a material adverse effect on the Corporation’s financial condition, results of operations or liquidity. For additional information regarding interest rate risk, see Part II, Item 7A, "Quantitative and Qualitative Disclosures About Market Risk."

Mortgage Banking – In September 2009, the Corporation entered into an agreement to originate and sell residential mortgage loans to the secondary market through the MPF Xtra program administered by the Federal Home Loan Banks of Pittsburgh and Chicago. The Corporation’s mortgage sales activity under this program was not significant in 2009, but increased in 2010, 2011 and 2012. At December 31, 2012, total residential mortgages serviced amounted to $100,631,000. The Corporation must strictly adhere to the MPF Xtra program guidelines for origination, underwriting and servicing loans, and failure to do so could result in the Corporation being forced to repurchase loans or being dropped from the program. If such a forced repurchase of loans were to occur, or if the Corporation were to be dropped from the program, it could have a material adverse effect on the Corporation’s financial condition, results of operations or liquidity.

Equity Securities Risk - The Corporation’s equity securities portfolio consists of investments in stocks of banks and bank holding companies. Investments in bank stocks are subject to the risk factors affecting the banking industry, and that could cause a general market decline in the value of bank stocks. Also, losses could occur in individual stocks held by the Corporation because of specific circumstances related to each bank. These factors could have a material adverse effect on the Corporation’s financial condition, results of operations or liquidity. For additional information regarding equity securities risk, including management’s assessment of equity securities for other-than-temporary impairment as of December 31, 2012, see Part II, Item 7A, "Quantitative and Qualitative Disclosures About Market Risk."

Debt Securities Risk – In 2009, the Corporation's earnings were materially impaired by securities losses. Much of the Corporation's 2009 losses from trust-preferred securities and other securities stem from the much-publicized economic problems affecting the national and international economy, which particularly hurt the banking industry. The Corporation has exposure to the possibility of future losses from investments in a senior tranche pooled trust-preferred security, a trust-preferred security issued by an individual bank, obligations of states and political subdivisions (also known as municipal bonds) and other debt securities. For additional information regarding debt securities, see Note 7 to the consolidated financial statements.

The Federal Home Loan Bank of Pittsburgh - Through its subsidiary (C&N Bank), the Corporation is a member of the Federal Home Loan Bank of Pittsburgh (FHLB-Pittsburgh), which is one of 12 regional Federal Home Loan Banks. The Corporation has a line of credit with the FHLB-Pittsburgh that is secured by a blanket lien on its loan portfolio. Access to this line of credit is critical if a funding need arises. However, there can be no assurance that the FHLB-Pittsburgh will be able to provide funding when needed, nor can there be assurance that the FHLB-Pittsburgh will provide funds specifically to the Corporation should its financial condition deteriorate and/or regulators prevent that access. The inability to access this source of funds could have a materially adverse effect on the Corporation's financial flexibility if alternate financing is not available at acceptable interest rates. The failure of the FHLB-Pittsburgh or the FHLB system in general, may materially impair the Corporation's ability to meet short- and long-term liquidity needs or to meet growth plans.

The Corporation owns common stock of the FHLB-Pittsburgh in order to qualify for membership in the FHLB system and access services from the FHLB-Pittsburgh. The FHLB-Pittsburgh faces a variety of risks in its operations including interest rate risk, counterparty credit risk, and adverse changes in its regulatory framework. In addition, the 12 Federal Home Loan Banks are jointly liable for the consolidated obligations of the FHLB system. To the extent that one FHLB cannot meet its obligations, other FHLBs can be called upon to make required payments. Such risks affecting the FHLB-Pittsburgh could adversely impact the value of the Corporation’s investment in the common stock of the FHLB-Pittsburgh and/or affect its access to credit.

Soundness of Other Financial Institutions - In addition to the FHLB-Pittsburgh, the Corporation maintains other credit facilities that provide it with additional liquidity. These facilities include secured and unsecured borrowings from the Federal Reserve Bank and third-party commercial banks. The Corporation believes that it maintains a strong liquidity position and that it is well positioned to withstand foreseeable market conditions. However, legal agreements with counterparties typically include provisions allowing them to restrict or terminate the Corporation’s access to these credit facilities with or without advance notice and at their sole discretion.

Financial institutions are interconnected as a result of trading, clearing, counterparty, and other relationships. Financial market conditions have been negatively impacted in the past and such disruptions or adverse changes in the Corporation's results of operations or financial condition could, in the future, have a negative impact on available sources of liquidity. Such a situation may arise due to circumstances that are outside the Corporation’s control, such as general market disruptions or operational problems affecting the Corporation or third parties. The Corporation’s efforts to monitor and manage liquidity risk may not be successful or sufficient to deal with dramatic or unanticipated reductions in available liquidity. In such events, the Corporation’s cost of funds may increase, thereby reducing net interest income, or the Corporation may need to sell a portion of its securities and/or loan portfolio, which, depending upon market conditions, could necessitate realizing a loss.

FDIC Insurance Assessments - In 2008 and 2009, higher levels of bank failures dramatically increased the resolution costs of the Federal Deposit Insurance Corporation, or the FDIC, and depleted the deposit insurance fund. In addition, the FDIC and the U.S. Congress have taken action to increase federal deposit insurance coverage, placing additional stress on the deposit insurance fund. In order to maintain a strong funding position and restore reserve ratios of the deposit insurance fund, in 2009 the FDIC increased assessment rates and imposed a special assessment on all insured institutions. The FDIC has indicated that future special assessments are possible, although it has not determined the magnitude or timing of any future assessments. In December 2009, we paid a pre-payment of the FDIC’s estimated assessment total for the next three years, totaling approximately $5.5 million. The pre-payment amount has been included in Other Assets in the consolidated balance sheet, with amounts amortized in 2010, 2011 and 2012 based on current assessments. At the end of 2012, approximately $2.8 million remains to be amortized, subject to adjustments imposed by the FDIC, over future years.

Although our total expenses from FDIC assessments have decreased to $633,000 in 2012, $832,000 in 2011 and $1,450,000 in 2010 from $2,092,000 in 2009, we are generally unable to control the amount of premiums that we are required to pay for FDIC insurance. If additional bank or financial institution failures occur, we may be required to pay higher FDIC premiums. Future increases in FDIC insurance premiums or additional special assessments may materially adversely affect our results of operations.

Breach of Information Security and Technology Dependence - The Corporation relies on software, communication, and information exchange on a variety of computing platforms and networks and over the Internet. Despite numerous safeguards, the Corporation cannot be certain that all of its systems are entirely free from vulnerability to attack or other technological difficulties or failures. The Corporation relies on the services of a variety of vendors to meet its data processing and communication needs. If information security is breached or other technology difficulties or failures occur, information may be lost or misappropriated, services and operations may be interrupted and the Corporation could be exposed to claims from customers. Any of these results could have a material adverse effect on the Corporation's financial condition, results of operations or liquidity.

Limited Geographic Diversification - The Corporation grants commercial, residential and personal loans to customers primarily in the Pennsylvania counties of Tioga, Bradford, Sullivan, Lycoming, Potter, Cameron and McKean, and in Steuben and Allegany Counties in New York State. Although the Corporation has a diversified loan portfolio, a significant portion of its debtors' ability to honor their contracts is dependent on the local economic conditions within the region. As described in the "Business" section of Form 10-K, in recent years the Corporation's market area has been significantly impacted by natural gas development activities associated with exploration of the Marcellus Shale. While Marcellus Shale-related development has created economic opportunities for business and individuals throughout much of our market area, natural gas exploration activity slowed over the course of 2012, and the possibility exists that this activity could be further reduced or cease as a result of changes in economic conditions, environmental concerns or other factors.

Deterioration in economic conditions, including possible effects if Marcellus Shale-related activity were to further diminish or cease, could adversely affect the quality of the Corporation's loan portfolio and the demand for its products and services, and accordingly, could have a material adverse effect on the Corporation's financial condition, results of operations or liquidity.

Competition - All phases of the Corporation’s business are competitive. Some competitors are much larger in total assets and capitalization than the Corporation, have greater access to capital markets and can offer a broader array of financial services. There can be no assurance that the Corporation will be able to compete effectively in its markets. Furthermore, developments increasing the nature or level of competition could have a material adverse effect on the Corporation's financial condition, results of operations or liquidity.

Government Regulation and Monetary Policy - The Corporation and the banking industry are subject to extensive regulation and supervision under federal and state laws and regulations. The requirements and limitations imposed by such laws and regulations limit the manner in which the Corporation conducts its business, undertakes new investments and activities and obtains financing. These regulations are designed primarily for the protection of the deposit insurance funds and consumers and not to benefit the Corporation's shareholders. Financial institution regulation has been the subject of significant legislation in recent years and may be the subject of further significant legislation in the future, none of which is in the control of the Corporation. Significant new laws or changes in, or repeals of, existing laws could have a material adverse effect on the Corporation's financial condition, results of operations or liquidity. Further, federal monetary policy, particularly as implemented through the Federal Reserve System, significantly affects short-term interest rates and credit conditions, and any unfavorable change in these conditions could have a material adverse effect on the Corporation's financial condition, results of operations or liquidity.

Bank Secrecy Act and Related Laws and Regulations - These laws and regulations have significant implications for all financial institutions. They increase due diligence requirements and reporting obligations for financial institutions, create new crimes and penalties, and require the federal banking agencies, in reviewing merger and other acquisition transactions, to consider the effectiveness of the parties to such transactions in combating money laundering activities. Even innocent noncompliance and inconsequential failure to follow the regulations could result in significant fines or other penalties, which could have a material adverse impact on the Corporation's financial condition, results of operations or liquidity.

Dodd-Frank Wall Street Reform and Consumer Protection Act (the “Act”) - On July 21, 2010, President Obama signed the Act into law. The Act contains numerous and wide-ranging changes to the structure of the U.S. financial system. Portions of the Act are effective at different times, and though some provisions have been implemented, many of the provisions require follow-on, more detailed rulemaking by regulators. Consequently, the Act’s impact on the financial system in general and the Corporation in particular cannot be predicted at this time. Some of the Act’s provisions that management believes may impact the Corporation’s financial condition and results of operations over the next few years are as follows:

- required the Federal Reserve to prescribe regulations to establish standards for determining that interchange transaction fees meet the new statutory standard of reasonable and proportional to the cost. These regulations were enacted, effective October 1, 2011, establishing maximum rates that may be paid to large (as defined) financial institutions. The maximum rates established under the rule are approximately 45% lower than the rates paid to the Corporation throughout most of the last several years. Although the rules do not apply directly to the Corporation (because the Corporation is not considered a large financial institution for this purpose), management believes interchange revenues could be reduced in the future, either because of lower volumes or because market conditions will dictate that smaller financial institutions receive rates similar to larger financial institutions.

- eliminated the prohibition against paying interest on commercial checking accounts;

- effective for the second quarter 2011 assessment, altered the FDIC's base for determining deposit insurance assessments by requiring the assessments be determined based on "average consolidated total assets" less the institution's "average tangible equity," rather than on a bank's deposits;

- increases the FDIC's minimum reserve ratio for the deposit insurance fund from 1.15% to 1.35% of estimated deposits with no upward limit. The FDIC is required to "offset the effect" of the increased minimum reserve ratio on institutions with less than $10 billion in total consolidated assets. The intent appears to be to require the FDIC to impose higher premiums on larger banks in order to get from the old minimum of 1.15% to the new 1.35%, but all institutions can expect assessments to remain significant for the foreseeable future. The Act allows the FDIC until September 30, 2020 to reach 1.35%; and

- requires the establishment of minimum leverage and risk-based capital requirements applicable to bank holding companies that are not less than those currently applicable to insured depository institutions (currently 5%, 6% and 10% to be "well capitalized", and 4%, 4% and 8% to be "adequately capitalized").

The Act has other significant features, some of which are as follows: (i) makes permanent the 2008 increase in the maximum deposit insurance amount to $250,000, and extended until December 31, 2012 full deposit insurance coverage for qualifying noninterest-bearing transaction accounts, (ii) within the Act is the Mortgage Reform and Anti-Predatory Lending Act, a broad piece of legislation intended to curtail abusive residential mortgage lending practices that contributed to the mortgage/housing crisis, (iii) required the formation of the Consumer Financial Protection Bureau as a new, independent bureau within the Federal Reserve, with very broad rulemaking and supervisory authority with respect to federal consumer financial laws, (iv) establishes the Financial Stability Oversight Council, to serve as an early warning system identifying risks in firms and market activities, to enhance oversight of the financial system as a whole and to harmonize prudential standards across financial regulatory agencies, and (v) establishes several requirements related to executive compensation and corporate governance.

ITEM 1B. UNRESOLVED STAFF COMMENTS

Not applicable.

ITEM 2. PROPERTIES

The Bank owns each of its properties, except for the branch facilities located at 130 Court Street, Williamsport, PA, and at 2 East Mountain Avenue, South Williamsport, PA, which are leased. In September 2011, the Athens, PA office was damaged by flooding and reopened in April 2012. The Bank did not incur a significant financial loss associated with the flooding, as almost all of the cost of replacement was covered by insurance. All of the other properties are in good condition. None of the owned properties are subject to encumbrance.

A listing of properties is as follows:

Main administrative offices:

90-92 Main Street	or	10 Nichols Street
Wellsboro, PA 16901		Wellsboro, PA 16901

Branch offices – Citizens & Northern Bank:

428 S. Main Street Athens, PA 18810	514 Main Street Laporte, PA 18626	2 East Mountain Avenue ** South Williamsport, PA 17702
10 North Main Street Coudersport, PA 16915	4534 Williamson Trail Liberty, PA 16930	41 Main Street Tioga, PA 16946
111 W. Main Street Dushore, PA 18614	1085 S. Main Street Mansfield, PA 16933	428 Main Street Towanda, PA 18848
563 Main Street East Smithfield, PA 18817	612 James Monroe Avenue Monroeton, PA 18832	64 Elmira Street Troy, PA 16947
104 W. Main Street Elkland, PA 16920	3461 Route 405 Highway Muncy, PA 17756	90-92 Main Street Wellsboro, PA 16901
135 East Fourth Street Emporium, PA 15834	100 Maple Street Port Allegany, PA 16743	1510 Dewey Avenue Williamsport, PA 17701
230 Railroad Street Jersey Shore, PA 17740	24 Thompson Street Ralston, PA 17763	130 Court Street ** Williamsport, PA 17701
102 E. Main Street Knoxville, PA 16928	1827 Elmira Street Sayre, PA 18840	1467 Golden Mile Road Wysox, PA 18854
3 Main Street Canisteo, NY 14823	6250 County Rte 64 Hornell, NY 14843	

Facilities management office:
13 Water Street
Wellsboro, PA 16901

** designates leased branch facility

ITEM 3. LEGAL PROCEEDINGS

The Corporation and the Bank are involved in various legal proceedings incidental to their business. Management believes the aggregate liability, if any, resulting from such pending and threatened legal proceedings will not have a material adverse effect on the Corporation's financial condition or results of operations.

ITEM 4. MINE SAFETY DISCLOSURE

Not applicable.

PART II

ITEM 5. MARKET FOR REGISTRANT'S COMMON EQUITY, RELATED STOCKHOLDER MATTERS AND ISSUER PURCHASES OF EQUITY SECURITIES

QUARTERLY SHARE DATA

Trades of the Corporation's stock are executed through various brokers who maintain a market in the Corporation's stock. The Corporation's stock is listed on the NASDAQ Capital Market with the trading symbol CZNC. As of December 31, 2012, there were 2,540 shareholders of record of the Corporation's common stock.

The following table sets forth the high and low sales prices of the common stock during 2012 and 2011.

	2012			2011		
	High	Low	Dividend Declared per Quarter	High	Low	Dividend Declared Per Quarter
First quarter	$22.48	$18.12	$ 0.18	$16.96	$14.37	$ 0.13
Second quarter	20.69	16.79	0.20	17.66	13.10	0.14
Third quarter	20.80	17.78	0.22	17.40	14.06	0.15
Fourth quarter	20.25	17.51	0.24	19.16	14.00	0.16

Future dividend payments will depend upon maintenance of a strong financial condition, future earnings and capital and regulatory requirements. Also, the Corporation and C&N Bank are subject to restrictions on the amount of dividends that may be paid without approval of banking regulatory authorities. These restrictions are described in Note 18 to the consolidated financial statements.

On May 19, 2011, the Corporation authorized a plan for repurchases of outstanding common stock, up to a total of $1 million. On September 22, 2011, the Corporation's Board of Directors authorized additional repurchases of outstanding common stock in open market or privately negotiated transactions, up to a total of $1 million, as an addition to the May 2011 stock repurchase program. The Board of Directors' authorizations provide that: (1) the treasury stock repurchase programs became effective when publicly announced and shall continue thereafter until suspended or terminated by the Board of Directors, in its sole discretion; and (2) all shares of common stock repurchased pursuant to the programs shall be held as treasury shares and be available for use and reissuance for purposes as and when determined by the Board of Directors including, without limitation, pursuant to the Corporation's Dividend Reinvestment and Stock Purchase Plan and its equity compensation program. As of December 31, 2012, the maximum additional value available for purchases under this program was $980,694.

In the fourth quarter 2012, the Corporation made no purchases of its equity securities.

PERFORMANCE GRAPH

Set forth below is a chart comparing the Corporation's cumulative return to stockholders against the cumulative return of the Russell 2000 and a Peer Group Index of similar banking organizations selected by the Corporation for the five-year period commencing December 31, 2007 and ended December 31, 2012. The index values are market-weighted dividend-reinvestment numbers, which measure the total return for investing $100.00 five years ago. This meets Securities & Exchange Commission requirements for showing dividend reinvestment share performance over a five-year period and measures the return to an investor for placing $100.00 into a group of bank stocks and reinvesting any and all dividends into the purchase of more of the same stock for which dividends were paid.

COMPARISON OF 5-YEAR CUMULATIVE RETURN

Citizens & Northern Corporation

	Period Ending					
Index	12/31/07	12/31/08	12/31/09	12/31/10	12/31/11	12/31/12
Citizens & Northern Corporation	100.00	117.61	59.21	95.22	122.54	130.91
Russell 2000	100.00	66.21	84.20	106.82	102.36	119.09
CZNC Peer Group Index*	100.00	83.21	76.93	83.57	80.69	96.04

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The Corporation’s peer group consists of banks headquartered in Pennsylvania with total assets of $700 million to $2 billion. This peer group consists of ACNB Corporation, Gettysburg; AmeriServ Financial, Inc., Johnstown; Bryn Mawr Bank Corporation, Bryn Mawr; Citizens Financial Services, Inc., Mansfield; CNB Financial Corporation, Clearfield; Codorus Valley Bancorp, Inc., York; ENB Financial Corp., Ephrata; First Keystone Corporation, Berwick; First National Community Bancorp, Inc., Dunmore; FNB Bancorp, Inc., Newtown; Franklin Financial Services Corporation, Chambersburg; Mid Penn Bancorp, Inc., Millersburg; Orrstown Financial Services, Inc., Shippensburg; Penns Woods Bancorp, Inc., Williamsport; Penseco Financial Services Corporation, Scranton; QNB Corp., Quakertown; Republic First Bancorp, Inc., Philadelphia; Royal Bancshares of Pennsylvania, Inc., Narberth; Somerset Trust Holding Company, Somerset.

The data for this graph was obtained from SNL Financial LC, Charlottesville, VA.

EQUITY COMPENSATION PLAN INFORMATION

The following table sets forth information concerning the Stock Incentive Plan and Independent Directors Stock Incentive Plan, both of which have been approved by the Corporation’s shareholders. The figures shown in the table below are as of December 31, 2012.

	Number of Securities to be Issued Upon Exercise of Outstanding Options	Weighted-average Exercise Price of Outstanding Options	Number of Securities Remaining for Future Issuance Under Equity Compen-sation Plans
Equity compensation plans approved by shareholders	337,670	$ 19.08	400,299
Equity compensation plans not approved by shareholders	0	N/A	0

More details related to the Corporation’s equity compensation plans are provided in Notes 1 and 13 to the consolidated financial statements.

ITEM 6. SELECTED FINANCIAL DATA

	As of or for the Year Ended December 31,				
INCOME STATEMENT (In Thousands)	2012	2011	2010	2009	2008
Interest and fee income	$56,632	$61,256	$62,114	$67,976	$74,237
Interest expense	9,031	13,556	19,245	24,456	31,049
Net interest income	47,601	47,700	42,869	43,520	43,188
Provision (credit) for loan losses	288	(285)	1,191	680	909
Net interest income after provision (credit) for loan losses	47,313	47,985	41,678	42,840	42,279
Noninterest income excluding securities gains (losses)	16,317	13,938	13,917	13,021	13,140
Net impairment losses recognized in earnings from available-for-sale securities	(67)	0	(433)	(85,363)	(10,088)
Net realized gains on available-for-sale securities	2,749	2,216	1,262	1,523	750
Loss on prepayment of debt	2,333	0	0	0	0
Noninterest expense excluding loss on prepayment of debt	32,848	32,057	31,569	34,011	33,703
Income (loss) before income tax provision (credit)	31,131	32,082	24,855	(61,990)	12,378
Income tax provision (credit)	8,426	8,714	5,800	(22,655)	2,319
Net income (loss)	22,705	23,368	19,055	(39,335)	10,059
U.S. Treasury preferred dividends	0	0	1,474	1,428	0
Net income (loss) available to common shareholders	$22,705	$23,368	$17,581	$(40,763)	$10,059
PER COMMON SHARE: (1)					
Basic earnings per share	$1.86	$1.92	$1.45	$(4.40)	$1.12
Diluted earnings per share	$1.85	$1.92	$1.45	$(4.40)	$1.12
Cash dividends declared per share	$0.84	$0.58	$0.39	$0.72	$0.96
Book value per common share at period-end	$14.89	$13.77	$11.43	$10.46	$13.66
Tangible book value per common share at period-end	$13.91	$12.77	$10.42	$9.43	$12.22
Weighted average common shares outstanding - basic	12,235,748	12,162,045	12,131,039	9,271,869	8,961,805
Weighted average common shares outstanding - diluted	12,260,208	12,166,768	12,131,039	9,271,869	8,983,300
END OF PERIOD BALANCES (In Thousands)					
Available-for-sale securities	$472,577	$481,685	$443,956	$396,288	$419,688
Gross loans	683,910	708,315	730,411	721,011	743,544
Allowance for loan losses	6,857	7,705	9,107	8,265	7,857
Total assets	1,286,907	1,323,735	1,316,588	1,321,795	1,281,637
Deposits	1,006,106	1,018,206	1,004,348	926,789	864,057
Borrowings	89,379	130,313	166,908	235,471	285,473

Stockholders' equity	182,786	167,385	138,944	152,410	122,026
Common stockholders' equity (stockholders' equity, excluding preferred stock)	182,786	167,385	138,944	126,661	122,026
AVERAGE BALANCES (In Thousands)					
Total assets	1,305,163	1,313,445	1,326,145	1,296,086	1,280,924
Earning assets	1,199,538	1,208,584	1,205,608	1,208,280	1,202,872
Gross loans	700,241	714,421	721,997	728,748	743,741
Deposits	1,008,469	1,001,125	965,615	886,703	847,714
Stockholders' equity	175,822	152,718	150,133	141,787	130,790

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ITEM 6. SELECTED FINANCIAL DATA, Continued

	As of or for the Year Ended Dec. 31,				
	2012	2011	2010	2009	2008
KEY RATIOS					
Return on average assets	1.74 %	1.78 %	1.44 %	-3.03 %	0.79 %
Return on average equity	12.91 %	15.30 %	12.69 %	-27.74 %	7.69 %
Average equity to average assets	13.47 %	11.63 %	11.32 %	10.94 %	10.21 %
Net interest margin (2)	4.26 %	4.22 %	3.81 %	3.84 %	3.77 %
Efficiency (3)	48.77 %	49.40 %	52.73 %	57.22 %	57.59 %
Cash dividends as a % of diluted earnings per share	45.41 %	30.21 %	26.90 %	NM	85.71 %
Tier 1 leverage	12.53 %	10.93 %	9.20 %	9.86 %	10.12 %
Tier 1 risk-based capital	22.86 %	19.95 %	15.87 %	16.70 %	13.99 %
Total risk-based capital	24.01 %	21.17 %	17.17 %	17.89 %	14.84 %
Tangible common equity/tangible assets	13.39 %	11.84 %	9.71 %	8.72 %	8.61 %
Nonperforming assets/total assets	0.82 %	0.73 %	0.92 %	0.76 %	0.69 %
Nonperforming loans/total loans	1.41 %	1.19 %	1.58 %	1.27 %	1.14 %
Allowance for loan losses/total loans	1.00 %	1.09 %	1.25 %	1.15 %	1.06 %
Net charge-offs/average loans	0.16 %	0.16 %	0.05 %	0.04 %	0.26 %

NM = Not a meaningful ratio.

(1) All share and per share data have been restated to give effect to stock dividends and splits.

(2) Rates of return on tax-exempt securities and loans are calculated on a fully-taxable equivalent basis.

(3) The efficiency ratio is calculated by dividing total noninterest expense by the sum of net interest income (including income from tax-exempt securities and loans on a fully-taxable equivalent basis) and noninterest income excluding securities gains and losses.

ITEM 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

Certain statements in this section and elsewhere in this Annual Report on Form 10-K are forward-looking statements. Citizens & Northern Corporation and its wholly-owned subsidiaries (collectively, the Corporation) intend such forward-looking statements to be covered by the safe harbor provisions for forward-looking statements contained in the Private Securities Reform Act of 1995. Forward-looking statements, which are not historical facts, are based on certain assumptions and describe future plans, business objectives and expectations, and are generally identifiable by the use of words such as, "should", “likely”, "expect", “plan”, "anticipate", “target”, “forecast”, and “goal”. These forward-looking statements are subject to risks and uncertainties that are difficult to predict, may be beyond management’s control and could cause results to differ materially from those expressed or implied by such forward-looking statements. Factors which could have a material, adverse impact on the operations and future prospects of the Corporation include, but are not limited to, the following:

- changes in monetary and fiscal policies of the Federal Reserve Board and the U.S. Government, particularly related to changes in interest rates
- changes in general economic conditions
- legislative or regulatory changes
- downturn in demand for loan, deposit and other financial services in the Corporation's market area
- increased competition from other banks and non-bank providers of financial services
- technological changes and increased technology-related costs
- changes in accounting principles, or the application of generally accepted accounting principles.

These risks and uncertainties should be considered in evaluating forward-looking statements and undue reliance should not be placed on such statements.

EARNINGS OVERVIEW

Net income available to common shareholders for 2012 was $22,705,000, or $1.86 per share – basic and $1.85 per share – diluted, as compared to $1.92 per basic and diluted share in 2011 and $1.45 per basic and diluted share in 2010.

2012 vs. 2011

Net income for 2012 of $22,705,000 was $663,000 (2.8%) lower than 2011 net income. Some of the more significant highlights related to annual earnings are as follows:

- Net interest income totaled $47,601,000 in 2012, down slightly ($99,000) from 2011. The fully taxable equivalent net interest margin of 4.26% in 2012 was 0.04% higher than the 2011 margin, while total average earning assets were 0.7% lower in 2012. In 2012 and 2011, net interest income included the benefit of accretion from the recovery of a previous write-down on a security, including a benefit of $855,000 in 2012 and $825,000 in 2011.

- The provision for loan losses was $288,000 in 2012 as compared to a credit (reduction in expense) of $285,000 in 2011. The provision for loan losses in 2012 included charges related to a few larger commercial loans, while both 2012 and 2011 included reductions in the general components of the allowance for loan losses attributable to reductions in total loans outstanding.

- Total noninterest revenue of $16,317,000 in 2012 was $2,379,000 higher than the corresponding 2011 amount. In 2011, noninterest revenue included an impairment loss of $948,000 related to an investment in a real estate limited partnership. Excluding the 2011 impairment loss, noninterest revenue for 2012 was $1,431,000 (9.6%) higher than the total in 2011. The increase in noninterest revenue for 2012 included a significant increase in gains from sales of residential mortgage loans, which totaled $1,925,000 in 2012, up $818,000 over 2011. Trust revenues totaled $3,847,000 in 2012, an increase of $375,000 (10.8%) over 2011, while brokerage revenues of $801,000 increased $161,000 (25.2%) over 2011. Service charges on deposit accounts of $5,036,000 in 2012 were up $263,000 (5.5%) over 2011. Included in noninterest revenue were net losses related to real estate properties acquired in foreclosures of $66,000 in 2012 as compared to net gains of $41,000 in 2011.

- In 2012, pre-tax net realized gains from securities totaled $2,682,000, while losses were incurred from prepayment of borrowings totaling $2,333,000. In comparison, security gains totaled $2,216,000 in 2011, and there were no losses from prepayments of borrowings. In both years, securities gains included significant amounts from sales of pooled trust-preferred securities that had previously been written off. The loss from pre-payment of borrowings included third quarter 2012 losses of $2,190,000 from prepayment of principal of $12 million on long-term borrowings (repurchase agreements) with an average interest rate of 3.93%.

- Noninterest expense, excluding the loss from prepayment of borrowings, was $32,848,000 in 2012, up $791,000 (2.5%) from 2011. The increase in noninterest expense in 2012 includes an increase in other operating expense of $597,000. Within other operating expense, the largest increases in 2012 included increases in software subscriptions and updates, ATM and debit card processing costs, legal fees related to lending and collection matters and expenses related to other real estate properties. Salaries and wages were $504,000, or 3.6%, higher for 2012 as compared to 2011, including an increase in stock-based compensation of $98,000. FDIC assessments were $199,000 lower in 2012 than in 2011, reflecting the benefit of a change in the FDIC's method for determining assessments that became effective in the second quarter 2011. Occupancy expense was $162,000 lower in 2012 as compared to 2011, in part due to reduced costs associated with the Court Street, Williamsport location.

2011 vs. 2010

The most significant fluctuations in earnings in 2011 as compared to 2010 are as follows:

- Net interest income of $47,700,000 was $4,831,000 (11.3%) higher in 2011 than 2010. The improvement in 2011 resulted from several factors, including reductions in cost of funds, reduction in outstanding borrowings and lower balances maintained in overnight investment with the Federal Reserve and other banks. In 2011, net interest income includes the benefit of accretion of $825,000 from the offset of a previous write-down on a security, with a corresponding benefit of $83,000 recorded in 2010.

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- In 2011, the provision for loan losses was a credit (reduction in expense) of $285,000, as compared to a provision of $1,191,000 in 2010. The credit for loan losses in 2011 resulted, in part, from a reduction in loans outstanding, as the general component of the allowance for loan losses was reduced.

- Total noninterest revenue was $13,938,000 in 2011, up $100,000 over 2010, despite an impairment loss in 2011 of $948,000 related to an investment in a real estate limited partnership. In 2011, noninterest revenue included net gains from sales of premises and equipment totaling $324,000, including a gain in the third quarter of $329,000 from sale of the banking facility at 130 Court Street, Williamsport, PA. The Corporation has entered into a leasing arrangement to continue to utilize a portion of the facility and continues to provide retail, trust and commercial banking services at the location. In 2010, noninterest revenue included net gains from sales of premises and equipment totaling $445,000. Excluding gains from sales of premises and equipment and the impairment loss, noninterest revenue for 2011 totaled $14,562,000, or 8.7% higher than the corresponding 2010 amount. In 2011, revenues increased significantly over 2010 from origination and sale of mortgage loans, interchange on debt card transactions, service charges on deposit accounts, brokerage services and other operating income.

- Gains from available-for-sale securities totaled $2,216,000 in 2011, considerably higher than the total gains of $829,000 realized in 2010. In the first quarter 2011, the Corporation realized gains of $1,510,000 from two pooled trust-preferred securities that had been written off in prior periods.

- Total noninterest expense was $32,057,000 in 2011, up $567,000, or 1.8%, over 2010. Total salaries and wages for 2011 were $803,000 (6.1%) higher than in 2010, including an increase in total employee stock-based compensation of $319,000. Pensions and employee benefits expense was $567,000 (14.8%) higher in 2011 than in 2010, including higher estimated self-insured employee health insurance expense. Furniture and equipment expense was $171,000 (8.1%) lower in 2011 as compared to 2010, as depreciation expense was lower due to some computer-related hardware and software becoming fully depreciated. FDIC assessments were $618,000 (42.6%) lower in 2011 than in 2010, reflecting the benefit of changes in the FDIC's method for determining assessments and improvements in the Corporation's financial data that impact the amounts assessed.

- The provision for income taxes totaled $8,714,000 or 27.2% of pre-tax income in 2011, up from $5,800,000 or 23.3% of pre-tax income in 2010. The provision for income taxes was higher in 2011 than in 2010 primarily because of the increase in pre-tax income. Also, the provision for income tax in 2010 included a benefit (reduction in expense) of $373,000 resulting from reduction in a valuation reserve.

- In the third quarter 2010, the Corporation redeemed preferred stock that had previously been issued, and had no preferred stock outstanding and no corresponding dividend costs in 2011. In 2010, earnings available for common shareholders were impacted by dividends paid on preferred stock totaling $1,474,000.

More detailed information concerning fluctuations in the Corporation's earnings results are provided in other sections of Management's Discussion and Analysis.

CRITICAL ACCOUNTING POLICIES

The presentation of financial statements in conformity with U.S. generally accepted accounting principles requires management to make estimates and assumptions that affect many of the reported amounts and disclosures. Actual results could differ from these estimates

A material estimate that is particularly susceptible to significant change is the determination of the allowance for loan losses. The Corporation maintains an allowance for loan losses that represents management's estimate of the losses inherent in the loan portfolio as of the balance sheet date and recorded as a reduction of the investment in loans. Management believes the allowance for loan losses is adequate and reasonable. Notes 1 and 8 to the consolidated financial statements provide an overview of the process management uses for evaluating and determining the allowance for loan losses, and additional discussion of the allowance for loan losses is provided in a separate section later in Management's Discussion and Analysis. Given the very subjective nature of identifying and valuing loan losses, it is likely that well-informed individuals could make materially different assumptions, and could, therefore calculate a materially different allowance value. While management uses available information to recognize losses on loans, changes in economic conditions may necessitate revisions in future years. In addition, various regulatory agencies, as an integral part of their examination process, periodically review the Corporation's allowance for loan losses. Such agencies may require the Corporation to recognize adjustments to the allowance based on their judgments of information available to them at the time of their examination.

Another material estimate is the calculation of fair values of the Corporation's debt securities. For most of the Corporation's debt securities, the Corporation receives estimated fair values of debt securities from an independent valuation service, or from brokers. In developing fair values, the valuation service and the brokers use estimates of cash flows, based on historical performance of similar instruments in similar interest rate environments. Based on experience, management is aware that estimated fair values of debt securities tend to vary among brokers and other valuation services.

As described in Note 7 to the consolidated financial statements, management evaluates securities for other-than-temporary impairment ("OTTI"). In making that evaluation, consideration is given to (1) the length of time and the extent to which the fair value has been less than cost, (2) the financial condition and near-term prospects of the issuer, and (3) whether the Corporation intends to sell the security or more likely than not will be required to sell the security before its anticipated recovery. Management's assessments of the likelihood and potential for recovery in value of securities are subjective and based on sensitive assumptions.

NET INTEREST INCOME

The Corporation's primary source of operating income is net interest income, which is equal to the difference between the amounts of interest income and interest expense. Tables I, II and III include information regarding the Corporation's net interest income in 2012, 2011, and 2010. In each of these tables, the amounts of interest income earned on tax-exempt securities and loans have been adjusted to a fully taxable-equivalent basis. Accordingly, the net interest income amounts reflected in these tables exceed the amounts presented in the consolidated financial statements. The discussion that follows is based on amounts in the tables.

2012 vs. 2011

Fully taxable equivalent net interest income was $51,041,000 in 2012, $86,000 (0.2%) higher than in 2011. As shown in Table III, net changes in volume had the effect of increasing net interest income $961,000 in 2012 compared to 2011, and interest rate changes had the effect of decreasing net interest income $875,000. The most significant components of the volume change in net interest income in 2012 were a decrease in interest expense of $1,203,000 attributable to a reduction in the balance of borrowed funds, a decrease in interest expense of $411,000 attributable to a reduction in the balance of interest-bearing deposits (primarily certificates of deposit and Individual Retirement Accounts), and a decrease in interest income of $887,000 attributable to a decline in the balance of loans receivable. The most significant components of the rate change in net interest income in 2012 were a decrease in interest expense of $2,894,000 due to lower rates paid on interest-bearing deposits, a decrease in interest income of $2,072,000 attributable to lower rates earned on available-for-sale securities and a decrease in interest income of $1,733,000 attributable to lower rates earned on loans receivable. As presented in Table II, the "Interest Rate Spread" (excess of average rate of return on earning assets over average cost of funds on interest-bearing liabilities) was 4.04% in 2012, as compared to 3.96% in 2011.

INTEREST INCOME AND EARNING ASSETS

Interest income totaled $60,072,000 in 2012, a decrease of 6.9% from 2011. Interest and fees on loans receivable decreased $2,620,000, or 5.8% while income from available-for-sale securities decreased $1,914,000, or 10.1%. As indicated in Table II, average available-for-sale securities (at amortized cost) totaled $464,349,000 in 2012, an increase of $2,445,000 (0.5%) from 2011. Net growth in the Corporation's available-for-sale securities portfolio was primarily made up of U.S. Government agency collateralized mortgage obligations and municipal securities. This growth was partially offset by reductions in the balances of mortgage-backed securities, U.S. Government agency bonds, and trust preferred securities. The Corporation's yield on taxable securities fell in 2011 and 2012 because of rapid prepayments on mortgage-backed securities and collateralized mortgage obligations as well as low market interest rates. Also, the Corporation had been booking a recovery on a trust preferred security that had been previously written down as OTTI but subsequently resumed payment; this security matured in May 2012. Additional information on this security is presented below. The average rate of return on available-for-sale securities was 3.67% for 2012 and 4.11% in 2011.

The average balance of gross loans receivable decreased 2.0% to $700,241,000 in 2012 from $714,421,000 in 2011. The Corporation experienced contraction in the balance of loans receivable due to borrowers prepaying or refinancing existing loans combined with modest demand for new loans. The decline in the balance of the residential mortgage portfolio was also affected by management's decision to sell a significant portion of newly originated residential mortgages on the secondary market. The Corporation's average rate of return on loans receivable declined to 6.11% in 2012 from 6.36% in 2011 as rates on new loans as well as existing, variable-rate loans have decreased.

The average balance of interest-bearing due from banks increased to $32,337,000 in 2012 from $31,359,000 in 2011. This has consisted primarily of balances held by the Federal Reserve, as well as FDIC-insured certificates of deposit. Although the rates of return on balances with the Federal Reserve are low, the Corporation has maintained relatively high levels of liquid assets in 2011 and 2012 (as opposed to increasing long-term, available-for-sale securities at higher yields) in order to maximize flexibility for dealing with possible fluctuations in cash requirements, and due to management's concern about the possibility of substantial increases in interest rates in the future. During the fourth quarter 2011, the Corporation began investing in FDIC-insured certificates of deposit issued by other financial institutions and maturing within five years; these investments totaled $4,820,000 at December 31, 2012. The average balance of certificates of deposit issued by other financial institutions increased to $4,554,000 in 2012 from $677,000 in 2011.

INTEREST EXPENSE AND INTEREST-BEARING LIABILITIES

Interest expense fell $4,525,000, or 33.4%, to $9,031,000 in 2012 from $13,556,000 in 2011. Table II shows that the overall cost of funds on interest-bearing liabilities fell to 0.97% in 2012 from 1.38% in 2011.

Total average deposits (interest-bearing and noninterest-bearing) increased 0.7%, to $1,008,469,000 in 2012 from $1,001,125,000 in 2011. Increases in the average balances of demand deposits, savings accounts, and money market accounts were partially offset by decreases in Individual Retirement Accounts and certificates of deposit. Consistent with continuing low short-term market interest rates, the average rates incurred on deposit accounts decreased significantly in 2012 as compared to 2011.

Variable-rate accounts made up $130,833,000 of the average balance in Individual Retirement Accounts in 2012 and $144,008,000 in 2011. Prior to May 2011, substantially all of these accounts were paid interest at a rate that could change quarterly at management's discretion with a contractual floor of 3.00%. Effective in May 2011, the rate floor was removed; following this change, the rate paid on these accounts was lowered several times and was 0.35% at December 31, 2012. As shown in Table II, the average rate on Individual Retirement Accounts decreased to 0.80% in 2012 from 2.04% in 2011.

Total average borrowed funds decreased $40,059,000 to $112,051,000 in 2012 from $152,110,000 in 2011. During 2011 and 2012, the Corporation has paid off long-term borrowings as they matured using the cash flow received from loans and investment securities. In September 2012, the Corporation prepaid principal of $12,000,000 on long-term borrowings (repurchase agreements). The Corporation incurred a loss from the prepayment totaling $2,190,000, which is reported in Other Expenses in the Consolidated Statements of Operations. The average rate on the borrowings that were partially prepaid was 3.93%, and management expects that the prepayment will have a favorable effect on the net interest margin in the future. After the effect of the prepayment, the remaining balance of long-term borrowings under repurchase agreements was $68,000,000 at December 31, 2012. The average rate on borrowed funds was 3.77% in 2012, compared to 3.58% in 2011.

The average balance of “RepoSweep” arrangements, which are used by the Corporation to borrow funds from commercial banking customers on an overnight basis and included within short-term borrowings, declined to $4,454,000 in 2012 from $17,216,000 in 2011 primarily as a result of changes to service charges assessed on related business checking accounts. During 2012, the Corporation took several short-term and overnight advances from the Federal Home Loan Bank of Pittsburgh (FHLB-Pittsburgh) to offset seasonal declines in deposit balances and meet other liquidity needs. Short-term and overnight advances averaged $2,377,000 in 2012 with no such advances outstanding during 2011. The Corporation had no short-term or overnight advances outstanding at December 31, 2012.

2011 vs. 2010

Fully taxable equivalent net interest income was $50,955,000 in 2011, $5,001,000 (10.9%) higher than in 2010. As shown in Table III, net changes in volume had the effect of increasing net interest income $3,238,000 in 2011 compared to 2010, and interest rate changes had the effect of increasing net interest income $1,763,000. The most significant components of the volume change in net interest income in 2011 were a decrease in interest expense of $1,623,000 attributable to a reduction in the balance of long-term borrowed funds and an increase in interest income of $1,600,000 attributable to growth in the balance of available-for-sale securities. The most significant components of the rate change in net interest income in 2011 were a decrease in interest expense of $3,260,000 due to lower rates paid on interest-bearing deposits and a decrease in interest income of $1,126,000 attributable to lower rates earned on available-for-sale securities. As presented in Table II, the “Interest Rate Spread” (excess of average rate of return on earning assets over average cost of funds on interest-bearing liabilities) was 3.96% in 2011, as compared to 3.53% in 2010.

INTEREST INCOME AND EARNING ASSETS

Interest income totaled $64,511,000 in 2011, a decrease of 1.1% from 2010. Income from available-for-sale securities increased $474,000 (2.6%), while interest and fees from loans receivable decreased $1,086,000, or 2.3%. As indicated in Table II, total average available-for-sale securities (at amortized cost) in 2011 increased to $461,904,000, an increase of $34,384,000, or 8.0% from 2010. During 2010 and 2011, the Corporation increased the size of its tax-exempt municipal security portfolio. Net growth in the taxable available-for-sale securities portfolio was primarily made up of U.S. Government agency collateralized mortgage obligations and also included a significant increase in the balance of taxable municipal securities. This growth was partially offset by reductions in the balances of U.S. Government agency bonds and pooled trust preferred securities. The Corporation's yield on taxable securities fell in 2010 and 2011 primarily because of low market interest rates, including the effects of management's decision to limit purchases of taxable securities to investments that mature or are expected to repay a substantial portion of principal within approximately four years or less. The average rate of return on available-for-sale securities was 4.11% for 2011 and 4.33% in 2010.

The average balance of gross loans receivable decreased 1.0% to $714,421,000 in 2011 from $721,997,000 in 2010. The Corporation experienced modest contraction in the residential mortgage and consumer loan portfolios, primarily resulting from management's decision to sell a portion of newly originated residential mortgages on the secondary market. The total average balance of commercial loans receivable increased slightly in 2011 compared to 2010. The Corporation's yield on loans receivable fell as rates on new loans as well as existing, variable-rate loans decreased. The average rate of return on loans receivable was 6.36% in 2011 and 6.44% in 2010.

The average balance of interest-bearing due from banks decreased to $31,359,000 in 2011 from $54,655,000 in 2010. This consisted primarily of balances held by the Federal Reserve. Although the rates of return on balances with the Federal Reserve are low, the Corporation maintained relatively high levels of liquid assets in 2010 and 2011 (as opposed to increasing long-term, available-for-sale securities at higher yields) in order to maximize flexibility for dealing with possible fluctuations in cash requirements, and due to management's concern about the possibility of substantial increases in interest rates in the future. Also, in 2010, management maintained a portion of the balance with the Federal Reserve in anticipation of repurchasing the TARP Preferred Stock and Warrant. These repurchases were completed during the third quarter 2010. During the fourth quarter 2011, the Corporation began investing in FDIC-insured certificates of deposit issued by other financial institutions and maturing within five years; these investments averaged $677,000 for 2011 and totaled $3,760,000 at December 31, 2011. The Corporation held no such investments in 2010 or prior periods.

INTEREST EXPENSE AND INTEREST-BEARING LIABILITIES

Interest expense fell $5,689,000, or 29.6%, to $13,556,000 in 2011 from $19,245,000 in 2010. Table II shows that the overall cost of funds on interest-bearing liabilities fell to 1.38% in 2011 from 1.88% in 2010.

Total average deposits (interest-bearing and noninterest-bearing) increased 3.7%, to $1,001,125,000 in 2011 from $965,615,000 in 2010. This increase came mainly in demand deposits, savings accounts, and interest checking; the increases were partially offset by decreases in the average balance of certificates of deposit and Individual Retirement Accounts. Consistent with continuing low short-term market interest rates, the average rates incurred on deposit accounts decreased significantly in 2011 as compared to 2010.

Variable-rate accounts comprised $144,008,000 of the average balance in Individual Retirement Accounts in 2011 and $151,688,000 in 2010. Prior to May 2011, substantially all of these accounts were paid interest at a rate that could change quarterly at management's discretion with a contractual floor of 3.00%. Effective in May 2011, the rate floor was removed; following this change, the rate paid on these accounts was lowered several times and was 0.75% at December 31, 2011. As shown in Table II, the average rate on Individual Retirement Accounts decreased to 2.04% in 2011 from 3.06% in 2010.

Total average borrowed funds decreased $50,682,000 to $152,110,000 in 2011 from $202,792,000 in 2010. During 2010 and 2011, the Corporation paid off long-term borrowings as they matured using the cash flow received from loans, mortgage-backed securities, and growth in deposit balances. The average rate on borrowed funds was 3.58% in 2011, down from 3.62% in 2010.

TABLE I - ANALYSIS OF INTEREST INCOME AND EXPENSE

	Years Ended December 31,			Increase/(Decrease)	
(In Thousands)	2012	2011	2010	2012/2011	2011/2010
INTEREST INCOME					
Available-for-sale securities:					
Taxable	$9,334	$11,297	$11,342	$(1,963)	$(45)
Tax-exempt	7,725	7,676	7,157	49	519
Total available-for-sale securities	17,059	18,973	18,499	(1,914)	474
Held-to-maturity securities,					
Taxable	0	0	2	0	(2)
Trading securities	0	0	2	0	(2)
Interest-bearing due from banks	114	73	124	41	(51)
Loans held for sale	107	53	74	54	(21)
Loans receivable:					
Taxable	40,453	43,178	44,155	(2,725)	(977)
Tax-exempt	2,339	2,234	2,343	105	(109)
Total loans receivable	42,792	45,412	46,498	(2,620)	(1,086)
Total Interest Income	60,072	64,511	65,199	(4,439)	(688)
INTEREST EXPENSE					
Interest-bearing deposits:					
Interest checking	206	399	798	(193)	(399)
Money market	354	494	872	(140)	(378)
Savings	108	161	194	(53)	(33)
Certificates of deposit	3,002	3,905	5,060	(903)	(1,155)
Individual Retirement Accounts	1,136	3,150	4,977	(2,014)	(1,827)
Other time deposits	1	3	6	(2)	(3)
Total interest-bearing deposits	4,807	8,112	11,907	(3,305)	(3,795)
Borrowed funds:					
Short-term	10	23	177	(13)	(154)
Long-term	4,214	5,421	7,161	(1,207)	(1,740)
Total borrowed funds	4,224	5,444	7,338	(1,220)	(1,894)
Total Interest Expense	9,031	13,556	19,245	(4,525)	(5,689)
Net Interest Income	$51,041	$50,955	$45,954	$86	$5,001

(1) Interest income from tax-exempt securities and loans has been adjusted to a fully taxable-equivalent basis, using the Corporation’s marginal federal income tax rate of 35% in 2012 and 34% in 2011 and 2010.

(2) Fees on loans are included with interest on loans and amounted to $1,427,000 in 2012, $1,312,000 in 2011 and $1,207,000 in 2010.

Table II - Analysis of Average Daily Balances and Rates

(Dollars in Thousands)

	Year Ended 12/31/2012 Average Balance	Rate of Return/ Cost of Funds %	Year Ended 12/31/2011 Average Balance	Rate of Return/ Cost of Funds %	Year Ended 12/31/2010 Average Balance	Rate of Return/ Cost of Funds %
EARNING ASSETS						
Available-for-sale securities, at amortized cost:						
Taxable	$332,911	2.80 %	$333,441	3.39 %	$314,462	3.61 %
Tax-exempt	131,438	5.88 %	128,463	5.98 %	113,058	6.33 %
Total available-for-sale securities	464,349	3.67 %	461,904	4.11 %	427,520	4.33 %
Held-to-maturity securities,						
Taxable	0	0.00 %	0	0.00 %	38	5.27 %
Trading securities	0	0.00 %	0	0.00 %	29	6.99 %
Interest-bearing due from banks	32,337	0.35 %	31,359	0.23 %	54,655	0.23 %
Federal funds sold	0	0.00 %	0	0.00 %	48	0.00 %
Loans held for sale	2,611	4.10 %	900	5.89 %	1,321	5.60 %
Loans receivable:						
Taxable	662,751	6.10 %	679,357	6.36 %	686,199	6.43 %
Tax-exempt	37,490	6.24 %	35,064	6.37 %	35,798	6.55 %
Total loans receivable	700,241	6.11 %	714,421	6.36 %	721,997	6.44 %
Total Earning Assets	1,199,538	5.01 %	1,208,584	5.34 %	1,205,608	5.41 %
Cash	17,408		17,762		17,505	
Unrealized gain/loss on securities	18,444		7,105		2,555	
Allowance for loan losses	(7,688)		(8,688)		(8,552)	
Bank premises and equipment	18,956		21,381		23,522	
Intangible Asset - Core Deposit Intangible	176		272		417	
Intangible Asset - Goodwill	11,942		11,942		11,942	
Other assets	46,387		55,087		73,148	
Total Assets	$1,305,163		$1,313,445		$1,326,145	
INTEREST-BEARING LIABILITIES						
Interest-bearing deposits:						
Interest checking	$163,840	0.13 %	$162,583	0.25 %	$147,494	0.54 %
Money market	208,814	0.17 %	206,612	0.24 %	203,191	0.43 %
Savings	108,218	0.10 %	97,099	0.17 %	78,012	0.25 %
Certificates of deposit	194,175	1.55 %	205,231	1.90 %	225,542	2.24 %
Individual Retirement Accounts	142,315	0.80 %	154,688	2.04 %	162,754	3.06 %
Other time deposits	1,191	0.08 %	1,231	0.24 %	1,242	0.48 %
Total interest-bearing deposits	818,553	0.59 %	827,444	0.98 %	818,235	1.46 %
Borrowed funds:						

Short-term	6,831	0.15	%	17,216	0.13	%	27,563	0.64	%
Long-term	105,220	4.00	%	134,894	4.02	%	175,229	4.09	%
Total borrowed funds	112,051	3.77	%	152,110	3.58	%	202,792	3.62	%
Total Interest-bearing Liabilities	930,604	0.97	%	979,554	1.38	%	1,021,027	1.88	%
Demand deposits	189,916			173,681			147,380		
Other liabilities	8,821			7,492			7,605		
Total Liabilities	1,129,341			1,160,727			1,176,012		
Stockholders' equity, excluding other comprehensive income/loss	164,316			148,324			148,735		
Other comprehensive income/loss	11,506			4,394			1,398		
Total Stockholders' Equity	175,822			152,718			150,133		
Total Liabilities and Stockholders' Equity	$1,305,163			$1,313,445			$1,326,145		
Interest Rate Spread		4.04	%		3.96	%		3.53	%
Net Interest Income/Earning Assets		4.26	%		4.22	%		3.81	%
Total Deposits (Interest-bearing and Demand)	$1,008,469			$1,001,125			$965,615		

(1) Rates of return on tax-exempt securities and loans are presented on a fully taxable-equivalent basis, using the Corporation’s marginal federal income tax rate of 35% in 2012 and 34% in 2011 and 2010.

(2) Nonaccrual loans have been included with loans for the purpose of analyzing net interest earnings.

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TABLE III - ANALYSIS OF VOLUME AND RATE CHANGES

(In Thousands)	Year Ended 12/31/12 vs. 12/31/11			Year Ended 12/31/11 vs. 12/31/10		
	Change in Volume	Change in Rate	Total Change	Change in Volume	Change in Rate	Total Change
EARNING ASSETS						
Available-for-sale securities:						
Taxable	$ (18)	$ (1,945)	$ (1,963)	$ 664	$ (709)	$ (45)
Tax-exempt	176	(127)	49	936	(417)	519
Total available-for-sale securities	158	(2,072)	(1,914)	1,600	(1,126)	474
Held-to-maturity securities,						
Taxable	0	0	0	(1)	(1)	(2)
Trading securities	0	0	0	(1)	(1)	(2)
Interest-bearing due from banks	2	39	41	(54)	3	(51)
Loans held for sale	74	(20)	54	(25)	4	(21)
Loans receivable:						
Taxable	(1,039)	(1,686)	(2,725)	(440)	(537)	(977)
Tax-exempt	152	(47)	105	(48)	(61)	(109)
Total loans receivable	(887)	(1,733)	(2,620)	(488)	(598)	(1,086)
Total Interest Income	(653)	(3,786)	(4,439)	1,031	(1,719)	(688)
INTEREST-BEARING LIABILITIES						
Interest-bearing deposits:						
Interest checking	3	(196)	(193)	75	(474)	(399)
Money market	5	(145)	(140)	15	(393)	(378)
Savings	16	(69)	(53)	41	(74)	(33)
Certificates of deposit	(201)	(702)	(903)	(430)	(725)	(1,155)
Individual Retirement Accounts	(234)	(1,780)	(2,014)	(236)	(1,591)	(1,827)
Other time deposits	0	(2)	(2)	0	(3)	(3)
Total interest-bearing deposits	(411)	(2,894)	(3,305)	(535)	(3,260)	(3,795)
Borrowed funds:						
Short-term	(15)	2	(13)	(49)	(105)	(154)
Long-term	(1,188)	(19)	(1,207)	(1,623)	(117)	(1,740)
Total borrowed funds	(1,203)	(17)	(1,220)	(1,672)	(222)	(1,894)
Total Interest Expense	(1,614)	(2,911)	(4,525)	(2,207)	(3,482)	(5,689)
Net Interest Income	$ 961	$ (875)	$ 86	$ 3,238	$ 1,763	$ 5,001

(1) Changes in income on tax-exempt securities and loans are presented on a fully taxable-equivalent basis, using the Corporation's marginal federal income tax rate of 35% in 2012 and 34% in 2011 and 2010.

(2) The change in interest due to both volume and rates has been allocated to volume and rate changes in proportion to the relationship of the absolute dollar amounts of the change in each.

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RECOVERY ON IMPAIRED INVESTMENT SECURITY

In 2009 and the first quarter 2010, the Corporation recorded OTTI on its holding of a trust preferred security issued by Carolina First Mortgage Loan Trust, a subsidiary of The South Financial Group, Inc. In the fourth quarter 2010, The Toronto-Dominion Bank acquired The South Financial Group, Inc., made a payment for the full amount of previously deferred interest, and resumed quarterly payments on the security. The Corporation recognized a material change in the expected cash flows and began recording accretion income (included in interest income) to offset the previous OTTI charges as an adjustment to the security's yield over its remaining life. The yield to maturity was 147.03%. The security had a face amount of $2,000,000 and matured in May 2012.

Accretion income from this security was recognized as follows:

	Accretion of Prior OTTI
4th Quarter 2010	$ 83
1st Quarter 2011	111
2nd Quarter 2011	160
3rd Quarter 2011	229
4th Quarter 2011	325
1st Quarter 2012	457
2nd Quarter 2012	398
Total	$ 1,763

Excluding interest income (including accretion) and the average balance of this security from the calculations used to determine Tables I, II and III, the interest rate spread and interest margin (fully taxable equivalent net interest income divided by average total earning assets) would be as follows:

	Year Ended December 31,		
	2012	2011	2010
Interest rate spread:			
Actual from Table II	4.04 %	3.96 %	3.53 %
Excluding Carolina First security	3.97 %	3.89 %	3.51 %
Interest margin:			
Actual from Table II	4.26 %	4.22 %	3.81 %
Excluding Carolina First security	4.18 %	4.14 %	3.80 %

NONINTEREST INCOME

Years Ended December 31, 2012, 2011 and 2010

The table below presents a comparison of noninterest income and excludes realized gains on available for sale securities, which are discussed in the "Earnings Overview" section of Management's Discussion and Analysis.

TABLE IV - COMPARISON OF NONINTEREST INCOME
(In Thousands)

	2012	2011	$ Change	% Change
Service charges on deposit accounts	$5,036	$4,773	$263	5.5
Service charges and fees	929	849	80	9.4
Trust and financial management revenue	3,847	3,472	375	10.8
Brokerage revenue	801	640	161	25.2
Insurance commissions, fees and premiums	221	257	(36)	(14.0)
Interchange revenue from debit card transactions	1,938	1,922	16	0.8
Net gains from sales of loans	1,925	1,107	818	73.9
Increase in cash surrender value of life insurance	455	509	(54)	(10.6)
Net (loss) gain from other real estate	(66)	41	(107)	(261.0)
Net gain from premises and equipment	270	324	(54)	(16.7)
Impairment loss on limited partnership investment	0	(948)	948	(100.0)
Other operating income	961	992	(31)	(3.1)
Total other operating income before realized gains on available-for-sale securities, net	$16,317	$13,938	$2,379	17.1

	2011	2010	$ Change	% Change
Service charges on deposit accounts	$4,773	$4,579	$194	4.2
Service charges and fees	849	858	(9)	(1.0)
Trust and financial management revenue	3,472	3,475	(3)	(0.1)
Brokerage revenue	640	465	175	37.6
Insurance commissions, fees and premiums	257	248	9	3.6
Interchange revenue from debit card transactions	1,922	1,678	244	14.5
Net gains from sales of loans	1,107	761	346	45.5
Increase in cash surrender value of life insurance	509	466	43	9.2
Net gain from other real estate	41	108	(67)	(62.0)
Net gain from premises and equipment	324	445	(121)	(27.2)
Impairment loss on limited partnership investment	(948)	0	(948)	
Other operating income	992	755	237	31.4
Total other operating income before realized gains on available-for-sale securities, net	$13,938	$13,838	$100	0.7

Total noninterest income, excluding realized gains on available-for-sale securities, increased $2,379,000 or 17.1% in 2012 compared to 2011. In 2011, total noninterest income increased $100,000 (0.7%) from 2010. Total noninterest income in 2011 included an impairment loss of $948,000 related to an investment in a real estate limited partnership (discussed in more detail below). Excluding the 2011 impairment loss on the limited partnership investment and gains from available-for-sale securities, noninterest income increased $1,431,000 (9.6%) in 2012 over 2011, and $1,048,000 (7.6%) in 2011 over 2010. Items of significance related to noninterest income are as follows:

2012 vs. 2011

- In 2011, the Corporation reported an impairment loss of $948,000 related to an investment in a real estate limited partnership. Based on updated financial information, management prepared an estimated valuation based on cash flow analysis. That analysis showed the estimated cash flows to be derived from the limited partnership's activities would not be sufficient to provide a return on the Corporation's limited partnership investment. Accordingly, management made the decision to completely write-off the limited partnership investment in 2011. In addition to the limited partnership investment, the Corporation has a loan receivable from the limited partnership with a balance of $1,021,000 at December 31, 2012 and $1,036,000 at December 31, 2011. The loan was scheduled to mature with a balloon payment of approximately $1,022,000 plus interest due in December 2012; however, the maturity date was extended to June 2013 to permit additional time for sale of the underlying real estate collateral. Based on management's estimate of the value of the underlying collateral, the Corporation has no allowance for loan losses associated with the loan to the limited partnership at December 31, 2012.

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- Net gains from sales of loans increased $818,000. Starting in late 2009, the Corporation began to sell a significant amount of residential mortgage loans into the secondary market through the MPF Xtra program administered by the Federal Home Loan Banks of Pittsburgh and Chicago. The increase in revenue from sales in 2012 reflects the impact of significant refinancing activity, as market interest rates have continued to fall throughout most of the time frame since the Corporation began to offer the program.

- Trust and financial management revenue increased $375,000, or 10.8%. Trust revenue from employee benefit and retirement services was $129,000 higher in 2012 as compared to 2011. The increase in trust revenue in 2012 reflects the impact of new business obtained as well as higher valuations of U.S. equities and fixed income securities throughout most of the period. Assets under management by the Corporation's Trust and financial management group totaled $707,912,000 at December 31, 2012, an increase of 11.5% over the total one year earlier.

- Service charges on deposit accounts increased $263,000, or 5.5%, reflecting changes in prices and terms for some types of fees effective at the beginning of 2012. Net revenues from consumer overdraft privilege services totaled approximately 66% of the total revenues in this category in 2012, down from approximately 74% in 2011.

- Brokerage revenue increased $161,000, or 25.2%, reflecting increased sales of annuities used by customers as investment vehicles in retirement.

- The net gain from premises and equipment of $270,000 in 2012 included a gain of $272,000 from the excess of insurance proceeds received over the historical book value of assets replaced or reconstructed at the Athens, PA branch, which was damaged by a flood in September 2011 and remained closed until it was re-opened in April 2012. In 2011, the Corporation realized net gains from sales of premises and equipment totaling $324,000, including a gain of $329,000 from sale of the Court Street, Williamsport, PA location. The Corporation has entered into a leasing arrangement to continue to utilize a portion of the facility. The leaseback is for use of approximately 18% of the total building space, for a period of two years with monthly rent of approximately $8,000 per month, plus allocable utilities, property taxes and other building-related expenses identified in the lease. The lease provides the Corporation with an option to renew for an additional two years, for monthly rent of approximately $9,000 per month, plus allocable building-related expenses. The Corporation's continuing interest in the property is limited to its role as lessee, and the Corporation did not provide financing to the buyer. The Corporation has accounted for the leaseback as an operating lease.

2011 vs. 2010

- Net gains from the sale of loans totaled $1,107,000 in 2011, an increase of $346,000 (45.5%) over 2010, reflecting the Corporation's increased originations and sales of residential mortgages as described in the "2012 vs. 2011" analysis above. Similar to 2012, the increasing volume of mortgage loans sold in 2011 reflected the impact of significant refinancing activity as a result of falling market interest rates on mortgages.

Interchange revenue from debit card transactions of $1,922,000 in 2011 was $244,000, or 14.5%, higher than in 2010. The increased level of interchange fees reflects customers' higher volume of debit card transactions.

- Other operating income of $992,000 in 2011 was $237,000 higher than in 2010. In 2011, this category included income of $150,000 from a limited liability equity investment in an entity performing title insurance services throughout Pennsylvania. Comparatively, the Corporation recognized $20,000 of income from investment in this entity in 2010. The Corporation also experienced increases in revenues from check sales (up $41,000) and merchant services (up $30,000) in 2011 as compared to 2010.

- Service charges on deposit accounts increased $194,000 or 4.2% in 2011 compared to 2010 mainly due to fee pricing changes for certain services effective at the beginning of 2011. Net revenues from consumer overdraft privilege services totaled approximately 74% of the total revenues in this category in 2011 as compared to 75% in 2010.

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- Brokerage revenue of $640,000 in 2011 was $175,000 higher than in 2010. The increase in brokerage revenue includes the effects of sales of annuities to customers who had previously held variable-rate Individual Retirement Accounts (deposits) with the Corporation. Changes in variable-rate Individual Retirement Account deposits are discussed in more detail in the Net Interest Income section of Management's Discussion and Analysis.

- As described above, in 2011 the Corporation reported an impairment loss of $948,000 related to an investment in a real estate limited partnership.

- As described above, in 2011 the Corporation realized net gains from sales of premises and equipment totaling $324,000, including a gain of $329,000 from sale of the Court Street, Williamsport, PA location. In 2010, net gains from sales of premises and equipment totaled $445,000, including a gain of $448,000 from the sale of a parcel adjacent to the Court Street, Williamsport location.

NONINTEREST EXPENSE

Years Ended December 31, 2012, 2011 and 2010

As shown in Table V below, total noninterest expense increased $3,124,000 in 2012 as compared to 2011. As discussed in the Earnings Overview section of Management's Discussion and Analysis, in 2012, the Corporation incurred losses totaling $2,333,000 from prepayment of borrowings (repurchase agreements) with an average interest rate of 3.93%. Excluding losses from prepayment of debt, total noninterest expense was $791,000 (2.5%) higher in 2012 as compared to 2011. In 2011 total noninterest expense increased $567,000 or 1.8% over 2011. Changes of significance (other than the previously discussed loss on prepayment of debt) are discussed in the narrative that follows.

TABLE V - COMPARISON OF NONINTEREST EXPENSE
(In Thousands)

	2012	2011	$ Change	% Change
Salaries and wages	$14,370	$13,866	$504	3.6
Pensions and other employee benefits	4,497	4,407	90	2.0
Occupancy expense, net	2,476	2,638	(162)	(6.1)
Furniture and equipment expense	1,887	1,932	(45)	(2.3)
FDIC Assessments	633	832	(199)	(23.9)
Pennsylvania shares tax	1,312	1,306	6	0.5
Loss on prepayment of debt	2,333	0	2,333	
Other operating expense	7,673	7,076	597	8.4
Total Other Expense	$35,181	$32,057	$3,124	9.7

$ %

	2011	2010	Change	Change
Salaries and wages	$13,866	$13,063	$ 803	6.1
Pensions and other employee benefits	4,407	3,840	567	14.8
Occupancy expense, net	2,638	2,645	(7)	(0.3)
Furniture and equipment expense	1,932	2,103	(171)	(8.1)
FDIC Assessments	832	1,450	(618)	(42.6)
Pennsylvania shares tax	1,306	1,222	84	6.9
Other operating expense	7,076	7,167	(91)	(1.3)
Total Other Expense	$32,057	$31,490	$ 567	1.8

2012 vs. 2011

Salaries and wages increased $504,000, or 3.6%, mainly as a result of merit-based salary increases. The number of full-time equivalent employees was 292 at December 31, 2012, up slightly from 290 at December 31, 2011. The increase in this category in 2012 also included an increase in stock-based compensation for employees (excluding non-employee Directors) of $98,000.

Occupancy expense decreased $162,000, or 6.1%. Within this category, snow removal and related expenses were $52,000 lower in 2012, reflecting the milder winter weather throughout the Corporation's market area. Depreciation expense was $118,000 lower in 2012, mainly due to the impact of the sale of the Court Street, Williamsport property in the third quarter 2011. In connection with the sale, the Corporation entered into a lease arrangement to continue to use a portion of the building. The lease is accounted for as an operating lease. Management estimates that total building-related expenses (including the effects of lower depreciation referred to above) for this location were $122,000 lower in 2012 than in 2011.

FDIC Assessments decreased $199,000, or 23.9%. Effective April 1, 2011, the FDIC's method of determining assessments to banks changed, with the new methodology resulting in higher assessments to larger, more complex or higher-risk institutions, and smaller assessments to many community and small regional banks. The Corporation's estimated first quarter 2012 FDIC assessment was substantially lower than the first quarter 2011 amount, reflecting the new methodology. The favorable decline also reflects rate changes attributed to improvements in the Corporation's risk profile based on financial ratios.

Other operating expense increased $597,000, or 8.4%. This category includes many different types of expenses, with the most significant differences in amounts between 2012 and 2011 as follows:

- Software-related subscriptions and updates, mainly related to lending-related activities, up $186,000, or 26.5%
- Fees paid related to interchange and ATM processing, up $110,000 or 10.8%
- Expense related to a change in third-party merchant processing in 2012 of $110,000, with no corresponding expense in 2011
- Attorney fees, mainly from lending-related collection matters, up $100,000, or 47.2%
- Expenses associated with other real estate properties, up $78,000, or 92.2%

2011 vs. 2010

Salaries and wages increased $803,000, or 6.1%. In 2011, salaries and wages expense includes officers' incentive stock option compensation of $244,000; however, since no stock options were awarded in 2010, there was no officers' incentive stock option expense incurred in 2010. In addition, salaries and wages expense in 2011 include increases of $55,000 in estimated incentive bonuses and $75,000 in officers' restricted stock compensation over the comparable 2010 amounts. Excluding performance based stock and bonus compensation incentives, total salaries and wages were 3.3% higher in 2011 as compared to 2010.

Pensions and other employee benefits increased $567,000, or 14.8%. Within this category, group health insurance expense was $368,000 higher in 2011. In the first quarter 2010, the Corporation recorded a reduction in group health insurance expense of $215,000 for the difference between actual and estimated claims from the previous year (2009). Payroll taxes and employer contributions expense associated with the Savings & Retirement Plan (a 401(k) plan) and Employee Stock Ownership Plan are $90,000 higher in 2011 than in the same period of 2010, including higher costs in the first quarter 2011 related to incentive compensation paid in January 2011 based on 2010 performance.

Furniture and equipment expense decreased $171,000, or 8.1% in 2011 with the decrease primarily associated with reductions in depreciation for the Corporation's core banking systems.

FDIC Assessments decreased $618,000, or 42.6% in 2011. Effective April 1, 2011, the FDIC's method of determining assessments to banks has changed, with the new methodology resulting in higher assessments to larger, more complex or higher-risk institutions, with smaller assessments to many community and small regional banks. Since the second quarter 2011, the Corporation's 2011 FDIC assessments, determined using the new methodology, are substantially lower than the amounts assessed for the prior several quarters. The favorable decline also reflects rate changes attributed to improvements in the Corporation's risk profile based on financial ratios.

Other operating expense decreased $91,000, or 1.3%, in 2011 as compared to 2010. This category includes many different types of expenses, with the most significant differences in amounts between 2011 and 2010 as follows:

- Professional fees and other costs associated with public company requirements, down $137,000, or 48.9%
- Consulting fees associated with an overdraft privilege program, down $71,000, or 93.3%
- Amortization of core deposit intangibles from 2005 and 2007 acquisitions, down $62,000, or 35.2%
- Out-of-pocket collection-related expenses, net of reimbursements, down $58,000, or 33.0%
- Office supplies, down $53,000, or 16.3%
- Attorney fees, primarily associated with lending and collection matters, down $51,000, or 19.4%
- Telephone data lines and service, down $39,000, or 7.6%

- Professional and administrative expenses associated with Citizens & Northern Investment Corporation activities, down $36,000, or 58.1%
- Expenses associated with other real estate properties, down $31,000, or 26.8%
- Software-related subscriptions and updates, up $164,000, or 25.3%
- Expenses associated with Bucktail Life Insurance Company, up $156,000. In the second quarter 2010, the Corporation recorded a $245,000 reduction in estimated insurance reserves
- Fees paid related to interchange and ATM processing increased $98,000, or 10.6%
- Charitable donations, up $26,000, mainly due to a $50,000 donation to the Red Cross for victims of flooding that occurred in the Corporation's market area in September 2011.

INCOME TAXES

The effective income tax rate was approximately 27% of pre-tax income in 2012 and 2011, and 23% in 2010. For 2012 and 2011, the Corporation's effective tax rates differ from the statutory rate of 35% principally because of the effects of tax-exempt interest income. In 2010, in addition to the effects of tax-exempt interest income, the Corporation's lower effective tax rate included the benefit of a reduction in expense of $373,000 from the elimination of a valuation reserve related to deferred tax assets that had been established in the preceding year.

The Corporation recognizes deferred tax assets and liabilities based on differences between the financial statement carrying amounts and the tax basis of assets and liabilities. At December 31, 2012, the net deferred tax asset was $1,725,000, down from the balance at December 31, 2011 of $6,173,000. The main reasons for the decrease in net deferred tax asset included: (1) reduction in deferred tax asset related to realized losses on securities to $1,254,000 at December 31, 2012 from $3,175,000 at December 31, 2011; (2) reduction in deferred tax asset related to the credit for alternative minimum tax (AMT) paid in prior periods, which decreased to $3,609,000 at December 31, 2012 from $4,569,000 at December 31, 2011; (3) reduction in deferred tax asset related to general business credit carryforwards, which fell to $0 at December 31, 2012 from $831,000 at December 31, 2011; and (4) increase in deferred tax liability associated with unrealized gains on available-for-sale securities to $6,228,000 at December 31, 2012 from $5,559,000 at December 31, 2011. The reduction in deferred tax asset from realized losses on securities resulted from the 2012 sale of a pooled trust-preferred security for which OTTI had been recorded for financial reporting purposes in previous years. The reduction in deferred tax assets for general business credit carryforwards and the credit for AMT resulted from the estimated excess of the Corporation's regular tax liability over the AMT liability in 2012, as results indicate the credits would be fully utilized and a portion of the credit for prior years' AMT paid would be realized.

The Corporation regularly reviews deferred tax assets for recoverability based on history of earnings, expectations for future earnings and expected timing of reversals of temporary differences. Realization of deferred tax assets ultimately depends on the existence of sufficient taxable income, including taxable income in prior carryback years, as well as future taxable income. Management believes the recorded net deferred tax asset at December 31, 2012 is fully realizable; however, if management determines the Corporation will be unable to realize all or part of the net deferred tax asset, the Corporation would adjust the deferred tax asset, which would negatively impact earnings.

Additional information related to income taxes is presented in Note 14 to the consolidated financial statements.

SECURITIES

Table VI shows the composition of the investment portfolio at December 31, 2012, 2011 and 2010. Comparison of the amortized cost totals of available-for-sale securities at each year-end presented reflects an increase of $19,334,000 to $465,335,000 at December 31, 2011 from December 31, 2010. This change was followed by a decrease of $10,554,000 to $454,781,000 at December 31, 2012. In both 2011 and 2012, the Corporation increased its holdings of municipal bonds and agency collateralized mortgage obligations. The increases were partially offset by decreases in the balances of U.S. Government agency securities, mortgage-backed securities, and trust preferred securities as management reinvested cash flows from these securities in other types of investments. Changes in the investment portfolio are discussed in more detail in the Net Interest Income section of Management's Discussion and Analysis. As discussed in more detail in Note 7 to the financial statements, in 2012 the Corporation reported net realized gains from available-for-sale securities of $2,682,000, including a realized pretax gain of $1,754,000 on the sale of a pooled trust preferred security in the third quarter 2012. Management has reviewed the Corporation's holdings as of December 31, 2012 and concluded that unrealized losses on all of the securities in an unrealized loss position are considered temporary. Notes 6 and 7 to the consolidated financial statements provide more detail concerning the Corporation's processes for evaluating securities for other-than-temporary impairment, and for valuation of trust-preferred securities. Management will continue to closely monitor the status of impaired securities in 2013.

TABLE VI - INVESTMENT SECURITIES

	As of December 31,					
	2012		2011		2010	
(In Thousands)	Amortized Cost	Fair Value	Amortized Cost	Fair Value	Amortized Cost	Fair Value
AVAILABLE-FOR-SALE SECURITIES:						
Obligations of U.S. Government agencies	$30,695	$31,217	$24,877	$25,587	$44,005	$44,247
Obligations of states and political subdivisions:						
Tax-exempt	130,168	137,020	129,401	132,962	127,210	119,874
Taxable	24,426	24,817	14,004	14,334	7,808	7,668
Mortgage-backed securities	76,368	80,196	116,602	121,769	113,176	118,386
Collateralized mortgage obligations,						
Issued by U.S. Government agencies	179,770	183,510	161,818	165,131	131,040	130,826
Corporate bonds	0	0	0	0	1,000	1,027
Trust preferred securities issued by individual institutions	5,167	5,171	7,334	8,146	6,535	7,838
Collateralized debt obligations:						
Pooled trust preferred securities - senior tranches	1,615	1,613	4,996	4,638	9,957	7,400
Pooled trust preferred securities - mezzanine tranches	0	0	0	730	0	0
Other collateralized debt obligations	660	660	660	660	681	681
Total debt securities	448,869	464,204	459,692	473,957	441,412	437,947

Marketable equity securities	5,912	8,373	5,643	7,728	4,589	6,009
Total	$454,781	$472,577	$465,335	$481,685	$446,001	$443,956

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The following table presents the contractual maturities and the weighted-average yields (calculated based on amortized cost) of investment securities as of December 31, 2012. Yields on tax-exempt securities are presented on a nominal basis, that is, the yields are not presented on a fully taxable-equivalent basis. Actual maturities may differ from contractual maturities because counterparties may have the right to call or prepay obligations with or without call or prepayment penalties.

(In Thousands, Except for Percentages)	Within One Year	Yield	One-Five Years	Yield	Five-Ten Years	Yield	After Ten Years	Yield	Total	Yield
AVAILABLE-FOR-SALE SECURITIES:										
Obligations of U.S. Government agencies	$2,038	1.89%	$18,602	1.89%	$10,055	1.23%	$0	0.00%	$30,695	1.67%
Obligations of states and political subdivisions:										
Tax-exempt	9,045	3.92%	19,184	2.02%	31,850	2.79%	70,089	4.91%	130,168	3.90%
Taxable	2,013	1.42%	13,800	2.18%	8,613	2.03%	0	0.00%	24,426	2.06%
Trust preferred securities issued by individual institutions	0	0.00%	0	0.00%	0	0.00%	5,167	8.94%	5,167	8.94%
Collateralized debt obligations:										
Pooled trust preferred securities - senior tranches	0	0.00%	0	0.00%	0	0.00%	1,615	7.84%	1,615	7.84%
Other collateralized debt obligations	0	0.00%	0	0.00%	0	0.00%	660	0.00%	660	0.00%
Subtotal	$13,096	3.22%	$51,586	2.02%	$50,518	2.35%	$77,531	5.20%	$192,731	3.47%
Mortgage-backed securities									76,368	3.13%
Collateralized mortgage obligations,										
Issued by U.S. Government agencies									179,770	1.84%
Total									$448,869	2.76%

The Corporation's mortgage-backed securities and collateralized mortgage obligations have stated maturities that may differ from actual maturities due to borrowers' ability to prepay obligations. Cash flows from such investments are dependent upon the performance of the underlying mortgage loans and are generally influenced by the level of interest rates. As rates increase, cash flows generally decrease as prepayments on the underlying mortgage loans decrease. As rates decrease, cash flows generally increase as prepayments increase. In the table above, the entire balances and weighted-average rates for mortgage-backed securities and collateralized mortgage obligations are shown in one period.

FINANCIAL CONDITION

Significant changes in the average balances of the Corporation's earning assets and interest-bearing liabilities are described in the Net Interest Income section of Management's Discussion and Analysis. The discussion provides useful information regarding changes in the Corporation's balance sheet over the 3-year period ended December 31, 2012, including discussions related to available-for-sale securities, loans, deposits and borrowings. Other significant balance sheet items - the allowance for loan losses and stockholders' equity - are discussed in separate sections of Management's Discussion and Analysis.

The total of loans outstanding (without consideration of the allowance for loan losses) at December 31, 2012 reflects a total decrease of $59,634,000 (8%) from the balance at December 31, 2008 to the total outstanding of $683,910,000 at December 31, 2012. Loan volumes are heavily dependent on economic conditions in the Corporation's market area, and are significantly influenced by interest rates. Since the end of 2008, the Corporation experienced a net decrease in total loans outstanding under the residential mortgage segment ($42,898,000) with more residential mortgage originations than in previous years sold into the secondary market. In September 2009, the Corporation initiated participation in the MPF Xtra program administered by the Federal Home Loan Banks of Pittsburgh and Chicago for the sale of mortgage loans to the secondary market. At December 31, 2012, the outstanding balance of residential mortgage loans originated by the Corporation, and sold with servicing retained was $100,631,000. Also, in the last four years, consumer loans have steadily decreased ($15,463,000) to the December 31, 2012 balance of $11,269,000. Total commercial segment loans outstanding decreased $1,273,000 at December 31, 2012 as compared to December 31, 2008, including a reduction of $7,381,000 at December 31, 2012 from year-end 2011.

Table VIII presents loan maturity data as of October 31, 2012 (the last date in 2012 for which the Corporation ran the interest rate simulation model used to generate the loan maturity information included in Table VIII). The interest rate simulation model classifies certain loans under different categories than they appear in Table VII. Fixed-rate loans are shown in Table VIII based on their contractually scheduled principal repayments, and variable-rate loans are shown based on the date of the next change in rate. Table VIII shows that fixed-rate loans are approximately 40% of the loan portfolio. Of the 60% of the portfolio made up of variable-rate loans, a significant portion (35%) will re-price after more than one year. Variable-rate loans re-pricing after more than one year include significant amounts of residential and commercial real estate loans. The Corporation's substantial investment in long-term, fixed-rate loans and variable-rate loans with extended periods until re-pricing is one of the concerns management attempts to address through interest rate risk management practices. See Part II, Item 7A for a more detailed discussion of the Corporation's interest rate risk.

Total future capital purchases in 2013 are estimated at approximately $1.7 million. Management does not expect capital expenditures to have a material, detrimental effect on the Corporation's financial condition during 2013.

TABLE VII - FIVE-YEAR SUMMARY OF LOANS BY TYPE

(In Thousands)	2012	%	2011	%	2010	%	2009	%	2008	%
Residential mortgage:										
Residential mortgage loans - first liens	$311,627	45.6	$331,015	46.7	$333,012	45.6	$340,268	47.2	$353,909	47.6
Residential mortgage loans - junior liens	26,748	3.9	28,851	4.1	31,590	4.3	35,734	5.0	40,657	5.5
Home equity lines of credit	33,017	4.8	30,037	4.2	26,853	3.7	23,577	3.3	21,304	2.9
1-4 Family residential construction	12,842	1.9	9,959	1.4	14,379	2.0	11,452	1.6	11,262	1.5
Total residential mortgage	384,234	56.2	399,862	56.5	405,834	55.6	411,031	57.0	427,132	57.4
Commercial:										
Commercial loans secured by real estate	158,413	23.2	156,388	22.1	167,094	22.9	163,483	22.7	165,979	22.3
Commercial and industrial	48,442	7.1	57,191	8.1	59,005	8.1	49,753	6.9	48,295	6.5
Political subdivisions	31,789	4.6	37,620	5.3	36,480	5.0	37,598	5.2	38,790	5.2
Commercial construction and	28,200	4.1	23,518	3.3	24,004	3.3	15,264	2.1	13,730	1.8

land										
Loans secured by farmland	11,403	1.7	10,949	1.5	11,353	1.6	11,856	1.6	9,140	1.2
Multi-family (5 or more) residential	6,745	1.0	6,583	0.9	7,781	1.1	8,338	1.2	8,367	1.1
Agricultural loans	3,053	0.4	2,987	0.4	3,472	0.5	3,848	0.5	4,495	0.6
Other commercial loans	362	0.1	552	0.1	392	0.1	638	0.1	884	0.1
Total commercial	288,407	42.2	295,788	41.8	309,581	42.4	290,778	40.3	289,680	39.0
Consumer	11,269	1.6	12,665	1.8	14,996	2.1	19,202	2.7	26,732	3.6
Total	683,910	100.0	708,315	100.0	730,411	100.0	721,011	100.0	743,544	100.0
Less: allowance for loan losses	(6,857)		(7,705)		(9,107)		(8,265)		(7,857)	
Loans, net	$677,053		$700,610		$721,304		$712,746		$735,687	

TABLE VIII – LOAN MATURITY DISTRIBUTION

(In Thousands)	As of October 31, 2012							
	Fixed-Rate Loans				Variable- or Adjustable-Rate Loans			
	1 Year or Less	1-5 Years	>5 Years	Total	1 Year or Less	1-5 Years	>5 Years	Total
Real Estate	$8,817	$15,677	$197,788	$222,282	$112,204	$221,503	$7,075	$340,782
Commercial	22,931	12,255	12,806	47,992	58,307	14,553	996	73,856
Consumer	2,630	5,911	3,441	11,982	126	21	0	147
Total	$34,378	$33,843	$214,035	$282,256	$170,637	$236,077	$8,071	$414,785

PROVISION AND ALLOWANCE FOR LOAN LOSSES

The Corporation maintains an allowance for loan losses that represents management's estimate of the losses inherent in the loan portfolio as of the balance sheet date and recorded as a reduction of the investment in loans. Notes 1 and 8 to the consolidated financial statements provide an overview of the process management uses for evaluating and determining the allowance for loan losses.

While management uses available information to recognize losses on loans, changes in economic conditions may necessitate revisions in future years. In addition, various regulatory agencies, as an integral part of their examination process, periodically review the Corporation's allowance for loan losses. Such agencies may require the Corporation to recognize adjustments to the allowance based on their judgments of information available to them at the time of their examination.

The allowance for loan losses of $6,857,000 at December 31, 2012 was down from $7,705,000 at December 31, 2011. As presented in Table X, the specific component of the allowance on impaired loans decreased to $623,000 at December 31, 2012 from $1,126,000 at December 31, 2011. The decrease in the allowance on impaired loans at December 31, 2012 as compared to December 31, 2011 included a reduction of $296,000 related to one commercial relationship. In 2012, charge-offs totaling $760,000 (all in the fourth quarter) were recorded related to this commercial relationship for which specific allowances totaling $380,000 had been established at December 31, 2011. After the impact of these charge-offs and re-evaluation of the allowances required, the Corporation had loans outstanding totaling $2,448,000 with a specific allowance of $84,000 at December 31, 2012 related to this commercial borrower.

Table X also shows that the collectively determined components of the allowance fell by a total of $345,000 as of December 31, 2012 compared to December 31, 2011, mainly because of the decrease in the balance of outstanding loans. In addition to the effect of the decrease in outstanding loans, the collectively determined allowance for the commercial segment was impacted by a lower net charge-off percentage used to determine a portion of the collectively determined allowance in 2012 as compared to 2011. (The Corporation used net charge-offs as a percentage of average outstanding loans for the previous three calendar years to estimate a portion of the collectively determined allowance at both December 31, 2012 and December 31, 2011.) The net charge-off percentages did not change significantly for the residential mortgage and consumer segments, and the qualitative factors used in determining the collectively evaluated components of the allowance did not change significantly for any of the segments, at December 31, 2012 as compared to December 31, 2011.

Table IX shows a provision for loan losses of $288,000 in 2012, in comparison to a credit for loan losses of $285,000 in 2011. As shown in Table XII, the average provision for loan losses for the five-year period ended December 31, 2012 was $557,000. The total amount of the provision for loan losses for each period is determined based on the amount required to maintain an appropriate allowance in light of all of the factors described above. In 2012, the Corporation’s provision for loan losses included a net provision of $464,000 related to the commercial relationship referred to above for which charge-offs totaling $760,000 were recorded. Also in 2012, the provision was reduced as a result of the reduction in the collectively determined components of the allowance, mainly due to the reduction in outstanding loans, as described above. In 2011, the credit for loan losses reflected a reduction in the collectively determined portion of the allowance, mainly due to a reduction in outstanding loans. Note 8 to the consolidated financial statements includes a summary of the provision (credit) for loan losses and activity in the allowance for loan losses, by segment and class, for 2012 and 2011.

Table XI presents information related to past due and impaired loans, and loans that have been modified under terms that are considered troubled debt restructurings (TDRs). At December 31, 2012, total impaired loans were $7,429,000, down from $7,864,000 at December 31, 2011. Nonaccrual loans totaled $7,353,000 at December 31, 2012, up from $7,197,000 at December 31, 2011, and total loans past due 90 days or more and still in accrual status increased to $2,311,000 at December 31, 2012 from $1,267,000 at December 31, 2011. Interest continues to be accrued on loans 90 days or more past due that management deems to be well secured and in the process of collection, and for which no loss is anticipated. Over the period 2008-2012, each period includes a few large commercial relationships that have required significant monitoring and workout efforts. As a result, a limited number of relationships may significantly impact the total amount of allowance required on impaired loans, and may significantly impact the amount of total charge-offs reported in any one period.

Management believes it has been conservative in its decisions concerning identification of impaired loans, estimates of loss, and nonaccrual status; however, the actual losses realized from these relationships could vary materially from the allowances calculated as of December 31, 2012. Management continues to closely monitor its commercial loan relationships for possible credit losses, and will adjust its estimates of loss and decisions concerning nonaccrual status, if appropriate.

Tables IX through XII present historical data related to the allowance for loan losses.

TABLE IX - ANALYSIS OF THE ALLOWANCE FOR LOAN LOSSES

(In Thousands)	Years Ended December 31,				
	2012	2011	2010	2009	2008
Balance, beginning of year	$7,705	$9,107	$8,265	$7,857	$8,859
Charge-offs:					
Residential mortgage	(552)	(100)	(340)	(146)	(173)
Commercial	(498)	(1,189)	(91)	(39)	(1,607)
Consumer	(171)	(157)	(188)	(293)	(259)
Total charge-offs	(1,221)	(1,446)	(619)	(478)	(2,039)
Recoveries:					
Residential mortgage	18	3	55	8	19
Commercial	8	255	113	77	22
Consumer	59	71	102	121	87
Total recoveries	85	329	270	206	128
Net charge-offs	(1,136)	(1,117)	(349)	(272)	(1,911)
Provision (credit) for loan losses	288	(285)	1,191	680	909
Balance, end of period	$6,857	$7,705	$9,107	$8,265	$7,857

TABLE X - COMPONENTS OF THE ALLOWANCE FOR LOAN LOSSES

(In Thousands)	As of December 31,				
	2012	2011	2010	2009	2008
ASC 310 - Impaired loans	$623	$1,126	$2,288	$1,126	$456
ASC 450 - Collective segments:					
Commercial	2,594	2,811	3,047	2,677	2,654
Residential mortgage	3,011	3,130	3,227	3,859	3,920
Consumer	188	204	232	281	399
Unallocated	441	434	313	322	428
Total Allowance	$6,857	$7,705	$9,107	$8,265	$7,857

The above allocation is based on estimates and subjective judgments and is not necessarily indicative of the specific amounts or loan categories in which losses may occur.

TABLE XI - PAST DUE AND IMPAIRED LOANS, NONPERFORMING ASSETS

AND TROUBLED DEBT RESTRUCTURINGS (TDRs)

(In Thousands)

	As of December 31,				
	2012	2011	2010	2009	2008
Impaired loans with a valuation allowance	$2,710	$3,433	$5,457	$2,690	$2,230
Impaired loans without a valuation allowance	4,719	4,431	3,191	3,257	3,435
Total impaired loans	$7,429	$7,864	$8,648	$5,947	$5,665
Total loans past due 30-89 days and still accruing	$7,756	$7,898	$7,125	$9,445	$9,875
Nonperforming assets:					
Total nonaccrual loans	$7,353	$7,197	$10,809	$9,092	$7,200
Total loans past due 90 days or more and still accruing	2,311	1,267	727	31	1,305
Total nonperforming loans	9,664	8,464	11,536	9,123	8,505
Foreclosed assets held for sale (real estate)	879	1,235	537	873	298
Total nonperforming assets	$10,543	$9,699	$12,073	$9,996	$8,803
Loans subject to troubled debt restructurings (TDRs):					
Performing	$906	$1,064	$645	$326	$0
Nonperforming	1,155	2,413	0	0	0
Total TDRs	$2,061	$3,477	$645	$326	$0
Total nonperforming loans as a % of loans	1.41 %	1.19 %	1.58 %	1.27 %	1.14 %
Total nonperforming assets as a % of assets	0.82 %	0.73 %	0.92 %	0.76 %	0.69 %
Allowance for loan losses as a % of total loans	1.00 %	1.09 %	1.25 %	1.15 %	1.06 %
Allowance for loan losses as a % of nonperforming loans	70.95 %	91.03 %	78.94 %	90.60 %	92.38 %

TABLE XII - FIVE-YEAR HISTORY OF LOAN LOSSES (In Thousands)

	2012	2011	2010	2009	2008	Average
Average gross loans	$700,241	$714,421	$721,997	$728,748	$743,741	$721,830
Year-end gross loans	683,910	708,315	730,411	721,011	743,544	717,438
Year-end allowance for loan losses	6,857	7,705	9,107	8,265	7,857	7,958
Year-end nonaccrual loans	7,353	7,197	10,809	9,092	7,200	8,330
Year-end loans 90 days or more past due and still accruing	2,311	1,267	727	31	1,305	1,128
Net charge-offs	1,136	1,117	349	272	1,911	957
Provision (credit) for loan losses	288	(285)	1,191	680	909	557
Earnings coverage of charge-offs	20	21	55	(145)	5	7
Allowance coverage of charge-offs	6	7	26	30	4	8
Net charge-offs as a % of provision (credit) for loan losses	394.44 %	-391.93 %	29.30 %	40.00 %	210.23 %	171.81 %
	0.16 %	0.16 %	0.05 %	0.04 %	0.26 %	0.13 %

Net charge-offs as a % of average gross loans						
Net income (loss)	22,705	23,368	19,055	(39,335)	10,059	7,170

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CONTRACTUAL OBLIGATIONS AND OFF-BALANCE SHEET ARRANGEMENTS

Table XIII presents the Corporation's significant fixed and determinable contractual obligations as of December 31, 2012 by payment date. The payment amounts represent the principal amounts of time deposits and borrowings and do not include interest.

TABLE XIII – CONTRACTUAL OBLIGATIONS

(In Thousands)

	1 Year or Less	1-3 Years	3-5 Years	Over 5 Years	Total
Time deposits	$197,014	$91,314	$24,091	$0	$312,419
Long-term borrowings:					
Federal Home Loan Bank of Pittsburgh	3,211	0	10,223	2,378	15,812
Repurchase agreements	0	0	68,000	0	68,000
Total	$200,225	$91,314	$102,314	$2,378	$396,231

In addition to the amounts described in Table XIII, the Corporation has obligations related to deposits without a stated maturity with outstanding principal balances totaling $693,687,000 at December 31, 2012. The Corporation also has obligations related to overnight customer repurchase agreements with principal balances of $5,567,000 at December 31, 2012.

The Corporation's operating lease commitments at December 31, 2012 are immaterial. The Corporation's significant off-balance sheet arrangements consist of commitments to extend credit and standby letters of credit. Off-balance sheet arrangements are described in Note 16 to the consolidated financial statements.

LIQUIDITY

Liquidity is the ability to quickly raise cash at a reasonable cost. An adequate liquidity position permits the Corporation to pay creditors, compensate for unforeseen deposit fluctuations and fund unexpected loan demand. At December 31, 2012, the Corporation maintained overnight interest-bearing deposits with the Federal Reserve Bank of Philadelphia and other correspondent banks totaling $33,660,000.

The Corporation maintains overnight borrowing facilities with several correspondent banks that provide a source of day-to-day liquidity. Also, the Corporation maintains borrowing facilities with the Federal Home Loan Bank of Pittsburgh, secured by various mortgage loans.

The Corporation has a line of credit with the Federal Reserve Bank of Philadelphia's Discount Window. Management intends to use this line of credit as a contingency funding source. As collateral for the line, the Corporation has pledged available-for-sale securities with a carrying value of $28,432,000 at December 31, 2012.

The Corporation's outstanding, available, and total credit facilities at December 31, 2012 and 2011 are as follows:

	Outstanding		Available		Total Credit	
(In Thousands)	Dec. 31, 2012	Dec. 31, 2011	Dec. 31, 2012	Dec. 31, 2011	Dec. 31, 2012	Dec. 31, 2011
Federal Home Loan Bank of Pittsburgh	$17,809	$40,363	$328,023	$292,304	$345,832	$332,667
Federal Reserve Bank Discount Window	0	0	27,367	27,438	27,367	27,438
Other correspondent banks	0	0	45,000	25,000	45,000	25,000
Total credit facilities	$17,809	$40,363	$400,390	$344,742	$418,199	$385,105

At December 31, 2012, the Corporation's outstanding credit facilities with the Federal Home Loan Bank of Pittsburgh consisted of long-term borrowings with a total amount of $15,812,000 as well as a letter of credit in the amount of $1,997,000. At December 31, 2011, the Corporation's outstanding credit facilities with the Federal Home Loan Bank of Pittsburgh consisted of long-term borrowings; no letters of credit were outstanding. Additional information regarding borrowed funds is included in Note 12 of the consolidated financial statements.

Additionally, the Corporation uses repurchase agreements placed with brokers to borrow funds secured by investment assets, and uses "RepoSweep" arrangements to borrow funds from commercial banking customers on an overnight basis. If required to raise cash in an emergency situation, the Corporation could sell available-for-sale securities to meet its obligations. At December 31, 2012, the carrying value of available-for-sale securities in excess of amounts required to meet pledging or repurchase agreement obligations was $218,190,000.

Management believes the Corporation is well-positioned to meet its short-term and long-term obligations.

STOCKHOLDERS' EQUITY AND CAPITAL ADEQUACY

The Corporation and C&N Bank are subject to various regulatory capital requirements administered by the federal banking agencies. Details concerning regulatory capital amounts and ratios are presented in Note 18 to the consolidated financial statements. As reflected in Note 18, at December 31, 2012 and 2011, the ratios of total capital to risk-weighted assets, tier 1 capital to risk-weighted assets and tier 1 capital to average total assets are well in excess of regulatory capital requirements.

Future dividend payments will depend upon maintenance of a strong financial condition, future earnings and capital and regulatory requirements. In addition, the Corporation, and C&N Bank are subject to restrictions on the amount of dividends that may be paid without approval of banking regulatory authorities. These restrictions are described in Note 18 to the consolidated financial statements.

The Corporation's total stockholders' equity is affected by fluctuations in the fair values of available-for-sale securities. The difference between amortized cost and fair value of available-for-sale securities, net of deferred income tax, is included in "Accumulated Other Comprehensive Income (Loss)" within stockholders' equity. The balance in Accumulated Other Comprehensive Income (Loss) related to unrealized gains or losses on available-for-sale securities, net of deferred income tax, amounted to $11,568,000 at December 31, 2012 and $10,791,000 at December 31, 2011. Changes in accumulated other comprehensive income are excluded from earnings and directly increase or decrease stockholders' equity. If available-for-sale securities are deemed to be other-than-temporarily impaired, unrealized losses are recorded as a charge against earnings, and amortized cost for the affected securities is reduced. Note 7 to the consolidated financial statements provides additional information concerning management's evaluation of available-for-sale securities for other-than-temporary impairment at December 31, 2012.

Stockholders' equity is also affected by the underfunded or overfunded status of defined benefit pension and postretirement plans. The balance in Accumulated Other Comprehensive Income (Loss) related to underfunded defined benefit plans, net of deferred income tax, was ($565,000) at December 31, 2012 and ($631,000) at December 31, 2011.

COMPREHENSIVE INCOME

In June 2011, the FASB issued ASU No. 2011-05, Comprehensive Income (Topic 220) – Presentation of Comprehensive Income. The intent of this standard is to increase the prominence of comprehensive income in the financial statements. Accordingly, the Corporation has included Statements of Comprehensive Income in the consolidated financial statements for 2012, 2011 and 2010.

Comprehensive Income is the total of (1) net income, and (2) all other changes in equity from non-stockholder sources, which are referred to as Other Comprehensive Income. Changes in the components of Accumulated Other Comprehensive Income (Loss) are included in Other Comprehensive Income, and for the Corporation, consist of changes in unrealized gains or losses on available-for-sale securities and changes in underfunded defined benefit plans.

Comprehensive Income totaled $23,548,000 in 2012 as compared to $35,129,000 in 2011 and $18,345,000 in 2010. In 2012, Comprehensive Income included: (1) Net Income of $22,705,000 in 2012, which was $663,000 lower than in 2011 and $3,650,000 higher than in 2010; (2) Other Comprehensive Income from unrealized gains on available-for-sale securities, net of deferred income tax, of $777,000 in 2012 as compared to $12,142,000 in 2011 and an Other Comprehensive Loss from net unrealized losses of $829,000 in 2010; and (3) Other Comprehensive Income from defined benefit plans of $66,000 in 2012 as compared to an Other Comprehensive Loss of $381,000 in 2011 and Other Comprehensive Income of $119,000 in 2011.

INFLATION

The Corporation is significantly affected by the Federal Reserve Board's efforts to control inflation through changes in short-term interest rates. Beginning in September 2007, in response to concerns about weakness in the U.S. economy, the Federal Reserve lowered the fed funds target rate numerous times; in December 2008, it established a target range of 0% to 0.25%, which it has maintained through 2012. Also, the Federal Reserve has injected massive amounts of liquidity into the nation's monetary system through a variety of programs. The Federal Reserve has purchased large amounts of securities in an effort to keep interest rates low and stimulate economic growth. Further, the Federal Reserve announced that it expects to continue exceptionally accommodative monetary policies with a general target of maintaining accommodative policy until the U.S. unemployment rate hits a sustainable level of 6.5% or less.

Despite the current low short-term rate environment, liquidity injections, and commodity price increases, inflation statistics indicate that the overall rate of inflation is unlikely to significantly affect the Corporation's operations within the near future. Although management cannot predict future changes in the rates of inflation, management monitors the impact of economic trends, including any indicators of inflationary pressures, in managing interest rate and other financial risks.

RECENT ACCOUNTING PRONOUNCEMENTS

See Note 2 to the consolidated financial statements for a description of recent accounting pronouncements and their recent or potential future effects on the Corporation's financial statements.

ITEM 7A. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

MARKET RISK

Market risk is the risk of loss arising from adverse changes in market rates and prices of the Corporation's financial instruments. In addition to the effects of interest rates, the market prices of the Corporation's debt securities within the available-for-sale securities portfolio are affected by fluctuations in the risk premiums (amounts of spread over risk-free rates) demanded by investors.

Management cannot control changes in market prices of securities based on fluctuations in the risk premiums demanded by investors, nor can management control the volume of deferrals or defaults by the issuers of debt securities owned by the Corporation. However, management attempts to limit the risk that economic conditions would force the Corporation to sell securities for realized losses by maintaining a strong capital position (discussed in the "Stockholders' Equity and Capital Adequacy" section of Management's Discussion and Analysis) and ample sources of liquidity (discussed in the "Liquidity" section of Management's Discussion and Analysis).

The Corporation's two major categories of market risk are interest rate risk and equity securities risk, which are discussed in the following sections.

INTEREST RATE RISK

Business risk arising from changes in interest rates is an inherent factor in operating a bank. The Corporation's assets are predominantly long-term, fixed-rate loans and debt securities. Funding for these assets comes principally from shorter-term deposits and borrowed funds. Accordingly, there is an inherent risk of lower future earnings or decline in fair value of the Corporation's financial instruments when interest rates change.

The Corporation uses a simulation model to calculate the potential effects of interest rate fluctuations on net interest income and the market value of portfolio equity. For purposes of these calculations, the market value of portfolio equity includes the fair values of financial instruments, such as securities, loans, deposits and borrowed funds, and the book values of nonfinancial assets and liabilities, such as premises and equipment and accrued expenses. The model measures and projects potential changes in net interest income, and calculates the discounted present value of anticipated cash flows of financial instruments, assuming an immediate increase or decrease in interest rates. Management ordinarily runs a variety of scenarios within a range of plus or minus 50-400 basis points of current rates.

The model makes estimates, at each level of interest rate change, regarding cash flows from principal repayments on loans and mortgage-backed securities and call activity on other investment securities. Actual results could vary significantly from these estimates, which could result in significant differences in the calculations of projected changes in net interest income and market value of portfolio equity. Also, the model does not make estimates related to changes in the composition of the deposit portfolio that could occur due to rate competition, and the table does not necessarily reflect changes that management would make to realign the portfolio as a result of changes in interest rates.

The Corporation's Board of Directors has established policy guidelines for acceptable levels of interest rate risk, based on an immediate increase or decrease in interest rates. The policy limits acceptable fluctuations in net interest income from the baseline (flat rates) one-year scenario and variances in the market value of portfolio equity from the baseline values based on current rates.

Table XIV, which follows this discussion, is based on the results of calculations performed using the simulation model as of October 31, 2012 and 2011. The table shows that as of October 31, 2012 and 2011, the changes in net interest income and changes in market value were within the policy limits in all scenarios.

TABLE XIV - THE EFFECT OF HYPOTHETICAL CHANGES IN INTEREST RATES

October 31, 2012 Data
(In Thousands) Period Ending October 31, 2013

Basis Point Change in Rates	Interest Income	Interest Expense	Net Interest Income (NII)	NII % Change	NII Risk Limit
+400	$60,813	$26,050	$ 34,763	-18.9 %	25.0 %
+300	58,329	20,789	37,540	-12.4 %	20.0 %
+200	55,398	16,004	39,394	-8.1 %	15.0 %
+100	52,592	11,338	41,254	-3.7 %	10.0 %
0	49,534	6,673	42,861	0.0 %	0.0 %
-100	46,881	6,236	40,645	-5.2 %	10.0 %
-200	46,178	6,233	39,945	-6.8 %	15.0 %
-300	45,925	6,233	39,692	-7.4 %	20.0 %
-400	45,800	6,233	39,567	-7.7 %	25.0 %

Market Value of Portfolio Equity at October 31, 2012

Basis Point Change in Rates	Present Value Equity	Present Value % Change	Present Value Risk Limit
+400	$165,826	-21.7 %	50.0 %
+300	179,904	-15.1 %	45.0 %
+200	193,117	-8.8 %	35.0 %
+100	204,290	-3.6 %	25.0 %
0	211,846	0.0 %	0.0 %
-100	207,561	-2.0 %	25.0 %
-200	230,184	8.7 %	35.0 %
-300	268,229	26.6 %	45.0 %
-400	309,611	46.1 %	50.0 %

October 31, 2011 Data
(In Thousands) Period Ending October 31, 2012

Basis Point Change in Rates	Interest Income	Interest Expense	Net Interest Income (NII)	NII % Change	NII Risk Limit