CITIZENS & NORTHERN CORP
Form 10-K
February 24, 2012

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, 2011

**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, 2011, the registrant’s most recently completed second fiscal quarter, was $179,234,623.

The number of shares of common stock outstanding at February 21, 2012 was 12,204,259.

**DOCUMENTS INCORPORATED BY REFERENCE**

Portions of the registrant’s proxy statement for the annual meeting of its shareholders to be held April 17, 2012 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:

- as described above, in May 2007, acquired Citizens Bancorp, Inc.;
- 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;

- 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 annual $150,000 (pre-tax) reduction in future operating expenses; and
- in the fourth quarter 2011, began rebuilding the Athens, PA, facility, which was damaged by flooding in September 2011, has been closed since the flooding and is expected to re-open in late March 2012.

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 2011, 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 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 2011.

At December 31, 2011, C&N Bank had total assets of $1,312,496,000, total deposits of $1,019,932,000, net loans outstanding of $700,610,000 and 290 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 and 2011. At December 31, 2011, total residential mortgages serviced amounted to $56,638,000. 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, 2011, see Part II, Item 7A, "Quantitative and Qualitative Disclosures About Market Risk."

**Debt Securities Risk –** As described in the Earnings Overview section of Management's Discussion and Analysis, the Corporation's earnings were materially impaired in 2009 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, trust-preferred securities issued by individual banks, 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.

Realization of Deferred Tax Asset – The Corporation recognizes deferred tax assets and liabilities based on differences between the financial statement carrying amounts and the tax bases of assets and liabilities. At December 31, 2011, the net deferred tax asset was $6.2 million, down from a balance of approximately $16.1 million at December 31, 2010. The decrease in the net deferred tax asset resulted from appreciation in the fair value of available-for-sale securities in 2011, as well as other changes described in more detail in the "Income Taxes" section of Management's Discussion and Analysis.

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. Based on current conditions, management believes the recorded net deferred tax asset at December 31, 2011 is fully realizable, including amounts classified as capital losses from securities. 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.

Federal Home Loan Bank of Pittsburgh Common Stock - We own common stock of the Federal Home Loan Bank of Pittsburgh, or the FHLB, in order to qualify for membership in the Federal Home Loan Bank system, which enables us to borrow funds under the Federal Home Loan Bank advance program. The carrying value and fair market value of our FHLB common stock, which is included in Other Assets in the consolidated balance sheet, was $6.6 million as of December 31, 2011. Published reports indicate that certain member banks of the Federal Home Loan Bank system may be subject to asset quality risks that could result in materially lower regulatory capital levels. In December 2008, the FHLB had notified its member banks that it had suspended dividend payments and the repurchase of capital stock until further notice is provided. Subsequently, though we have received no dividends from the FHLB since 2008, we have received capital stock redemptions in 2010 and 2011 totaling $1.9 million. Further, in February 2012, the FHLB declared a dividend of 0.10% annualized, payable to FHLB shareholders on February 23, 2012. In an extreme situation, it is possible that the capitalization of a Federal Home Loan Bank, including the FHLB, could be substantially diminished or reduced to zero. Consequently, given that there is no market for our FHLB common stock, we believe that there is a risk that our investment could be deemed other-than-temporarily impaired at some time in the future. If this occurs, it may adversely affect our results of operations and financial condition. If the FHLB were to cease operations, or if we were required to write-off our investment in the FHLB, our business, financial condition, liquidity, capital and results of operations may be materially adversely affected.

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 and 2011 based on current assessments. At the end of 2011, approximately $3.4 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 $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, the possibility exists that this activity could be 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 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 were implemented in 2010 and 2011, 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 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.

- effective in July 2011, eliminated the prohibition against paying interest on commercial checking accounts, effective one year after enactment;

- 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 given that the current reserve ratio is negative, 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 extends 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 Bureau of Consumer Financial Protection 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 two 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 has been closed since that time. The process of rebuilding the office is underway, and management expects to reopen the office in late March 2012. Management does not expect to incur a significant financial loss associated with the flooding, as almost all of the cost of replacement is 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<br>Wellsboro, PA  16901 | or | 10 Nichols Street<br>Wellsboro, PA  16901 |

Branch offices – Citizens & Northern Bank:

| | | |
|---|---|---|
| 428 S. Main Street<br>Athens, PA  18810 | 514 Main Street<br>Laporte, PA  18626 | 2 East Mountain Avenue **<br>South Williamsport, PA  17702 |

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

Facilities management office:

13 Water Street
Wellsboro, PA 16901

** designates leased branch facility

7

**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, 2011, there were 2,512 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 2011 and 2010.

| | **2011** | | | **2010** | | |
|---|---|---|---|---|---|---|
| | High | Low | Dividend Declared per Quarter | High | Low | Dividend Declared Per Quarter |
| First quarter | $16.96 | $14.37 | $ 0.13 | $12.95 | $8.76 | $ 0.08 |
| Second quarter | 17.66 | 13.10 | 0.14 | 13.86 | 10.70 | 0.09 |
| Third quarter | 17.40 | 14.06 | 0.15 | 13.30 | 10.15 | 0.10 |
| Fourth quarter | 19.16 | 14.00 | 0.16 | 15.84 | 12.45 | 0.12 |

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, 2011, the maximum additional value available for purchases under this program was $980,694.

The following table sets forth a summary of the purchases by the Corporation, on the open market, of its equity securities in the fourth quarter 2011:

| Period | Total Number of Shares Purchased | Average Price Paid per Share | Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs | Maximum Dollar Value of Shares that May Yet be Purchased Under the Plans or Programs |
|---|---|---|---|---|
| October 1 - 31, 2011 | 2,439 | $ 14.75 | 70,849 | $ 980,694 |
| November 1 - 30, 2011 | 0 | | 70,849 | $ 980,694 |
| December 1 - 31, 2011 | 0 | | 70,849 | $ 980,694 |

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, 2006 and ended December 31, 2011. 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 | 12/31/06 | 12/31/07 | 12/31/08 | 12/31/09 | 12/31/10 | 12/31/11 |
| Citizens & Northern Corporation | 100.00 | 85.08 | 100.06 | 50.37 | 81.01 | 104.25 |
| Russell 2000 | 100.00 | 98.43 | 65.18 | 82.89 | 105.14 | 100.75 |
| CZNC Peer Group Index* | 100.00 | 85.56 | 76.60 | 72.25 | 82.42 | 79.00 |

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 1st Summit Bancorp of Johnstown, Inc., Johnstown; 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; ESSA Bancorp, Inc., Stroudsburg; First Keystone Corporation, Berwick; FNB Bancorp, Inc., Newtown; Fox Chase Bancorp, Inc., Hatboro; Franklin Financial Services Corporation, Chambersburg; Harleysville Savings Financial Corporation, Harleysville; 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; VIST Financial Corp., Wyomissing.

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, 2011.

| | 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 Compensation Plans |
|---|---|---|---|
| Equity compensation plans approved by shareholders | 301,797 | $ 19.05 | 492,448 |
| 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) | 2011 | 2010 | 2009 | 2008 | 2007 |
| Interest and fee income | $61,256 | $62,114 | $67,976 | $74,237 | $70,221 |
| Interest expense | 13,556 | 19,245 | 24,456 | 31,049 | 33,909 |
| Net interest income | 47,700 | 42,869 | 43,520 | 43,188 | 36,312 |
| (Credit) provision for loan losses | (285) | 1,191 | 680 | 909 | 529 |
| Net interest income after (credit) provision for loan losses | 47,985 | 41,678 | 42,840 | 42,279 | 35,783 |
| Noninterest income excluding securities/gains (losses) | 13,938 | 13,917 | 13,021 | 13,140 | 10,440 |
| Net impairment losses recognized in earnings from available-for-sale securities | 0 | (433) | (85,363) | (10,088) | 0 |
| Net realized gains on available-for-sale securities | 2,216 | 1,262 | 1,523 | 750 | 127 |
| Noninterest expense | 32,057 | 31,569 | 34,011 | 33,703 | 33,283 |
| Income (loss) before income tax provision (credit) | 32,082 | 24,855 | (61,990) | 12,378 | 13,067 |
| Income tax provision (credit) | 8,714 | 5,800 | (22,655) | 2,319 | 2,643 |
| Net income (loss) | 23,368 | 19,055 | (39,335) | 10,059 | 10,424 |
| U.S. Treasury preferred dividends | 0 | 1,474 | 1,428 | 0 | 0 |
| Net income (loss) available to common shareholders | $23,368 | $17,581 | $(40,763) | $10,059 | $10,424 |
| | | | | | |
| PER COMMON SHARE: (1) | | | | | |
| Basic earnings per share | $1.92 | $1.45 | $(4.40) | $1.12 | $1.19 |
| Diluted earnings per share | $1.92 | $1.45 | $(4.40) | $1.12 | $1.19 |
| Cash dividends declared per share | $0.58 | $0.39 | $0.72 | $0.96 | $0.96 |
| Stock dividend | None | None | None | None | 1% |
| Book value per common share at period-end | $13.77 | $11.43 | $10.46 | $13.66 | $15.34 |
| Tangible book value per common share at period-end | $12.77 | $10.42 | $9.43 | $12.22 | $13.85 |
| Weighted average common shares outstanding - basic | 12,162,045 | 12,131,039 | 9,271,869 | 8,961,805 | 8,784,134 |
| Weighted average common shares outstanding - diluted | 12,166,768 | 12,131,039 | 9,271,869 | 8,983,300 | 8,795,366 |
| END OF PERIOD BALANCES (In Thousands) | | | | | |
| Available-for-sale securities | $481,685 | $443,956 | $396,288 | $419,688 | $432,755 |
| Gross loans | 708,315 | 730,411 | 721,011 | 743,544 | 735,941 |
| Allowance for loan losses | 7,705 | 9,107 | 8,265 | 7,857 | 8,859 |
| Total assets | 1,323,735 | 1,316,588 | 1,321,795 | 1,281,637 | 1,283,746 |
| Deposits | 1,018,206 | 1,004,348 | 926,789 | 864,057 | 838,503 |
| Borrowings | 130,313 | 166,908 | 235,471 | 285,473 | 300,132 |
| Stockholders' equity | 167,385 | 138,944 | 152,410 | 122,026 | 137,781 |
| Common stockholders' equity (stockholders' equity, excluding preferred stock) | 167,385 | 138,944 | 126,661 | 122,026 | 137,781 |

| | | | | | |
|---|---|---|---|---|---|
| AVERAGE BALANCES (In Thousands) | | | | | |
| Total assets | 1,313,445 | 1,326,145 | 1,296,086 | 1,280,924 | 1,178,904 |
| Earning assets | 1,208,584 | 1,205,608 | 1,208,280 | 1,202,872 | 1,090,035 |
| Gross loans | 715,321 | 723,318 | 728,748 | 743,741 | 729,269 |
| Deposits | 1,001,125 | 965,615 | 886,703 | 847,714 | 812,255 |
| Stockholders' equity | 152,718 | 150,133 | 141,787 | 130,790 | 138,669 |

**ITEM 6. SELECTED FINANCIAL DATA, Continued**

| | As of or for the Year Ended December 31, | | | | |
|---|---|---|---|---|---|
| | 2011 | 2010 | 2009 | 2008 | 2007 |
| KEY RATIOS | | | | | |
| Return on average equity | 15.30 % | 12.69 % | -27.74 % | 7.69 % | 7.52 % |
| Average equity to average assets | 11.63 % | 11.32 % | 10.94 % | 10.21 % | 11.76 % |
| Net interest margin (2) | 4.22 % | 3.81 % | 3.84 % | 3.77 % | 3.51 % |
| Efficiency (3) | 49.40 % | 52.73 % | 57.22 % | 57.59 % | 68.39 % |
| Cash dividends as a % of diluted earnings per share | 30.21 % | 26.90 % | NM | 85.71 % | 80.67 % |
| Tier 1 leverage | 10.93 % | 9.20 % | 9.86 % | 10.12 % | 10.91 % |
| Tier 1 risk-based capital | 19.95 % | 15.87 % | 16.70 % | 13.99 % | 15.46 % |
| Total risk-based capital | 21.17 % | 17.17 % | 17.89 % | 14.84 % | 16.52 % |
| Tangible common equity/tangible assets | 11.84 % | 9.71 % | 8.72 % | 8.61 % | 9.79 % |
| Nonperforming assets/total assets | 0.73 % | 0.92 % | 0.76 % | 0.69 % | 0.66 % |
| Nonperforming loans/total loans | 1.19 % | 1.58 % | 1.27 % | 1.14 % | 1.11 % |
| Allowance for loan losses/total loans | 1.09 % | 1.25 % | 1.15 % | 1.06 % | 1.20 % |
| Net charge-offs/average loans | 0.16 % | 0.05 % | 0.04 % | 0.26 % | 0.06 % |

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**

In 2011, net income available to common shareholders was $23,368,000, or $1.92 per basic and diluted share, up 32.4% over net income per share of $1.45 in 2010. The Corporation reported a net loss available to common shareholders of $40,763,000 ($4.40 per share-basic and diluted) in 2009, including the impact of after-tax other-than-temporary impairment (OTTI) charges on available-for-sale securities (adjusted for realized gains on some securities subsequently sold) of $55,849,000.

**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 has 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 $826,000 from the offset of a previous write-down on a security, with a corresponding benefit of $83,000 recorded in 2010.

- 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. Further, in recent years, the Corporation has experienced a limited amount of loan-related credit problems, as compared to averages for comparable-sized peer banks.

- 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 has 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.

**2010 vs. 2009**

Net income available to common shareholders was $17,581,000 ($1.45 per share) in 2010 compared to a net loss of $40,763,000 ($4.40 per share) in 2009. The most significant fluctuations in the components of earnings for 2010 compared to 2009 are as follows:

- In 2010, gains from sales of available-for-sale securities totaled $829,000, including realized gains totaling $1,262,000 and impairment losses of $433,000. In contrast, in 2009, the Corporation experienced significant losses from available-for-sale securities. Losses from available-for-sale securities totaled $83,340,000 in 2009, including impairment losses of $85,363,000, net of realized gains of $1,523,000. The securities losses in 2009 included $73,674,000 from pooled trust-preferred securities.

- Net interest income was $42,869,000 in 2010, down 1.5% from 2009 net interest income of $43,520,000. On a fully taxable equivalent basis, net interest income was 1.0% lower in 2010 than in 2009. While the Corporation's interest margin benefited in 2010 from a lower cost of funds, the average yield on available-for-sale securities dropped significantly as compared to 2009. Also, the Corporation held approximately $25 million more in average overnight investments (mainly at the Federal Reserve) in 2010 than in 2009, which gave the Corporation a great deal of flexibility from a liquidity standpoint but which generated an average yield of only 0.23%.

- The provision for loan losses was $1,191,000, up from $680,000 in 2009. In 2010, management increased the estimated allowance for loan losses related to individually impaired loans.

- Non-interest revenue for 2010 was $896,000, or 6.9%, higher than in 2009, reflecting substantial increases for 2010 in revenue from sales of mortgages, as well as from debit card-related interchange fees.

- Non-interest expense was $2,442,000, or 7.2%, lower than in 2009. The decrease reflects the impact of lower FDIC assessments, lower furniture and equipment expense primarily associated with much of the core banking system software and equipment becoming fully depreciated, as well as reductions in several other categories of operating costs.

- The provision for income taxes for 2010 was $5,800,000, or 23.3% of pre-tax income. In 2009, the Corporation recorded a credit provision for income taxes based on an effective tax rate of 36.5%. Fluctuations in the tax provision/pre-tax income rate for these periods include the impact of changes in the average holdings of tax-exempt securities and loans. Also, the 2010 provision includes the reversal of a valuation allowance established in 2009 on certain deferred tax assets.

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. Management believes that the allowance for loan losses is adequate and reasonable. The Corporation's methodology for determining the allowance for loan losses is described 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 6 to the consolidated financial statements, management calculates the fair values of pooled trust-preferred securities by applying discount rates to estimated cash flows for each security. Management estimated the cash flows expected to be received from each security, taking into account estimated levels of deferrals and defaults by the underlying issuers, and used discount rates considered reflective of a market participant's expectations regarding the extent of credit and liquidity risk inherent in the securities. Management's estimates of cash flows and discount rates used to calculate fair values of pooled trust-preferred securities were based on sensitive assumptions, and use of different assumptions could result in calculations of fair values that would be substantially different than the amounts calculated by management.

As described in Note 7 to the consolidated financial statements, management evaluates securities for 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. Also, management's estimates of cash flows used to evaluate OTTI of pooled trust-preferred securities are based on sensitive assumptions, and use of different assumptions could produce different conclusions for each security.

**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 2011, 2010, and 2009. 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.

**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 decreased $1,107,000, or 2.4%. 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 decreased 1.1% to $715,321,000 in 2011 from $723,318,000 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 increased slightly in 2011 compared to 2010. The Corporation’s yield on loans fell as rates on new loans as well as existing, variable-rate loans have decreased. The average rate of return on loans 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 has consisted primarily of balances held by the Federal Reserve. Although the rates of return on balances with the Federal Reserve are low, the Corporation has 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 within the next few years. 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 interest checking, savings accounts, and demand deposits; 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 have 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 has 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.

**2010 vs. 2009**

Fully taxable equivalent net interest income was $45,954,000 in 2010, $464,000 (1.0%) lower than in 2009. As shown in Table III, net changes in volume had the effect of increasing net interest income $816,000 in 2010 compared to 2009, and interest rate changes had the effect of decreasing net interest income $1,280,000. The most significant components of the volume change in net interest income in 2010 were: a decrease in interest income of $1,260,000 attributable to a reduction in the balance of taxable available-for-sale securities and a decrease in interest expense of $1,902,000 attributable to a reduction in the balance of long-term borrowed funds. The most significant components of the rate change in net interest income in 2010 were: a decrease in interest income of $3,895,000 attributable to lower rates earned on taxable available-for-sale securities and a decrease in interest expense of $3,315,000 due to lower rates paid on interest-bearing deposits. 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 3.53% in 2010, as compared to 3.47% in 2009.

## INTEREST INCOME AND EARNING ASSETS

Interest income totaled $65,199,000 in 2010, a decrease of 8.0% from 2009. Income from available-for-sale securities decreased $4,540,000 (19.7%), while interest and fees from loans decreased $1,102,000, or 2.3%. As indicated in Table II, total average available-for-sale securities (at amortized cost) in 2010 decreased to $427,520,000, a decrease of $12,303,000, or 2.8% from 2009. During 2009 and 2010, the Corporation increased the size of its tax-exempt municipal security portfolio, while shrinking the average taxable available-for-sale securities portfolio. The Corporation’s yield on taxable securities fell in 2009 and 2010 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. In addition to the impact of falling rates, the Corporation’s yield on taxable securities was also negatively affected in 2010 by higher-than-expected prepayments on mortgage-backed securities; these prepayments were caused by procedural changes by the U.S. Government agencies that issued the securities. The average rate of return on available-for-sale securities was 4.33% for 2010 and 5.24% in 2009.

The average balance of gross loans decreased 0.7% to $723,318,000 in 2010 from $728,748,000 in 2009. Due to the challenging economic environment and the Corporation's decision to sell a portion of its newly originated residential mortgages on the secondary market, the Corporation experienced contraction in the balance of its mortgage and consumer loan portfolios, with modest growth in average commercial loan balances. The Corporation's yield on loans fell as rates on new loans as well as existing, variable-rate loans decreased. The average rate of return on loans was 6.44% in 2010 and 6.54% in 2009.

The average balance of interest-bearing due from banks increased to $54,655,000 in 2010 from $29,348,000 in 2009. In the last half of 2009 and all of 2010, this consisted primarily of balances held by the Federal Reserve. In early 2009, more overnight funds were invested in federal funds sold to other banks, which decreased to an average balance of $48,000 in 2010 from $8,983,000 in 2009. Although the rates of return on balances with the Federal Reserve are low, the Corporation maintained relatively high levels of liquid assets in 2009 and 2010 (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 within the next few years. 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.

INTEREST EXPENSE AND INTEREST-BEARING LIABILITIES

Interest expense fell $5,211,000, or 21.3%, to $19,245,000 in 2010 from $24,456,000 in 2009. Table II shows that the overall cost of funds on interest-bearing liabilities fell to 1.88% in 2010 from 2.40% in 2009.

Total average deposits (interest-bearing and noninterest-bearing) increased 8.9%, to $965,615,000 in 2010 from $886,703,000 in 2009. This increase came mainly in interest checking, savings, Individual Retirement Accounts, and demand deposits. Consistent with substantial reductions in short-term global interest rates, the average rates incurred on deposit accounts decreased significantly in 2010 as compared to 2009. As shown in Table III, decreases in rates reduced interest expense on deposits by $3,315,000.

Total average borrowed funds decreased $57,621,000 to $202,792,000 in 2010 from $260,413,000 in 2009. During 2009 and 2010, 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 3.62% in 2010, down from 3.77% in 2009. This change primarily reflects lower rates being paid on customer repurchase agreements, which make up most of the Corporation's short-term borrowed funds.

**TABLE I - ANALYSIS OF INTEREST INCOME AND EXPENSE**

| | Years Ended December 31, | | | Increase/(Decrease) | |
|---|---|---|---|---|---|
| (In Thousands) | 2011 | 2010 | 2009 | 2011/2010 | 2010/2009 |
| INTEREST INCOME | | | | | |
| Available-for-sale securities: | | | | | |
| Taxable | $11,297 | $11,342 | $16,497 | $ (45) | $ (5,155) |
| Tax-exempt | 7,676 | 7,157 | 6,542 | 519 | 615 |
| Total available-for-sale securities | 18,973 | 18,499 | 23,039 | 474 | (4,540) |
| Held-to-maturity securities, | | | | | |
| Taxable | 0 | 2 | 21 | (2) | (19) |
| Trading securities | 0 | 2 | 64 | (2) | (62) |
| Interest-bearing due from banks | 73 | 124 | 61 | (51) | 63 |
| Federal funds sold | 0 | 0 | 15 | 0 | (15) |
| Loans: | | | | | |
| Taxable | 43,231 | 44,229 | 45,236 | (998) | (1,007) |
| Tax-exempt | 2,234 | 2,343 | 2,438 | (109) | (95) |
| Total loans | 45,465 | 46,572 | 47,674 | (1,107) | (1,102) |
| Total Interest Income | 64,511 | 65,199 | 70,874 | (688) | (5,675) |
| INTEREST EXPENSE | | | | | |
| Interest-bearing deposits: | | | | | |
| Interest checking | 399 | 798 | 901 | (399) | (103) |
| Money market | 494 | 872 | 2,004 | (378) | (1,132) |
| Savings | 161 | 194 | 272 | (33) | (78) |
| Certificates of deposit | 3,905 | 5,060 | 6,672 | (1,155) | (1,612) |
| Individual Retirement Accounts | 3,150 | 4,977 | 4,796 | (1,827) | 181 |
| Other time deposits | 3 | 6 | 6 | (3) | 0 |
| Total interest-bearing deposits | 8,112 | 11,907 | 14,651 | (3,795) | (2,744) |
| Borrowed funds: | | | | | |
| Short-term | 23 | 177 | 544 | (154) | (367) |
| Long-term | 5,421 | 7,161 | 9,261 | (1,740) | (2,100) |
| Total borrowed funds | 5,444 | 7,338 | 9,805 | (1,894) | (2,467) |
| Total Interest Expense | 13,556 | 19,245 | 24,456 | (5,689) | (5,211) |
| Net Interest Income | $50,955 | $45,954 | $46,418 | $ 5,001 | $ (464) |

(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 34%.

(2) Fees on loans are included with interest on loans and amounted to $1,312,000 in 2011, $1,207,000 in 2010 and $1,176,000 in 2009.

18

**Table II - Analysis of Average Daily Balances and Rates**

**(Dollars in Thousands)**

| | 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 % | Year Ended 12/31/2009 Average Balance | Rate of Return/ Cost of Funds % |
|---|---|---|---|---|---|---|
| EARNING ASSETS | | | | | | |
| Available-for-sale securities, at amortized cost: | | | | | | |
| Taxable | $333,441 | 3.39 % | $314,462 | 3.61 % | $342,332 | 4.82 % |
| Tax-exempt | 128,463 | 5.98 % | 113,058 | 6.33 % | 97,491 | 6.71 % |
| Total available-for-sale securities | 461,904 | 4.11 % | 427,520 | 4.33 % | 439,823 | 5.24 % |
| Held-to-maturity securities, | | | | | | |
| Taxable | 0 | 0.00 % | 38 | 5.27 % | 373 | 5.63 % |
| Trading securities | 0 | 0.00 % | 29 | 6.99 % | 1,005 | 6.37 % |
| Interest-bearing due from banks | 31,359 | 0.23 % | 54,655 | 0.23 % | 29,348 | 0.21 % |
| Federal funds sold | 0 | 0.00 % | 48 | 0.00 % | 8,983 | 0.17 % |
| Loans: | | | | | | |
| Taxable | 680,257 | 6.36 % | 687,520 | 6.43 % | 689,275 | 6.56 % |
| Tax-exempt | 35,064 | 6.37 % | 35,798 | 6.55 % | 39,473 | 6.18 % |
| Total loans | 715,321 | 6.36 % | 723,318 | 6.44 % | 728,748 | 6.54 % |
| Total Earning Assets | 1,208,584 | 5.34 % | 1,205,608 | 5.41 % | 1,208,280 | 5.87 % |
| Cash | 17,762 | | 17,505 | | 17,042 | |
| Unrealized gain/loss on securities | 7,105 | | 2,555 | | (24,334) | |
| Allowance for loan losses | (8,688) | | (8,552) | | (7,914) | |
| Bank premises and equipment | 21,381 | | 23,522 | | 25,239 | |
| Intangible Asset - Core Deposit Intangible | 272 | | 417 | | 669 | |
| Intangible Asset - Goodwill | 11,942 | | 11,942 | | 11,953 | |
| Other assets | 55,087 | | 73,148 | | 65,151 | |
| Total Assets | $1,313,445 | | $1,326,145 | | $1,296,086 | |
| | | | | | | |
| INTEREST-BEARING LIABILITIES | | | | | | |
| Interest-bearing deposits: | | | | | | |
| Interest checking | $162,583 | 0.25 % | $147,494 | 0.54 % | $104,444 | 0.86 % |
| Money market | 206,612 | 0.24 % | 203,191 | 0.43 % | 200,982 | 1.00 % |
| Savings | 97,099 | 0.17 % | 78,012 | 0.25 % | 69,002 | 0.39 % |
| Certificates of deposit | 205,231 | 1.90 % | 225,542 | 2.24 % | 226,913 | 2.94 % |
| Individual Retirement Accounts | 154,688 | 2.04 % | 162,754 | 3.06 % | 154,340 | 3.11 % |
| Other time deposits | 1,231 | 0.24 % | 1,242 | 0.48 % | 1,276 | 0.47 % |
| Total interest-bearing deposits | 827,444 | 0.98 % | 818,235 | 1.46 % | 756,957 | 1.94 % |
| Borrowed funds: | | | | | | |
| Short-term | 17,216 | 0.13 % | 27,563 | 0.64 % | 38,731 | 1.40 % |
| Long-term | 134,894 | 4.02 % | 175,229 | 4.09 % | 221,682 | 4.18 % |
| Total borrowed funds | 152,110 | 3.58 % | 202,792 | 3.62 % | 260,413 | 3.77 % |

| | | | | | | |
|---|---|---|---|---|---|---|
| Total Interest-bearing Liabilities | 979,554 | 1.38 % | 1,021,027 | 1.88 % | 1,017,370 | 2.40 % |
| Demand deposits | 173,681 | | 147,380 | | 129,746 | |
| Other liabilities | 7,492 | | 7,605 | | 7,183 | |
| Total Liabilities | 1,160,727 | | 1,176,012 | | 1,154,299 | |
| Stockholders' equity, excluding other comprehensive income/loss | 148,324 | | 148,735 | | 158,120 | |
| Other comprehensive income/loss | 4,394 | | 1,398 | | (16,333) | |
| Total Stockholders' Equity | 152,718 | | 150,133 | | 141,787 | |
| Total Liabilities and Stockholders' Equity | $1,313,445 | | $1,326,145 | | $1,296,086 | |
| Interest Rate Spread | | 3.96 % | | 3.53 % | | 3.47 % |
| Net Interest Income/Earning Assets | | 4.22 % | | 3.81 % | | 3.84 % |
| | | | | | | |
| Total Deposits (Interest-bearing and Demand) | $1,001,125 | | $965,615 | | $886,703 | |

(1) Rates of return on tax-exempt securities and loans are calculated on a fully-taxable equivalent basis, using the Corporation’s marginal federal income tax rate of 34%.
(2) Nonaccrual loans are included in the loan balances above.

19

**TABLE III - ANALYSIS OF VOLUME AND RATE CHANGES**

| (In Thousands) | Year Ended 12/31/11 vs. 12/31/10 | | | Year Ended 12/31/10 vs. 12/31/09 | | |
|---|---|---|---|---|---|---|
| | Change in Volume | Change in Rate | Total Change | Change in Volume | Change in Rate | Total Change |
| EARNING ASSETS | | | | | | |
| Available-for-sale securities: | | | | | | |
| Taxable | $ 664 | $ (709) | $ (45) | $ (1,260) | $ (3,895) | $ (5,155) |
| Tax-exempt | 936 | (417) | 519 | 1,001 | (386) | 615 |
| Total available-for-sale securities | 1,600 | (1,126) | 474 | (259) | (4,281) | (4,540) |
| Held-to-maturity securities, | | | | | | |
| Taxable | (1) | (1) | (2) | (18) | (1) | (19) |
| Trading securities | (1) | (1) | (2) | (64) | 2 | (62) |
| Interest-bearing due from banks | (54) | 3 | (51) | 57 | 6 | 63 |
| Federal funds sold | 0 | 0 | 0 | (7) | (8) | (15) |
| Loans: | | | | | | |
| Taxable | (465) | (533) | (998) | (115) | (892) | (1,007) |
| Tax-exempt | (48) | (61) | (109) | (236) | 141 | (95) |
| Total loans | (513) | (594) | (1,107) | (351) | (751) | (1,102) |
| Total Interest Income | 1,031 | (1,719) | (688) | (642) | (5,033) | (5,675) |
| | | | | | | |
| INTEREST-BEARING LIABILITIES | | | | | | |
| Interest-bearing deposits: | | | | | | |
| Interest checking | 75 | (474) | (399) | 299 | (402) | (103) |
| Money market | 15 | (393) | (378) | 22 | (1,154) | (1,132) |
| Savings | 41 | (74) | (33) | 32 | (110) | (78) |
| Certificates of deposit | (430) | (725) | (1,155) | (40) | (1,572) | (1,612) |
| Individual Retirement Accounts | (236) | (1,591) | (1,827) | 258 | (77) | 181 |
| Other time deposits | 0 | (3) | (3) | 0 | 0 | 0 |
| Total interest-bearing deposits | (535) | (3,260) | (3,795) | 571 | (3,315) | (2,744) |
| Borrowed funds: | | | | | | |
| Short-term | (49) | (105) | (154) | (127) | (240) | (367) |
| Long-term | (1,623) | (117) | (1,740) | (1,902) | (198) | (2,100) |
| Total borrowed funds | (1,672) | (222) | (1,894) | (2,029) | (438) | (2,467) |
| Total Interest Expense | (2,207) | (3,482) | (5,689) | (1,458) | (3,753) | (5,211) |
| | | | | | | |
| Net Interest Income | $ 3,238 | $ 1,763 | $ 5,001 | $ 816 | $ (1,280) | $ (464) |

(1) Changes in interest 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 34%.

(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.

**NON-INTEREST INCOME**

**Years 2011, 2010 and 2009**

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

TABLE IV - COMPARISON OF NON-INTEREST INCOME

| (In Thousands) | 2011 | % Change | 2010 | % Change | 2009 |
|---|---|---|---|---|---|
| Service charges on deposit accounts | $4,773 | 4.2 | $4,579 | (4.4) | $4,791 |
| Service charges and fees | 849 | (1.0) | 858 | 7.8 | 796 |
| Trust and financial management revenue | 3,472 | (0.1) | 3,475 | 6.5 | 3,262 |
| Brokerage revenue | 640 | 37.6 | 465 | 0.2 | 464 |
| Insurance commissions, fees and premiums | 257 | 3.6 | 248 | (15.4) | 293 |
| Interchange revenue from debit card transactions | 1,922 | 14.5 | 1,678 | 25.4 | 1,338 |
| Net gains from sales of loans | 1,107 | 45.5 | 761 | 617.9 | 106 |
| Increase in cash surrender value of life insurance | 509 | 9.2 | 466 | (7.0) | 501 |
| Net gain (loss) from sale of premises and equipment | 324 | (27.2) | 445 | | (30) |
| Net gain from other real estate | 41 | (62.0) | 108 | (65.2) | 310 |
| Impairment loss on limited partnership investment | (948) | | 0 | | 0 |
| Other operating income | 992 | 31.4 | 755 | (36.6) | 1,190 |
| Total other operating income before realized gains (losses) on available-for-sale securities, net | $13,938 | 0.7 | $13,838 | 6.3 | $13,021 |

Total non-interest income, as shown in Table IV, increased $100,000 or less than 1% in 2011 compared to 2010. In 2010, total non-interest income increased $817,000 (6.3%) from 2009. Items of significance are as follows:

**2011 vs. 2010**

Service charges on deposit accounts increased $194,000 or 4.2% in 2011 compared to 2010. Overdraft fee revenues associated with an overdraft privilege program represented approximately 80% of this category in 2011, and remained relatively stable (increase of $35,000) compared to 2010. Overdraft privilege programs were impacted by 2009 federal legislation that requires all consumers to "opt in" for participation in the program. Other deposit account fees increased $159,000 in 2011 compared to 2010, mainly due to fee pricing changes effective at the beginning of 2011.

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.

Interchange revenue from debit card transactions of $1,922,000 in 2011 is $244,000, or 14.5%, higher than in 2010. The increased level of interchange fees reflects customers' higher volume of debit card transactions. The Federal Reserve issued a final rule, effective October 1, 2011, which establishes maximum interchange rates that may be paid to large (as defined) financial institutions. The maximum rates established under the rule are approximately 45% lower than the average market rates paid to the Corporation throughout the last several years. Although the rule's rate constraints do not directly apply to the Corporation (because the Corporation is not considered a large financial institution for this purpose), management believes interchange revenues could be reduced either because of lower volumes or because market conditions may dictate that smaller financial institutions receive rates similar to large financial institutions. Management is monitoring regulatory and market conditions associated with interchange processing, but cannot reasonably estimate the timing or amount of future changes in interchange revenues that may occur.

Net gains from the sale of loans totaled $1,107,000 in 2011, an increase of $346,000 (45.5%) over 2010. In 2010, management began to sell a significant amount of residential mortgage originations into the secondary market. The Corporation sells mortgage loans through the MPF Xtra program administered by the Federal Home Loan Banks of Pittsburgh and Chicago. The increased volume of mortgage loans sold reflects the impact of significant refinancing activity, with a new upsurge starting in the third quarter 2011, triggered by falling long-term market interest rates on mortgages. The recent increase in volume is similar to the surge in refinancing activity the Corporation experienced in the last several months of 2010.

As described in the Earnings Overview section of Management's Discussion and Analysis, in the third quarter 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. 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.