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.

- 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

(In Thousands)	Years Ended December 31, 2012	2011	2010	Increase/(Decrease) 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.

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.

- 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.

- 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.

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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

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	
+400	$66,369	$29,617	$ 36,752	-18.0	%	25.0	%
+300	63,690	24,535	39,155	-12.6	%	20.0	%
+200	60,927	19,806	41,121	-8.2	%	15.0	%
+100	58,095	15,076	43,019	-4.0	%	10.0	%
0	55,164	10,346	44,818	0.0	%	0.0	%
-100	51,929	8,720	43,209	-3.6	%	10.0	%
-200	50,441	8,680	41,761	-6.8	%	15.0	%

-300	49,961	8,680	41,281	-7.9	%	20.0	%
-400	49,828	8,680	41,148	-8.2	%	25.0	%

Market Value of Portfolio Equity at October 31, 2011

Basis Point Change in Rates	Present Value Equity	Present Value % Change		Present Value Risk Limit	
+400	$153,307	-23.2	%	50.0	%
+300	165,701	-17.0	%	45.0	%
+200	178,261	-10.7	%	35.0	%
+100	189,315	-5.2	%	25.0	%
0	199,726	0.0	%	0.0	%
-100	197,329	-1.2	%	25.0	%
-200	211,794	6.0	%	35.0	%
-300	238,309	19.3	%	45.0	%
-400	278,876	39.6	%	50.0	%

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 risk factors that affect the banking industry in general, including credit risk, competition from non-bank entities, interest rate risk and other factors, which could result in a decline in market prices. Also, losses could occur in individual stocks held by the Corporation because of specific circumstances related to each bank. As discussed further in Note 7 of the consolidated financial statements, the Corporation recognized an impairment loss in earnings related to a bank stock of $67,000 in 2012. The Corporation recognized no OTTI losses related to bank stocks in 2011.

Equity securities held as of December 31, 2012 and 2011 are presented in Table XV. Table XV presents quantitative data concerning the effects of a decline in fair value of the Corporation's equity securities of 10% or 20%. The data in Table XV does not reflect the effects of any appreciation in value that may occur, nor does it present the Corporation's maximum exposure to loss on equity securities, which would be 100% of their fair value as of December 31, 2012.

TABLE XV - EQUITY SECURITIES RISK
(In Thousands)

	Dec. 31, 2012	Dec. 31, 2011
Cost	$5,912	$5,643
Fair Value	8,373	7,728
Hypothetical 10% Decline In Market Value	(837)	(773)
Hypothetical 20% Decline In Market Value	(1,675)	(1,546)

ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA
CONSOLIDATED BALANCE SHEETS

(In Thousands, Except Share and Per Share Data)	December 31, 2012	December 31, 2011
ASSETS		
Cash and due from banks:		
Noninterest-bearing	$ 21,356	$ 17,618
Interest-bearing	38,480	42,957
Total cash and due from banks	59,836	60,575
Available-for-sale securities, at fair value	472,577	481,685
Loans held for sale	2,545	939
Loans receivable	683,910	708,315
Allowance for loan losses	(6,857)	(7,705)
Loans, net	677,053	700,610
Bank-owned life insurance	21,344	20,889
Accrued interest receivable	4,281	4,797
Bank premises and equipment, net	18,707	19,028
Foreclosed assets held for sale	879	1,235
Deferred tax asset, net	1,725	6,173
Intangible asset - Core deposit intangibles	138	212
Intangible asset - Goodwill	11,942	11,942
Other assets	15,880	15,650
TOTAL ASSETS	$ 1,286,907	$ 1,323,735
LIABILITIES		
Deposits:		
Noninterest-bearing	$ 189,941	$ 193,595
Interest-bearing	816,165	824,611
Total deposits	1,006,106	1,018,206
Short-term borrowings	5,567	4,950
Long-term borrowings	83,812	125,363
Accrued interest and other liabilities	8,636	7,831
TOTAL LIABILITIES	1,104,121	1,156,350
STOCKHOLDERS' EQUITY		
Preferred stock, $1,000 par value; authorized 30,000 shares; $1,000 liquidation preference per share; no shares issued at December 31, 2012 and December 31, 2011	0	0
Common stock, par value $1.00 per share; authorized 20,000,000 shares in 2012 and 2011; issued 12,525,411 at December 31, 2012 and 12,460,920 at December 31, 2011	12,525	12,461
Paid-in capital	68,622	67,568
Retained earnings	94,839	82,302
Treasury stock, at cost; 251,376 shares at December 31, 2012 and 305,391 shares at December 31, 2011	(4,203)	(5,106)
Sub-total	171,783	157,225
Accumulated other comprehensive income:		
Unrealized gains on available-for-sale securities	11,568	10,791

Defined benefit plans	(565)	(631)
Total accumulated other comprehensive income	11,003	10,160
TOTAL STOCKHOLDERS' EQUITY	182,786	167,385
TOTAL LIABILITIES & STOCKHOLDERS' EQUITY	$ 1,286,907	$ 1,323,735

The accompanying notes are an integral part of the consolidated financial statements.

Consolidated Statements of Income	Years Ended December 31,		
(In Thousands Except Per Share Data)	2012	2011	2010
INTEREST INCOME			
Interest and fees on loans	$40,453	$43,178	$44,155
Interest on balances with depository institutions	114	73	124
Interest on loans to political subdivisions	1,539	1,499	1,582
Interest on mortgages held for sale	107	53	74
Interest on trading securities	0	0	1
Income from available-for-sale and held-to-maturity securities:			
Taxable	9,029	11,036	11,092
Tax-exempt	5,085	5,156	4,834
Dividends	305	261	252
Total interest and dividend income	56,632	61,256	62,114
INTEREST EXPENSE			
Interest on deposits	4,807	8,112	11,907
Interest on short-term borrowings	10	23	177
Interest on long-term borrowings	4,214	5,421	7,161
Total interest expense	9,031	13,556	19,245
Net interest income	47,601	47,700	42,869
Provision (credit) for loan losses	288	(285)	1,191
Net interest income after provision (credit) for loan losses	47,313	47,985	41,678
OTHER INCOME			
Service charges on deposit accounts	5,036	4,773	4,579
Service charges and fees	929	849	858
Trust and financial management revenue	3,847	3,472	3,475
Interchange revenue from debit card transactions	1,938	1,922	1,678
Net gains from sale of loans	1,925	1,107	761
Increase in cash surrender value of life insurance	455	509	466
Insurance commissions, fees and premiums	221	257	248
Impairment loss on limited partnership investment	0	(948)	0
Other operating income	1,966	1,997	1,773
Sub-total	16,317	13,938	13,838
Total other-than-temporary impairment losses on available-for-sale securities	(67)	0	(381)
Portion of (gain) recognized in other comprehensive loss (before taxes)	0	0	(52)
Net impairment losses recognized in earnings	(67)	0	(433)
Realized gains on available-for-sale securities, net	2,749	2,216	1,262
Net realized gains recognized in earnings on available-for-sale securities	2,682	2,216	829
Total other income	18,999	16,154	14,667
OTHER EXPENSES			
Salaries and wages	14,370	13,866	13,063
Pensions and other employee benefits	4,497	4,407	3,840
Occupancy expense, net	2,476	2,638	2,645
Furniture and equipment expense	1,887	1,932	2,103
FDIC Assessments	633	832	1,450
Pennsylvania shares tax	1,312	1,306	1,222
Loss on prepayment of debt	2,333	0	0
Other operating expense	7,673	7,076	7,167
Total other expenses	35,181	32,057	31,490

Income before income tax provision	31,131	32,082	24,855
Income tax provision	8,426	8,714	5,800
Net income	22,705	23,368	19,055
U.S. Treasury preferred dividends	0	0	1,474
NET INCOME AVAILABLE TO COMMON SHAREHOLDERS	$22,705	$23,368	$17,581
NET INCOME PER SHARE - BASIC	$1.86	$1.92	$1.45
NET INCOME PER SHARE - DILUTED	$1.85	$1.92	$1.45

The accompanying notes are an integral part of the consolidated financial statements.

CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

(In Thousands)	2012	2011	2010
Net income	$22,705	$23,368	$19,055
Unrealized gains (losses) on available-for-sale securities:			
Unrealized holding gains (losses) on available-for-sale securities	4,128	20,611	(448)
Reclassification adjustment for gains realized in income	(2,682)	(2,216)	(829)
Other comprehensive gain (loss) on available-for-sale securities	1,446	18,395	(1,277)
Unfunded pension and postretirement obligations:			
Change in items from defined benefit plans included in accumulated other comprehensive gain (loss)	8	(626)	126
Amortization of net transition obligation, prior service cost and net actuarial loss included in net periodic benefit cost	77	55	53
Other comprehensive gain (loss) on unfunded retirement obligations	85	(571)	179
Other comprehensive income (loss) before income tax	1,531	17,824	(1,098)
Income tax related to other comprehensive (income) loss	(688)	(6,063)	388
Net other comprehensive income (loss)	843	11,761	(710)
Comprehensive income	$23,548	$35,129	$18,345

The accompanying notes are an integral part of the consolidated financial statements.

Consolidated Statements of Changes in Stockholders' Equity
(In Thousands Except Share and Per Share Data)

	Common Shares	Treasury Shares	Preferred Stock	Common Stock	Paid-in Capital	Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Treasu Stock
Balance, January 1, 2010	12,374,481	262,780	$25,749	$12,374	$66,726	$53,027	$(891)	$(4,57
Net income						19,055		
Other comprehensive loss, net							(710)	
Accretion of discount associated with U.S. Treasury preferred stock			691			(691)		
Cash dividends on U.S. Treasury preferred stock						(783)		
Redemption of U.S. Treasury preferred stock, 26,440 shares			(26,440)					
Redemption of U.S. Treasury warrant					(400)			
Cash dividends declared on common stock, $.39 per share						(4,730)		
Shares issued for dividend reinvestment plan	33,731			34	399			
Restricted stock granted		(9,125)			(159)			159
Forfeiture of restricted stock		959			15			(15
Stock-based compensation expense					67			
Tax benefit from employee benefit plan						42		
Balance, December 31, 2010	12,408,212	254,614	0	12,408	66,648	65,920	(1,601)	(4,43
Net income						23,368		
Other comprehensive income, net							11,761	
Cash dividends declared on common stock, $.58 per share						(7,052)		
Treasury stock purchased		70,849						(1,02
Shares issued for dividend reinvestment plan	52,708			53	772			
Shares issued from treasury related to exercise of stock options		(4,856)			(11)			82
Restricted stock granted		(15,622)			(272)			272
Forfeiture of restricted stock		406			7			(7
Stock-based compensation expense					423			
Tax benefit from stock-based compensation					1			
Tax benefit from employee benefit plan						66		
Balance, December 31, 2011	12,460,920	305,391	0	12,461	67,568	82,302	10,160	(5,10
Net income						22,705		
Other comprehensive income, net							843	
Cash dividends declared on common stock, $.84 per share						(10,272)		
	64,491			64	1,147			

Shares issued for dividend reinvestment plan								
Shares issued from treasury related to exercise of stock options		(15,023)			(22)			251
Restricted stock granted		(42,552)			(711)			711
Forfeiture of restricted stock		3,560			59			(59
Stock-based compensation expense					567			
Tax benefit from stock-based compensation					14			
Tax benefit from employee benefit plan						104		
Balance, December 31, 2012	12,525,411	251,376	$0	$12,525	$68,622	$94,839	$11,003	$(4,20

The accompanying notes are an integral part of the consolidated financial statements.

CONSOLIDATED STATEMENTS OF CASH FLOWS	Years Ended December 31,		
(In Thousands)	2012	2011	2010
CASH FLOWS FROM OPERATING ACTIVITIES:			
Net income	$22,705	$23,368	$19,055
Adjustments to reconcile net income to net cash provided by operating activities:			
Provision (credit) for loan losses	288	(285)	1,191
Realized gains on available-for-sale securities, net	(2,682)	(2,216)	(829)
Loss on prepayment of debt	2,333	0	0
Gain on disposition of premises and equipment	(270)	(324)	(445)
Loss (gain) on sale of foreclosed assets, net	66	(41)	(108)
Depreciation expense	1,939	2,077	2,339
Accretion and amortization on securities, net	1,581	1,317	2,233
Accretion and amortization on loans, deposits and borrowings, net	(49)	(35)	(262)
Amortization of mortgage servicing rights	97	68	12
Impairment loss on limited partnership interest	0	948	0
Increase in cash surrender value of life insurance	(455)	(509)	(466)
Stock-based compensation	567	423	67
Amortization of core deposit intangibles	74	114	176
Deferred income taxes	3,760	3,818	6,371
Gains on sales of mortgage loans, net	(1,925)	(1,107)	(761)
Origination of mortgage loans for sale	(62,829)	(26,610)	(30,720)
Proceeds from sales of mortgage loans	62,821	31,786	26,826
Net decrease in trading securities	0	0	1,045
(Increase) decrease in accrued interest receivable and other assets	(1,043)	3,580	9,624
Increase (decrease) in accrued interest payable and other liabilities	674	1,092	(302)
Net Cash Provided by Operating Activities	27,652	37,464	35,046
CASH FLOWS FROM INVESTING ACTIVITIES:			
Purchase of certificates of deposit	(1,060)	(3,760)	0
Proceeds from maturity of held-to-maturity securities	0	0	300
Proceeds from sales of available-for-sale securities	24,228	25,471	53,115
Proceeds from calls and maturities of available-for-sale securities	114,247	108,138	163,618
Purchase of available-for-sale securities	(126,820)	(152,044)	(267,082)
Redemption of Federal Home Loan Bank of Pittsburgh stock	1,931	1,513	429
Net decrease (increase) in loans	22,320	19,264	(10,330)
Proceeds from bank-owned life insurance	0	1,442	1,442
Purchase of premises and equipment	(1,622)	(998)	(707)
Proceeds from disposition of premises and equipment	456	3,060	103
Purchase of investment in limited liability entity	(538)	(397)	0
Return of principal on limited liability entity investments	114	116	66
Proceeds from sale of foreclosed assets	1,380	1,112	1,169
Net Cash Provided by (Used in) Investing Activities	34,636	2,917	(57,877)
CASH FLOWS FROM FINANCING ACTIVITIES:			
Net (decrease) increase in deposits	(12,106)	13,839	77,537
Net increase (decrease) in short-term borrowings	617	(13,463)	(20,816)
Repayments of long-term borrowings	(43,884)	(23,132)	(47,607)
Redemption of US Treasury preferred stock and warrant	0	0	(26,840)
Purchase of treasury stock	0	(1,022)	0
Sale of treasury stock	229	71	0

Tax benefit from compensation plans	118	67	42
US Treasury preferred dividends paid	0	0	(952)
Common dividends paid	(9,061)	(6,227)	(4,297)
Net Cash Used in Financing Activities	(64,087)	(29,867)	(22,933)
(DECREASE) INCREASE IN CASH AND CASH EQUIVALENTS	(1,799)	10,514	(45,764)
CASH AND CASH EQUIVALENTS, BEGINNING OF YEAR	56,815	46,301	92,065
CASH AND CASH EQUIVALENTS, END OF YEAR	$55,016	$56,815	$46,301

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CONSOLIDATED STATEMENTS OF CASH FLOWS (Continued)	Years Ended December 31,		
(In Thousands)	2012	2011	2010
Assets acquired through foreclosure of real estate loans	$1,004	$1,769	$725
Interest paid	$9,246	$13,609	$19,614
Income taxes paid (refunded)	$4,250	$3,616	$(8,134)

The accompanying notes are an integral part of the consolidated financial statements.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

1. NATURE OF OPERATIONS AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

BASIS OF CONSOLIDATION - The consolidated financial statements include the accounts of Citizens & Northern Corporation and its subsidiaries, Citizens & Northern Bank ("C&N Bank"), Bucktail Life Insurance Company and Citizens & Northern Investment Corporation (collectively, "Corporation"), as well as C&N Bank's wholly-owned subsidiary, C&N Financial Services Corporation. The consolidated financial statements also include the accounts of the former Canisteo Valley Corporation (merged into Citizens & Northern Corporation in September 2010) and its former wholly-owned subsidiary, First State Bank (merged into C&N Bank, effective September 1, 2010). All material intercompany balances and transactions have been eliminated in consolidation.

NATURE OF OPERATIONS - The Corporation is primarily engaged in providing a full range of banking and mortgage services to individual and corporate customers in North Central Pennsylvania and Southern New York State. Lending products include mortgage loans, commercial loans and consumer loans, as well as specialized instruments such as commercial letters-of-credit. Deposit products include various types of checking accounts, passbook and statement savings, money market accounts, interest checking accounts, Individual Retirement Accounts and certificates of deposit. The Corporation also offers non-insured "RepoSweep" accounts.

The Corporation provides Trust and Financial Management services, including administration of trusts and estates, retirement plans, and other employee benefit plans, and investment management services. The Corporation offers a variety of personal and commercial insurance products through C&N Financial Services Corporation. C&N Financial Services Corporation also offers mutual funds, annuities, educational savings accounts and other investment products through registered agents. Management has determined that the Corporation has one reportable segment, "Community Banking." All of the Corporation's activities are interrelated, and each activity is dependent and assessed based on how each of the activities of the Corporation supports the others.

The Corporation is subject to competition from other financial institutions. It is also subject to regulation by certain federal and state agencies and undergoes periodic examination by those regulatory authorities. As a consequence, the Corporation's business is particularly susceptible to being affected by future federal and state legislation and regulations.

USE OF ESTIMATES - The financial information is presented in accordance with generally accepted accounting principles and general practice for financial institutions in the United States of America. In preparing financial statements, management is required to make estimates and assumptions that affect the reported amount of assets and liabilities and disclosure of contingent assets and liabilities as of the date of the financial statements. In addition, these estimates and assumptions affect revenues and expenses in the financial statements and as such, actual results could differ from those estimates.

Material estimates that are particularly susceptible to change include: (1) the allowance for loan losses, (2) fair values of debt securities based on estimates from independent valuation services or from brokers, (3) fair values of debt securities based on unobservable inputs, as determined using management's estimates of cash flows and applicable discount rates,(4) assessment of impaired securities to determine whether or not the securities are other-than-temporarily impaired, (5) valuation of deferred tax assets and (6) valuation of obligations from defined benefit plans.

INVESTMENT SECURITIES - Investment securities are accounted for as follows:

Available-for-sale securities - includes debt securities not classified as held-to-maturity or trading, and unrestricted equity securities. Such securities are reported at fair value, with unrealized gains and losses excluded from earnings and reported separately through accumulated other comprehensive income, net of tax. Amortization of premiums and accretion of discounts on available-for-sale securities are recorded using the level yield method over the remaining contractual life of the securities, adjusted for actual prepayments. Realized gains and losses on sales of available-for-sale securities are computed on the basis of specific identification of the adjusted cost of each security. Securities within the available-for-sale portfolio may be used as part of the Corporation's asset and liability management strategy and may be sold in response to changes in interest rate risk, prepayment risk or other factors.

Other-than-temporary impairment - Declines in the fair value of available-for-sale securities that are deemed to be other-than-temporary are reflected in earnings as realized losses. In estimating other-than-temporary impairment losses, management considers (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, (3) the intent and ability of the Corporation to retain its investment in the issuer for a period of time sufficient to allow for any anticipated recovery in fair value, and (4) whether the Corporation intends to sell the security or if it is more likely than not that the Corporation will be required to sell the security before the recovery of its amortized cost basis. The credit-related impairment is recognized in earnings and is the difference between a security's amortized cost basis and the present value of expected future cash flows discounted at the security's effective interest rate. For debt securities classified as held-to-maturity, if any, the amount of noncredit-related impairment is recognized in other comprehensive income and accreted over the remaining life of the debt security as an increase in the carrying value of the security. In addition, the risk of future other-than-temporary impairment may be influenced by additional bank failures, prolonged recession in the U.S. economy, changes to real estate values, interest deferrals and whether the federal government provides assistance to financial institutions.

Restricted equity securities - Restricted equity securities consist primarily of Federal Home Loan Bank of Pittsburgh stock, and are carried at cost and evaluated for impairment. Holdings of restricted equity securities are included in Other Assets in the Consolidated Balance Sheet, and dividends received on restricted securities are included in Other Income in the Consolidated Statement of Income.

LOANS HELD FOR SALE - Mortgage loans held for sale are reported at the lower of cost or market, determined in the aggregate.

LOANS RECEIVABLE - Loans receivable which management has the intent and ability to hold for the foreseeable future or until maturity or payoff are stated at unpaid principal balances, less the allowance for loan losses and net deferred loan fees. Interest income is accrued on the unpaid principal balance. Loan origination and commitment fees, as well as certain direct origination costs, are deferred and amortized as a yield adjustment over the lives of the related loans using the interest method.

The loans receivable portfolio is segmented into residential mortgage, commercial and consumer loans. The residential mortgage segment includes the following classes: first and junior lien residential mortgages, home equity lines of credit and residential construction loans. The most significant classes of commercial loans are commercial loans secured by real estate, non-real estate secured commercial and industrial loans, loans to political subdivisions, commercial construction, and loans secured by farmland.

Loans are placed on nonaccrual status for all classes of loans when, in the opinion of management, collection of interest is doubtful. Any unpaid interest previously accrued on those loans is reversed from income. Interest income is not recognized on specific impaired loans unless the likelihood of further loss is remote. Interest payments received on loans for which the risk of further loss is greater than remote are applied as a reduction of the loan principal balance. Interest income on other nonaccrual loans is recognized only to the extent of interest payments received. Generally, loans are restored to accrual status when the obligation is brought current, has performed in accordance with the contractual terms for a reasonable period of time (generally six months) and the ultimate collectability of the total contractual principal and interest is no longer in doubt. The past due status of all classes of loans receivable is determined based on contractual due dates for loan payments. Also, the amortization of deferred loan fees is discontinued when a loan is placed on nonaccrual status.

ALLOWANCE FOR LOAN LOSSES - The allowance for loan losses represents management's estimate of losses inherent in the loan portfolio as of the balance sheet date and is recorded as a reduction to loans. The allowance for loan losses is increased by the provision for loan losses, and decreased by charge-offs, net of recoveries. Loans deemed to be uncollectible are charged against the allowance for loan losses, and subsequent recoveries, if any, are credited to the allowance. All, or part, of the principal balance of loans receivable are charged off to the allowance as soon as it is determined that the repayment of all, or part, of the principal balance is highly unlikely. Non-residential consumer loans are generally charged off no later than when they are 120 days past due on a contractual basis, or earlier in the event of bankruptcy or if there is an amount deemed uncollectible.

The allowance for loan losses is maintained at a level considered adequate to provide for losses that can be reasonably anticipated. Management performs a quarterly evaluation of the adequacy of the allowance. The allowance is based on the Corporation's past loan loss experience, known and inherent risks in the portfolio, adverse situations that may affect the borrower's ability to repay, the estimated value of any underlying collateral, composition of the loan portfolio, current economic conditions and other relevant factors. This evaluation is inherently subjective as it requires material estimates that may be susceptible to significant revision as more information becomes available. 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. In the process of evaluating the loan portfolio, management also considers the Corporation's exposure to losses from unfunded loan commitments. As of December 31, 2012 and 2011, management determined that no allowance for credit losses related to unfunded loan commitments was required.

The allowance consists primarily of two major components – (1) a specific component based on a detailed assessment of certain larger loan relationships, mainly commercial purpose, determined on a loan-by-loan basis; and (2) a general component for the remainder of the portfolio based on a collective evaluation of pools of loans with similar risk characteristics. The general component is assigned to each pool of loans based on both historical net charge-off experience, and an evaluation of certain qualitative factors. An unallocated component is maintained to cover uncertainties that could affect management's estimate of probable losses. The unallocated component of the allowance reflects the margin of imprecision inherent in the underlying assumptions used in the above methodologies for estimating specific and general losses in the portfolio.

The specific component relates to loans that are classified as impaired based on a detailed assessment of certain larger loan relationships evaluated by a management committee referred to as the Watch List Committee. Specific loan relationships are identified for evaluation based on the related credit risk rating. For individual loans classified as impaired, an allowance is established when the collateral value less estimated selling costs, present value of discounted cash flows or observable market price of the impaired loan is lower than the carrying value of that loan.

The general component covers pools of loans by loan class including commercial loans not considered individually impaired, as well as smaller balance homogeneous classes of loans, such as residential real estate, home equity lines of credit and other consumer loans. Accordingly, the Corporation generally does not separately identify individual consumer and residential loans for impairment disclosures, unless such loans are subject to a restructuring agreement. The pools of loans for each loan segment are evaluated for loss exposure based upon average historical net charge-off rates (currently three years), adjusted for qualitative factors. Qualitative risk factors (described in the following paragraph) are evaluated for the impact on each of the three distinct segments (residential mortgage, commercial and consumer) within the loan portfolio. Each qualitative factor is assigned a value to reflect improving, stable or declining conditions based on management’s judgment using relevant information available at the time of the evaluation. Any adjustments to the factors are supported by a narrative documentation of changes in conditions accompanying the allowance for loan loss calculation.

The qualitative factors used in the general component calculations are designed to address credit risk characteristics associated with each segment. The Corporation’s credit risk associated with all of the segments is significantly impacted by these factors, which include economic conditions within its market area, the Corporation’s lending policies, changes or trends in the portfolio, risk profile, competition, regulatory requirements and other factors. Further, the residential mortgage segment is significantly affected by the values of residential real estate that provide collateral for the loans. The majority of the Corporation’s commercial segment loans (approximately 71% at December 31, 2012) is secured by real estate, and accordingly, the Corporation’s risk for the commercial segment is significantly affected by commercial real estate values. The consumer segment includes a wide mix of loans for different purposes, primarily secured loans, including loans secured by motor vehicles, manufactured housing and other types of collateral.

Loans are classified as impaired when, based on current information and events, it is probable that the Corporation will be unable to collect the scheduled payments of principal or interest when due according to the contractual terms of the loan agreement. Factors considered by management in determining impairment include payment status, collateral value and the probability of collecting scheduled principal and interest payments when due. Loans that experience insignificant payment delays and payment shortfalls generally are not classified as impaired. Management determines the significance of payment delays and payment shortfalls on a case-by-case basis, taking into consideration all of the circumstances surrounding the loan and the borrower, including the length of the delay, the reasons for the delay, the borrower’s prior payment record and the amount of shortfall in relation to the principal and interest owed. Impairment is measured on a loan-by-loan basis for commercial loans by the fair value of the collateral (if the loan is collateral dependent), by future cash flows discounted at the loan’s effective rate or by the loan’s observable market price.

For commercial loans secured by real estate, estimated fair values are determined primarily through third-party appraisals. When a real estate secured loan becomes impaired, a decision is made regarding whether an updated certified appraisal of the real estate is necessary. This decision is based on various considerations, including the age of the most recent appraisal, the loan-to-value ratio based on the original appraisal and the condition of the property. Appraised values are discounted to arrive at the estimated selling price of the collateral, which is considered to be the estimated fair value. The discounts also include estimated costs to sell the property.

For commercial and industrial loans secured by non-real estate collateral, such as accounts receivable, inventory and equipment, estimated fair values are determined based on the borrower's financial statements, inventory reports, accounts receivable agings or equipment appraisals or invoices. Indications of value from these sources are generally discounted based on the age of the financial information or the quality of the assets.

Loans whose terms are modified are classified as troubled debt restructurings if the Corporation grants such borrowers concessions and it is deemed that those borrowers are experiencing financial difficulty. Concessions granted under a troubled debt restructuring generally involve an extension of a loan's stated maturity date or a temporary reduction in interest rate. Non-accrual troubled debt restructurings are restored to accrual status if principal and interest payments, under the modified terms, are current for six consecutive months after modification. Loans classified as troubled debt restructurings are designated as impaired.

BANK PREMISES AND EQUIPMENT - Bank premises and equipment are stated at cost less accumulated depreciation. Repair and maintenance expenditures which extend the useful lives of assets are capitalized, and other repair and maintenance expenditures are expensed as incurred. Depreciation expense is computed using the straight-line method.

IMPAIRMENT OF LONG-LIVED ASSETS - The Corporation reviews long-lived assets, such as premises and equipment and intangibles, for impairment whenever events or changes in circumstances indicate the carrying amount of an asset may not be recoverable. These changes in circumstances may include a significant decrease in the market value of an asset or the manner in which an asset is used. If there is an indication the carrying value of an asset may not be recoverable, future undiscounted cash flows expected to result from use of the asset are estimated. If the sum of the expected cash flows is less than the carrying value of the asset, a loss is recognized for the difference between the carrying value and fair market value of the asset.

INTEREST COSTS - The Corporation capitalizes interest as a component of the cost of premises and equipment constructed or acquired for its own use. The amount of capitalized interest in 2012, 2011, and 2010 was not significant.

FORECLOSED ASSETS HELD FOR SALE - Foreclosed assets held for sale consist of real estate acquired by foreclosure and are initially recorded at fair value, less estimated selling costs.

GOODWILL AND CORE DEPOSIT INTANGIBLE ASSETS - Goodwill represents the excess of the cost of acquisitions over the fair value of the net assets acquired. Goodwill is tested at least annually for impairment, or more often if events or circumstances indicate there may be impairment. Core deposit intangibles are being amortized over periods of time that represent the expected lives using a method of amortization that reflects the pattern of economic benefit. Core deposit intangibles are subject to impairment testing whenever events or changes in circumstances indicate their carrying amounts may not be recoverable.

SERVICING RIGHTS - The estimated fair value of servicing rights related to mortgage loans sold and serviced by the Corporation is recorded as an asset upon the sale of such loans. The valuation of servicing rights is adjusted quarterly, with changes in fair value included in Other Operating Income in the consolidated statements of operations. Significant inputs to the valuation include expected net servicing income to be received, the expected life of the underlying loans and the discount rate. The servicing rights asset is included in Other Assets in the consolidated balance sheet, with a balance equal to fair value of $605,000 at December 31, 2012 and $375,000 at December 31, 2011.

INCOME TAXES - Deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amount of existing assets and liabilities and their respective tax bases given the provisions of the enacted tax laws. Deferred tax assets are reduced, if necessary, by the amount of such benefits that are not expected to be realized based upon available evidence. The Corporation includes income tax penalties in the provision for income tax. The Corporation has no accrued interest related to unrecognized tax benefits.

STOCK COMPENSATION PLANS - The Corporation's stock-based compensation policy applies to all forms of stock-based compensation including stock options and restricted stock units. All stock-based compensation is accounted for under the fair value method as required by generally accepted accounting principles in the United States. The expense associated with stock-based compensation is recognized over the vesting period of each individual arrangement.

The fair value of each stock option is estimated on the date of grant using the Black-Scholes-Merton option valuation model. The fair value of restricted stock is based on the current market price on the date of grant.

OFF-BALANCE SHEET FINANCIAL INSTRUMENTS - In the ordinary course of business, the Corporation has entered into off-balance sheet financial instruments consisting of commitments to extend credit and standby letters of credit. Such financial instruments are recorded in the financial statements when they become payable.

CASH FLOWS - The Corporation utilizes the net reporting of cash receipts and cash payments for certain deposit and lending activities. Cash equivalents include federal funds sold and all cash and amounts due from depository institutions and interest-bearing deposits in other banks with original maturities of three months or less.

TRUST ASSETS AND INCOME - Assets held by the Corporation in a fiduciary or agency capacity for its customers are not included in the financial statements since such items are not assets of the Corporation. Trust income is recorded on a cash basis, which is not materially different from the accrual basis.

2. RECENT ACCOUNTING PRONOUNCEMENTS:

The FASB issues Accounting Standards Updates (ASUs) to the FASB Accounting Standards Codification (ASC). This section provides a summary description of recent ASUs that have significant implications (elected or required) within the consolidated financial statements, or that management expects may have a significant impact on financial statements issued in the near future.

In April 2011, the FASB issued ASU 2011-02, Receivables (Topic 310) - A Creditor's Determination of Whether a Restructuring Is a Troubled Debt Restructuring. The Update amends ASC Topic 310 to provide guidance in evaluating whether a restructuring constitutes a Troubled Debt Restructuring. The main provisions conclude that a creditor must separately conclude that both of the following exist – (1) the restructuring constitutes a concession, and (2) the debtor is experiencing financial difficulties. The amendments then provide guidance on a creditor's evaluation of each of the requirements for a Troubled Debt Restructuring. For public entities, the Update was effective for the first interim or annual period beginning on or after June 15, 2011, including retrospective application to the beginning of the annual period of adoption. Note 8 provides disclosures required by this standard.

In May 2011, the FASB issued ASU 2011-04, Fair Value Measurement (Topic 820) – Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRSs. The amendments in this Update will result in common fair value measurement and disclosure requirements in U.S. GAAP and IFRSs. The Update includes various amendments, including amendments that: (1) clarify FASB's intent about the application of existing fair value measurement and disclosure requirements, and (2) change some particular principles or requirements for measuring fair value or disclosing information about fair value measurements. There were no changes in the Corporation's procedures for determining fair value measurements as a result of this Update; however, additional quantitative disclosures about unobservable inputs used in fair value measurements categorized within Level 3 of the fair value hierarchy are provided. The amendments in this ASU are applied prospectively, and Note 6 includes disclosures required by this ASU.

In June 2011, the FASB issued ASU 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. This standard requires the components of comprehensive income be presented either in a single continuous statement of comprehensive income or in two separate but consecutive statements. The single format includes the traditional income statement and the components of other comprehensive income, total other comprehensive income and total comprehensive income. In the two statement approach, the first statement is the traditional income statement, which would be immediately followed by a separate statement which would include the components of other comprehensive income, total other comprehensive income and total comprehensive income. The amendments in this ASU are applied retrospectively, and the Corporation has adopted the two statement approach as reflected in the accompanying financial statements.

In September 2011, the FASB issued ASU 2011-08, Intangibles – Goodwill and Other (Topic 350) – Testing Goodwill for Impairment. The amendments in this ASU permit an entity to first assess qualitative factors to determine whether it is more likely than not that the fair value of a reporting unit is less than its carrying amount as a basis for determining whether it is necessary to perform the two-step goodwill impairment test described in Topic 350. The amendments in this ASU are effective for annual and interim goodwill impairment tests performed for fiscal years beginning after December 15, 2011.

In December 2011, the FASB issued ASU 2011-12, Deferral of the Effective Date for Amendments to the Presentation of Reclassifications of Items Out of Accumulated Other Comprehensive Income in Accounting Standards Update No. 2011-05. This ASU deferred only those changes in ASU 2011-05 (discussed above) that relate to the presentation of reclassification adjustments.

In February 2013, the FASB issued ASU 2013-02, Reporting of Amounts Reclassified Out of Accumulated Other Comprehensive Income. The amendments in this standard will require an entity to provide information about the amounts reclassified out of accumulated other comprehensive income by component. In addition, this standard will require an entity to present, either on the face of the statement where net income is presented or in the notes, significant amounts reclassified out of accumulated other comprehensive income by the respective line items of net income but only if the amount is required under U.S. GAAP to be reclassified to net income in its entirety in the same reporting period. For other amounts that are not required by U.S. GAAP to be reclassified in their entirety to net income, an entity will be required to cross-reference to other disclosures required under U.S. GAAP that provide additional detail about those amounts. The amendments in this ASU are effective prospectively for annual and interim periods beginning after December 15, 2012.

3. COMPREHENSIVE INCOME

Comprehensive income (loss) is the total of (1) net income (loss), and (2) all other changes in equity from non-stockholder sources, which are referred to as other comprehensive income. The components of other comprehensive income (loss), and the related tax effects, are as follows:

(In Thousands)	Before-Tax Amount	Income Tax Effect	Net-of-Tax Amount
2012			
Unrealized gains on available-for-sale securities:			
Unrealized holding gains on available-for-sale securities	$ 4,128	$ (1,608)	$ 2,520
Reclassification adjustment for (gains) realized in income	(2,682)	939	(1,743)
Other comprehensive gain on available-for-sale securities	1,446	(669)	777
Unfunded pension and postretirement obligations:			
Change in items from defined benefit plans included in accumulated other comprehensive income	8	(2)	6
Amortization of net transition obligation, prior service cost and net actuarial loss included in net periodic benefit cost	77	(17)	60
Other comprehensive gain on unfunded retirement obligations	85	(19)	66
Total other comprehensive income	$ 1,531	$ (688)	$ 843

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(In Thousands)	Before-Tax Amount	Income Tax Effect	Net-of-Tax Amount
2011			
Unrealized gains on available-for-sale securities:			
Unrealized holding gains on available-for-sale securities	$ 20,611	$ (7,006)	$ 13,605
Reclassification adjustment for gains realized in income	(2,216)	753	(1,463)
Other comprehensive gain on available-for-sale securities	18,395	(6,253)	12,142
Unfunded pension and postretirement obligations:			
Change in items from defined benefit plans included in accumulated other comprehensive income	(626)	208	(418)
Amortization of net transition obligation, prior service cost and net actuarial loss included in net periodic benefit cost	55	(18)	37
Other comprehensive loss on unfunded retirement obligations	(571)	190	(381)
Total other comprehensive income	$ 17,824	$ (6,063)	$ 11,761

(In Thousands)	Before-Tax Amount	Income Tax Effect	Net-of-Tax Amount
2010			
Unrealized losses on available-for-sale securities:			
Unrealized holding losses on available-for-sale securities	$ (448)	$ 166	$ (282)
Reclassification adjustment for gains realized in income	(829)	282	(547)
Other comprehensive loss on available-for-sale securities	(1,277)	448	(829)
Unfunded pension and postretirement obligations:			
Change in items from defined benefit plans included in accumulated other comprehensive income	126	(42)	84
Amortization of net transition obligation, prior service cost and net actuarial loss included in net periodic benefit cost	53	(18)	35
Other comprehensive gain on unfunded retirement obligations	179	(60)	119
Total other comprehensive loss	$ (1,098)	$ 388	$ (710)

Changes in the components of accumulated other comprehensive income (loss), included in stockholders' equity, are as follows:

(In Thousands)	Unrealized Holding Gains (Losses) on Securities	Unfunded Retirement Obligations	Accumulated Other Comprehensive Income (Loss)
2012			
Balance, beginning of period	$ 10,791	$ (631)	$ 10,160
Change during year ended December 31, 2012	777	66	843
Balance, end of period	$ 11,568	$ (565)	$ 11,003

2011			
Balance, beginning of period	$ (1,351)	$ (250)	$ (1,601)
Change during year ended December 31, 2011	12,142	(381)	11,761
Balance, end of period	$ 10,791	$ (631)	$ 10,160
2010			
Balance, beginning of period	$ (522)	$ (369)	$ (891)
Change during year ended December 31, 2010	(829)	119	(710)
Balance, end of period	$ (1,351)	$ (250)	$ (1,601)

4. PER SHARE DATA

Net income per share is based on the weighted-average number of shares of common stock outstanding. The following data show the amounts used in computing basic and diluted net income per share. As shown in the table that follows, diluted earnings per share is computed using weighted average common shares outstanding, plus weighted-average common shares available from the exercise of all dilutive stock options, less the number of shares that could be repurchased with the proceeds of stock option exercises based on the average share price of the Corporation's common stock during the period.

	Net Income	Weighted-Average Common Shares	Earnings Per Share
2012			
Earnings per share – basic	$22,705,000	12,235,748	$ 1.86
Dilutive effect of potential common stock arising from stock options:			
Exercise of outstanding stock options		200,589	
Hypothetical share repurchase at $ 19.16		(176,129)	
Earnings per share – diluted	$22,705,000	12,260,208	$ 1.85
2011			
Earnings per share – basic	$23,368,000	12,162,045	$ 1.92
Dilutive effect of potential common stock arising from stock options:			
Exercise of outstanding stock options		92,398	
Hypothetical share repurchase at $ 15.87		(87,675)	
Earnings per share – diluted	$23,368,000	12,166,768	$ 1.92
2010			
Earnings per common share – basic and diluted	$17,581,000	12,131,039	$ 1.45

Stock options and a warrant that were anti-dilutive were excluded from net income per share calculations. Weighted-average common shares available from anti-dilutive instruments totaled 145,333 shares in 2012, 223,333 shares in 2011 and 359,092 shares in 2010.

5. CASH AND DUE FROM BANKS

Cash and due from banks at December 31, 2012 and 2011 include the following:

(In thousands)	Dec. 31, 2012	Dec. 31, 2011
Cash and cash equivalents	$55,016	$56,815
Certificates of deposit	4,820	3,760
Total cash and due from banks	$59,836	$60,575

Certificates of deposit are issues by U.S. banks with original maturities greater than three months. Each certificate of deposit is fully FDIC-insured. The Corporation maintains cash and cash equivalents with certain financial institutions in excess of the FDIC insurance limit.

The Corporation is required to maintain reserves against deposit liabilities in the form of cash and balances with the Federal Reserve Bank. The reserves are based on deposit levels, account activity, and other services provided by the Federal Reserve Bank. Required reserves were $14,128,000 at December 31, 2012 and $14,035,000 at December 31, 2011.

6. FAIR VALUE MEASUREMENTS AND FAIR VALUES OF FINANCIAL INSTRUMENTS

The Corporation measures certain assets at fair value. Fair value is defined as the price that would be received to sell an asset in an orderly transaction between market participants at the measurement date. FASB ASC topic 820, “Fair Value Measurements and Disclosures” establishes a framework for measuring fair value that includes a hierarchy used to classify the inputs used in measuring fair value. The hierarchy prioritizes the inputs used in determining valuations into three levels. The level in the fair value hierarchy within which the fair value measurement falls is determined based on the lowest level input that is significant to the fair value measurement. The levels of the fair value hierarchy are as follows:

Level 1 – Fair value is based on unadjusted quoted prices in active markets that are accessible to the Corporation for identical assets. These generally provide the most reliable evidence and are used to measure fair value whenever available.

Level 2 – Fair value is based on significant inputs, other than Level 1 inputs, that are observable either directly or indirectly for substantially the full term of the asset through corroboration with observable market data. Level 2 inputs include quoted market prices in active markets for similar assets, quoted market prices in markets that are not active for identical or similar assets and other observable inputs.

Level 3 – Fair value is based on significant unobservable inputs. Examples of valuation methodologies that would result in Level 3 classification include option pricing models, discounted cash flows and other similar techniques.

The Corporation monitors and evaluates available data relating to fair value measurements on an ongoing basis and recognizes transfers among the levels of the fair value hierarchy as of the date of an event or change in circumstances that affects the valuation method chosen. Examples of such changes may include the market for a particular asset becoming active or inactive, changes in the availability of quoted prices, or changes in the availability of other market data.

At December 31, 2012 and 2011, assets measured at fair value and the valuation methods used are as follows:

		December 31, 2012		
	Quoted Prices in Active Markets	Other Observable Inputs	Unobservable Inputs	Total Fair

(In Thousands)	(Level 1)	(Level 2)	(Level 3)	Value
Recurring fair value measurements				
AVAILABLE-FOR-SALE SECURITIES:				
Obligations of U.S. Government agencies	$ 0	$31,217	$ 0	$31,217
Obligations of states and political subdivisions:				
Tax-exempt	0	137,020	0	137,020
Taxable	0	24,817	0	24,817
Mortgage-backed securities	0	80,196	0	80,196
Collateralized mortgage obligations,				
Issued by U.S. Government agencies	0	183,510	0	183,510
Trust preferred securities issued by individual institutions	0	5,171	0	5,171
Collateralized debt obligations:				
Pooled trust preferred securities - senior tranches	0	0	1,613	1,613
Other collateralized debt obligations	0	660	0	660
Total debt securities	0	462,591	1,613	464,204
Marketable equity securities	8,373	0	0	8,373
Total available-for-sale securities	8,373	462,591	1,613	472,577
Servicing rights	0	0	605	605
Total recurring fair value measurements	$ 8,373	$462,591	$ 2,218	$473,182
Nonrecurring fair value measurements				
Impaired loans with a valuation allowance	$ 0	$0	$ 2,710	$2,710
Valuation allowance	0	0	(623)	(623)
Impaired loans, net	0	0	2,087	2,087
Foreclosed assets held for sale	0	0	879	879
Total nonrecurring fair value measurements	$ 0	$0	$ 2,966	$2,966

(In Thousands)	December 31, 2011 Quoted Prices in Active Markets (Level 1)	Other Observable Inputs (Level 2)	Unobservable Inputs (Level 3)	Total Fair Value
Recurring fair value measurements				
AVAILABLE-FOR-SALE SECURITIES:				
Obligations of U.S. Government agencies	$ 0	$25,587	$ 0	$25,587
Obligations of states and political subdivisions:				
Tax-exempt	0	132,962	0	132,962
Taxable	0	14,334	0	14,334
Mortgage-backed securities	0	121,769	0	121,769
Collateralized mortgage obligations,				
Issued by U.S. Government agencies	0	165,131	0	165,131
Trust preferred securities issued by individual institutions	0	8,146	0	8,146
Collateralized debt obligations:				
Pooled trust preferred securities - senior tranches	0	0	4,638	4,638
Pooled trust preferred securities - mezzanine tranches	0	0	730	730
Other collateralized debt obligations	0	660	0	660
Total debt securities	0	468,589	5,368	473,957
Marketable equity securities	7,728	0	0	7,728
Total available-for-sale securities	7,728	468,589	5,368	481,685
Servicing rights	0	0	375	375
Total recurring fair value measurements	$ 7,728	$468,589	$ 5,743	$482,060
Nonrecurring fair value measurements				
Impaired loans with a valuation allowance	$ 0	$0	$ 3,433	$3,433
Valuation allowance	0	0	(1,126)	(1,126)
Impaired loans, net	0	0	2,307	2,307
Foreclosed assets held for sale	0	0	1,235	1,235
Total nonrecurring fair value measurements	$ 0	$0	$ 3,542	$3,542

Management determined there have been few trades of pooled trust-preferred securities since 2008, except for a limited number of transactions that have taken place as a result of bankruptcies, forced liquidations or similar circumstances. Also, in management's judgment, there were no available quoted market prices in active markets for assets sufficiently similar to the Corporation's pooled trust-preferred securities to be reliable as observable inputs. Accordingly, the Corporation follows a method of valuing pooled trust-preferred securities using a Level 3 methodology, based on discounted cash flows.

Management has calculated the fair value of the Corporation's pooled trust-preferred securities by applying a discount rate to the estimated cash flows. Management used the cash flow estimates determined using the process described in Note 7 for evaluating pooled trust-preferred securities for other-than-temporary impairment (OTTI). Management used discount rates considered reflective of a market participant's expectations regarding the extent of credit and liquidity risk inherent in the securities. In establishing the discount rate, management considered: (1) the implied discount rates as of the end of 2007, prior to the market for trust-preferred securities becoming inactive; (2) an adjustment to the year-end 2007 discount rates for the change in the spread between indicative market rates and corresponding risk-free rates; and (3) an additional adjustment for liquidity risk. Management considered the adjustment for liquidity risk necessary in order to give some consideration to price estimates based on trades made under distressed conditions, as reported by brokers and pricing services.

Loans are classified as impaired when, based on current information and events, it is probable that the Corporation will be unable to collect the scheduled payments of principal or interest when due according to the contractual terms of the loan agreement. Foreclosed assets held for sale consist of real estate acquired by foreclosure. For impaired commercial loans secured by real estate and foreclosed assets held for sale, estimated fair values are determined primarily using values from third-party appraisals less estimated selling costs.

Management's evaluation and selection of valuation techniques and the unobservable inputs used in determining the fair values of assets valued using Level 3 methodologies include sensitive assumptions. Other market participants might use substantially different assumptions, which could result in calculations of fair values that would be substantially different than the amount calculated by management. The following table shows quantitative information regarding significant techniques and inputs used at December 31, 2012 for assets measured using unobservable inputs (Level 3 methodologies) on a recurring basis:

Asset	Fair Value at 12/31/12 (In Thousands)	Valuation Technique	Unobservable Input(s)	Method or Value As of 12/31/12		
Pooled trust preferred securities - senior tranches	$ 1,613	Discounted cash flow	Issuer defaults	50.26	%	Actual deferrals and defaults as % of outstanding collateral
				19.73	%	Expected additional net deferrals and defaults as % of performing collateral
			Issuer prepayments	41.24	%	Expected issuer prepayments as % of performing collateral
			Discount rate	11.70	%	Implied 7.57% discount rate at 12/31/07 plus 4.13% spread for credit and liquidity risk
Servicing rights	605	Discounted cash flow	Discount rate	12.00	%	Rate used through modeling period
			Loan prepayment speeds	288.00	%	Weighted-average PSA
			Servicing fees	0.25	%	of loan balances
				5.00	%	of payments are late
				5.00	%	late fees assessed
				$1.94		Miscellaneous fees per account per month
			Servicing costs	$6.00		Monthly servicing cost per account
				$24.00		Additional monthly servicing cost per loan on loans more than 30 days delinquent
				1.50	%	of loans more than 30 days delinquent
				3.00	%	annual increase in servicing costs

Increases (decreases) in actual or expected issuer defaults tend to decrease (increase) the fair value of the Corporation's pooled trust preferred securities. The fair value of servicing rights is affected by expected future interest rates. Increases (decreases) in future expected interest rates tend to increase (decrease) the fair value of the Corporation's servicing rights because of changes in expected prepayment behavior by the borrowers on the underlying loans.

Following is a reconciliation of activity for Level 3 assets measured at fair value on a recurring basis:

	Year Ended December 31, 2012			
(In Thousands)	Pooled Trust Preferred Securities - Senior Tranches	Pooled Trust Preferred Securities - Mezzanine Tranches	Servicing Rights	Total
Balance, beginning of period	$4,638	$ 730	$ 375	$5,743
Issuances of servicing rights	0	0	327	327
Accretion and amortization, net	(8)	0	0	(8)
Proceeds from sales and calls	(3,429)	(1,835)	0	(5,264)
Realized gains, net	56	1,835	0	1,891
Unrealized losses included in earnings	0	0	(97)	(97)
Unrealized gains (losses) included in other comprehensive income	356	(730)	0	(374)
Balance, end of period	$1,613	$ 0	$ 605	$2,218

	Year Ended December 31, 2011			
	Pooled Trust Preferred Securities - Senior Tranches	Pooled Trust Preferred Securities - Mezzanine Tranches	Servicing Rights	Total
Balance, beginning of period	$7,400	$ 0	$ 204	$7,604
Issuances of servicing rights	0	0	239	239
Accretion and amortization, net	(41)	0	0	(41)
Proceeds from sales and calls	(5,001)	(98)	0	(5,099)
Realized gains, net	81	98	0	179
Unrealized losses included in earnings	0	0	(68)	(68)
Unrealized gains included in other comprehensive income	2,199	730	0	2,929
Balance, end of period	$4,638	$ 730	$ 375	$5,743

	Year Ended December 31, 2010				
	Pooled Trust Preferred Securities - Senior Tranches	Pooled Trust Preferred Securities - Mezzanine Tranches	Trust Preferred Securities Issued by Individual Institutions	Servicing Rights	Total
Balance, beginning of period	$8,199	$ 115	$ 800	$ 0	$9,114
Issuances of servicing rights	0	0	0	216	216
Transfers	0	0	(240)	0	(240)
Accretion and amortization, net	(117)	(162)	0	0	(279)
Proceeds from sales and calls	(1,309)	(310)	(240)	0	(1,859)
Realized gains, net	0	310	0	0	310
Unrealized losses included in earnings	0	(103)	(320)	(12)	(435)
Unrealized gains included in other comprehensive income	627	150	0	0	777
Balance, end of period	$7,400	$ 0	$ 0	$ 204	$7,604

No other-than-temporary impairment losses on securities valued using Level 3 methodologies were recorded in 2012 or 2011. Unrealized losses included in earnings shown above include other-than-temporary impairment losses on securities valued using Level 3 methodologies, as described in Note 7, of $423,000 in 2010, which are presented in net impairment losses recognized in earnings in the Consolidated Statements of Income.

Certain of the Corporation's financial instruments are not measured at fair value in the consolidated financial statements. In cases where quoted market prices are not available, fair values are based on estimates using present value or other valuation techniques. Those techniques are significantly affected by the assumptions used, including the discount rate and estimates of future cash flows. Accordingly, the fair value estimates may not be realized in an immediate settlement of the instrument. Certain financial instruments and all nonfinancial instruments are excluded from disclosure requirements. Therefore, the aggregate fair value amounts presented may not represent the underlying fair value of the Corporation.

The Corporation used the following methods and assumptions in estimating fair value disclosures for financial instruments:

CASH AND CASH EQUIVALENTS - The carrying amounts of cash and short-term instruments approximate fair values.

CERTIFICATES OF DEPOSIT - Fair values for certificates of deposit, included in cash and due from banks in the consolidated balance sheet, are based on quoted market prices for certificates of similar remaining maturities.

SECURITIES - Fair values for securities, excluding restricted equity securities, are based on quoted market prices or other methods as described above. The carrying value of restricted equity securities approximates fair value based on applicable redemption provisions.

LOANS HELD FOR SALE - Fair values of loans held for sale are determined based on applicable sale prices available under the Federal Home Loan Banks’ MPF Xtra program.

LOANS - Fair values are estimated for portfolios of loans with similar financial characteristics. Loans are segregated by type such as commercial, commercial real estate, residential mortgage and other consumer. Each loan category is further segmented into fixed and adjustable rate interest terms and by performing and nonperforming categories. The fair value of performing loans is calculated by discounting contractual cash flows, adjusted for estimated prepayments based on historical experience, using estimated market discount rates that reflect the credit and interest rate risk inherent in the loans. Fair value of nonperforming loans is based on recent appraisals or estimates prepared by the Corporation’s lending officers.

SERVICING RIGHTS - The fair value of servicing rights, included in other assets in the consolidated balance sheet, is determined through a discounted cash flow valuation. Significant inputs include expected net servicing income, the discount rate and the expected prepayment speeds of the underlying loans.

DEPOSITS - The fair value of deposits with no stated maturity, such as noninterest-bearing demand deposits, savings, money market and interest checking accounts, is (by definition) equal to the amount payable on demand at December 31, 2012 and 2011. The fair value of time deposits, such as certificates of deposit and Individual Retirement Accounts, is based on the discounted value of contractual cash flows. The discount rate is estimated using the rates currently offered for deposits of similar remaining maturities. The fair value estimates of deposits do not include the benefit that results from the low-cost funding provided by the deposit liabilities compared to the cost of borrowing funds in the market, commonly referred to as the core deposit intangible.

BORROWED FUNDS - The fair value of borrowings is estimated using discounted cash flow analyses based on rates currently available to the Corporation for similar types of borrowing arrangements.

ACCRUED INTEREST - The carrying amounts of accrued interest receivable and payable approximate fair values.

OFF-BALANCE SHEET COMMITMENTS - The Corporation has commitments to extend credit and has issued standby letters of credit. Standby letters of credit are conditional guarantees of performance by a customer to a third party. Estimates of the fair value of these off-balance sheet items were not made because of the short-term nature of these arrangements and the credit standing of the counterparties.

The estimated fair values, and related carrying amounts, of the Corporation’s financial instruments are as follows:

(In Thousands)	Valuation	December 31, 2012		December 31, 2011	
	Method(s)	Carrying	Fair	Carrying	Fair

	Used	Amount	Value	Amount	Value
Financial assets:					
Cash and cash equivalents	Level 1	$55,016	$55,016	$56,815	$56,815
Certificates of deposit	Level 2	4,820	4,860	3,760	3,683
Available-for-sale securities	See Above	472,577	472,577	481,685	481,685
Restricted equity securities (included in Other Assets)	Level 2	4,842	4,842	6,773	6,773
Loans held for sale	Level 1	2,545	2,545	939	939
Loans, net	Level 3	677,053	693,047	700,610	718,670
Accrued interest receivable	Level 1	4,281	4,281	4,797	4,797
Servicing rights	Level 3	605	605	375	375
Financial liabilities:					
Deposits with no stated maturity	Level 1	693,687	693,687	677,461	677,461
Time deposits	Level 3	312,419	315,005	340,745	344,936
Short-term borrowings	Level 3	5,567	5,527	4,950	4,897
Long-term borrowings	Level 3	83,812	96,032	125,363	145,641
Accrued interest payable	Level 1	137	137	358	358

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7. SECURITIES

Amortized cost and fair value of available-for-sale securities at December 31, 2012 and 2011 are summarized as follows:

	December 31, 2012			
(In Thousands)	Amortized Cost	Gross Unrealized Holding Gains	Gross Unrealized Holding Losses	Fair Value
Obligations of U.S. Government agencies	$ 30,695	$ 572	$ (50)	$ 31,217
Obligations of states and political subdivisions:				
Tax-exempt	130,168	7,030	(178)	137,020
Taxable	24,426	462	(71)	24,817
Mortgage-backed securities	76,368	3,828	0	80,196
Collateralized mortgage obligations,				
Issued by U.S. Government agencies	179,770	3,887	(147)	183,510
Trust preferred securities issued by individual institutions	5,167	4	0	5,171
Collateralized debt obligations:				
Pooled trust preferred securities - senior tranches	1,615	0	(2)	1,613
Other collateralized debt obligations	660	0	0	660
Total debt securities	448,869	15,783	(448)	464,204
Marketable equity securities	5,912	2,500	(39)	8,373
Total	$ 454,781	$ 18,283	$ (487)	$ 472,577

	December 31, 2011			
(In Thousands)	Amortized Cost	Gross Unrealized Holding Gains	Gross Unrealized Holding Losses	Fair Value
Obligations of U.S. Government agencies	$ 24,877	$ 710	$ 0	$ 25,587
Obligations of states and political subdivisions:				
Tax-exempt	129,401	4,891	(1,330)	132,962
Taxable	14,004	334	(4)	14,334
Mortgage-backed securities	116,602	5,167	0	121,769
Collateralized mortgage obligations,				
Issued by U.S. Government agencies	161,818	3,350	(37)	165,131
Trust preferred securities issued by individual institutions	7,334	865	(53)	8,146
Collateralized debt obligations:				
Pooled trust preferred securities - senior tranches	4,996	0	(358)	4,638
Pooled trust preferred securities - mezzanine tranches	0	730	0	730

Other collateralized debt obligations	660	0	0	660
Total debt securities	459,692	16,047	(1,782)	473,957
Marketable equity securities	5,643	2,186	(101)	7,728
Total	$ 465,335	$ 18,233	$ (1,883)	$ 481,685

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The following table presents gross unrealized losses and fair value of available-for-sale securities with unrealized loss positions that are not deemed to be other-than-temporarily impaired, aggregated by length of time that individual securities have been in a continuous unrealized loss position at December 31, 2012 and 2011:

December 31, 2012 (In Thousands)	Less Than 12 Months Fair Value	 Unrealized Losses	12 Months or More Fair Value	 Unrealized Losses	Total Fair Value	 Unrealized Losses
Obligations of U.S. Government agencies	$ 10,006	$ (50)	$ 0	$ 0	$ 10,006	$ (50)
Obligations of states and political subdivisions:						
Tax-exempt	7,082	(92)	3,285	(86)	10,367	(178)
Taxable	4,149	(71)	0	0	4,149	(71)
Collateralized mortgage obligations,						
Issued by U.S. Government agencies	16,755	(146)	454	(1)	17,209	(147)
Collateralized debt obligations,						
Pooled trust preferred securities - senior tranches	0	0	1,613	(2)	1,613	(2)
Total debt securities	37,992	(359)	5,352	(89)	43,344	(448)
Marketable equity securities	95	(6)	67	(33)	162	(39)
Total temporarily impaired available-for-sale securities	$ 38,087	$ (365)	$ 5,419	$ (122)	$ 43,506	$ (487)

December 31, 2011 (In Thousands)	Less Than 12 Months Fair Value	 Unrealized Losses	12 Months or More Fair Value	 Unrealized Losses	Total Fair Value	 Unrealized Losses
Obligations of states and political subdivisions:						
Tax-exempt	$ 4,301	$ (34)	$ 20,692	$ (1,296)	$ 24,993	$ (1,330)
Taxable	927	(2)	244	(2)	1,171	(4)
Collateralized mortgage obligations,						
Issued by U.S. Government agencies	6,886	(36)	5,075	(1)	11,961	(37)
Trust preferred securities issued by individual institutions	0	0	947	(53)	947	(53)
Collateralized debt obligations,						
Pooled trust preferred securities - senior tranches	0	0	4,638	(358)	4,638	(358)
Total debt securities	12,114	(72)	31,596	(1,710)	43,710	(1,782)
Marketable equity securities	776	(44)	98	(57)	874	(101)
Total temporarily impaired available-for-sale securities	$ 12,890	$ (116)	$ 31,694	$ (1,767)	$ 44,584	$ (1,883)

Gross realized gains and losses from available-for-sale securities (including OTTI losses in gross realized losses) and the related income tax provision were as follows:

(In Thousands)

	2012	2011	2010
Gross realized gains	$2,798	$2,226	$1,270
Gross realized losses	(116)	(10)	(441)
Net realized gains	$2,682	$2,216	$829
Income tax provision related to net realized gains	$939	$753	$282

The amortized cost and fair value of available-for-sale debt securities by contractual maturity are shown in the following table as of December 31, 2012. 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)	Amortized Cost	Fair Value
Due in one year or less	$ 13,096	$ 13,315
Due from one year through five years	51,586	52,896
Due from five years through ten years	50,518	51,657
Due after ten years	77,531	82,630
Subtotal	192,731	200,498
Mortgage-backed securities	76,368	80,196
Collateralized mortgage obligations, Issued by U.S. Government agencies	179,770	183,510
Total	$ 448,869	$ 464,204

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. In the table above, mortgage-backed securities and collateralized mortgage obligations are shown in one period.

Investment securities carried at $293,310,000 at December 31, 2012 and $266,149,000 at December 31, 2011 were pledged as collateral for public deposits, trusts and certain other deposits as provided by law. See Note 12 for information concerning securities pledged to secure borrowing arrangements.

Management evaluates securities for OTTI at least on a quarterly basis, and more frequently when economic or market conditions warrant such 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.

The Corporation recognized net impairment losses in earnings, as follows:

(In Thousands)	2012	2011	2010
Trust preferred securities issued by individual institutions	$ 0	$ 0	$ (320)
Pooled trust preferred securities - mezzanine tranches	0	0	(103)

Marketable equity securities (bank stocks)	(67)	0	(10)
Net impairment losses recognized in earnings	$(67)	$ 0	$(433)

A summary of information management considered in evaluating debt and equity securities for OTTI at December 31, 2012 is provided below.

Debt Securities

At December 31, 2012, management performed an assessment for possible OTTI of the Corporation's debt securities on an issue-by-issue basis, relying on information obtained from various sources, including publicly available financial data, ratings by external agencies, brokers and other sources. The extent of individual analysis applied to each security depended on the size of the Corporation's investment, as well as management's perception of the credit risk associated with each security. Based on the results of the assessment, management believes impairment of these debt securities, including municipal bonds with no external ratings, at December 31, 2012 to be temporary.

The credit rating agencies have withdrawn their ratings on numerous municipal bonds held by the Corporation. At December 31, 2012, the total amortized cost basis of municipal bonds with no external credit ratings was $21,396,000, with an aggregate unrealized gain of $311,000. At the time of purchase, each of these bonds was considered investment grade and had been rated by at least one credit rating agency. The bonds for which the ratings were removed were almost all insured by an entity that has reported significant financial problems and declines in its regulatory capital ratios, and most of the ratings were removed in the fourth quarter 2009. However, the insurance remains in effect on the bonds, and none of the affected municipal bonds has failed to make a scheduled interest payment.

The following table provides detailed information related to a security issued by Astoria Capital Trust I, a subsidiary of Astoria Financial Corporation, which is the only trust preferred security issued by an individual institution held by the Corporation as of December 31, 2012:

Par Amount Outstanding	$5,000
Amortized Cost	5,167
Fair Value	5,171
Unrealized Gain	4
Cumulative Realized Credit Losses	0
Moody's Credit Rating	Ba1
S&P Credit Rating	BB
Fitch Credit Rating	B+

Management assesses the security shown above for the possibility of OTTI by reviewing financial information that is publicly available. Astoria Financial Corporation has not deferred or defaulted on payments associated with the Corporation's security.

The Corporation recognized OTTI charges in 2009 and 2010 related to 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. After the acquisition, The Toronto-Dominion Bank 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 in the fourth quarter 2010. The security had a face amount of $2,000,000 and matured in May 2012. The Corporation recorded accretion income (included in interest income) totaling $855,000 in 2012, $825,000 in 2011 and $83,000 in 2010.

Pooled trust-preferred securities are very long-term (usually 30-year maturity) instruments. Each pool contains debt securities issued by banks and/or insurance companies. The Corporation's investments in pooled trust-preferred securities are each made up of companies with geographic and size diversification. Most of the underlying debt securities are issued by banking companies, with a lesser amount issued by insurance companies. Trust-preferred securities typically permit deferral of quarterly interest payments for up to five years. Some of the issuers of trust-preferred securities that are included in the Corporation's pooled investments have elected to defer payment of interest on these obligations, and some issuers have defaulted.

Management evaluated pooled trust-preferred securities for OTTI by estimating the cash flows expected to be received from each security, taking into account estimated levels of deferrals and defaults by the underlying issuers. In determining cash flows, management assumed all issuers currently deferring or in default would make no future payments, and assigned estimated future default levels for the remaining issuers in each security based on financial strength ratings assigned by a national ratings service. Management's estimates of cash flows used to evaluate other-than-temporary impairment of pooled trust-preferred securities were based on sensitive assumptions regarding the timing and amounts of defaults that may occur, and changes in the assumptions used could produce different conclusions for each security. Additional information regarding these assumptions is included in Note 6.

During the third quarter 2012, management sold the Corporation's holdings of the mezzanine tranches of U.S. Capital Funding II, Ltd. The securities were sold for aggregate pretax proceeds of $1,754,000, which was recorded as a gain on the sale of securities. During the first quarter 2011, management sold the Corporation's holding of the mezzanine tranche of MMCAPS Funding I, Ltd. The security was sold for aggregate pretax proceeds of $1,485,000, which was recorded as a gain on the sale of securities.

The following table provides detailed information related to ALESCO Preferred Funding IX, Ltd., which is the only mezzanine tranche pooled trust preferred security held by the Corporation as of December 31, 2012:

Tranche	C-1
Original Face Amount	$3,000
Amortized Cost	0
Fair Value	0
Unrealized Gain	0
Cumulative OTTI	$(2,988)

As of December 31, 2012, the Corporation’s investment in the senior tranche of MMCAPS Funding I, Ltd. is the only senior tranche pooled trust preferred security held by the Corporation. The security, with an amortized cost of $1,615,000, has an investment grade rating and has been subjected to impairment analysis based on estimated cash flows (using the process described above). Management determined that impairment was temporary as of December 31, 2012. The following table provides detailed information related to this security:

Number of Issuers Currently Performing	8
Moody's Credit Rating	A3
Fitch Credit Rating	A
Actual Deferrals and Defaults as % of Outstanding Collateral	50.26%
Expected Additional Net Deferrals and Defaults as % of Performing Collateral	19.73%
Excess Subordination as % of Performing Collateral	67.90%
Expected Issuer Prepayments as % of Performing Collateral	41.24%

In the table above, “Excess Subordination as % of Performing Collateral” (Excess Subordination Ratio) was calculated as follows: (Total face value of performing collateral – Face value of all outstanding note balances not subordinate to the Corporation’s investment)/Total face value of performing collateral.

The Excess Subordination Ratio measures the extent to which there may be tranches within the pooled trust preferred structure available to absorb credit losses before the Corporation’s security would be impacted. A positive Excess Subordination Ratio signifies there is available support from subordinate tranches to absorb losses before the Corporation’s investment would be impacted. A negative Excess Subordination Ratio signifies there is no available support from subordinate tranches to absorb losses before the Corporation’s securities would be impacted. The Excess Subordination Ratio is not definitive, in isolation, for determining OTTI or whether the Corporation will receive future payments on a pooled trust preferred security. Other factors affect the timing and amount of cash flows available for payments to the note holders (investors), including the excess interest paid by the issuers, who typically pay higher rates of interest than are paid out to the note holders.

The Corporation separates OTTI related to the trust-preferred securities into (a) the amount of the total impairment related to credit loss, which is recognized in the statement of earnings, and (b) the amount of the total impairment related to all other factors, which is recognized in other comprehensive income. The Corporation measures the credit loss component of OTTI based on the difference between: (1) the present value of estimated cash flows, at the book yield in effect prior to recognition of any OTTI, as of the most recent balance sheet date, and (2) the present value of estimated cash flows as of the previous quarter-end balance sheet date based on management’s cash flow assumptions at that time.

The Corporation recorded no OTTI losses related to pooled trust-preferred securities in 2012 or 2011. Total OTTI from pooled trust-preferred securities in 2010 amounted to $51,000, including a pre-tax loss reflected in earnings of $103,000, with a pre-tax other comprehensive gain of $52,000 included in other comprehensive income.

A roll-forward of the credit losses from securities for which a portion of OTTI has been recognized in other comprehensive income is as follows:

(In Thousands)	2012	2011	2010
Balance of credit losses on debt securities for which a portion of OTTI was recognized in other comprehensive income, beginning of period	$ 0	$ 0	$(10,695)
Reduction for securities losses realized during the period	0	0	10,798
Additional credit loss for which an OTTI was previously recognized when the Corporation does not intend to sell the security and it is not more likely than not the Corporation will be required to sell the security before recovery of its amortized cost basis	0	0	(103)
Balance of credit losses on debt securities for which a portion of OTTI was recognized in other comprehensive income, end of period	$ 0	$ 0	$0

The line item labeled “Reduction for securities losses realized during the period” in the table immediately above includes OTTI write-downs associated with securities the Corporation continues to hold, but which have been deemed worthless.