

CITIZENS & NORTHERN CORP
Form 10-Q
May 07, 2010

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended March 31, 2010
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: 000-16084

CITIZENS & NORTHERN CORPORATION
(Exact name of Registrant as specified in its charter)
PENNSYLVANIA 23-2451943
(State or other jurisdiction of (I.R.S. Employer
incorporation or organization) 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)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes No

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

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of "accelerated filer and large accelerated filer" in Rule 12b-2 of the Exchange Act. (Check one):
Large accelerated filer Accelerated filer Non-accelerated filer

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

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

Common Stock (\$1.00 par value)

12,120,024 Shares Outstanding on May 4, 2010

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CITIZENS & NORTHERN
CORPORATION
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PART 1 - FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

Consolidated Balance Sheet (In Thousands Except Share Data)

| | March 31, 2010 (Unaudited) | December 31, 2009 (Note) |
|--|----------------------------------|--------------------------------|
| ASSETS | | |
| Cash and due from banks: | | |
| Noninterest-bearing | \$16,474 | \$18,247 |
| Interest-bearing | 60,700 | 73,818 |
| Total cash and cash equivalents | 77,174 | 92,065 |
| Trading securities | 0 | 1,045 |
| Available-for-sale securities | 436,297 | 396,288 |
| Held-to-maturity securities | 0 | 300 |
| Loans, net | 711,996 | 713,338 |
| Bank-owned life insurance | 22,910 | 22,798 |
| Accrued interest receivable | 5,627 | 5,613 |
| Bank premises and equipment, net | 23,872 | 24,316 |
| Foreclosed assets held for sale | 669 | 873 |
| Deferred tax asset, net | 21,957 | 22,037 |
| Intangible asset - Core deposit intangibles | 458 | 502 |
| Intangible asset - Goodwill | 11,942 | 11,942 |
| Other assets | 34,409 | 30,678 |
| TOTAL ASSETS | \$1,347,311 | \$1,321,795 |
| LIABILITIES | | |
| Deposits: | | |
| Noninterest-bearing | \$150,130 | \$137,470 |
| Interest-bearing | 802,341 | 789,319 |
| Total deposits | 952,471 | 926,789 |
| Dividends payable | 169 | 169 |
| Short-term borrowings | 36,443 | 39,229 |
| Long-term borrowings | 196,032 | 196,242 |
| Accrued interest and other liabilities | 6,712 | 6,956 |
| TOTAL LIABILITIES | 1,191,827 | 1,169,385 |
| STOCKHOLDERS' EQUITY | | |
| Preferred stock, \$1,000 par value; authorized 30,000 shares; \$1,000 liquidation preference per share; 26,440 shares issued at March 31, 2010 and December 31, 2009 | 25,791 | 25,749 |
| Common stock, par value \$1.00 per share; authorized 20,000,000 shares in 2010 and 2009; issued 12,374,481 at March 31, 2010 and December 31, 2009 | 12,374 | 12,374 |
| Paid-in capital | 66,772 | 66,833 |
| Retained earnings | 56,123 | 53,027 |
| Unamortized stock compensation | (179) | (107) |
| Treasury stock, at cost; 254,457 shares at March 31, 2010 and 262,780 shares at December 31, 2009 | (4,429) | (4,575) |
| Sub-total | 156,452 | 153,301 |
| Accumulated other comprehensive loss: | (718) | (522) |

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Unrealized losses on available-for-sale securities (including an unrealized gain of \$1 at March 31, 2010 and an unrealized loss of \$100 at December 31, 2009 for which a portion of an other-than-temporary impairment loss has been recognized in earnings)

| | | |
|--|-------------|-------------|
| Defined benefit plans | (250) | (369) |
| Total accumulated other comprehensive loss | (968) | (891) |
| TOTAL STOCKHOLDERS' EQUITY | 155,484 | 152,410 |
| TOTAL LIABILITIES & STOCKHOLDERS' EQUITY | \$1,347,311 | \$1,321,795 |

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

Note: The balance sheet at December 31, 2009 has been derived from the audited financial statements at that date but does not include all the information and notes required by U.S. generally accepted accounting principles for complete financial statements.

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CONSOLIDATED STATEMENT OF OPERATIONS

(In Thousands, Except Per Share Data) (Unaudited)

| | 3 Months Ended | |
|---|-------------------|-------------------|
| | March 31, 2010 | March 31, 2009 |
| INTEREST INCOME | | |
| Interest and fees on loans | \$10,950 | \$11,357 |
| Interest on balances with depository institutions | 38 | 1 |
| Interest on loans to political subdivisions | 398 | 393 |
| Interest on federal funds sold | 0 | 8 |
| Interest on trading securities | 1 | 23 |
| Income from available-for-sale and held-to-maturity securities: | | |
| Taxable | 3,085 | 4,654 |
| Tax-exempt | 1,181 | 936 |
| Dividends | 80 | 199 |
| Total interest and dividend income | 15,733 | 17,571 |
| INTEREST EXPENSE | | |
| Interest on deposits | 3,157 | 3,981 |
| Interest on short-term borrowings | 100 | 170 |
| Interest on long-term borrowings | 2,003 | 2,455 |
| Total interest expense | 5,260 | 6,606 |
| Net interest margin | 10,473 | 10,965 |
| Provision (credit) for loan losses | 207 | (173) |
| Net interest margin after provision (credit) for loan losses | 10,266 | 11,138 |
| OTHER INCOME | | |
| Service charges on deposit accounts | 1,093 | 1,047 |
| Service charges and fees | 193 | 190 |
| Trust and financial management revenue | 899 | 769 |
| Insurance commissions, fees and premiums | 60 | 81 |
| Increase in cash surrender value of life insurance | 112 | 151 |
| Other operating income | 1,088 | 528 |
| Sub-total | 3,445 | 2,766 |
| Total other-than-temporary impairment losses on available-for-sale securities | (381) | (24,981) |
| Portion of (gain) loss recognized in other comprehensive (loss) income (before taxes) | (50) | 8,301 |
| Net impairment losses recognized in earnings | (431) | (16,680) |
| Realized gains on available-for-sale securities, net | 489 | 1 |
| Net realized gains (losses) on available-for-sale securities | 58 | (16,679) |
| Total other income (loss) | 3,503 | (13,913) |
| OTHER EXPENSES | | |
| Salaries and wages | 3,078 | 3,341 |
| Pensions and other employee benefits | 939 | 1,244 |
| Occupancy expense, net | 699 | 742 |
| FDIC Assessments | 404 | 302 |
| Furniture and equipment expense | 568 | 674 |
| Pennsylvania shares tax | 305 | 318 |
| Other operating expense | 1,901 | 2,017 |
| Total other expenses | 7,894 | 8,638 |

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| | | |
|--|-----------|-----------|
| Income (loss) before income tax provision (credit) | 5,875 | (11,413) |
| Income tax provision (credit) | 1,437 | (4,388) |
| Net income (loss) | 4,438 | (7,025) |
| U.S. Treasury preferred dividends | 373 | 309 |
| NET INCOME (LOSS) AVAILABLE TO COMMON SHAREHOLDERS | \$4,065 | (\$7,334) |
| NET INCOME (LOSS) PER SHARE - BASIC | \$ 0.34\$ | (0.82) |
| NET INCOME (LOSS) PER SHARE - DILUTED | \$ 0.34\$ | (0.82) |

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

CITIZENS & NORTHERN CORPORATION – FORM 10-Q

CONSOLIDATED STATEMENT OF CASH FLOWS

(In Thousands) (Unaudited)

| | Three Months Ended March 31, | |
|--|------------------------------|---------------|
| | 2010 | 2009 |
| CASH FLOWS FROM OPERATING ACTIVITIES: | | |
| Net income (loss) | \$4,438 | (\$7,025) |
| Adjustments to reconcile net income (loss) to net cash provided by operating activities: | | |
| Provision (credit) for loan losses | 207 | (173) |
| Realized (gains) losses on available-for-sale securities, net | (58) | 16,679 |
| Loss (gain) on sale of foreclosed assets, net | 38 | (1) |
| Depreciation expense | 612 | 713 |
| (Gain) loss on disposition of premises and equipment | (430) | 10 |
| Accretion and amortization on securities, net | 609 | (50) |
| Accretion and amortization on loans, deposits and borrowings, net | (76) | (81) |
| Increase in cash surrender value of life insurance | (112) | (151) |
| Stock-based compensation | 13 | 190 |
| Amortization of core deposit intangibles | 44 | 80 |
| Deferred income taxes | 128 | (5,615) |
| Origination of mortgage loans for sale | (5,606) | (2,638) |
| Proceeds from sales of mortgage loans | 5,652 | 2,098 |
| Net decrease (increase) in trading securities | 1,045 | (379) |
| Increase in accrued interest receivable and other assets | (164) | (1,050) |
| Decrease in accrued interest payable and other liabilities | (32) | (950) |
| Net Cash Provided by Operating Activities | 6,308 | 1,657 |
| CASH FLOWS FROM INVESTING ACTIVITIES: | | |
| Proceeds from maturity of held-to-maturity securities | 300 | 1 |
| Proceeds from sales of available-for-sale securities | 9,140 | 6,430 |
| Proceeds from calls and maturities of available-for-sale securities | 44,617 | 14,224 |
| Purchase of available-for-sale securities | (97,858) | (31,369) |
| Purchase of Federal Home Loan Bank of Pittsburgh stock | 0 | (4) |
| Net decrease in loans | 1,054 | 12,126 |
| Purchase of premises and equipment | (228) | (368) |
| Return of principal on limited liability entity investments | 13 | 13 |
| Proceeds from disposition of premises and equipment | 100 | 0 |
| Proceeds from sale of foreclosed assets | 221 | 187 |
| Net Cash (Used in) Provided by Investing Activities | (42,641) | 1,240 |
| CASH FLOWS FROM FINANCING ACTIVITIES: | | |
| Net increase in deposits | 25,677 | 9,913 |
| Net (decrease) in short-term borrowings | (2,786) | (6,778) |
| Repayments of long-term borrowings | (149) | (415) |
| Issuance of US Treasury preferred stock and warrant | 0 | 26,409 |
| Sale of treasury stock | 0 | 13 |
| Tax benefit from compensation plans | 0 | 92 |
| US Treasury preferred dividends paid | (331) | (106) |
| Common dividends paid | (969) | (1,803) |
| Net Cash Provided by Financing Activities | 21,442 | 27,325 |
| (DECREASE) INCREASE IN CASH AND CASH EQUIVALENTS | (14,891) | 30,222 |

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| | | |
|--|----------|----------|
| CASH AND CASH EQUIVALENTS, BEGINNING OF YEAR | 92,065 | 24,028 |
| CASH AND CASH EQUIVALENTS, END OF PERIOD | \$77,174 | \$54,250 |

SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION:

| | | |
|--|---------|---------|
| Assets acquired through foreclosure of real estate loans | \$55 | \$945 |
| Interest paid | \$5,340 | \$6,503 |
| Income taxes paid | \$28 | \$0 |

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

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Consolidated Statement of Changes in Stockholders' Equity

Three Months Ended March 31, 2010 and 2009

(In Thousands Except Per Share Data)

(Unaudited)

| | Preferred Stock | Common Stock | Paid-in Capital | Retained Earnings | Accum. Other Comprehensive Loss | Unamortized Stock Compensation | Treasury Stock | Total |
|---|--------------------|-----------------|--------------------|----------------------|---------------------------------------|--------------------------------------|-------------------|-----------|
| Three Months Ended March 31, 2010: | | | | | | | | |
| Balance, December 31, 2009 | \$25,749 | \$12,374 | \$66,833 | \$53,027 | (\$891) | (\$107) | (\$4,575) | \$152,410 |
| Comprehensive income: | | | | | | | | |
| Net income | | | | 4,438 | | | | 4,438 |
| Unrealized loss on securities, net of reclassification and tax | | | | | (196) | | | (196) |
| Other comprehensive income related to defined benefit plans | | | | | 119 | | | 119 |
| Total comprehensive income | | | | | | | | 4,361 |
| Accretion of discount associated with U.S. Treasury preferred stock | 42 | | | (42) | | | | 0 |
| Cash dividends on U.S. Treasury preferred stock | | | | (331) | | | | (331) |
| Cash dividends declared on common stock, \$.08 per share | | | | (969) | | | | (969) |
| Restricted stock granted | | | (59) | | | (100) | 159 | 0 |
| Forfeiture of restricted stock | | | (2) | | | 15 | (13) | 0 |
| Stock-based compensation expense | | | | | | 13 | | 13 |
| Balance, March 31, 2010 | \$25,791 | \$12,374 | \$66,772 | \$56,123 | (\$968) | (\$179) | (\$4,429) | \$155,484 |
| Three Months Ended March 31, 2009: | | | | | | | | |
| Balance, December 31, 2008 | \$0 | \$9,284 | \$44,308 | \$97,757 | (\$23,214) | (\$48) | (\$6,061) | \$122,026 |
| Comprehensive loss: | | | | | | | | |
| Net loss | | | | (7,025) | | | | (7,025) |
| Unrealized gain on securities, net of reclassification and tax | | | | | 1,682 | | | 1,682 |
| Other comprehensive loss related to defined benefit plans | | | | | (159) | | | (159) |
| Total comprehensive loss | | | | | | | | (5,502) |
| Reclassify non-credit portion of other- than-temporary impairment losses recognized in prior period | | | | 2,378 | (2,378) | | | 0 |
| Issuance of U.S. Treasury preferred stock | 25,588 | | 821 | | | | | 26,409 |
| Accretion of discount associated with U.S. Treasury preferred stock | 34 | | | (34) | | | | 0 |
| Cash dividends on U.S. Treasury preferred stock | | | | (275) | | | | (275) |
| Cash dividends declared on common stock, \$.24 per share | | | | (2,148) | | | | (2,148) |
| Common shares issued for dividend reinvestment plan | | | (11) | | | | 352 | 341 |
| Common shares issued from treasury | | | | | | | | |

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| | | | | | | | | | | |
|--|----------|---------|----------|----------|------------|------|--|---------|-----------|-----------|
| related to exercise of stock options | | | | (3) | | | | 16 | 13 | |
| Restricted stock granted | | | | 10 | | (79) | | 69 | 0 | |
| Forfeiture of restricted stock | | | | (1) | | 3 | | (2) | 0 | |
| Stock-based compensation expense | | | | 170 | | | | 20 | 190 | |
| Tax benefit from employee benefit plan | | | | | | | | | 92 | |
| Balance, March 31, 2009 | \$25,622 | \$9,284 | \$45,294 | \$90,745 | (\$24,069) | | | (\$104) | (\$5,626) | \$141,146 |

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

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Notes to Consolidated Financial Statements

1. BASIS OF INTERIM PRESENTATION

The financial information included herein, with the exception of the consolidated balance sheet dated December 31, 2009, is unaudited; however, such information reflects all adjustments (consisting solely of normal recurring adjustments) that are, in the opinion of management, necessary for a fair presentation of the financial position, results of operations, cash flows and changes in stockholders' equity for the interim periods. Certain 2009 information has been reclassified for consistency with the 2010 presentation.

Results reported for the three months ended March 31, 2010 might not be indicative of the results for the year ending December 31, 2010.

This document has not been reviewed or confirmed for accuracy or relevance by the Federal Deposit Insurance Corporation or any other regulatory agency.

2. PER COMMON SHARE DATA

Basic net income (loss) per average common share represents income (loss) available to common shareholders divided by the weighted-average number of shares of common stock outstanding. For both the three months ended March 31, 2010 and 2009, outstanding stock options and the warrant (issued in January 2009) are anti-dilutive, and are therefore excluded in determining diluted loss per common share.

| | Net Income | Weighted- Average Common Shares | Earnings (Loss) Per Share |
|---|---------------|--|------------------------------------|
| Quarter Ended March 31, 2010 | | | |
| Earnings per common share – basic and diluted | \$4,065,000 | 12,113,584 | \$0.34 |
| Quarter Ended March 31, 2009 | | | |
| Loss per common share – basic and diluted | (\$7,334,000) | 8,956,076 | (\$0.82) |

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3. COMPREHENSIVE INCOME (LOSS)

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 comprehensive income (loss), and the related tax effects, are as follows:

| (In Thousands) | 3 Months Ended | |
|--|----------------|-----------|
| | March 31, | |
| | 2010 | 2009 |
| Net income (loss) | \$4,438 | (\$7,025) |
| Unrealized losses on available-for-sale securities: | | |
| Unrealized holding losses on available-for-sale securities | (247) | (14,130) |
| Reclassification adjustment for (gains) losses realized in income | (58) | 16,679 |
| Other comprehensive (loss) gain before income tax | (305) | 2,549 |
| Income tax related to other comprehensive (loss) gain | (109) | 867 |
| Other comprehensive (loss) gain on available-for-sale securities | (196) | 1,682 |
| Unfunded pension and postretirement obligations: | | |
| Change in items from defined benefit plans included in accumulated other comprehensive income (loss) | 166 | (253) |
| Amortization of net transition obligation, prior service cost and net actuarial loss included in net periodic benefit cost | 14 | 12 |
| Other comprehensive gain (loss) before income tax | 180 | (241) |
| Income tax related to other comprehensive gain (loss) | 61 | (82) |
| Other comprehensive gain (loss) on unfunded retirement obligations | 119 | (159) |
| Net other comprehensive (loss) gain | (77) | 1,523 |
| Total comprehensive income (loss) | \$4,361 | (\$5,502) |

In the three-month period ended March 31, 2010, the Corporation recognized other comprehensive gain of \$50,000 before income tax (\$33,000 after income tax) related to available-for-sale debt securities for which a portion of an OTTI loss has been recognized in earnings. In the three-month period March 31, 2009, the Corporation recognized other comprehensive loss of \$8,301,000 before income tax (\$5,479,000 after income tax) related to available-for-sale debt securities for which a portion of an OTTI loss has been recognized in earnings.

4. FAIR VALUE MEASUREMENTS AND FAIR VALUES OF FINANCIAL INSTRUMENTS

The Corporation measures certain assets at fair value on a recurring basis. 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" (formerly Statement of Financial Accounting Standards No. 157) 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.

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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.

At March 31, 2010 and December 31, 2009, assets measured at fair value on a recurring basis and the valuation methods used are as follows:

| (In Thousands) | March 31, 2010 Market Values Based on: | | | Total Fair Value |
|--|--|--|-------------------------------------|------------------------|
| | Quoted Prices in Active Markets (Level 1) | Other Observable Inputs (Level 2) | Unobservable Inputs (Level 3) | |
| AVAILABLE-FOR-SALE SECURITIES: | | | | |
| Obligations of other U.S. Government agencies | \$0 | \$63,808 | \$0 | \$63,808 |
| Obligations of states and political subdivisions | 314 | 103,951 | 0 | 104,265 |
| Mortgage-backed securities | 17,085 | 156,656 | 0 | 173,741 |
| Collateralized mortgage obligations: | | | | |
| Issued by U.S. Government agencies | 6,005 | 53,742 | 0 | 59,747 |
| Private label | 0 | 13,558 | 0 | 13,558 |
| Corporate bonds | 0 | 1,040 | 0 | 1,040 |
| Trust preferred securities issued by individual institutions | 0 | 5,197 | 480 | 5,677 |
| Collateralized debt obligations: | | | | |
| Pooled trust preferred securities - senior tranches | 0 | 0 | 8,064 | 8,064 |
| Pooled trust preferred securities - mezzanine tranches | 0 | 0 | 8 | 8 |
| Other collateralized debt obligations | 0 | 690 | 0 | 690 |
| Total debt securities | 23,404 | 398,642 | 8,552 | 430,598 |
| Marketable equity securities | 5,699 | 0 | 0 | 5,699 |
| Total available-for-sale securities | \$29,103 | \$398,642 | \$8,552 | \$436,297 |

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| (In Thousands) | Quoted Prices in Active Markets (Level 1) | December 31, 2009 Market Values Based on: | | Total Fair Value |
|--|--|--|-------------------------------------|------------------------|
| | | Other Observable Inputs (Level 2) | Unobservable Inputs (Level 3) | |
| AVAILABLE-FOR-SALE SECURITIES: | | | | |
| Obligations of other U.S. Government agencies | \$13,512 | \$35,481 | \$0 | \$48,993 |
| Obligations of states and political subdivisions | 0 | 104,990 | 0 | 104,990 |
| Mortgage-backed securities | 5,212 | 151,166 | 0 | 156,378 |
| Collateralized mortgage obligations: | | | | |
| Issued by U.S. Government agencies | 5,095 | 42,613 | 0 | 47,708 |
| Private label | 0 | 15,494 | 0 | 15,494 |
| Corporate bonds | 0 | 1,041 | 0 | 1,041 |
| Trust preferred securities issued by individual institutions | 0 | 5,218 | 800 | 6,018 |
| Collateralized debt obligations: | | | | |
| Pooled trust preferred securities - senior tranches | 0 | 0 | 8,199 | 8,199 |
| Pooled trust preferred securities - mezzanine tranches | 0 | 0 | 115 | 115 |
| Other collateralized debt obligations | 0 | 690 | 0 | 690 |
| Total debt securities | 23,819 | 356,693 | 9,114 | 389,626 |
| Marketable equity securities | 6,662 | 0 | 0 | 6,662 |
| Total available-for-sale securities | 30,481 | 356,693 | 9,114 | 396,288 |
| TRADING SECURITIES, | | | | |
| Obligations of states and political subdivisions | 0 | 1,045 | 0 | 1,045 |
| Total | \$30,481 | \$357,738 | \$9,114 | \$397,333 |

Management determined there have been few trades of pooled trust-preferred securities since the first half of 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, in the third quarter of 2008, the Corporation changed its method of valuing pooled trust-preferred securities from a Level 2 methodology that had been used in prior periods, based on price quotes received from pricing services, to a Level 3 methodology, using discounted cash flows.

At March 31, 2010, management calculated the fair values of pooled trust-preferred securities by applying discount rates to estimated cash flows for each security. Management used the cash flow estimates for each security determined using the process described in Note 5 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 rates, management considered: (1) the implied discount rates as of the end of 2007, prior to the market for trust-preferred securities becoming inactive; (2) adjustment to the year-end 2007 discount rates for the change in the spread between indicative market rates over corresponding risk-free rates in 2010; and (3) an additional adjustment – an increase of 2% in the discount rate – for liquidity risk. Management considered the additional 2% increase in the discount rate necessary in order to give some consideration to price estimates based on trades made under distressed

conditions, as reported by brokers and pricing services. Management's estimates of cash flows and discount rates used to calculate fair values of pooled trust-preferred securities were based on sensitive assumptions, and market participants might use substantially different assumptions, which could result in calculations of fair values that would be substantially different than the amounts calculated by management.

In the fourth quarter 2009, the Corporation transferred a trust preferred security issued by a financial institution (The South Financial Group, Inc.) to Level 3 from Level 2. This security was transferred to Level 3 because management had been trying to sell the security since October 2009, but had not been able to obtain a bid from a potential buyer nor otherwise been able to find a price quote. In April 2010, management received an offer to purchase a portion of the Corporation's holding and agreed to sell a portion of the security held. Management has valued the security at March 31, 2010 based on the price from the April 2010 sale.

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Following is a reconciliation of activity for assets measured at fair value based on significant unobservable information:

| | 3 Months Ended March 31 | |
|---|-------------------------|----------------------|
| | 2010 (Current) | 2009 (Prior Year) |
| Balance, beginning of period | \$9,114 | \$58,914 |
| Purchases, issuances and settlements | (178) | 113 |
| Realized losses, net | 0 | (335) |
| Unrealized losses included in earnings | (421) | (11,105) |
| Unrealized gains included in other comprehensive income | 37 | 2,246 |
| Balance, end of period | \$8,552 | \$49,833 |

Unrealized losses included in earnings are from the Corporation's other-than-temporary impairment analysis of securities, as described in Note 5, and are included in net impairment losses recognized in earnings in the consolidated statement of operations.

Assets measured at fair value on a nonrecurring basis include impaired commercial loans and foreclosed real estate assets held for sale. All of the Corporation's impaired commercial loans for which a valuation allowance was necessary at March 31, 2010 and December 31, 2009 were valued based on the estimated amount of net proceeds from liquidation of real estate and other collateral, or based on the estimated present value of cash flows to be received. The Corporation considers the fair value of such impaired commercial loans to be based on unobservable inputs (Level 3), and the balance of impaired loans for which a valuation allowance was recorded, net of allowance for loan losses, was \$1,551,000 at March 31, 2010 and \$1,564,000 at December 31, 2009. Similarly, the carrying values of foreclosed real estate assets held for sale were based on unobservable inputs (Level 3), with a balance of \$669,000 at March 31, 2010 and \$873,000 at December 31, 2009.

Certain of the Corporation's financial instruments are not measured at fair value in the consolidated financial statements. The fair value of a financial instrument is the current amount that would be exchanged between willing parties, other than in a forced liquidation. When possible, fair value is determined based upon quoted market prices. However, in many instances, there are no quoted market prices for the Corporation's financial instruments. 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.

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 - 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.

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 March 31, 2010 and December 31, 2009. The fair value of all other deposit categories 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.

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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.

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

| (In Thousands) | March 31, 2010 | | December 31, 2009 | |
|-------------------------------|-----------------|------------|-------------------|------------|
| | Carrying Amount | Fair Value | Carrying Amount | Fair Value |
| Financial assets: | | | | |
| Cash and cash equivalents | \$77,174 | \$77,174 | \$92,065 | \$92,065 |
| Trading securities | 0 | 0 | 1,045 | 1,045 |
| Available-for-sale securities | 436,297 | 436,297 | 396,288 | 396,288 |
| Held-to-maturity securities | 0 | 0 | 300 | 302 |
| Restricted equity securities | 8,970 | 8,970 | 8,970 | 8,970 |
| Loans, net | 711,996 | 717,770 | 713,338 | 719,689 |
| Accrued interest receivable | 5,627 | 5,627 | 5,613 | 5,613 |
| Financial liabilities: | | | | |
| Deposits | 952,471 | 960,051 | 926,789 | 935,380 |
| Short-term borrowings | 36,443 | 36,032 | 39,229 | 38,970 |
| Long-term borrowings | 196,032 | 216,272 | 196,242 | 218,767 |
| Accrued interest payable | 657 | 657 | 681 | 681 |

5. SECURITIES

Amortized cost and fair value of available-for-sale and held-to-maturity securities at March 31, 2010 and December 31, 2009 are summarized as follows:

| (In Thousands) | Amortized Cost | March 31, 2010 | | Fair Value |
|--|----------------|--------------------------------|---------------------------------|------------|
| | | Gross Unrealized Holding Gains | Gross Unrealized Holding Losses | |
| AVAILABLE-FOR-SALE SECURITIES: | | | | |
| Obligations of other U.S. Government agencies | \$63,757 | \$186 | (\$135) | \$63,808 |
| Obligations of states and political subdivisions | 108,439 | 1,383 | (5,557) | 104,265 |
| Mortgage-backed securities | 168,644 | 5,356 | (259) | 173,741 |
| Collateralized mortgage obligations: | | | | |
| Issued by U.S. Government agencies | 58,703 | 1,145 | (101) | 59,747 |
| Private label | 13,524 | 46 | (12) | 13,558 |
| Corporate bonds | 1,000 | 40 | 0 | 1,040 |
| Trust preferred securities issued by individual institutions | 6,724 | 0 | (1,047) | 5,677 |
| Collateralized debt obligations: | | | | |
| Pooled trust preferred securities - senior tranches | 11,363 | 0 | (3,299) | 8,064 |
| Pooled trust preferred securities - mezzanine tranches | 7 | 1 | 0 | 8 |

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| | | | | |
|---------------------------------------|-----------|---------|------------|-----------|
| Other collateralized debt obligations | 690 | 0 | 0 | 690 |
| Total debt securities | 432,851 | 8,157 | (10,410) | 430,598 |
| Marketable equity securities | 4,521 | 1,178 | 0 | 5,699 |
| Total | \$437,372 | \$9,335 | (\$10,410) | \$436,297 |

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| (In Thousands) | December 31, 2009 | | | Fair Value |
|--|-------------------|--------------------------------|---------------------------------|------------|
| | Amortized Cost | Gross Unrealized Holding Gains | Gross Unrealized Holding Losses | |
| AVAILABLE-FOR-SALE SECURITIES: | | | | |
| Obligations of other U.S. Government agencies | \$48,949 | \$131 | (\$87) | \$48,993 |
| Obligations of states and political subdivisions | 109,109 | 1,487 | (5,606) | 104,990 |
| Mortgage-backed securities | 150,700 | 5,700 | (22) | 156,378 |
| Collateralized mortgage obligations: | | | | |
| Issued by U.S. Government agencies | 47,083 | 898 | (273) | 47,708 |
| Private label | 15,465 | 50 | (21) | 15,494 |
| Corporate bonds | 1,000 | 41 | 0 | 1,041 |
| Trust preferred securities issued by individual institutions | 7,043 | 0 | (1,025) | 6,018 |
| Collateralized debt obligations: | | | | |
| Pooled trust preferred securities - senior tranches | 11,383 | 0 | (3,184) | 8,199 |
| Pooled trust preferred securities - mezzanine tranches | 266 | 0 | (151) | 115 |
| Other collateralized debt obligations | 690 | 0 | 0 | 690 |
| Total debt securities | 391,688 | 8,307 | (10,369) | 389,626 |
| Marketable equity securities | 5,367 | 1,295 | 0 | 6,662 |
| Total | \$397,055 | \$9,602 | (\$10,369) | \$396,288 |
| HELD-TO-MATURITY SECURITIES, | | | | |
| Obligations of the U.S. Treasury | \$300 | \$2 | \$0 | \$302 |

The following table presents gross unrealized losses and fair value of available-for-sale investments aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position at March 31, 2010 and December 31, 2009.

| March 31, 2010 (In Thousands) | Less Than 12 Months | | 12 Months or More | | Total | |
|--|---------------------|-------------------|-------------------|-------------------|------------|-------------------|
| | Fair Value | Unrealized Losses | Fair Value | Unrealized Losses | Fair Value | Unrealized Losses |
| AVAILABLE-FOR-SALE SECURITIES: | | | | | | |
| Obligations of other U.S. Government agencies | \$25,964 | (\$135) | \$0 | \$0 | \$25,964 | (\$135) |
| Obligations of states and political subdivisions | 19,972 | (453) | 36,129 | (5,104) | 56,101 | (5,557) |
| Mortgage-backed securities | 26,172 | (259) | 0 | 0 | 26,172 | (259) |
| Collateralized mortgage obligations: | | | | | | |
| Issued by U.S. Government agencies | 9,891 | (101) | 0 | 0 | 9,891 | (101) |
| Private label | 0 | 0 | 2,188 | (12) | 2,188 | (12) |
| Trust preferred securities issued by individual institutions | 0 | 0 | 5,197 | (1,047) | 5,197 | (1,047) |
| Collateralized debt obligations: | | | | | | |
| Pooled trust preferred securities - senior tranches | 0 | 0 | 8,063 | (3,299) | 8,063 | (3,299) |

| | | | | | | |
|--|----------|---------|----------|-----------|-----------|------------|
| Total temporarily impaired available-for-sale securities | \$81,999 | (\$948) | \$51,577 | (\$9,462) | \$133,576 | (\$10,410) |
|--|----------|---------|----------|-----------|-----------|------------|

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| December 31, 2009 (In Thousands) | Less Than 12 Months | | 12 Months or More | | Total | |
|--|---------------------|-------------------|-------------------|-------------------|------------|-------------------|
| | Fair Value | Unrealized Losses | Fair Value | Unrealized Losses | Fair Value | Unrealized Losses |
| AVAILABLE-FOR-SALE SECURITIES: | | | | | | |
| Obligations of other U.S. Government agencies | \$17,796 | (\$87) | \$0 | \$0 | \$17,796 | (\$87) |
| Obligations of states and political subdivisions | 19,001 | (422) | 36,939 | (5,184) | 55,940 | (5,606) |
| Mortgage-backed securities | 3,544 | (21) | 20 | (1) | 3,564 | (22) |
| Collateralized mortgage obligations: | | | | | | |
| Issued by U.S. Government agencies | 18,229 | (273) | 0 | 0 | 18,229 | (273) |
| Private label | 0 | 0 | 3,219 | (21) | 3,219 | (21) |
| Trust preferred securities issued by individual institutions | 0 | 0 | 5,218 | (1,025) | 5,218 | (1,025) |
| Collateralized debt obligations: | | | | | | |
| Pooled trust preferred securities - senior tranches | 0 | 0 | 8,199 | (3,184) | 8,199 | (3,184) |
| Pooled trust preferred securities - mezzanine tranches | 0 | 0 | 115 | (151) | 115 | (151) |
| Total temporarily impaired available-for-sale Securities | \$58,570 | (\$803) | \$53,710 | (\$9,566) | \$112,280 | (\$10,369) |

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) | 3 Months Ended | |
|--|----------------|----------------|
| | March 31, 2010 | March 31, 2009 |
| Trust preferred securities issued by individual institutions | (\$320) | \$0 |
| Pooled trust preferred securities - mezzanine tranches | (101) | (11,105) |
| Marketable equity securities (bank stocks) | (10) | (5,575) |
| Net impairment losses recognized in earnings | (\$431) | (\$16,680) |

A summary of information management considered in evaluating debt and equity securities for OTTI at March 31, 2010 is provided below.

Debt Securities

At March 31, 2010, management performed an assessment for possible OTTI of the Corporation's investments in U.S. Government agency bonds and mortgage-backed securities, obligations of state and political subdivisions (municipal bonds), collateralized mortgage obligations (CMOs) and trust preferred securities issued by individual issuers (banking companies) 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. In the fourth quarter 2009, a rating agency removed its investment grade ratings on some of the municipal bonds. At March 31, 2010, the total amortized cost basis of municipal bonds for which the external rating was removed totaled \$25,264,000, with an aggregate unrealized loss of \$2,797,000. 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. 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 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. Except as reflected in the table above and described below, based on the results of the assessment, management believes impairment of these debt securities, including the municipal bonds with no external ratings, at March 31, 2010 to be temporary.

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The following table provides information related to trust preferred securities issued by individual institutions as of March 31, 2010:

(In Thousands)

| Name of Issuer | Issuer's Parent Company | Amortized Cost | Fair Value | Unrealized Gain (Loss) | Cumulative Realized Credit Losses | Moody's/ S&P/ Fitch Credit Ratings |
|------------------------------------|---------------------------------|----------------|------------|------------------------|-----------------------------------|--|
| Astoria Capital Trust I | Astoria Financial Corporation | \$5,244 | \$4,352 | (\$892) | \$0 | Baa3/BB-/BB- |
| Carolina First Mortgage Loan Trust | The South Financial Group, Inc. | 480 | 480 | 0 | (3,529) | NR |
| Patriot Capital Trust I | Susquehanna Bancshares, Inc. | 1,000 | 845 | (155) | 0 | NR |
| Total | | \$6,724 | \$5,677 | (\$1,047) | (\$3,529) | |

NR = not rated.

Management assesses each of the trust preferred securities issued by individual institutions for the possibility of OTTI by reviewing financial information that is publicly available. Neither Astoria Financial Corporation nor Susquehanna Bancshares, Inc. has deferred or defaulted on payments associated with the Corporation's securities. In 2009, the Corporation recorded OTTI of \$3,209,000 on the Carolina First Mortgage Loan Trust security, and in 2010, The South Financial Group, Inc. deferred on payments on the security. In April 2010, the Corporation sold half of its investment in the security, and in the first quarter 2010 recorded OTTI of \$320,000 to further write down amortized cost based on the selling price of the April transaction.

Pooled trust-preferred securities are very long-term (usually 30-year maturity) instruments with characteristics of both debt and equity, mainly issued by banks. The Corporation's investments in pooled trust-preferred securities are each made up of companies with geographic and size diversification. Almost all of the Corporation's pooled trust-preferred securities are composed of debt issued by banking companies, with lesser amounts issued by insurance companies and real estate investment trusts. 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 (trust-preferred securities typically permit deferral of quarterly interest payments for up to five years), and some issuers have defaulted.

As of each quarter-end in 2009 and as of March 31, 2010, 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 calculated the present value of each security based on the current book yield, adjusted for future changes in 3-month LIBOR (which is the index rate on the Corporation's adjustable-rate pooled trust-preferred securities) based on the applicable forward curve.

In the third quarter 2009, management made significant changes in assumptions regarding future deferrals and defaults, in comparison to assumptions used in the previous four quarters' analyses. These changes had the effect of increasing estimated future defaults, which resulted in lower levels of future cash flows expected to be received, as compared to estimated future cash flows to be received based on the assumptions used in previous quarters. Management selected several of the trust preferred offerings in which the Corporation holds securities, and analyzed the change in deferral or default status, and the change in financial strength rating from the national ratings service used in its quarterly analyses, over the period starting in the third quarter 2008 (which was the first quarter in which the Corporation performed the detailed cash flow analysis for each security) through the second quarter 2009. Management believes the results of its analysis of the securities selected to be similar to the results that would be produced in an analysis of all of the Corporation's pooled trust-preferred securities. The analysis demonstrated that significant credit deterioration had occurred over the previous four quarterly periods, as evidenced in the data by average higher deferrals and defaults, and lower financial strength ratings. In determining how to apply the results of this analysis, management made two critical assumptions: (1) the deteriorating trend will continue at approximately the same rate over the next four quarters, and (2) every issuer (bank) that would be assumed to defer payment within the next four quarters, based on the trend reflected in the data, would eventually default with no recovery. At March 31, 2010, management's assumptions regarding future deferrals and defaults were consistent with the revisions established in the third quarter 2009.

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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 those assumptions could produce different conclusions for each security.

As of March 31, 2010, the Corporation's investment in a senior tranche security (the senior tranche of MM Caps Funding I, Ltd., for which the Corporation also owns an investment in the mezzanine tranche security) has an investment grade rating. The senior tranche security, with an amortized cost of \$11,363,000, has been subjected to impairment analysis based on estimated cash flows (using the process described above), and management has determined that impairment was temporary as of March 31, 2010.

As shown in the table above, the Corporation's total credit losses from mezzanine pooled trust-preferred securities amounted to \$101,000 in the first quarter 2010 and \$11,105,000 in the first quarter 2009. For the year ended December 31, 2009, credit losses from pooled trust-preferred securities totaled \$73,674,000. The Corporation sold several mezzanine pooled trust-preferred securities in the fourth quarter 2009, and recorded a realized gain of \$153,000 from the sales, determined based on the excess of the aggregate sale proceeds over the amortized cost bases of the securities, as adjusted for credit losses that had been previously realized.

The following table provides detailed information related to pooled trust preferred securities – mezzanine tranches held as of March 31, 2010:

(In Thousands)

| Description | Amortized Cost | Fair Value | Unrealized Gain | Credit Losses in | Cumulative |
|---|----------------|------------|-----------------|-------------------------------|---------------|
| | | | | 3 Months Ended March 31, 2010 | Credit Losses |
| MMCAPS Funding I, Ltd. | \$7 | \$8 | \$1 | \$0 | (\$5,831) |
| U.S. Capital Funding II, Ltd. (B-1) | 0 | 0 | 0 | (40) | (1,991) |
| U.S. Capital Funding II, Ltd. (B-2) | 0 | 0 | 0 | (61) | (2,973) |
| ALESCO Preferred Funding VI, Ltd. | 0 | 0 | 0 | 0 | (2,018) |
| ALESCO Preferred Funding IX, Ltd. | 0 | 0 | 0 | 0 | (2,988) |
| Preferred Term Securities XVIII, Ltd. | 0 | 0 | 0 | 0 | (7,293) |
| Preferred Term Securities XXI, Ltd. | 0 | 0 | 0 | 0 | (1,502) |
| Preferred Term Securities XXIII, Ltd. (C-1) | 0 | 0 | 0 | 0 | (3,466) |
| Preferred Term Securities XXIII, Ltd. (D-1) | 0 | 0 | 0 | 0 | (5,024) |
| Tropic CDO III, Ltd. | 0 | 0 | 0 | 0 | (6,970) |
| Total | \$7 | \$8 | \$1 | (\$101) | (\$40,056) |

The table that follows provides additional information related to the senior tranche and mezzanine tranche pooled trust-preferred securities that had not been completely written off prior to the first quarter 2010:

| Number of Banks | Moody's/ Fitch | Actual | Expected | Excess Subordination as % of |
|-----------------|-------------------|--------------------------------|---|---------------------------------|
| | | Deferrals and Defaults as % of | Additional Net Deferrals and Defaults as % of | |

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| Description | Currently Performing | Credit Ratings (1) | Outstanding Collateral | Performing Collateral | Performing Collateral |
|---|----------------------|-----------------------|------------------------|-----------------------|-----------------------|
| MMCAPS Funding I, Ltd. - Senior Tranche | 22 | A3/A (2) | 17.2% | 46.8% | 28.2% |
| MMCAPS Funding I, Ltd. - Mezzanine | 22 | Ca/C | 17.2% | 46.8% | -7.4% |
| U.S. Capital Funding II, Ltd. (B-1) | 44 | Ca/C | 16.1% | 52.6% | -10.2% |
| U.S. Capital Funding II, Ltd. (B-2) | 44 | Ca/C | 16.1% | 52.6% | -10.2% |

(1) The table above presents ratings information as of March 31, 2010.

(2) Fitch has placed the Senior Tranche security on Negative Watch.

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 our investment)/Total face value of performing collateral.

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The Excess Subordination Ratio measures the extent to which there may be tranches within each pooled trust preferred structure available to absorb credit losses before the Corporation's securities would be impacted. The positive Excess Subordination Ratio for the senior tranche security signifies there is some support from subordinate tranches available to absorb losses before the Corporation's investment would be impacted, while the negative Excess Subordination Ratio for each of the mezzanine tranche securities indicates there is no support. A negative Excess Subordination Ratio is not definitive, in isolation, for determining whether or not OTTI should be recorded for 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 (the issuers 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. Total other-than-temporary impairment from pooled trust-preferred securities in the three months ended March 31, 2010 amounted to \$51,000, including a pre-tax loss reflected in earnings of \$101,000, with a gain of \$50,000 included in other comprehensive income. In the three months ended March 31, 2009, total other-than-temporary impairment from pooled trust-preferred securities amounted to \$19,406,000, including a pre-tax loss reflected in earnings of \$11,105,000, and a pre-tax other comprehensive loss of \$8,301,000.

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) | 3 Months Ended March 31, 2010 | 3 Months Ended March 31, 2009 |
|---|--|--|
| Balance of credit losses on debt securities for which a portion of OTTI was recognized in other comprehensive income, beginning of period (as measured effective January 1, 2009 upon adoption of ASC Topic 320) | (\$10,695) | (\$2,362) |
| Additional credit loss for which an OTTI was not previously recognized | 0 | (7,497) |
| Reduction for securities losses realized during the period | 4,965 | 0 |
| 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 | (101) | (3,608) |
| Balance of credit losses on debt securities for which a portion of OTTI was recognized in other comprehensive income, end of period | (\$5,831) | (\$13,467) |

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 as of March 31, 2010, but which have been deemed worthless.

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Equity Securities

The Corporation's marketable equity securities at March 31, 2010 and December 31, 2009 consisted exclusively of stocks of banking companies. The Corporation recorded OTTI on bank stocks totaling \$10,000 in the first quarter 2010 and \$5,575,000 in the first quarter 2009. Management's decision to record OTTI losses on bank stocks was based on a combination of: (1) significant market depreciation in market prices in the first quarter 2009 (with some improvement subsequent to March 31, 2009), and (2) management's intent to sell some of the stocks to generate capital losses, which could be carried back and offset against capital gains generated in previous years to realize tax refunds. Realized gains from sales of bank stocks totaled \$349,000 in the first quarter 2010 and \$277,000 in the first quarter 2009. Realized gains from sales of bank stocks included net gains of \$284,000 in the first quarter 2010 and \$34,000 in the first quarter 2009 from stocks for which an OTTI had been previously recognized. After the impact of the impairment charges and sales, there were no unrealized losses on bank stocks at March 31, 2010.

C&N Bank is a member of the Federal Home Loan Bank of Pittsburgh (FHLB-Pittsburgh), which is one of 12 regional Federal Home Loan Banks. As a member, C&N Bank is required to purchase and maintain stock in FHLB-Pittsburgh in an amount determined based on outstanding advances, unused borrowing capacity and other factors. There is no active market for FHLB-Pittsburgh stock, and it must ordinarily be redeemed by FHLB-Pittsburgh in order to be liquidated. At March 31, 2010 and December 31, 2009, C&N Bank's investment in FHLB-Pittsburgh stock, which was included in Other Assets in the consolidated balance sheet, was \$8,585,000. The Corporation evaluated its holding of FHLB-Pittsburgh stock for impairment and deemed the stock to not be impaired at March 31, 2010 and December 31, 2009. In making this determination, management concluded that recovery of total outstanding par value, which equals the carrying value, is expected. The decision was based on review of financial information that FHLB-Pittsburgh has made publicly available.

6. DEFINED BENEFIT PLANS

The Corporation sponsors a defined benefit health care plan that provides postretirement medical benefits and life insurance to employees who meet certain age and length of service requirements. This plan contains a cost-sharing feature, which causes participants to pay for all future increases in costs related to benefit coverage. Accordingly, actuarial assumptions related to health care cost trend rates do not affect the liability balance at March 31, 2010 and December 31, 2009, and will not affect the Corporation's future expenses. The Corporation uses a December 31 measurement date for the postretirement plan.

In 2007, the Corporation assumed the Citizens Trust Company Retirement Plan, a defined benefit pension plan for which benefit accruals and participation were frozen in 2002. Information related to the Citizens Trust Company Retirement Plan has been included in the table that follows. The Corporation uses a December 31 measurement date for this plan.

The components of net periodic benefit costs from these defined benefit plans are as follows:

Defined Benefit Plans
(In Thousands)

| | Pension | | Postretirement | |
|---------------|---------------------------------|------|---------------------------------|------|
| | Three Months Ended March 31, | | Three Months Ended March 31, | |
| | 2010 | 2009 | 2010 | 2009 |
| Service cost | \$0 | \$0 | \$17 | \$19 |
| Interest cost | 17 | 0 | 22 | 23 |

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| | | | | |
|---------------------------------------|------|-----|------|------|
| Expected return on plan assets | (17) | 0 | 0 | 0 |
| Amortization of transition obligation | 0 | 0 | 9 | 9 |
| Amortization of prior service cost | 0 | 0 | 4 | 3 |
| Recognized net actuarial loss | 1 | 0 | 0 | 0 |
| Net periodic benefit cost | \$1 | \$0 | \$52 | \$54 |

In the first quarter 2010, the Corporation funded postretirement contributions totaling \$15,000, with estimated annual postretirement contributions of \$62,000 expected in 2010 for the full year. Based upon the related actuarial reports, the Corporation has no required contributions to the Citizens Trust Company Retirement Plan for the 2010 plan year; however, the Corporation may elect to make discretionary contributions later in 2010.

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7. STOCK-BASED COMPENSATION PLANS

In the first quarter 2010, the Corporation made no awards of stock options. In the first quarter 2009, the Corporation granted options to purchase a total of 79,162 shares of common stock through its Stock Incentive and Independent Directors Stock Incentive Plans. The exercise price for the 2009 awards is \$19.88 per share, based on the market price as of the date of grant.

The Corporation records stock option expense based on estimated fair value calculated using an option valuation model. In calculating the 2009 fair value, the Corporation utilized the Black-Scholes-Merton option-pricing model. The calculated fair value of each option granted, and significant assumptions used in the calculations, are as follows:

| | | |
|-----------------------------------|----------------------|---------|
| | 2010 | 2009 |
| Fair value of each option granted | Not applicable (N/A) | \$4.21 |
| Volatility | N/A | 28% |
| Expected option lives | N/A | 9 Years |
| Risk-free interest rate | N/A | 3.15% |
| Dividend yield | N/A | 3.94% |

In calculating the estimated fair value of 2009 stock option awards, management based its estimates of volatility and dividend yield on the Corporation's experience over the immediately prior period of time consistent with the estimated lives of the options. The risk-free interest rate was based on the published yield of zero-coupon U.S. Treasury strips with an applicable maturity as of the grant dates. The 9-year expected option life was based on management's estimates of the average term for all options issued under both plans. Management assumed a 23% forfeiture rate for options granted under the Stock Incentive Plan, and a 0% forfeiture rate for the Directors Stock Incentive Plan. These estimated forfeiture rates were determined based on the Corporation's historical experience.

In the first quarter 2010, the Corporation awarded 9,125 shares of restricted stock to the Chief Executive Officer under the Stock Incentive Plan. This award provides that vesting will occur upon the earliest of (i) the third anniversary of the date of grant, (ii) death or disability or (iii) the occurrence of a change in control of the Corporation. Also, vesting may not occur prior to the Corporation's redemption of preferred stock issued to the U.S. Treasury under the TARP Capital Purchase Program. In the first quarter 2009, the Corporation awarded a total of 3,890 shares of restricted stock under the Stock Incentive and Independent Directors Stock Incentive Plans. Compensation cost related to restricted stock is recognized based on the market price of the stock at the grant date over the vesting period. For restricted stock awards granted under the Stock Incentive Plan in 2009 and 2008, the Corporation must meet an annual targeted return on average equity ("ROAE") performance ratio, as defined, in order for participants to vest. The Corporation did not meet the ROAE target for the 2009 plan year, and accordingly, the participants did not vest in the applicable shares associated with 2009 and 2008 restricted stock awards. The Corporation met the ROAE target for the 2008 plan year, and accordingly, in January 2009, the participants vested in 1/3 of the restricted shares awarded in 2008. Management has estimated restricted stock expense in the first quarter 2010 based on assumptions that the Corporation will redeem the TARP preferred stock within three years, and that the ROAE target for 2010 will be met.

Total stock-based compensation expense is as follows:

| | | |
|----------------|----------------|-----------|
| (In Thousands) | 3 Months Ended | |
| | March 31, | March 31, |
| | 2010 | 2009 |
| Stock options | \$0 | \$170 |

| | | |
|------------------|------|-------|
| Restricted stock | 13 | 20 |
| Total | \$13 | \$190 |

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8. INCOME TAXES

The following temporary differences gave rise to the net deferred tax asset at March 31, 2010 and December 31, 2009:
(In Thousands)

| | March 31, 2010 | Dec. 31, 2009 |
|---|-------------------|------------------|
| Deferred tax assets: | | |
| Unrealized holding losses on securities | (\$356) | (\$247) |
| Defined benefit plans - FASB 158 | (133) | (194) |
| Net realized losses on securities | (16,240) | (16,052) |
| Allowance for loan losses | (2,929) | (2,871) |
| Credit for alternative minimum tax paid | (3,495) | (3,495) |
| Low income housing tax credits | (208) | (685) |
| Other deferred tax assets | (1,127) | (1,097) |
| | (24,488) | (24,641) |
| Valuation allowance | 373 | 373 |
| Total deferred tax assets | (24,115) | (24,268) |
| Deferred tax liabilities: | | |
| Bank premises and equipment | 1,748 | 1,798 |
| Core deposit intangibles | 159 | 175 |
| Other deferred tax liabilities | 251 | 258 |
| Total deferred tax liabilities | 2,158 | 2,231 |
| Deferred tax asset, net | \$ (21,957) | \$ (22,037) |

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. The deferred tax asset from realized losses on securities resulted primarily from OTTI charges for financial statement purposes that are not deductible for income tax reporting purposes through March 31, 2010. Of the total deferred tax asset from realized losses on securities, a portion is from securities that, if the Corporation were to sell them, would be classified as capital losses for income tax reporting purposes. The valuation allowance of \$373,000 at March 31, 2010 and December 31, 2009 reflects the estimated amount of tax benefits associated with capital assets that is dependent upon realization of future capital gains.

The Corporation has available, unused tax credits arising from investments in low income and elderly housing projects. These tax credits may provide future benefits and if unused, would expire in varying annual amounts from 2024 through 2029. The reduction in the deferred tax asset associated with low income housing tax credits at March 31, 2010 to \$208,000 from \$685,000 at December 31, 2009 resulted from estimated realization of the credits based on management's calculation of taxable income generated in the first quarter 2010. The amount of low income housing income tax credits realized in 2010, if any, will depend on the Corporation's taxable income for the year ending December 31, 2010.

The provision (credit) for income tax for the 3-month periods ended March 31, 2010 and 2009 is based on the Corporation's estimate of the effective tax rate expected to be applicable for the full year. The effective tax rates of 24.5% for the 3-month period ended March 31, 2010 and 38.5% for the 3-month period ended March 31, 2009 differ from the statutory rate of 35% principally because of the effects of tax-exempt interest income.

The Corporation has no unrecognized tax benefits, nor pending examination issues related to tax positions taken in preparation of its income tax returns. The Corporation is no longer subject to examination by the Internal Revenue Service for years prior to 2006.

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9. ISSUANCE OF PREFERRED STOCK AND WARRANT UNDER THE TARP CAPITAL PURCHASE PROGRAM

On January 16, 2009, the Corporation issued 26,440 shares of Series A Preferred Stock (“Preferred Stock”) and a Warrant to purchase up to 194,794 shares of common stock at an exercise price of \$20.36 per share. The Corporation sold the Preferred Stock and Warrant to the United States Department of the Treasury (“Treasury”) under the TARP Capital Purchase Program (the “Program”) for an aggregate price of \$26,440,000.

The Preferred Stock has no maturity date. The Preferred Stock has a par value of \$1,000 per share and a liquidation preference amount of \$1,000 per share. The Preferred Stock pays a cumulative dividend rate of 5% per annum for the first five years and will reset to a rate of 9% per annum after year five. The dividend is payable quarterly in arrears. The Treasury may transfer the Preferred Stock to a third party at any time. The American Recovery and Reinvestment Act of 2009, which became effective in February 2009, included a change to the Program that permits the Corporation to redeem the Preferred Stock at any time, subject to approval of banking regulators, for a price equal to the original issue price plus any accrued but unpaid dividends.

The shares of Preferred Stock are non-voting, other than class voting rights on (i) any authorization or issuance of shares ranking senior to the Preferred Stock, (ii) any amendment to the rights of the shares of Preferred Stock, or (iii) any merger, exchange or similar transaction which would adversely affect the rights of the Preferred Stock. If dividends on the Preferred Stock are not paid in full for six dividend periods, whether or not consecutive, the holders of the Preferred Stock will have the right to elect 2 directors. The right to elect directors will end when full dividends have been paid for four consecutive dividend periods. As of March 31, 2010, no dividends on the preferred stock were in arrears.

Pursuant to participation in the Program, the Corporation may continue to pay dividends on its common stock, subject to the following requirements and limitations: (1) all accrued and unpaid dividends for all past dividend periods on the Preferred Stock must be fully paid; and (2) consent of the Treasury is required for any increase in the per share dividends on common shares until January 16, 2012, unless prior to that date, the Corporation has redeemed the Preferred Stock in whole or the Treasury has transferred all of the Preferred Stock to third parties. Also, until January 16, 2012 (unless prior to that date, the Corporation has redeemed the Preferred Stock in whole or the Treasury has transferred all of the Preferred Stock to third parties) the Treasury’s consent is required for any repurchases of common stock, except for repurchases of shares in connection with employee benefit plans in the ordinary course of business consistent with past practice.

The Warrant is exercisable and has a term of 10 years. The number of common shares that could be acquired upon exercise was based on 15% of the total proceeds, with the exercise price determined using the average market price of the Corporation’s common stock for the 20 trading days immediately prior to issuance. Treasury has agreed that it will not vote any of the shares of common stock that it acquires upon exercise of the Warrant. This does not apply to any other person who acquires from Treasury any portion of the Warrant, or the shares of common stock underlying the Warrant.

In 2009, the Corporation recorded issuance of the Preferred Stock and Warrant as increases in stockholders’ equity. Proceeds from the transaction, net of direct issuance costs of \$31,000, have been allocated between Preferred Stock and the Warrant based on their respective fair values at the date of issuance. The fair value of the Preferred Stock was estimated based on dividend rates on recent preferred stock and other capital issuances by banking companies, and the fair value of the Warrant was estimated using the Black-Scholes-Merton option model. The amount allocated to the Warrant (recorded as an increase in Paid in Capital) was \$821,000, and the amount initially

allocated to Preferred Stock was \$25,588,000. As a result, the Preferred Stock's initial carrying value was at a discount to the liquidation value or stated value of \$26,440,000. In accordance with the SEC's Staff Accounting Bulletin No. 68, "Increasing Rate Preferred Stock," the discount is considered an unstated dividend cost that shall be accreted over the period preceding commencement of the perpetual dividend using the effective interest method, by charging the imputed dividend cost against retained earnings and increasing the carrying amount of the Preferred Stock by a corresponding amount. The discount is therefore being accreted over five years, resulting in an effective dividend rate (including stated dividends and the accretion of the discount on Preferred Stock) of 5.80%. Total dividends on Preferred Stock (\$373,000 in the first quarter 2010 and \$309,000 in the first quarter 2009), has been deducted from net income to arrive at net income available to common shareholders in the Consolidated Statements of Earnings. Dividends on Preferred Stock include a quarterly dividend paid in February of each year, plus dividends accrued based on the stated value and the accretion of the discount on Preferred Stock. The accretion of the discount on Preferred Stock was \$42,000 in the first quarter 2010 and \$34,000 in the first quarter 2009.

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10. CONTINGENCIES

In the normal course of business, the Corporation may be subject to pending and threatened lawsuits in which claims for monetary damages could be asserted. In management's opinion, the Corporation's financial position and results of operations would not be materially affected by the outcome of such pending legal proceedings.

11. SUBSEQUENT EVENTS

The Corporation has evaluated and disclosed all material subsequent events through the date of the filing of these consolidated financial statements that provide additional evidence about conditions that existed as of March 31, 2010.

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ITEM 2. MANAGEMENT’S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

Certain statements in this section and elsewhere in this quarterly report on Form 10-Q 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.

REFERENCES TO 2010 AND 2009

Unless otherwise noted, all references to “2010” in the following discussion of operating results are intended to mean the three months ended March 31, 2010, and similarly, references to “2009” relate to the three months ended March 31, 2009.

EARNINGS OVERVIEW

In the first quarter 2010, the Corporation reported positive net income available to common shareholders of \$4,065,000, or \$0.34 per share – basic and diluted, as compared to net income available to common shareholders of \$4,242,000, or \$0.42 per share - basic and diluted in the fourth quarter 2009 and as compared to a net loss of \$7,334,000, or \$0.82 per share in the first quarter 2009. For the first quarter 2010, the number of weighted average common shares outstanding increased to 12,113,584 from 10,141,903 in the immediately previous quarter, reflecting the issuance of shares of common stock in a public offering in December 2009 that raised capital of \$21.4 million, net of offering costs. Results for the first quarter 2010 included pre-tax realized gains from available-for-sale securities of \$58,000, while fourth quarter 2009 results included realized losses from available-for-sale securities of \$318,000. First quarter 2009 results were significantly impacted by pre-tax realized losses from securities totaling \$16,679,000.

STATEMENT REGARDING NON-GAAP FINANCIAL MEASUREMENT

This report contains supplemental financial information determined by a method other than in accordance with Accounting Principles Generally Accepted in the United States of America (“GAAP”). Management uses this non-GAAP measure in its analysis of the Corporation’s performance. This measure, Core Earnings, excludes the effects of OTTI losses on available-for-sale securities and realized gains on securities for which OTTI has previously been recognized. Management believes the presentation of this financial measure, which excludes the impact of the specified items, provides useful supplemental information that is essential to a proper understanding of the financial results of the Corporation. The Core Earnings measure provides a method to assess operating performance excluding some of the impact of market volatility related to investments in securities. This disclosure should not be viewed as a substitute for results determined in accordance with GAAP, nor is it necessarily comparable to non-GAAP performance measures that may be presented by other companies

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RECONCILIATION OF NON-GAAP MEASURE (UNAUDITED)

(In thousands, except per-share data)

| | 1st Quarter 2010 | 4th Quarter 2009 | 1st Quarter 2009 |
|---|------------------------|------------------------|------------------------|
| Net income (loss) available to common shareholders | \$4,065 | \$4,242 | (\$7,334) |
| Other-than-temporary impairment losses on available-for-sale securities | (431) | (956) | (16,680) |
| Realized gains on assets previously written down | 284 | 947 | 34 |
| Other-than-temporary impairment losses on available-for-sale securities, net of related gains | (147) | (9) | (16,646) |
| Income taxes (1) | 50 | 516 | 5,660 |
| Other-than-temporary impairment losses, net | (97) | 507 | (10,986) |
| Core earnings available to common shareholders | \$4,162 | \$3,735 | \$3,652 |
| Net income (loss) per share - diluted | \$0.34 | \$0.42 | (\$0.82) |
| Core earnings per share - diluted | \$0.34 | \$0.37 | \$0.41 |
| Weighted average shares outstanding - diluted | 12,113,584 | 10,141,903 | 8,958,604 |

(1) Income tax has been allocated to the non-core losses at 34%, adjusted for a valuation allowance on deferred tax assets associated with losses from securities classified as capital assets for federal income tax reporting purposes.

A valuation allowance of \$886,000 was recorded in the third quarter 2009, and was reduced to \$373,000 in the fourth quarter 2009.

The higher amount of Core Earnings for the first quarter 2010, as compared to the fourth quarter 2009, included the impact of a charge to the income tax provision in the fourth quarter 2009 of \$460,000 which resulted from a 1% change in the tax rate used to estimate the deferred tax benefit to be received from securities losses. In addition, significant changes in the pre-tax components of Core Earnings for the first quarter 2010, as compared to the corresponding period in 2009, were as follows:

- Noninterest expense was \$744,000, or 8.6%, lower in 2010, including a reduction of \$568,000 in compensation-related costs. The reduction in compensation-related costs included a net reduction in stock-based compensation of \$177,000 and the impact of a \$215,000 reduction in health insurance costs associated with settlement of the difference between estimated and actual claims from the previous plan year.
- Noninterest revenue was \$679,000, or 24.5%, higher in 2010, including the impact of a pre-tax gain of \$448,000 from the sale of property at one of the banking locations in the first quarter 2010. Revenue from Trust and Financial Management services was \$130,000, or 16.9%, higher in 2010.
- The net interest margin was \$492,000, or 4.5%, lower in 2010, reflecting the effects of a lower average return on securities, and a lower average balance of loans outstanding.

- The provision for loan losses was \$207,000 in the first quarter of 2010, which is a modest amount by normal banking standards, but \$380,000 higher than the net credit of \$173,000 recorded in the first quarter 2009.

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TABLE I - QUARTERLY FINANCIAL DATA
(In Thousands)

| | Mar. 31, 2010 | Dec 31, 2009 | Sept. 30, 2009 | June 30, 2009 | Mar. 31, 2009 |
|---|------------------|-----------------|-------------------|------------------|------------------|
| Interest income | \$15,733 | \$16,256 | \$16,808 | \$17,341 | \$17,571 |
| Interest expense | 5,260 | 5,670 | 6,016 | 6,164 | 6,606 |
| Interest margin | 10,473 | 10,586 | 10,792 | 11,177 | 10,965 |
| Provision (credit) for loan losses | 207 | 126 | 634 | 93 | (173) |
| Interest margin after provision for loan losses | 10,266 | 10,460 | 10,158 | 11,084 | 11,138 |
| Other income | 3,445 | 3,567 | 3,282 | 3,054 | 2,766 |
| Net gains (losses) on available-for-sale securities | 58 | (318) | (47,848) | (18,995) | (16,679) |
| Other expenses | 7,894 | 7,586 | 8,277 | 9,158 | 8,638 |
| Income (loss) before income tax provision | 5,875 | 6,123 | (42,685) | (14,015) | (11,413) |
| Income tax provision (credit) | 1,437 | 1,508 | (14,491) | (5,284) | (4,388) |
| Net income (loss) | 4,438 | 4,615 | (28,194) | (8,731) | (7,025) |
| US Treasury preferred dividends | 373 | 373 | 373 | 373 | 309 |
| Net income (loss) available to common shareholders | \$4,065 | \$4,242 | (\$28,567) | (\$9,104) | (\$7,334) |
| Net income (loss) per common share – basic | \$0.34 | \$0.42 | (\$3.17) | (\$1.01) | (\$0.82) |
| Net income (loss) per common share – diluted | \$0.34 | \$0.42 | (\$3.17) | (\$1.01) | (\$0.82) |

CRITICAL ACCOUNTING POLICIES

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

A material estimate that is particularly susceptible to significant change is the determination of the allowance for loan losses. Management believes that the allowance for loan losses is adequate and reasonable. The Corporation's methodology for determining the allowance for loan losses is described in a separate section later in Management's Discussion and Analysis. Given the very subjective nature of identifying and valuing loan losses, it is likely that well-informed individuals could make materially different assumptions, and could, therefore calculate a materially different allowance value. While management uses available information to recognize losses on loans, changes in economic conditions may necessitate revisions in future years. In addition, various regulatory agencies, as an integral part of their examination process, periodically review the Corporation's allowance for loan losses. Such agencies may require the Corporation to recognize adjustments to the allowance based on their judgments of information available to them at the time of their examination.

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

As described in Note 4 to the consolidated financial statements, management calculates the fair values of pooled trust-preferred securities by applying discount rates to estimated cash flows for each security. Management estimated

the cash flows expected to be received from each security, taking into account estimated levels of deferrals and defaults by the underlying issuers, and used discount rates considered reflective of a market participant's expectations regarding the extent of credit and liquidity risk inherent in the securities. Management's estimates of cash flows and discount rates used to calculate fair values of pooled trust-preferred securities were based on sensitive assumptions, and use of different assumptions could result in calculations of fair values that would be substantially different than the amounts calculated by management.

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As described in Note 5 to the consolidated financial statements, management evaluates securities for OTTI. In making that evaluation, consideration is given to (1) the length of time and the extent to which the fair value has been less than cost, (2) the financial condition and near-term prospects of the issuer, and (3) whether the Corporation intends to sell the security or more likely than not will be required to sell the security before its anticipated recovery. Management's assessments of the likelihood and potential for recovery in value of securities are subjective and based on sensitive assumptions. Also, management's estimates of cash flows used to evaluate other-than-temporary impairment of pooled trust-preferred securities are based on sensitive assumptions, and use of different assumptions could produce different conclusions for each security.

NET INTEREST MARGIN

The Corporation's primary source of operating income is represented by the net interest margin. The net interest margin is equal to the difference between the amounts of interest income and interest expense. Tables II, III and IV include information regarding the Corporation's net interest margin for the three-month periods ended March 31, 2010 and March 31, 2009. In each of these tables, the amounts of interest income earned on tax-exempt securities and loans have been adjusted to a fully taxable-equivalent basis. Accordingly, the net interest margin amounts reflected in these tables exceed the amounts presented in the consolidated financial statements. The discussion that follows is based on amounts in the related Tables.

The fully taxable equivalent net interest margin was \$11,227,000 in 2010, \$370,000 (3.2%) lower than in 2009. As shown in Table IV, changes in volume had the effect of decreasing net interest income \$471,000 in 2010 over 2009, and interest rate changes had the effect of increasing net interest income \$101,000. The most significant components of the volume change in net interest income in 2010 were: a decrease in interest income of \$869,000 attributable to a reduction in the balance of taxable available-for-sale securities, an increase in interest income of \$435,000 attributable to growth in the tax-exempt portion of the available-for-sale securities portfolio, and a decrease in interest expense of \$415,000 attributable to a reduction in the balance of long-term borrowed funds. The most significant components of the rate change in net interest income in 2010 were: a decrease in interest income of \$815,000 attributable to lower rates earned on taxable available-for-sale securities and a decrease in interest expense of \$1,034,000 due to lower rates paid on interest-bearing deposits. As presented in Table III, the "Interest Rate Spread" (excess of average rate of return on earning assets over average cost of funds on interest-bearing liabilities) was 3.49% in 2010, as compared to 3.38% in 2009.

INTEREST INCOME AND EARNING ASSETS

Interest income totaled \$16,487,000 in 2010, a decrease of 9.4% from 2009. Income from available-for-sale securities decreased \$1,315,000 (21.1%), while interest and fees from loans decreased \$394,000, or 3.3%. As indicated in Table III, total average available-for-sale securities (at amortized cost) in 2010 decreased to \$414,823,000, a decrease of \$49,125,000, or 10.6% from 2009. During 2009, the Corporation increased the size of its tax-exempt municipal security portfolio, while shrinking the taxable available-for-sale securities portfolio. The Corporation's yield on taxable securities fell in 2009 and 2010 primarily because of low market interest rates, including the effects of management's decision to limit purchases of taxable securities to investments that mature or are expected to repay a substantial portion of principal within approximately four years or less. The Corporation's yield on taxable securities was also negatively affected in 2010 by higher-than-expected prepayments on mortgage-backed securities; these prepayments were caused by procedural changes by the U.S. Government agencies that issued the securities. The average rate of return on available-for-sale securities was 4.80% for 2010 and 5.44% in 2009.

The average balance of gross loans decreased 2.1% to \$720,264,000 in 2010 from \$735,519,000 in 2009. Due to the challenging economic environment and the Corporation's decision to sell a portion of its newly originated residential mortgages on the secondary market, the Corporation has experienced contraction in the balance of its mortgage and consumer loan portfolios, with slight growth in average commercial loan balances. The Corporation's yield on loans fell as rates on new loans as well as existing, variable-rate loans have decreased. The average rate of return on loans was 6.50% in 2010 and 6.58% in 2009.

The average balance of interest-bearing due from banks, which in 2010 has consisted primarily of balances held by the Federal Reserve, increased to \$66,887,000 in 2010 from \$7,964,000 in 2009. The average balance of federal funds sold decreased to \$60,000 in 2010 from \$19,231,000 in 2009. Although the rates of return are low, the Corporation has maintained relatively high levels of these liquid assets in 2009 and 2010 (as opposed to increasing long-term, available-for-sale securities at higher yields) due to management's concern about the possibility of substantial increases in interest rates later in 2010 or in 2011.

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INTEREST EXPENSE AND INTEREST-BEARING LIABILITIES

Interest expense fell \$1,346,000, or 20.4%, to \$5,260,000 in 2010 from \$6,606,000 in 2009. Table III shows that the overall cost of funds on interest-bearing liabilities fell to 2.07% in 2010 from 2.63% in 2009.

Total average deposits (interest-bearing and noninterest-bearing) increased 7.9%, to \$931,223,000 in 2010 from \$862,677,000 in 2009. This increase has come mainly in interest checking, individual retirement accounts, and demand deposits. Consistent with substantial reductions in short-term global interest rates, the average rates incurred on deposit accounts have decreased significantly in 2010 as compared to 2009. As shown in Table IV, decreases in rates reduced interest expense on deposits by \$1,034,000.

Total average borrowed funds decreased \$46,149,000 to \$233,331,000 in 2010 from \$279,480,000 in 2009. During 2009 and early 2010, the Corporation has generally 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 3.66% in 2010, down from 3.81% in 2009. This change primarily reflects lower rates being paid on customer repurchase agreements, which make up most of the Corporation's short-term borrowed funds.

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TABLE II - ANALYSIS OF INTEREST INCOME AND EXPENSE

| (In Thousands) | Three Months Ended | | Increase/ (Decrease) |
|-------------------------------------|--------------------|-------------------|-------------------------|
| | 2010 | March 31, 2009 | |
| INTEREST INCOME | | | |
| Available-for-sale securities: | | | |
| Taxable | \$3,163 | \$4,847 | (\$1,684) |
| Tax-exempt | 1,744 | 1,375 | 369 |
| Total available-for-sale securities | 4,907 | 6,222 | (1,315) |
| Held-to-maturity securities, | | | |
| Taxable | 2 | 6 | (4) |
| Trading securities | 2 | 34 | (32) |
| Interest-bearing due from banks | 38 | 1 | 37 |
| Federal funds sold | 0 | 8 | (8) |
| Loans: | | | |
| Taxable | 10,950 | 11,357 | (407) |
| Tax-exempt | 588 | 575 | 13 |
| Total loans | 11,538 | 11,932 | (394) |
| Total Interest Income | 16,487 | 18,203 | (1,716) |
| INTEREST EXPENSE | | | |
| Interest-bearing deposits: | | | |
| Interest checking | 207 | 205 | 2 |
| Money market | 249 | 704 | (455) |
| Savings | 44 | 84 | (40) |
| Certificates of deposit | 1,426 | 1,856 | (430) |
| Individual Retirement Accounts | 1,230 | 1,131 | 99 |
| Other time deposits | 1 | 1 | 0 |
| Total interest-bearing deposits | 3,157 | 3,981 | (824) |
| Borrowed funds: | | | |
| Short-term | 100 | 170 | (70) |
| Long-term | 2,003 | 2,455 | (452) |
| Total borrowed funds | 2,103 | 2,625 | (522) |
| Total Interest Expense | 5,260 | 6,606 | (1,346) |
| Net Interest Income | \$11,227 | \$11,597 | (\$370) |

Note: Interest income from tax-exempt securities and loans has been adjusted to a fully tax-equivalent basis, using the Corporation's marginal federal income tax rate of 34%.

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Table III - Analysis of Average Daily Balances and Rates
(Dollars in Thousands)

| | 3 Months Ended 3/31/2010 Average Balance | Rate of Return/ Cost of Funds % | 3 Months Ended 3/31/2009 Average Balance | Rate of Return/ Cost of Funds % |
|--|--|--|--|--|
| EARNING ASSETS | | | | |
| Available-for-sale securities, at amortized cost: | | | | |
| Taxable | \$306,966 | 4.18% | \$382,840 | 5.13% |
| Tax-exempt | 107,857 | 6.56% | 81,108 | 6.88% |
| Total available-for-sale securities | 414,823 | 4.80% | 463,948 | 5.44% |
| Held-to-maturity securities, | | | | |
| Taxable | 154 | 5.27% | 405 | 6.01% |
| Trading securities | 116 | 6.99% | 2,112 | 6.53% |
| Interest-bearing due from banks | 66,887 | 0.23% | 7,964 | 0.05% |
| Federal funds sold | 60 | 0.00% | 19,231 | 0.17% |
| Loans: | | | | |
| Taxable | 683,899 | 6.49% | 697,231 | 6.61% |
| Tax-exempt | 36,365 | 6.56% | 38,288 | 6.09% |
| Total loans | 720,264 | 6.50% | 735,519 | 6.58% |
| Total Earning Assets | 1,202,304 | 5.56% | 1,229,179 | 6.01% |
| Cash | 16,922 | | 16,248 | |
| Unrealized gain/loss on securities | (204) | | (37,886) | |
| Allowance for loan losses | (8,410) | | (7,940) | |
| Bank premises and equipment | 24,164 | | 25,820 | |
| Intangible Asset - Core Deposit Intangible | 484 | | 795 | |
| Intangible Asset - Goodwill | 11,942 | | 11,988 | |
| Other assets | 79,191 | | 57,814 | |
| Total Assets | \$1,326,393 | | \$1,296,018 | |
| INTEREST-BEARING LIABILITIES | | | | |
| Interest-bearing deposits: | | | | |
| Interest checking | \$127,117 | 0.66% | \$93,126 | 0.89% |
| Money market | 197,023 | 0.51% | 196,867 | 1.45% |
| Savings | 71,581 | 0.25% | 68,578 | 0.50% |
| Certificates of deposit | 236,951 | 2.44% | 232,040 | 3.24% |
| Individual Retirement Accounts | 161,127 | 3.10% | 147,513 | 3.11% |
| Other time deposits | 990 | 0.41% | 1,018 | 0.40% |
| Total interest-bearing deposits | 794,789 | 1.61% | 739,142 | 2.18% |
| Borrowed funds: | | | | |
| Short-term | 37,189 | 1.09% | 42,746 | 1.61% |
| Long-term | 196,142 | 4.14% | 236,734 | 4.21% |
| Total borrowed funds | 233,331 | 3.66% | 279,480 | 3.81% |
| Total Interest-bearing Liabilities | 1,028,120 | 2.07% | 1,018,622 | 2.63% |

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| | | | | |
|--|---------------|-------|---------------|-------|
| Demand deposits | 136,434 | | 123,535 | |
| Other liabilities | 7,465 | | 6,779 | |
| Total Liabilities | 1,172,019 | | 1,148,936 | |
| Stockholders' equity, excluding other comprehensive income/loss | 154,897 | | 172,200 | |
| Other comprehensive income/loss | (523) | | (25,118) | |
| Total Stockholders' Equity | 154,374 | | 147,082 | |
| Total Liabilities and Stockholders' Equity | \$1,326,393 | | \$1,296,018 | |
| Interest Rate Spread | | 3.49% | | 3.38% |
| Net Interest Income/Earning Assets | | 3.79% | | 3.83% |
| Total Deposits (Interest-bearing and Demand) | \$931,223 | | \$862,677 | |

- (1) Rates of return on tax-exempt securities and loans are presented on a fully taxable-equivalent basis.
(2) Nonaccrual loans have been included with loans for the purpose of analyzing net interest earnings.

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TABLE IV - ANALYSIS OF VOLUME AND RATE CHANGES

(In Thousands)

| | 3 Months Ended 3/31/10 vs. 3/31/09 | | |
|---|------------------------------------|-------------------|-----------------|
| | Change in Volume | Change in Rate | Total Change |
| EARNING ASSETS | | | |
| Available-for-sale securities: | | | |
| Taxable | (\$869) | (\$815) | (\$1,684) |
| Tax-exempt | 435 | (66) | 369 |
| Total available-for-sale securities | (434) | (881) | (1,315) |
| Held-to-maturity securities, | | | |
| Taxable | (3) | (1) | (4) |
| Trading securities | (34) | 2 | (32) |
| Interest-bearing due from banks | 24 | 13 | 37 |
| Federal funds sold | (4) | (4) | (8) |
| Loans: | | | |
| Taxable | (215) | (192) | (407) |
| Tax-exempt | (30) | 43 | 13 |
| Total loans | (245) | (149) | (394) |
| Total Interest Income | (696) | (1,020) | (1,716) |
| INTEREST-BEARING LIABILITIES | | | |
| Interest-bearing deposits: | | | |
| Interest checking | 63 | (61) | 2 |
| Money market | 1 | (456) | (455) |
| Savings | 4 | (44) | (40) |
| Certificates of deposit | 38 | (468) | (430) |
| Individual Retirement Accounts | 104 | (5) | 99 |
| Other time deposits | 0 | 0 | 0 |
| Total interest-bearing deposits | 210 | (1,034) | (824) |
| Borrowed funds: | | | |
| Short-term | (20) | (50) | (70) |
| Long-term | (415) | (37) | (452) |
| Total borrowed funds | (435) | (87) | (522) |
| Total Interest Expense | (225) | (1,121) | (1,346) |
| Net Interest Income | (\$471) | \$101 | (\$370) |

(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 34%.

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

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TABLE V - COMPARISON OF NON-INTEREST INCOME
(In Thousands)

| | 3 Months Ended | |
|--|-------------------|-------------------|
| | March 31, 2010 | March 31, 2009 |
| Service charges on deposit accounts | \$1,093 | \$1,047 |
| Service charges and fees | 193 | 190 |
| Trust and financial management revenue | 899 | 769 |
| Insurance commissions, fees and premiums | 60 | 81 |
| Increase in cash surrender value of life insurance | 112 | 151 |
| Other operating income | 1,088 | 528 |
| Total other operating income, before realized gains (losses) on available-for-sale securities, net | \$3,445 | \$2,766 |

Table V excludes realized gains and losses on available-for-sale securities, which are discussed in the “Earnings Overview” section of Management’s Discussion and Analysis. Total noninterest income shown in Table V increased \$679,000 or 24.5%, in 2010 compared to 2009. Items of significance are as follows:

- Service charges on deposit accounts increased \$46,000, or 4.4%, in 2010 as compared to 2009. Overdraft fee revenues associated with an overdraft privilege program implemented in early 2008 increased \$37,000.
- Trust and financial management revenue increased \$130,000, or 16.9%, in 2010 as compared to 2009. The value of assets under management has increased 15.1% over the last 12 months, to \$598,793,000 at March 31, 2010, mainly associated with increases in market values of equity securities. In 2010, new accounts added \$8,399,000 to the value of assets under management.
- The increase in the cash surrender value of life insurance decreased \$39,000, or 25.8%, in 2010 over 2009. The decrease primarily relates to the changes in the earnings credit rate for the underlying contracts.
- Other operating income increased \$560,000, or 106.1%, in 2010 as compared to 2009. In 2010, the category includes a gain of \$448,000 from the sale of a parcel adjacent to one of the bank operating locations. The sale proceeds include \$390,000 associated with long-term privileges within a municipal parking facility currently under construction. The category also includes gains from disposition of mortgages held for sale of \$75,000, which represents an increase of \$52,000 over the first quarter of 2009.

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TABLE VI- COMPARISON OF NON-INTEREST EXPENSE

(In Thousands)

| | 3 Months Ended | |
|--------------------------------------|-------------------|-------------------|
| | March 31, 2010 | March 31, 2009 |
| Salaries and wages | \$3,078 | \$3,341 |
| Pensions and other employee benefits | 939 | 1,244 |
| Occupancy expense, net | 699 | 742 |
| FDIC Assessments | 404 | 302 |
| Furniture and equipment expense | 568 | 674 |
| Pennsylvania shares tax | 305 | 318 |
| Other operating expense | 1,901 | 2,017 |
| Total Other Expense | \$7,894 | \$8,638 |

Total non-interest expense decreased \$744,000, or 8.6%, in 2010 from 2009. Significant changes in 2010 as compared to 2009 include the following:

- Salaries and wages decreased \$263,000, or 7.9%. Due to the operating losses incurred in 2009, no stock options were awarded in 2010, and accordingly, there was no officers' incentive stock option expense incurred in 2010, as compared to officers' stock option expense of \$102,000 in 2009. Also, base salary costs have been reduced in 2010 due to net reductions in hourly staff schedules and elimination of one senior executive position. Further, in 2009, severance costs totaling \$51,000 were incurred.
- Pensions and other employee benefits decreased \$305,000, or 24.5%. Within this category, group health insurance expense was \$205,000 lower primarily due to favorable rate adjustments based on 2009 claims experience. In addition, employer contributions expense associated with the Savings & Retirement Plan (a 401(k) plan) and Employee Stock Ownership Plan was \$54,000 lower in 2010 than in 2009. The reduced level of expense represents the lower level of required contributions consistent with the reduced salaries and wages discussed above.
- Occupancy expense decrease of \$43,000 (5.8%) is primarily due to reduced seasonal fuel and snow removal costs incurred in 2010.
- FDIC Insurance costs increased \$102,000 to \$404,000 for the first quarter. The 2010 FDIC insurance costs reflect the impact of higher rates and higher levels of insured deposits.
- Other operating expense decreased \$116,000 or 5.8%. The category includes a variety of expenses, with the most significant increases and decreases in some of the individual expenses, as follows:
 - o There was no stock option expense in 2010 from the Independent Directors Stock Incentive Plan. In 2009, such costs were \$68,000.
 - o Expenses related to foreclosed properties decreased in 2010 by \$104,000 compared to 2009, primarily from lower expenses associated with one large commercial property. This benefit was partially offset by an increase of \$42,000 in collection costs in 2010 as compared to 2009, primarily associated with several commercial properties.
 - o Amortization of core deposit intangibles decreased \$36,000.

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FINANCIAL CONDITION

Significant changes in the average balances of the Corporation's earning assets and interest-bearing liabilities are described in the "Net Interest Margin" section of Management's Discussion and Analysis. Other significant balance sheet items, including the allowance for loan losses and stockholders' equity, are discussed in separate sections of Management's Discussion and Analysis.

Total capital purchases for 2010 are estimated at approximately \$1.6 million. Management does not expect capital expenditures to have a material, detrimental effect on the Corporation's financial condition in 2010.

PROVISION AND ALLOWANCE FOR LOAN LOSSES

The allowance for loan losses is maintained at a level which, in management's judgment, is adequate to absorb credit losses inherent in the loan portfolio. The amount of the allowance is based on management's evaluation of the collectability of the loan portfolio. In evaluating collectability, management considers a number of factors, including the status of specific impaired loans, trends in historical loss experience, delinquency trends, credit concentrations, and economic conditions within the Corporation's market area. Allowances for impaired loans are determined based on collateral values or the present value of estimated cash flows. The allowance is increased by a provision for loan losses, which is charged to expense, and reduced by charge-offs, net of recoveries.

There are two major components of the allowance – (1) "FASB Accounting Standards Codification" (the "ASC") topic 310 (formerly SFAS 114) allowances – on larger loans, mainly commercial purpose, determined on a loan-by-loan basis; and (2) ASC topic 450 (formerly SFAS 5) allowances – estimates of losses incurred on the remainder of the portfolio, determined based on collective evaluation of impairment for various categories of loans. FASB ASC 450 allowances include a portion based on historical net charge-off experience, and a portion based on evaluation of qualitative factors.

Each quarter, management performs a detailed assessment of the allowance and provision for loan losses. A management committee referred to as the Watch List Committee performs this assessment. Quarterly, the Watch List Committee and the applicable Lenders discuss each loan relationship under review, and reach a consensus on the appropriate FASB ASC 310 estimated loss amount for the quarter. The Watch List Committee's focus is on ensuring that all pertinent facts have been considered, and that the FASB ASC 310 loss amounts are reasonable. The assessment process includes review of certain loans reported on the "Watch List." All loans, which Lenders or the Credit Administration staff has assigned a risk rating of Special Mention, Substandard, Doubtful or Loss, are included in the Watch List. The scope of loans evaluated individually for impairment (FASB ASC 310 evaluation) include all loan relationships greater than \$200,000 for C&N Bank loans, and \$50,000 for First State Bank, for which there is at least one extension of credit graded Special Mention, Substandard, Doubtful or Loss. Also, loan relationships less than \$200,000 in the aggregate, but with an estimated loss of \$100,000 or more, are individually evaluated for impairment.

Since 2007, the Corporation's Risk Management personnel performed annual, independent credit reviews of large credit relationships. In prior years, outside consulting firms were retained to perform such functions. Management gives substantial consideration to the classifications and recommendations of the credit reviewers in determining the allowance for loan losses.

The FASB ASC 450 component of the allowance includes estimates of losses incurred on loans that have not been individually evaluated for impairment. Management uses loan categories included in the Call Report (a quarterly

report filed by FDIC-insured banks) to identify categories of loans with similar risk characteristics, and multiplies the loan balances for each category as of each quarter-end by two different factors to determine the FASB ASC 450 allowance amounts. These two factors are based on: (1) historical net charge-off experience, and (2) qualitative factors. The sum of the allowance amounts calculated for each risk category, including both the amount based on historical net charge-off experience and the amount based on evaluation of qualitative factors, is equal to the total FASB ASC 450 component of the allowance.

The historical net charge-off portion of the FASB ASC 450 allowance component is calculated by the Accounting Department as of the end of the applicable quarter. For each loan classification category used in the Call Report, the Accounting Department multiplies the outstanding balance as of the quarter-end (excluding loans individually evaluated for impairment) by the ratio of net charge-offs to average quarterly loan balances for the previous three calendar years. Prior to the fourth quarter 2005, C&N Bank had utilized the ratio of net charge-offs to average balances over a five-year period in calculating the historical loan loss experience portion of the allowance portfolio. Management made the change to the three-year assumption, which had very little effect on the allowance valuation as of December 31, 2005, mainly because management believes net charge-off experience over a 3-year period may be more representative of losses existing in the portfolio as of the balance sheet date.

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Management also calculates the effects of specific qualitative factors criteria to determine a percentage increase or decrease in the FASB ASC 450 allowance, in relation to the historical net charge-off percentage. The qualitative factors analysis involves assessment of changes in factors affecting the portfolio, to provide for estimated differences between losses currently inherent in the portfolio and the amounts determined based on recent historical loss rates and from identification of losses on specific individual loans. A management committee referred to as the Qualitative Factors Committee meets quarterly, near the end of the final month of each quarter. The Qualitative Factors Committee discusses several qualitative factors, including economic conditions, lending policies, changes in the portfolio, risk profile of the portfolio, competition and regulatory requirements, and other factors, with consideration given to how the factors affect three distinct parts of the loan portfolio: Commercial, Mortgage and Consumer. During or soon after completion of the meeting, each member of the Committee prepares an update to his or her recommended percentage adjustment for each qualitative factor, and average qualitative factor adjustments are calculated for Commercial, Mortgage and Consumer loans. The Accounting Department multiplies the outstanding balance as of the quarter-end (excluding loans individually evaluated for impairment) by the applicable qualitative factor percentages, to determine the portion of the FASB ASC 450 allowance attributable to qualitative factors. Average qualitative factors used in calculating the FASB ASC 450 portion of the allowance did not change significantly (by more than a few basis points) for any category over the course of the past year and the first quarter of 2010.

The allocation of the allowance for loan losses table (Table VIII) includes the FASB ASC 310 component of the allowance on the line item called “Impaired Loans.” FASB ASC 450 estimated losses, including both the portion determined based on historical net charge-off results, as well as the portion based on management’s assessment of qualitative factors, are allocated in Table VIII to the applicable categories of commercial, consumer mortgage and consumer loans. The increase in the valuation allowance on impaired loans to \$1,395,000 at March 31, 2010 from \$1,126,000 at December 31, 2009 is primarily attributed to changes in the assessment of two commercial relationships by the Watch List Committee. As of both March 31, 2010 and December 31, 2009, the FASB ASC 310 valuation allowance on impaired loans includes \$716,000 related to two other unrelated commercial relationships.

The allowance for loan losses was \$8,417,000 at March 31, 2010 up slightly from \$8,265,000 at December 31, 2009. As shown in Table VII, net charge-offs in 2010 of \$55,000 were down compared to the annual net charge-offs of \$272,000 in 2009, and well below the historical levels of the last five years. Also, Table VII shows the provision for loan losses of \$207,000 for the first quarter 2010, which is favorable by comparison to the average quarterly amount over the previous five years of \$241,000. The credit provision in the first quarter of 2009 was primarily due to a reduction in the portion of the allowance based on qualitative factors during that quarter. 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.

Table IX presents information related to past due and impaired loans. As of March 31, 2010, total impaired loans were \$6,010,000 which represents a small increase from \$5,947,000 at December 31, 2009, though down from the historical average levels of \$6,811,000 for the last five years. Nonaccrual loans decreased to \$8,556,000 at March 31, 2010 from \$9,092,000 at December 31, 2009, the highest level within the last five years and primarily due to the recent addition in late 2009 of a few larger commercial relationships. Over the period 2005-2009 and the first quarter of 2010, 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 category fluctuations within Table IX. 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 March 31, 2010. 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.

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Tables VII through X present historical data related to the allowance for loan losses:

TABLE VII - ANALYSIS OF THE ALLOWANCE FOR LOAN LOSSES

| (In Thousands) | Qtr. | Qtr. | Years Ended December 31, | | | | |
|--|----------------------------|----------------------------|--------------------------|---------|---------|---------|---------|
| | Ended March 31, 2010 | Ended March 31, 2009 | 2009 | 2008 | 2007 | 2006 | 2005 |
| Balance, beginning of year | \$8,265 | \$7,857 | \$7,857 | \$8,859 | \$8,201 | \$8,361 | \$6,787 |
| Charge-offs: | | | | | | | |
| Real estate loans | 87 | 5 | 149 | 1,457 | 196 | 611 | 264 |
| Installment loans | 70 | 73 | 293 | 254 | 216 | 259 | 224 |
| Credit cards and related plans | 0 | 8 | 0 | 5 | 5 | 22 | 198 |
| Commercial and other loans | 24 | 6 | 36 | 323 | 127 | 200 | 298 |
| Total charge-offs | 181 | 92 | 478 | 2,039 | 544 | 1,092 | 984 |
| Recoveries: | | | | | | | |
| Real estate loans | 1 | 0 | 8 | 20 | 8 | 27 | 14 |
| Installment loans | 30 | 43 | 104 | 83 | 41 | 65 | 61 |
| Credit cards and related plans | 0 | 0 | 0 | 4 | 9 | 25 | 30 |
| Commercial and other loans | 95 | 16 | 94 | 21 | 28 | 143 | 50 |
| Total recoveries | 126 | 59 | 206 | 128 | 86 | 260 | 155 |
| Net charge-offs | 55 | 33 | 272 | 1,911 | 458 | 832 | 829 |
| Allowance for loan losses recorded in acquisitions | 0 | 0 | 0 | 0 | 587 | 0 | 377 |
| Provision (credit) for loan losses | 207 | (173) | 680 | 909 | 529 | 672 | 2,026 |
| Balance, end of period | \$8,417 | \$7,651 | \$8,265 | \$7,857 | \$8,859 | \$8,201 | \$8,361 |

TABLE VIII - ALLOCATION OF THE ALLOWANCE FOR LOAN LOSSES BY TYPE

| (In Thousands) | As of | | As of December 31, | | | |
|-------------------|-------------------|----------|--------------------|----------|----------|----------|
| | March 31, 2010 | 2009 | 2008 | 2007 | 2006 | 2005 |
| Commercial | \$ 2,679 | \$ 2,677 | \$ 2,654 | \$ 1,870 | \$ 2,372 | \$ 2,705 |
| Consumer mortgage | 3,739 | 3,859 | 3,920 | 4,201 | 3,556 | 2,806 |
| Impaired loans | 1,395 | 1,126 | 456 | 2,255 | 1,726 | 2,374 |
| Consumer | 267 | 281 | 399 | 533 | 523 | 476 |
| Unallocated | 337 | 322 | 428 | - | 24 | - |
| Total Allowance | \$ 8,417 | \$ 8,265 | \$ 7,857 | \$ 8,859 | \$ 8,201 | \$ 8,361 |

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TABLE IX - PAST DUE AND IMPAIRED LOANS

| (In Thousands) | As of March 31, 2010 | 2009 | As of December 31, | | | |
|---|----------------------------|---------|--------------------|---------|---------|---------|
| | | | 2008 | 2007 | 2006 | 2005 |
| Impaired loans without a valuation allowance | \$3,064 | \$3,257 | \$3,435 | \$857 | \$2,674 | \$910 |
| Impaired loans with a valuation allowance | 2,946 | 2,690 | 2,230 | 5,361 | 5,337 | 7,306 |
| Total impaired loans | \$6,010 | \$5,947 | \$5,665 | \$6,218 | \$8,011 | \$8,216 |
| Valuation allowance related to impaired loans | \$1,395 | \$1,126 | \$456 | \$2,255 | \$1,726 | \$2,374 |
| Total nonaccrual loans | \$8,556 | \$9,092 | \$7,200 | \$6,955 | \$8,506 | \$6,365 |
| Total loans past due 90 days or more and still accruing | \$530 | \$31 | \$1,305 | \$1,200 | \$1,559 | \$1,369 |

TABLE X - SUMMARY OF LOANS BY TYPE

| (In Thousands) | March 31, 2010 | 2009 | As of December 31, | | | |
|------------------------------------|-------------------|-----------|--------------------|-----------|-----------|-----------|
| | | | 2008 | 2007 | 2006 | 2005 |
| Real estate - residential mortgage | \$418,115 | \$420,365 | \$433,377 | \$441,692 | \$387,410 | \$361,857 |
| Real estate - commercial mortgage | 163,273 | 163,483 | 165,979 | 144,742 | 178,260 | 153,661 |
| Real estate - construction | 28,931 | 26,716 | 24,992 | 22,497 | 10,365 | 5,552 |
| Consumer | 17,609 | 19,202 | 26,732 | 37,193 | 35,992 | 31,559 |
| Agricultural | 3,763 | 3,848 | 4,495 | 3,553 | 2,705 | 2,340 |
| Commercial | 51,547 | 49,753 | 48,295 | 52,241 | 39,135 | 69,396 |
| Other | 281 | 638 | 884 | 1,010 | 1,227 | 1,871 |
| Political subdivisions | 36,894 | 37,598 | 38,790 | 33,013 | 32,407 | 27,063 |
| Total | 720,413 | 721,603 | 743,544 | 735,941 | 687,501 | 653,299 |
| Less: allowance for loan losses | (8,417) | (8,265) | (7,857) | (8,859) | (8,201) | (8,361) |
| Loans, net | \$711,996 | \$713,338 | \$735,687 | \$727,082 | \$679,300 | \$644,938 |

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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 March 31, 2010, the Corporation maintained overnight interest-bearing deposits with the Federal Reserve Bank of Philadelphia and other correspondent banks totaling \$60,700,000.

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 \$26,357,000 at March 31, 2010.

The Corporation's outstanding, available, and total credit facilities are presented in the following table.

TABLE XI – CREDIT FACILITIES

| (In Thousands) | Outstanding | | Available | | Total Credit | |
|--------------------------------------|------------------|------------------|------------------|------------------|------------------|------------------|
| | Mar. 31, 2010 | Dec. 31, 2009 | Mar. 31, 2010 | Dec. 31, 2009 | Mar. 31, 2010 | Dec. 31, 2009 |
| Federal Home Loan Bank of Pittsburgh | \$103,452 | \$133,602 | \$243,326 | \$210,954 | \$346,778 | \$344,556 |
| Federal Reserve Bank Discount Window | 0 | 0 | 23,738 | 25,802 | 23,738 | 25,802 |
| Other correspondent banks | 0 | 0 | 29,379 | 29,722 | 29,379 | 29,722 |
| Total credit facilities | \$103,452 | \$133,602 | \$296,443 | \$266,478 | \$399,895 | \$400,080 |

At March 31, 2010, 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.

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 non-pledged investment securities to meet its obligations. At March 31, 2010, the carrying value of non-pledged available-for-sale securities was \$64,648,000.

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

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STOCKHOLDERS' EQUITY AND CAPITAL ADEQUACY

The Corporation and the subsidiary banks (Citizens & Northern Bank and First State Bank) are subject to various regulatory capital requirements administered by the federal banking agencies. Details concerning the Corporation's and the subsidiary banks' capital ratios at March 31, 2010 and December 31, 2009 are presented below. Management believes, as of March 31, 2010 and December 31, 2009, that the Corporation and subsidiary banks meet all capital adequacy requirements to which they are subject.

(Dollars in Thousands)

| | Actual | | Minimum Capital Requirement | | Minimum To Be Well Capitalized Under Prompt Corrective Action Provisions | |
|---|-----------|--------|-----------------------------------|-------|--|-------|
| | Amount | Ratio | Amount | Ratio | Amount | Ratio |
| March 31, 2010: | | | | | | |
| Total capital to risk-weighted assets: | | | | | | |
| Consolidated | \$137,196 | 18.36% | \$59,795 | 38% | n/a | n/a |
| C&N Bank | 121,601 | 16.76% | 58,027 | 38% | \$72,534 | 310% |
| First State Bank | 4,568 | 23.60% | 1,548 | 38% | 1,935 | 310% |
| Tier 1 capital to risk-weighted assets: | | | | | | |
| Consolidated | 128,249 | 17.16% | 29,897 | 34% | n/a | n/a |
| C&N Bank | 113,279 | 15.62% | 29,014 | 34% | 43,520 | 36% |
| First State Bank | 4,417 | 22.82% | 774 | 34% | 1,161 | 36% |
| Tier 1 capital to average assets: | | | | | | |
| Consolidated | 128,249 | 9.88% | 51,902 | 34% | n/a | n/a |
| C&N Bank | 113,279 | 9.08% | 49,890 | 34% | 62,362 | 35% |
| First State Bank | 4,417 | 9.02% | 1,959 | 34% | 2,448 | 35% |
| December 31, 2009: | | | | | | |
| Total capital to risk-weighted assets: | | | | | | |
| Consolidated | \$133,311 | 17.89% | \$59,628 | 38% | n/a | n/a |
| C&N Bank | 117,320 | 16.22% | 57,869 | 38% | \$72,337 | 310% |
| First State Bank | 4,545 | 24.73% | 1,470 | 38% | 1,838 | 310% |
| Tier 1 capital to risk-weighted assets: | | | | | | |
| Consolidated | 124,463 | 16.70% | 29,814 | 34% | n/a | n/a |
| C&N Bank | 109,112 | 15.08% | 28,935 | 34% | 43,402 | 36% |
| First State Bank | 4,395 | 23.92% | 735 | 34% | 1,103 | 36% |
| Tier 1 capital to average assets: | | | | | | |
| Consolidated | 124,463 | 9.86% | 50,513 | 34% | n/a | n/a |
| C&N Bank | 109,112 | 9.02% | 48,393 | 34% | 60,491 | 35% |
| First State Bank | 4,395 | 9.33% | 1,885 | 34% | 2,356 | 35% |

Management expects the Corporation and the subsidiary banks to maintain capital levels that exceed the regulatory standards for well-capitalized institutions for the next 12 months and for the foreseeable future. Planned capital expenditures are not expected to have a significantly detrimental effect on capital ratios.

In January 2009, the Corporation issued Preferred Stock and a Warrant to purchase up to 194,794 shares of common stock at an exercise price of \$20.36 per share to the United States Department of the Treasury under the TARP Program. The Corporation sold the Preferred Stock and Warrant for an aggregate price of \$26,440,000. The Preferred Stock pays a cumulative dividend rate of 5% per annum for the first five years and will reset to a rate of 9% per annum after year five. Pursuant to participation in the TARP Program, the Corporation may continue to pay dividends on its common stock, subject to the following requirements and limitations: (1) all accrued and unpaid dividends for all past dividend periods on the preferred stock issued to the Treasury must be fully paid; and (2) consent of the Treasury is required for any increase over \$0.24 per quarter in the per share dividends on common shares until January 16, 2012, unless prior to that date, the Corporation has redeemed the preferred stock issued to the Treasury in whole or the Treasury has transferred all of the preferred stock to third parties. Also, until January 16, 2012 (unless prior to that date, the Corporation has redeemed the preferred stock issued to the Treasury in whole or the Treasury has transferred all of the preferred stock to third parties) the Treasury's consent is required for any repurchases of common stock, except for repurchases of shares in connection with employee benefit plans in the ordinary course of business consistent with past practice. Management is considering redemption of the Preferred Stock in 2010; however, our ability to do so is dependent upon approval from banking regulatory authorities and the Treasury. In the event the Preferred Stock is redeemed, either partially or in total, risk-based capital ratios will decline, but management expects the Banks will remain well-capitalized and the Corporation will continue to meet minimum capital requirements.

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Future dividend payments will depend upon maintenance of a strong financial condition, future earnings and capital and regulatory requirements. In addition to the restrictions imposed by participation in TARP (described above), the Corporation, C&N Bank and First State Bank are subject to restrictions on the amount of dividends that may be paid without approval of banking regulatory authorities. Also, under guidance issued in 2009 by the Federal Reserve, until further notice the Corporation must consult the Federal Reserve before declaring dividends on either common or preferred stock.

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 (Loss) Income" within stockholders' equity. The balance in Accumulated Other Comprehensive (Loss) Income related to unrealized gains or losses on available-for-sale securities, net of deferred income tax, amounted to (\$718,000) at March 31, 2010 and (\$522,000) at December 31, 2009. 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 5 to the consolidated financial statements provides additional information concerning management's evaluation of available-for-sale securities for other-than-temporary impairment at March 31, 2010.

Stockholders' equity is also affected by the underfunded or overfunded status of defined benefit pension and postretirement plans. The balance in Accumulated Other Comprehensive (Loss) Income related to underfunded defined benefit plans, net of deferred income tax, was (\$250,000) at March 31, 2010 and (\$369,000) at December 31, 2009.

INCOME TAXES

In 2010, the provision for income tax was \$1,437,000, or 24.5%, of pre-tax income. In 2009, the credit for income tax was (\$4,388,000), or 38.5%, of the pre-tax loss. A large portion of the 2009 credit for income tax was deferred, and related to securities write-downs that were not currently deductible for income tax reporting purposes. The provision (credit) for income tax for the 3-month periods ended March 31, 2010 and 2009 is based on the Corporation's estimate of the effective tax rate expected to be applicable for the full year. The Corporation's effective tax rates differ from the statutory rate of 35% principally because of the effects of tax-exempt interest income.

The Corporation recognizes deferred tax assets and liabilities based on differences between the financial statement carrying amounts and the tax bases of assets and liabilities. At March 31, 2010, the net deferred tax asset was \$21,957,000, down slightly from the balance at December 31, 2009 of \$22,037,000. The net deferred tax asset balance at March 31, 2010 attributable to realized securities losses was \$15,867,000, exclusive of a valuation allowance of \$373,000. 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. Of the total deferred tax asset from realized losses on securities, a portion is from securities that, if the Corporation were to sell them, would be classified as capital losses for income tax reporting purposes. The valuation allowance at March 31, 2010 reflects the excess of the tax benefit that would be generated from selling all of the capital assets, over the amount that could be realized from available carryback and offset against capital gains generated in 2007 and 2008. Realization of the remaining \$373,000 of tax benefits associated with capital assets is dependent upon realization of future capital gains. After adjustment for the valuation allowance on capital assets, management believes the recorded net deferred tax asset at March 31, 2010 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 8 to the consolidated financial statements.

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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 took the unusual step of establishing a target range of 0% to 0.25%, which it has maintained through the first three months of 2010. Also, the Federal Reserve has injected massive amounts of liquidity into the nation's monetary system through a variety of programs.

The current low short-term rate environment and liquidity injections could, in the future, lead to inflationary pressures. Recent data indicate that the national economy and financial system have stabilized, and the Federal Reserve has begun scaling back the emergency liquidity programs put in place during 2008 and 2009. The Federal Reserve is widely expected to begin raising short-term interest rates in late 2010 or 2011, which management would expect to be adverse to the Corporation's cost of funds and net interest margin. 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

On June 30, 2009, the Financial Accounting Standards Board ("FASB") issued an accounting pronouncement establishing the "FASB Accounting Standards Codification" (the "ASC") as the source of authoritative accounting principles recognized by the FASB to be applied by nongovernmental entities. The pronouncement, ASC 105 "Generally Accepted Accounting Principles", was effective for financial statements issued for interim and annual periods ending after September 15, 2009, for most entities. On the effective date, all non-SEC accounting and reporting standards were superseded. The Corporation adopted this new accounting pronouncement for the quarterly period ended September 30, 2009, as required, and adoption did not have any material impact on the Corporation's consolidated financial statements.

Since July 1, 2009, the FASB has issued FASB 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 December 2009, the FASB issued ASU 2009-16, Transfers and Servicing (Topic 860) – Accounting for Transfers of Financial Assets. ASU 2009-16 amends the derecognition accounting and disclosure guidance. ASU 2009-16 eliminates the exemption from consolidation for QSPEs and also requires a transferor to evaluate all existing QSPEs to determine whether they must be consolidated. ASU 2009-16 was effective as of the beginning of the first annual reporting period that begins after November 15, 2009, and did not have a significant impact on the Corporation's ongoing financial position or results of operations.

In December 2009, the Financial Accounting Standards Board (the "FASB") issued Accounting Standards Update ("ASU") ASU 2009-17, Consolidation (Topic 810) – Improvements to Financial Reporting by Enterprises Involved with Variable Interest Entities. ASU 2009-17 amends the consolidation guidance applicable to variable interest entities. The amendments to the consolidation guidance affect all entities, as well as qualifying special-purpose entities that were previously excluded from previous consolidation guidance. ASU 2009-17 was effective as of the beginning of the first annual reporting period that begins after November 15, 2009. Adoption of the new guidance did not have a significant impact on the Corporation's ongoing financial position or results of operations.

In January 2010, the FASB issued ASU 2010-06, Fair Value Measurements and Disclosures (Topic 820) – Improving Disclosures about Fair Value Measurements. ASU 2010-06 revises two disclosure requirements concerning fair value measurements and clarifies two others. It requires separate presentation of significant transfers into and out of Levels 1 and 2 of the fair value hierarchy and disclosure of the reasons for such transfers. It will also require the presentation of purchases, sales, issuances and settlements within Level 3 on a gross basis rather than a net basis. The amendments also clarify that disclosures should be disaggregated by class of asset or liability and that disclosures about inputs and valuation techniques should be provided for both recurring and non-recurring fair value measurements. The Corporation's disclosures about fair value measurements are presented in Note 4 to the consolidated financial statements. These new disclosure requirements were adopted by the Corporation during the current period, with the exception of the requirement concerning gross presentation of Level 3 activity, which is effective for fiscal years beginning after December 15, 2010. With respect to the portions of this ASU that were adopted during the current period, the adoption of this standard did not have a significant impact on the Corporation's financial position, results of operations or disclosures. Management does not believe that the adoption of the remaining portion of this ASU will have a significant impact on the Corporation's ongoing financial position, results of operation or disclosures.

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The FASB has issued ASU 2010-08, Technical Corrections to Various Topics, thereby amending the Codification. This ASU resulted from a review by the FASB of its standards to determine if any provisions are outdated, contain inconsistencies, or need clarifications to reflect the FASB's original intent. The FASB believes the amendments do not fundamentally change U.S. GAAP. However, certain clarifications on embedded derivatives and hedging reflected in Topic 815, Derivatives and Hedging, may cause a change in the application of the guidance in Subtopic 815-15. Accordingly, the FASB provided special transition provisions for those amendments. Currently, the provisions of this ASU have no material impact on the Corporation's consolidated financial statements.

The FASB issued ASU 2010-10, Consolidation (Topic 810): Amendments for Certain Investment Funds, and the ASU's defers the effective date of certain amendments to the consolidation requirements of Topic 810, Consolidation, resulting from the issuance of FASB Accounting Standard No. 167, Amendments to FASB Interpretation 46(R). Specifically, the amendments to the consolidation requirements of Topic 810 resulting from the issuance of Statement 167 are deferred for a reporting entity's interest in an entity:

- That has all the attributes of an investment company; or
- For which it is industry practice to apply measurement principles for financial reporting purposes that are consistent with those followed by investment companies.

ASU 2010-10 does not defer the disclosure requirements in the Statement 167 amendments to Topic 810. The amendments in this ASU are effective for the Corporation's 2010 annual reporting period, and for all interim periods within the first annual reporting period. The provisions of this ASU have no material impact on the Corporation's consolidated financial statements.

FASB ASU 2010-11, Derivatives and Hedging (Topic 815): Scope Exception Related to Embedded Credit Derivatives clarifies the type of embedded credit derivative that is exempt from embedded derivative bifurcation requirements. Specifically, only one form of embedded credit derivative qualifies for the exemption - one that is related only to the subordination of one financial instrument to another. As a result, entities that have contracts containing an embedded credit derivative feature in a form other than such subordination may need to separately account for the embedded credit derivative feature. The amendments of ASU 2010-11 are effective for each reporting entity at the beginning of its first fiscal quarter beginning after June 15, 2010. Currently, the provisions of this ASU have no material impact on the Corporation's consolidated financial statements.

ITEM 3. 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 other entities on trust-preferred securities. 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.

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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 50-300 basis points of current 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 provides limits at +/- 100, 200 and 300 basis points from current rates for fluctuations in net interest income from the baseline (flat rates) one-year scenario. The policy also limits acceptable market value variances from the baseline values based on current rates.

Table XII, which follows this discussion, is based on the results of the simulation model as of January 31, 2010 and November 30, 2009. The 2009 figures include a pro forma adjustment to increase equity by \$21,410,000, which represents the proceeds received from the Corporation's sale of common stock in December 2009 net of issuance costs. The table also includes pro forma adjustments to reflect the Corporation's December 2009 purchases of several investment securities. The securities purchased totaled approximately \$22,382,000 and included obligations of U.S. Government agencies and a collateralized mortgage obligation issued by a U.S. Government agency.

As indicated in the table, the Corporation is liability sensitive, and therefore net interest income and market value generally increase when interest rates fall and decrease when interest rates rise. The table shows that as of January 31, 2010 and November 30, 2009, the changes in net interest income and changes in market value were within the policy limits in all scenarios.

In December 2007, the Corporation entered into repurchase agreements (borrowings) totaling \$80 million to fund the purchase of investment securities. In addition to generating positive earnings from the spread of the return on the investment securities over the current cost of the borrowings, the transaction reduces the magnitude of the Corporation's overall liability sensitive position. Specifically, the borrowings include embedded caps providing that, if 3-month LIBOR were to exceed 5.15%, the interest rate payable on the repurchase agreements would fall, down to a minimum of 0%, based on parameters included in the repurchase agreements. The embedded cap on one of the \$40 million borrowings expires in December 2010, and the embedded cap on the other \$40 million borrowing expires in December 2012. Three-month LIBOR has not exceeded 5.15% since the embedded caps were acquired; therefore, they have not affected interest expense to date. The 3-month LIBOR was 0.25% at January 31, 2010 and 0.26% at November 30, 2009. Since the embedded caps are effective only when 3-month LIBOR exceeds 5.15%, the Corporation would be unable to realize an interest expense reduction in any scenario at January 2010 or November 2009.

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 margin 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.

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TABLE XII - THE EFFECT OF HYPOTHETICAL CHANGES IN INTEREST RATES

January 31, 2010 Data

(In Thousands)

Period Ending January 31, 2011

| Basis Point Change in Rates | Interest Income | Interest Expense | Net Interest Income (NII) | NII % Change | NII Risk Limit |
|-----------------------------|--------------------|---------------------|------------------------------|-----------------|-------------------|
| +300 | \$69,488 | \$34,209 | \$35,279 | -14.9% | 20.0% |
| +200 | 66,946 | 28,902 | 38,044 | -8.2% | 15.0% |
| +100 | 64,216 | 23,635 | 40,581 | -2.1% | 10.0% |
| 0 | 61,129 | 19,678 | 41,451 | 0.0% | 0.0% |
| -100 | 57,590 | 18,710 | | | |