CITIZENS & NORTHERN CORP
Form 10-K
February 18, 2016

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

**Washington, D.C. 20549**

**FORM 10-K**

**(Mark One)**

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

For the fiscal year ended December 31, 2015

**OR**

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

**For the transition period from _______________ to _________________________.**

Commission file number: 0-16084

**CITIZENS & NORTHERN CORPORATION**

(Exact name of Registrant as specified in its charter)

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

90-92 MAIN STREET, WELLSBORO, PA 16901

(Address of principal executive offices) (Zip code)

570-724-3411

(Registrant's telephone number including area code)

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

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

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

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

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes ¨ No x

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes x No ¨

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

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. ¨

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

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

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

Yes ¨ No x

The aggregate market value of the registrant's common stock held by non-affiliates at June 30, 2015, the registrant's most recently completed second fiscal quarter, was $244,570,133.

The number of shares of common stock outstanding at February 12, 2016 was 12,151,108.

**DOCUMENTS INCORPORATED BY REFERENCE**

Portions of the registrant's proxy statement for the annual meeting of its shareholders to be held April 21, 2016 are incorporated by reference into Parts III and IV of this report.

## PART I

## ITEM 1. BUSINESS

Citizens & Northern Corporation ("Corporation") is a holding company whose principal activity is community banking. The Corporation's principal office is located in Wellsboro, Pennsylvania. The largest subsidiary is Citizens & Northern Bank ("C&N Bank" or the "Bank"). The Corporation's other wholly-owned subsidiaries are Citizens & Northern Investment Corporation and Bucktail Life Insurance Company ("Bucktail"). Citizens & Northern Investment Corporation was formed in 1999 to engage in investment activities. Bucktail reinsures credit and mortgage life and accident and health insurance on behalf of C&N Bank.

C&N Bank is a Pennsylvania banking institution that was formed by the consolidation of Northern National Bank of Wellsboro and Citizens National Bank of Towanda on October 1, 1971. Subsequent mergers included: First National Bank of Ralston in May 1972; Sullivan County National Bank in October 1977; Farmers National Bank of Athens in January 1984; and First National Bank of East Smithfield in May 1990. In 2005, the Corporation acquired Canisteo Valley Corporation and its subsidiary, First State Bank, a New York State chartered commercial bank with offices in Canisteo and South Hornell, NY. In 2010, the First State Bank operations were merged into C&N Bank and Canisteo Valley Corporation was merged into the Corporation. On May 1, 2007, the Corporation acquired Citizens Bancorp, Inc. ("Citizens"), with banking offices in Coudersport, Emporium and Port Allegany, Pennsylvania. Citizens Trust Company, the banking subsidiary of Citizens, was merged with and into C&N Bank as part of the transaction. C&N Bank has held its current name since May 6, 1975, at which time C&N Bank changed its charter from a national bank to a Pennsylvania bank.

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

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

Major initiatives within the last 5 years included the following:

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

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

- in 2013, worked with consultants on projects which resulted in increases in revenues from service charges on deposit accounts, starting primarily in the fourth quarter 2013, and reductions in electronic funds processing expenses and other benefits over approximately the next five years;

- in 2014, approved a new treasury stock repurchase program. Under the new program, the Corporation is authorized to repurchase up to 622,500 shares of the Corporation’s common stock, or approximately 5% of the Corporation’s outstanding shares at July 16, 2014. Cumulatively through December 31, 2015, 435,200 shares had been repurchased; and

- in 2015, began an organization-wide effort to enhance customer relationships, growth and profitability, including working with consultants on enhanced employee engagement and customer service training, and hiring four new lending personnel to provide more access to commercial and mortgage lending opportunities.

Virtually all of the Corporation’s banking offices are located in the “Marcellus Shale,” an area extending across portions of New York State, Pennsylvania, Ohio, Maryland, West Virginia and Virginia. In recent years, most of the Pennsylvania counties in which the Corporation operates were significantly affected by an upsurge in natural gas exploration, as technological developments made exploration of the Marcellus Shale commercially feasible. After a surge of activity in 2009 through most of 2011, the market price of natural gas declined, causing Marcellus Shale natural gas exploration activity to slow, though some activity has continued to occur throughout the Corporation’s market area. Through December 31, 2015, the Corporation has not experienced significant credit issues as a result of the expansion and subsequent reduction in Marcellus Shale-related activity.

At December 31, 2015, C&N Bank had total assets of $1,209,389,000, total deposits of $942,331,000, net loans outstanding of $696,991,000 and 283 full-time equivalent employees.

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

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

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

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

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

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

## ITEM 1A. RISK FACTORS

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

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

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

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

**Limited Geographic Diversification -** The Corporation grants commercial, residential and personal loans to customers primarily in the Pennsylvania counties of Tioga, Bradford, Sullivan, Lycoming, Potter, Cameron and McKean, and in Steuben and Allegany Counties in New York State. Although the Corporation has a diversified loan portfolio, a significant portion of its debtors' ability to honor their contracts is dependent on the local economic conditions within the region. Deterioration in economic conditions could adversely affect the quality of the Corporation's loan portfolio and the demand for its products and services, and accordingly, could have a material adverse effect on the Corporation's financial condition, results of operations or liquidity.

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

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

**Mortgage Banking** – In September 2009, the Corporation entered into an agreement to originate and sell residential mortgage loans to the secondary market through the MPF Xtra program administered by the Federal Home Loan Banks of Pittsburgh and Chicago. The Corporation’s mortgage sales activity under this program was not significant in 2009, but has subsequently increased. In 2014, the Corporation entered into an agreement and in June 2014 began to originate and sell residential mortgage loans to the secondary market through the MPFX Original program, which is also administered by the Federal Home Loan Banks of Pittsburgh and Chicago. At December 31, 2015, total residential mortgages sold and serviced through the two programs amounted to $152,448,000. The Corporation must strictly adhere to the MPF Xtra and MPFX Original program guidelines for origination, underwriting and servicing loans, and failure to do so may result in the Corporation being forced to repurchase loans or being dropped from the program. As of December 31, 2015, the total outstanding balance of residential mortgage loans the Corporation has repurchased as a result of identified instances of noncompliance amounted to $1,968,000. If the volume of such forced repurchases of loans were to increase significantly, or if the Corporation were to be dropped from the programs, it could have a material adverse effect on the Corporation’s financial condition, results of operations or liquidity.

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

The Federal Home Loan Bank of Pittsburgh - Through its subsidiary (C&N Bank), the Corporation is a member of the Federal Home Loan Bank of Pittsburgh (FHLB-Pittsburgh), which is one of 11 regional Federal Home Loan Banks. The Corporation has a line of credit with the FHLB-Pittsburgh that is secured by a blanket lien on its loan portfolio. Access to this line of credit is critical if a funding need arises. However, there can be no assurance that the FHLB-Pittsburgh will be able to provide funding when needed, nor can there be assurance that the FHLB-Pittsburgh will provide funds specifically to the Corporation should its financial condition deteriorate and/or regulators prevent that access. The inability to access this source of funds could have a materially adverse effect on the Corporation's financial flexibility if alternate financing is not available at acceptable interest rates. The failure of the FHLB-Pittsburgh or the FHLB system in general, may materially impair the Corporation's ability to meet short- and long-term liquidity needs or to meet growth plans.

The Corporation owns common stock of the FHLB-Pittsburgh in order to qualify for membership in the FHLB system and access services from the FHLB-Pittsburgh. The FHLB-Pittsburgh faces a variety of risks in its operations including interest rate risk, counterparty credit risk, and adverse changes in its regulatory framework. In addition, the 11 Federal Home Loan Banks are jointly liable for the consolidated obligations of the FHLB system. To the extent that one FHLB cannot meet its obligations, other FHLBs can be called upon to make required payments. Such risks affecting the FHLB-Pittsburgh could adversely impact the value of the Corporation's investment in the common stock of the FHLB-Pittsburgh and/or affect its access to credit.

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

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

FDIC Insurance Assessments - In 2008 and 2009, higher levels of bank failures dramatically increased the resolution costs of the Federal Deposit Insurance Corporation, or the FDIC, and depleted the deposit insurance fund. In addition, the FDIC and the U.S. Congress increased federal deposit insurance coverage, placing additional stress on the deposit insurance fund. In order to maintain a strong funding position and restore reserve ratios of the deposit insurance fund, in 2009 the FDIC increased assessment rates. Although our total expenses from FDIC assessments have steadily decreased – to $600,000 in 2014 (up slightly to $603,000 in 2015) from $2,092,000 in 2009, we are generally unable to control the amount of premiums that we are required to pay for FDIC insurance. If a significant number of bank or financial institution failures occur, we may be required to pay higher FDIC premiums. Future increases in FDIC insurance premiums or additional special assessments may materially adversely affect our results of operations.

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

**ITEM 1B. UNRESOLVED STAFF COMMENTS**

Not applicable.

**ITEM 2. PROPERTIES**

The Bank owns each of its properties, except for the branch facilities located at 130 Court Street, Williamsport, PA, and at 2 East Mountain Avenue, South Williamsport, PA, which are leased. All of the properties are in good condition. None of the owned properties are subject to encumbrance.

A listing of properties is as follows:

Main administrative offices:

| | | |
|---|---|---|
| 90-92 Main Street<br>Wellsboro, PA 16901 | or | 10 Nichols Street<br>Wellsboro, PA 16901 |

Branch offices – Citizens & Northern Bank:

| | | |
|---|---|---|
| 428 S. Main Street<br>Athens, PA 18810 | 514 Main Street<br>Laporte, PA 18626 | 2 East Mountain Avenue **<br>South Williamsport, PA 17702 |
| 10 North Main Street<br>Coudersport, PA 16915 | 4534 Williamson Trail<br>Liberty, PA 16930 | 41 Main Street<br>Tioga, PA 16946 |
| 111 W. Main Street<br>Dushore, PA 18614 | 1085 S. Main Street<br>Mansfield, PA 16933 | 428 Main Street<br>Towanda, PA 18848 |
| 563 Main Street<br>East Smithfield, PA 18817 | 612 James Monroe Avenue<br>Monroeton, PA 18832 | 64 Elmira Street<br>Troy, PA 16947 |
| 104 W. Main Street<br>Elkland, PA 16920 | 3461 Route 405 Highway<br>Muncy, PA 17756 | 90-92 Main Street<br>Wellsboro, PA 16901 |
| 135 East Fourth Street<br>Emporium, PA 15834 | 100 Maple Street<br>Port Allegany, PA 16743 | 1510 Dewey Avenue<br>Williamsport, PA 17701 |

| | | |
|---|---|---|
| 230 Railroad Street<br>Jersey Shore, PA 17740 | 24 Thompson Street<br>Ralston, PA 17763 | 130 Court Street **<br>Williamsport, PA 17701 |
| 102 E. Main Street<br>Knoxville, PA 16928 | 1827 Elmira Street<br>Sayre, PA 18840 | 1467 Golden Mile Road<br>Wysox, PA 18854 |
| 3 Main Street<br>Canisteo, NY 14823 | 6250 County Rte 64<br>Hornell, NY 14843 | |

Facilities management office:

13 Water Street

Wellsboro, PA 16901

** designates leased branch facility

**ITEM 3. LEGAL PROCEEDINGS**

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

**ITEM 4. MINE SAFETY DISCLOSURE**

Not applicable.

**PART II**

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

**QUARTERLY SHARE DATA**

Trades of the Corporation’s stock are executed through various brokers who maintain a market in the Corporation’s stock. The Corporation’s stock is listed on the NASDAQ Capital Market with the trading symbol CZNC. As of December 31, 2015, there were 2,316 shareholders of record of the Corporation’s common stock.

The following table sets forth the high and low sales prices of the common stock during 2015 and 2014.

| | 2015 | | | 2014 | | |
|---|---|---|---|---|---|---|
| | High | Low | Dividend Declared per Quarter | High | Low | Dividend Declared per Quarter |
| First quarter | $21.50 | $19.01 | $ 0.26 | $20.74 | $18.19 | $ 0.26 |
| Second quarter | 21.17 | 19.16 | 0.26 | 20.10 | 17.94 | 0.26 |
| Third quarter | 20.73 | 19.25 | 0.26 | 20.10 | 18.50 | 0.26 |
| Fourth quarter | 21.45 | 19.07 | 0.26 | 21.49 | 18.83 | 0.26 |

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

Effective July 17, 2014, the Corporation terminated its existing treasury stock repurchase programs and approved a new treasury stock repurchase program. Under the new program, the Corporation is authorized to repurchase up to 622,500 shares of the Corporation’s common stock, or approximately 5% of the Corporation’s issued and outstanding shares at July 16, 2014. As permitted by securities laws and other legal requirements and subject to market conditions and other factors, purchases under the new program may be made from time to time in the open market at prevailing prices, or through privately negotiated transactions.

Consistent with previous programs, the Board of Directors' July 17, 2014 authorization provides that: (1) the new treasury stock repurchase program shall be effective when publicly announced and shall continue thereafter until suspended or terminated by the Board of Directors, in its sole discretion; and (2) all shares of common stock repurchased pursuant to

the new program shall be held as treasury shares and be available for use and reissuance for purposes as and when determined by the Board of Directors including, without limitation, pursuant to the Corporation's Dividend Reinvestment and Stock Purchase Plan and its equity compensation program. Through December 31, 2015, 435,200 shares had been repurchased at a cost of $8,417,000.

The following table sets forth a summary of purchases by the Corporation, in the open market, of its equity securities during the fourth quarter 2015:

| Period | Total Number of Shares Purchased | Average Price Paid per Share | Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs | Maximum Number of Shares that May Yet be Purchased Under the Plans or Programs |
|---|---|---|---|---|
| October 1 - 31, 2015 | 8,000 | $ 19.41 | 419,400 | 203,100 |
| November 1 - 30, 2015 | 13,700 | $ 19.98 | 433,100 | 189,400 |
| December 1 - 31, 2015 | 2,100 | $ 20.01 | 435,200 | 187,300 |

**PERFORMANCE GRAPH**

Set forth below is a chart comparing the Corporation's cumulative return to stockholders against the cumulative return of the Russell 2000 and a Peer Group Index of similar banking organizations selected by the Corporation for the five-year period commencing December 31, 2010 and ended December 31, 2015. The index values are market-weighted dividend-reinvestment numbers, which measure the total return for investing $100.00 five years ago. This meets Securities & Exchange Commission requirements for showing dividend reinvestment share performance over a five-year period and measures the return to an investor for placing $100.00 into a group of bank stocks and reinvesting any and all dividends into the purchase of more of the same stock for which dividends were paid.

| | Period Ending | | | | | |
|---|---|---|---|---|---|---|
| Index | 12/31/10 | 12/31/11 | 12/31/12 | 12/31/13 | 12/31/14 | 12/31/15 |
| Citizens & Northern Corporation | 100.00 | 128.69 | 137.49 | 157.68 | 166.63 | 178.31 |
| Russell 2000 | 100.00 | 95.82 | 111.49 | 154.78 | 162.35 | 155.18 |
| CZNC Peer Group Index* | 100.00 | 93.86 | 112.37 | 140.86 | 154.64 | 162.21 |

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The Corporation's peer group consists of banks headquartered in Pennsylvania with total assets of $700 million to $2 billion as of September 30, 2015. This peer group consists of ACNB Corporation, Gettysburg; AmeriServ Financial, Inc., Johnstown; CB Financial Services , Inc., Carmichaels; Citizens Financial Services, Inc., Mansfield; Codorus Valley Bancorp, Inc., York; DNB Financial Corporation, Downingtown; ENB Financial Corp., Ephrata; ESSA Bancorp, Inc., Stroudsburg; Fidelity D&D Bancorp, Inc., Dunmore; First Keystone Corporation, Berwick; First National Community Bancorp, Inc., Dunmore; FNB Bancorp, Inc., Newtown; Fox Chase Bancorp, Inc., Hatboro; Franklin Financial Services Corporation, Chambersburg; Harleysville Savings Financial Corporation, Harleysville; Norwood Financial Corp., Honesdale; Orrstown Financial Services, Inc., Shippensburg; Penns Woods Bancorp, Inc., Williamsport; Peoples Financial Services Corp., Scranton; QNB Corp., Quakertown; Republic First Bancorp, Inc., Philadelphia; Royal Bancshares of Pennsylvania, Inc., Bala Cynwyd; Somerset Trust Holding Company, Somerset;1$^{st}$ Summit Bancorp of Johnstown, Inc., Johnstown; Mid Penn Bancorp, Inc., Millersburg; Embassy Bancorp, Inc., Bethlehem.

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

**EQUITY COMPENSATION PLAN INFORMATION**

The following table sets forth information concerning the Stock Incentive Plan and Independent Directors Stock Incentive Plan, both of which have been approved by the Corporation's shareholders. The figures shown in the table below are as of December 31, 2015.

| | Number of Securities to be Issued Upon Exercise of Outstanding Options | Weighted-average Exercise Price of Outstanding Options | Number of Securities Remaining for Future Issuance Under Equity Compensation Plans |
|---|---|---|---|
| Equity compensation plans approved by shareholders | 248,486 | $ 18.59 | 323,977 |
| Equity compensation plans not approved by shareholders | 0 | N/A | 0 |

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

**ITEM 6. SELECTED FINANCIAL DATA**

**As of or for the Year Ended December 31,**

| INCOME STATEMENT (In Thousands) | 2015 | 2014 | 2013 | 2012 | 2011 |
|---|---|---|---|---|---|
| Interest and fee income | $44,519 | $46,009 | $48,914 | $56,632 | $61,256 |
| Interest expense | 4,602 | 5,122 | 5,765 | 9,031 | 13,556 |
| Net interest income | 39,917 | 40,887 | 43,149 | 47,601 | 47,700 |
| Provision (credit) for loan losses | 845 | 476 | 2,047 | 288 | (285) |
| Net interest income after provision (credit) for loan losses | 39,072 | 40,411 | 41,102 | 47,313 | 47,985 |
| Noninterest income excluding securities gains | 15,404 | 15,420 | 16,451 | 16,383 | 13,897 |
| Net impairment losses recognized in earnings from available-for-sale securities | 0 | 0 | (25) | (67) | 0 |
| Net realized gains on available-for-sale securities | 2,861 | 1,104 | 1,743 | 2,749 | 2,216 |
| Loss on prepayment of debt | 2,573 | 0 | 1,023 | 2,333 | 0 |
| Noninterest expense excluding loss on prepayment of debt | 32,956 | 34,157 | 33,471 | 32,914 | 32,016 |
| Income before income tax provision | 21,808 | 22,778 | 24,777 | 31,131 | 32,082 |
| Income tax provision | 5,337 | 5,692 | 6,183 | 8,426 | 8,714 |
| Net income | $16,471 | $17,086 | $18,594 | $22,705 | $23,368 |
| | | | | | |
| PER COMMON SHARE: | | | | | |
| Basic earnings per share | $1.35 | $1.38 | $1.51 | $1.86 | $1.92 |
| Diluted earnings per share | $1.35 | $1.38 | $1.50 | $1.85 | $1.92 |
| Cash dividends declared per share | $1.04 | $1.04 | $1.00 | $0.84 | $0.58 |
| Book value per common share at period-end | $15.39 | $15.34 | $14.49 | $14.89 | $13.77 |
| Tangible book value per common share at period-end | $14.41 | $14.36 | $13.51 | $13.91 | $12.77 |
| Weighted average common shares outstanding - basic | 12,211,941 | 12,390,067 | 12,352,383 | 12,235,748 | 12,162,045 |
| Weighted average common shares outstanding - diluted | 12,233,773 | 12,412,050 | 12,382,790 | 12,260,208 | 12,166,768 |
| END OF PERIOD BALANCES (In Thousands) | | | | | |
| Available-for-sale securities | $420,290 | $516,807 | $482,658 | $472,577 | $481,685 |
| Gross loans | 704,880 | 630,545 | 644,303 | 683,910 | 708,315 |
| Allowance for loan losses | 7,889 | 7,336 | 8,663 | 6,857 | 7,705 |
| Total assets | 1,223,417 | 1,241,963 | 1,237,695 | 1,286,907 | 1,323,735 |
| Deposits | 935,615 | 967,989 | 954,516 | 1,006,106 | 1,018,206 |
| Borrowings | 92,263 | 78,597 | 96,723 | 89,379 | 130,313 |
| Stockholders' equity | 187,487 | 188,362 | 179,472 | 182,786 | 167,385 |

| | | | | | |
|---|---|---|---|---|---|
| Common shares outstanding | 12,180,623 | 12,279,980 | 12,390,063 | 12,274,035 | 12,155,529 |
| AVERAGE BALANCES (In Thousands) | | | | | |
| Total assets | 1,243,209 | 1,239,897 | 1,237,096 | 1,305,163 | 1,313,445 |
| Earning assets | 1,159,298 | 1,155,401 | 1,145,340 | 1,199,538 | 1,208,584 |
| Gross loans | 657,727 | 627,753 | 656,495 | 700,241 | 714,421 |
| Deposits | 968,201 | 965,418 | 964,031 | 1,008,469 | 1,001,125 |
| Stockholders' equity | 188,905 | 185,469 | 181,412 | 175,822 | 152,718 |

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**ITEM 6. SELECTED FINANCIAL DATA (Continued)**

**As of or for the Year Ended December 31,**

| | 2015 | 2014 | 2013 | 2012 | 2011 |
|---|---|---|---|---|---|
| KEY RATIOS | | | | | |
| Return on average assets | 1.32 % | 1.38 % | 1.50 % | 1.74 % | 1.78 % |
| Return on average equity | 8.72 % | 9.21 % | 10.25% | 12.91% | 15.30% |
| Average equity to average assets | 15.19% | 14.96% | 14.66% | 13.47% | 11.63% |
| Net interest margin (1) | 3.69 % | 3.80 % | 4.05 % | 4.26 % | 4.22 % |
| Efficiency (2) | 56.60% | 57.59% | 53.27% | 48.82% | 49.37% |
| Cash dividends as a % of diluted earnings per share | 77.04% | 75.36% | 66.67% | 45.41% | 30.21% |
| Tier 1 leverage | 14.31% | 13.89% | 13.78% | 12.53% | 10.93% |
| Tier 1 risk-based capital | 23.40% | 26.26% | 25.15% | 22.86% | 19.95% |
| Total risk-based capital | 24.45% | 27.60% | 26.60% | 24.01% | 21.17% |
| Tangible common equity/tangible assets | 14.49% | 14.34% | 13.66% | 13.39% | 11.84% |
| Nonperforming assets/total assets | 1.31 % | 1.34 % | 1.53 % | 0.82 % | 0.73 % |
| Nonperforming loans/total loans | 2.09 % | 2.45 % | 2.80 % | 1.41 % | 1.19 % |
| Allowance for loan losses/total loans | 1.12 % | 1.16 % | 1.34 % | 1.00 % | 1.09 % |
| Net charge-offs/average loans | 0.04 % | 0.29 % | 0.04 % | 0.16 % | 0.16 % |

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

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

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

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

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

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

**EARNINGS OVERVIEW**

In 2015, net income totaled $16,471,000, or $1.35 per common share - basic and diluted, as compared to $1.38 per share – basic and diluted in 2014 and $1.51 per share basic and $1.50 per share – diluted in 2013. The results for 2015 represented a return on average assets of 1.32% and a return on average equity of 8.72%.

**2015 vs. 2014**

Net income per share – diluted for 2015 was 2.2% lower than in 2014. Some of the more significant highlights related to annual earnings in 2015 as compared to 2014 are as follows:

- Net interest income totaled $39,917,000 in 2015, down $970,000 (2.4%) from 2014. In 2015, yields earned on securities and loans fell by more than the corresponding drop in interest rates paid on deposits and borrowings. The net interest margin was 3.69% in 2015, down from 3.80% in 2014.

- The provision for loan losses was $845,000 in 2015, up from $476,000 in 2014. The higher 2015 provision for loan losses reflected an increase in outstanding loans in the year which resulted in an increase in the collectively determined portion of the allowance for loan losses. Gross loans at December 31, 2015 were $74.3 million, or 11.8%, higher than the balance a year earlier.

- In 2015, noninterest revenue, excluding net realized gains on available-for-sale securities, totaled $15,404,000, which was down slightly from $15,420,000 in 2014 The most significant changes in components of noninterest revenue for the year ended December 31, 2015 as compared to the corresponding period in 2014 included the following: (1) decrease of $161,000 (3.2%) in service charges on deposit accounts, primarily as a result of lower overdraft fees; (2) reduction of $135,000 as the fair value of servicing rights declined $162,000 in 2015 as compared to $27,000 in 2014; (3) net increase in revenues from Trust and brokerage services of $74,000 (1.4%); and (4) an increase in other operating income of $315,000, including a gain of $212,000 from a life insurance arrangement in which benefits were split between the Corporation and the heirs of a former employee as well as an increase of $36,000 in dividends from Federal Home Loan Bank of Pittsburgh stock and an increase of $28,000 in revenue from merchant services.

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- Realized gains from available-for-sale securities totaled $2,861,000 and losses from prepayment of borrowings totaled $2,573,000 in 2015, while in 2014 realized gains from securities totaled $1,104,000 and there were no losses from prepayment of borrowings. In 2015, the Corporation sold a significant portion of its marketable equity securities portfolio, which was made up of bank stocks, generating realized gains of $2,220,000. Losses from prepayment of borrowings stemmed from pay-downs made in May and December 2015 totaling $34,000,000 on a long-term repurchase agreement with an interest rate of 4.265%. After the effects of these pay-downs, there was no balance outstanding on this repurchase agreement as of December 31, 2015. Management expects the combined result of the debt prepayments and reinvestment of proceeds from sales of stocks will make a positive contribution to net interest income in 2016.

- In 2015, noninterest expenses, excluding losses on prepayment of borrowings; totaled $32,956,000, which was $1,201,000 (3.5%) lower than total 2014 noninterest expenses. The reduction in noninterest expenses for the year ended December 31, 2015 as compared to the corresponding period in 2014 included the following: (1) a reduction in salaries and wages expenses of $439,000, mainly due to severance expenses in 2014; (2) a reduction in employee benefit-related expenses of $349,000 due to lower employee health insurance expense as a result of lower claims; (3) a reduction in Pennsylvania shares tax expense of $176,000, reflecting an increase in tax credits; (4) a reduction in professional fees expense of $161,000, as 2014 included expenses associated with an executive search; and (5) a reduction in other expenses of $182,000, including reductions in expenses from loan collections and other real estate properties.

**2014 vs. 2013**

Net income per share – diluted for 2014 was 8.0% lower than in 2013. Some of the more significant highlights related to annual earnings in 2014 as compared to 2013 are as follows:

- Net interest income totaled $40,887,000 in 2014, down $2,262,000 (5.2%) from 2013. In 2014, yields earned on securities and loans fell by more than the corresponding drop in interest rates paid on deposits and borrowings. Also, average total loans outstanding were 4.3% lower in 2014 as compared to 2013. The net interest margin was 3.80% in 2014, down from 4.05% in 2013.

- The provision for loan losses was $476,000 in 2014, down from $2,047,000 in 2013. The higher levels of expense in 2013 included a provision of $1,552,000 from loans to one commercial customer.

- In 2014, noninterest revenue, excluding net realized gains on available-for-sale securities, totaled $15,420,000, which was lower than the 2013 amount by $1,031,000 (6.3%). Gains from sales of residential mortgage loans totaled $768,000 in 2014, down from $1,969,000 in 2013, reflecting lower volume from refinancing activity. Service charges on deposit accounts fell $221,000 in 2014 as compared to 2013, a decline of 4.2%, primarily as a result of lower net overdraft fees. Total Trust and brokerage revenue of $5,391,000 in 2014 was $520,000 (10.7%) higher than in 2013.

- Realized gains from available-for-sale securities totaled $1,104,000 in 2014, while in 2013 realized gains from securities totaled $1,718,000 and losses from prepayment of borrowings totaled $1,023,000.

- In 2014, noninterest expenses totaled $34,157,000, which was $686,000 (2.0%) higher than total 2013 noninterest expenses, excluding the loss on prepayment of borrowings. Salaries and wages expense increased $915,000 in 2014 as compared to 2013, mainly as a result of severance benefits. Pensions and other employee benefit expenses increased $619,000, mainly due to higher health care costs and a charge related to a distribution from a defined benefit pension plan. Professional fees expense was $835,000 lower in 2014 as compared to 2013, as the total in 2013 included fees associated with projects designed to identify sources of noninterest revenue and reductions in debit card and ATM processing expense.

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

**CRITICAL ACCOUNTING POLICIES**

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

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

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

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

**NET INTEREST INCOME**

The Corporation's primary source of operating income is net interest income, which is equal to the difference between the amounts of interest income and interest expense. Tables I, II and III include information regarding the Corporation's net interest income in 2015, 2014, and 2013. In each of these tables, the amounts of interest income earned on tax-exempt securities and loans have been adjusted to a fully taxable-equivalent basis. Accordingly, the net interest income amounts reflected in these tables exceed the amounts presented in the consolidated financial statements. The discussion that follows is based on amounts in the tables.

**2015 vs. 2014**

Fully taxable equivalent net interest income was $42,819,000 in 2015, which was $1,074,000 (2.4%) lower than in 2014. As shown in Table III, in 2015 compared to 2014, interest rate changes had the effect of decreasing net interest income $2,283,000, and net changes in volume had the effect of increasing net interest income $1,209,000. The most significant components of the rate-related change in net interest income in 2015 were a decrease in interest income of $1,957,000 attributable to lower rates earned on loans receivable and a decrease of $468,000 in interest income on available-for-sale securities. The most significant components of the volume-related increase in net interest income in 2015 was an increase in interest income of $1,544,000 attributable to an increase in the balance of loans receivable, a decrease in interest expense of $270,000 attributable to a reduction in the balance of borrowed funds, and a decrease in interest expense of $117,000 attributable to a reduction in the balance of interest-bearing deposits (primarily certificates of deposit), partially offset by a volume-related decrease in interest income on available-for-securities of $681,000. As presented in Table II, the "Interest Rate Spread" (excess of average rate of return on earning assets over average cost of funds on interest-bearing liabilities) was 3.54% in 2015 as compared to 3.63% in 2014.

INTEREST INCOME AND EARNING ASSETS

Interest income totaled $47,421,000 in 2015, a decrease of 3.2% from 2014. Interest and fees on loans receivable decreased $413,000, or 1.2%. As indicated in Table II, average available-for-sale securities (at amortized cost) totaled $479,148,000 in 2015, a decrease of $15,786,000 (3.2%) from 2014. The net decrease in the Corporation's available-for-sale securities portfolio consisted of decreases in tax-exempt municipal securities, U.S. Government mortgage-backed securities, U.S. Government agency bonds, and equity securities. These decreases were partially offset by increases in the balances of collateralized mortgage obligations and taxable municipal securities. The Corporation's yield on securities was lower in 2015 than in 2014, primarily because of low market interest rates on new investments combined with higher-yielding securities maturing. The average rate of return on available-for-sale securities was 2.81% for 2015 and 2.95% in 2014.

The average balance of gross loans receivable increased 4.8% to $657,727,000 in 2015 from $627,753,000 in 2014. The Corporation experienced growth in the balances of tax free municipal loans, residential mortgages and participation loans purchased. These increases were partially offset by decreases in balances of commercial real estate loans. The Corporation's average rate of return on loans receivable declined to 5.15% in 2015 from 5.46% in 2014.

The average balance of interest-bearing due from banks decreased to $22,201,000 in 2015 from $32,510,000 in 2014. This has consisted primarily of balances held by the Federal Reserve and also includes other overnight deposits and FDIC-insured certificates of deposit issued by other financial institutions.

INTEREST EXPENSE AND INTEREST-BEARING LIABILITIES

Interest expense fell $520,000, or 10.2%, to $4,602,000 in 2015 from $5,122,000 in 2014. Table II shows that the overall cost of funds on interest-bearing liabilities fell to 0.55% in 2015 from 0.61% in 2014.

Total average deposits (interest-bearing and noninterest-bearing) increased 0.3%, to $968,201,000 in 2015 from $965,418,000 in 2014. Decreases in the average balances of certificates of deposit, Individual Retirement Accounts, and money market accounts were partially offset by increases in average balances of interest checking, savings accounts and non-interest bearing demand deposits. The average rate paid on interest-bearing deposits fell slightly to 0.26% in 2015 from 0.28% in 2014.

Total average borrowed funds decreased $2,298,000 to $77,642,000 in 2015 from $79,940,000 in 2014. The average rate on borrowed funds was 3.45% in 2015 compared to 3.70% in 2014, reflecting a $6,982,000 reduction in the average balance of higher-rate, long-term borrowings resulting from pre-payment of a long-term repurchase agreement borrowing with an interest rate of 4.265%. The Corporation paid off $10 million of principal on this borrowing in May 2015, and $24 million in December 2015, leaving no remaining balance outstanding at December 31, 2015. (The pre-payment of long-term borrowings is described in the Earnings Overview section.) The average balance of short-term borrowings increased $4,684,000 in 2015 over 2014, as average overnight borrowings were higher in 2015 and the Corporation funded the pay-off of the long-term repurchase agreement in December 2015 with funds from a series of short-term advances from the FHLB-Pittsburgh totaling $25,072,000 and an average rate of 0.86%.

**2014 vs. 2013**

Fully taxable equivalent net interest income was $43,893,000 in 2014, which was $2,491,000 (5.3%) lower than in 2013. As shown in Table III, in 2014 compared to 2013, interest rate changes had the effect of decreasing net interest income $1,622,000, and net changes in volume had the effect of decreasing net interest income $869,000. The most significant component of the rate-related change in net interest income in 2014 was a decrease in interest income of $1,718,000 attributable to lower rates earned on loans receivable. The most significant components of the volume-related decrease in net interest income in 2014 were a decrease in interest income of $1,602,000 attributable to a decline in the balance of loans receivable, partially offset by a volume-related increase in interest income on available-for-securities of $499,000, a decrease in interest expense of $161,000 attributable to a reduction in the balance of interest-bearing deposits (primarily certificates of deposit) and a decrease in interest expense of $109,000 attributable to a reduction in the balance of borrowed funds. As presented in Table II, the "Interest Rate Spread" (excess of average rate of return on earning assets over average cost of funds on interest-bearing liabilities) was 3.63% in 2014 as compared to 3.88% in 2013.

## INTEREST INCOME AND EARNING ASSETS

Interest income totaled $49,015,000 in 2014, a decrease of 6.0% from 2013. Interest and fees on loans receivable decreased $3,320,000, or 8.8%. As indicated in Table II, average available-for-sale securities (at amortized cost) totaled $494,934,000 in 2014, an increase of $33,370,000 (7.2%) from 2013. Net increase in the Corporation's available-for-sale securities portfolio was primarily made up of U.S. Government agency mortgage-backed securities and collateralized mortgage obligations. This increase was partially offset by decreases in the balances of U.S. Government agency bonds. The Corporation's yield on securities was lower in 2014 than in 2013, primarily because of low market interest rates. The average rate of return on available-for-sale securities was 2.95% for 2014 and 3.12% in 2013.

The average balance of gross loans receivable decreased 4.3% to $627,753,000 in 2014 from $656,495,000 in 2013. The Corporation experienced contraction in the balance of loans receivable due to borrowers prepaying or refinancing existing loans combined with modest demand for new loans. The decline in the balance of the residential mortgage portfolio was also affected by management's decision to sell a significant portion of newly originated residential mortgages on the secondary market. The Corporation's average rate of return on loans receivable declined to 5.46% in 2014 from 5.73% in 2013.

The average balance of interest-bearing due from banks increased to $32,510,000 in 2014 from $26,159,000 in 2013. This has consisted primarily of balances held by the Federal Reserve and also includes other overnight deposits and FDIC-insured certificates of deposit issued by other financial institutions.

INTEREST EXPENSE AND INTEREST-BEARING LIABILITIES

Interest expense fell $643,000, or 11.1%, to $5,122,000 in 2014 from $5,765,000 in 2013. Table II shows that the overall cost of funds on interest-bearing liabilities fell to 0.61% in 2014 from 0.67% in 2013.

Total average deposits (interest-bearing and noninterest-bearing) increased 0.1%, to $965,418,000 in 2014 from $964,031,000 in 2013. Decreases in the average balances of certificates of deposit, Individual Retirement Accounts, and money market accounts were partially offset by increases in average balances of interest checking, savings accounts and non-interest bearing demand deposits. Consistent with continuing low short-term market interest rates, the average rates incurred on certificates of deposit and Individual Retirement Accounts have continued to decrease in 2014 as compared to 2013.

Total average borrowed funds decreased $2,388,000 to $79,940,000 in 2014 from $82,328,000 in 2013. The average rate on borrowed funds was 3.70% in 2014, compared to 3.72% in 2013.

TABLE I - ANALYSIS OF INTEREST INCOME AND EXPENSE

| (In Thousands) | Years Ended December 31, 2015 | 2014 | 2013 | Increase/(Decrease) 2015/2014 | 2014/2013 |
|---|---|---|---|---|---|
| INTEREST INCOME | | | | | |
| Available-for-sale securities: | | | | | |
| Taxable | $7,587 | $8,028 | $7,105 | $(441) | $923 |
| Tax-exempt | 5,869 | 6,577 | 7,296 | (708) | (719) |
| Total available-for-sale securities | 13,456 | 14,605 | 14,401 | (1,149) | 204 |
| Interest-bearing due from banks | 93 | 125 | 105 | (32) | 20 |
| Loans held for sale | 16 | 16 | 54 | 0 | (38) |
| Loans receivable: | | | | | |
| Taxable | 31,311 | 32,127 | 35,484 | (816) | (3,357) |
| Tax-exempt | 2,545 | 2,142 | 2,105 | 403 | 37 |
| Total loans receivable | 33,856 | 34,269 | 37,589 | (413) | (3,320) |
| Total Interest Income | 47,421 | 49,015 | 52,149 | (1,594) | (3,134) |
| INTEREST EXPENSE | | | | | |
| Interest-bearing deposits: | | | | | |
| Interest checking | 214 | 216 | 211 | (2) | 5 |
| Money market | 299 | 286 | 290 | 13 | (4) |
| Savings | 128 | 121 | 117 | 7 | 4 |
| Certificates of deposit | 831 | 1,069 | 1,522 | (238) | (453) |
| Individual Retirement Accounts | 451 | 470 | 562 | (19) | (92) |
| Other time deposits | 1 | 1 | 1 | 0 | 0 |
| Total interest-bearing deposits | 1,924 | 2,163 | 2,703 | (239) | (540) |
| Borrowed funds: | | | | | |
| Short-term | 32 | 9 | 9 | 23 | 0 |
| Long-term | 2,646 | 2,950 | 3,053 | (304) | (103) |
| Total borrowed funds | 2,678 | 2,959 | 3,062 | (281) | (103) |
| Total Interest Expense | 4,602 | 5,122 | 5,765 | (520) | (643) |
| Net Interest Income | $42,819 | $43,893 | $46,384 | $(1,074) | $(2,491) |

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

(2) Fees on loans are included with interest on loans and amounted to $1,004,000 in 2015, $1,013,000 in 2014, and $1,338,000 in 2013.

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**TABLE II - ANALYSIS OF AVERAGE DAILY BALANCES AND RATES**

**(Dollars in Thousands)**

| | Year Ended 12/31/2015 Average Balance | Rate of Return/ Cost of Funds % | Year Ended 12/31/2014 Average Balance | Rate of Return/ Cost of Funds % | Year Ended 12/31/2013 Average Balance | Rate of Return/ Cost of Funds % |
|---|---|---|---|---|---|---|
| EARNING ASSETS | | | | | | |
| Available-for-sale securities, at amortized cost: | | | | | | |
| Taxable | $366,448 | 2.07 % | $371,125 | 2.16 % | $330,980 | 2.15 % |
| Tax-exempt | 112,700 | 5.21 % | 123,809 | 5.31 % | 130,584 | 5.59 % |
| Total available-for-sale securities | 479,148 | 2.81 % | 494,934 | 2.95 % | 461,564 | 3.12 % |
| Interest-bearing due from banks | 22,201 | 0.42 % | 32,510 | 0.38 % | 26,159 | 0.40 % |
| Federal funds sold | 0 | 0.00 % | 0 | 0.00 % | 4 | 0.00 % |
| Loans held for sale | 222 | 7.21 % | 204 | 7.84 % | 1,118 | 4.83 % |
| Loans receivable: | | | | | | |
| Taxable | 603,771 | 5.19 % | 589,120 | 5.45 % | 620,412 | 5.72 % |
| Tax-exempt | 53,956 | 4.72 % | 38,633 | 5.54 % | 36,083 | 5.83 % |
| Total loans receivable | 657,727 | 5.15 % | 627,753 | 5.46 % | 656,495 | 5.73 % |
| Total Earning Assets | 1,159,298 | 4.09 % | 1,155,401 | 4.24 % | 1,145,340 | 4.55 % |
| Cash | 16,639 | | 16,865 | | 16,854 | |
| Unrealized gain/loss on securities | 8,871 | | 6,350 | | 8,875 | |
| Allowance for loan losses | (7,380) | | (7,992) | | (7,204) | |
| Bank premises and equipment | 15,911 | | 16,789 | | 18,154 | |
| Intangible Asset - Core Deposit Intangible | 41 | | 70 | | 113 | |
| Intangible Asset – Goodwill | 11,942 | | 11,942 | | 11,942 | |
| Other assets | 37,887 | | 40,472 | | 43,022 | |
| Total Assets | $1,243,209 | | $1,239,897 | | $1,237,096 | |
| | | | | | | |
| INTEREST-BEARING LIABILITIES | | | | | | |
| Interest-bearing deposits: | | | | | | |
| Interest checking | $195,940 | 0.11 % | $183,874 | 0.12 % | $174,790 | 0.12 % |
| Money market | 196,585 | 0.15 % | 198,990 | 0.14 % | 203,023 | 0.14 % |
| Savings | 128,355 | 0.10 % | 121,685 | 0.10 % | 117,055 | 0.10 % |
| Certificates of deposit | 121,803 | 0.68 % | 134,732 | 0.79 % | 148,598 | 1.02 % |
| Individual Retirement Accounts | 110,659 | 0.41 % | 120,016 | 0.39 % | 129,255 | 0.43 % |
| Other time deposits | 1,031 | 0.10 % | 1,039 | 0.10 % | 1,062 | 0.09 % |

| | | | | | | |
|---|---|---|---|---|---|---|
| Total interest-bearing deposits | 754,373 | 0.26 % | 760,336 | 0.28 % | 773,783 | 0.35 % |
| Borrowed funds: | | | | | | |
| Short-term | 11,428 | 0.28 % | 6,744 | 0.13 % | 6,422 | 0.14 % |
| Long-term | 66,214 | 4.00 % | 73,196 | 4.03 % | 75,906 | 4.02 % |
| Total borrowed funds | 77,642 | 3.45 % | 79,940 | 3.70 % | 82,328 | 3.72 % |
| Total Interest-bearing Liabilities | 832,015 | 0.55 % | 840,276 | 0.61 % | 856,111 | 0.67 % |
| Demand deposits | 213,828 | | 205,082 | | 190,248 | |
| Other liabilities | 8,461 | | 9,070 | | 9,325 | |
| Total Liabilities | 1,054,304 | | 1,054,428 | | 1,055,684 | |
| Stockholders' equity, excluding other comprehensive income/loss | 183,125 | | 181,271 | | 175,893 | |
| Other comprehensive income/loss | 5,780 | | 4,198 | | 5,519 | |
| Total Stockholders' Equity | 188,905 | | 185,469 | | 181,412 | |
| Total Liabilities and Stockholders' Equity | $1,243,209 | | $1,239,897 | | $1,237,096 | |
| Interest Rate Spread | | 3.54 % | | 3.63 % | | 3.88 % |
| Net Interest Income/Earning Assets | | 3.69 % | | 3.80 % | | 4.05 % |
| | | | | | | |
| Total Deposits (Interest-bearing and Demand) | $968,201 | | $965,418 | | $964,031 | |

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

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

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TABLE III - ANALYSIS OF VOLUME AND RATE CHANGES

| (In Thousands) | Year Ended 12/31/15 vs. 12/31/14 | | | Year Ended 12/31/14 vs. 12/31/13 | | |
|---|---|---|---|---|---|---|
| | Change in Volume | Change in Rate | Total Change | Change in Volume | Change in Rate | Total Change |
| EARNING ASSETS | | | | | | |
| Available-for-sale securities: | | | | | | |
| Taxable | $ (100) | $ (341) | $ (441) | $ 868 | $ 55 | $ 923 |
| Tax-exempt | (581) | (127) | (708) | (369) | (350) | (719) |
| Total available-for-sale securities | (681) | (468) | (1,149) | 499 | (295) | 204 |
| Interest-bearing due from banks | (42) | 10 | (32) | 24 | (4) | 20 |
| Loans held for sale | 1 | (1) | 0 | (60) | 22 | (38) |
| Loans receivable: | | | | | | |
| Taxable | 786 | (1,602) | (816) | (1,746) | (1,611) | (3,357) |
| Tax-exempt | 758 | (355) | 403 | 144 | (107) | 37 |
| Total loans receivable | 1,544 | (1,957) | (413) | (1,602) | (1,718) | (3,320) |
| Total Interest Income | 822 | (2,416) | (1,594) | (1,139) | (1,995) | (3,134) |
| | | | | | | |
| INTEREST-BEARING LIABILITIES | | | | | | |
| Interest-bearing deposits: | | | | | | |
| Interest checking | 14 | (16) | (2) | 11 | (6) | 5 |
| Money market | (3) | 16 | 13 | (6) | 2 | (4) |
| Savings | 7 | 0 | 7 | 5 | (1) | 4 |
| Certificates of deposit | (97) | (141) | (238) | (133) | (320) | (453) |
| Individual Retirement Accounts | (38) | 19 | (19) | (38) | (54) | (92) |
| Other time deposits | 0 | 0 | 0 | 0 | 0 | 0 |
| Total interest-bearing deposits | (117) | (122) | (239) | (161) | (379) | (540) |
| Borrowed funds: | | | | | | |
| Short-term | 9 | 14 | 23 | 0 | 0 | 0 |
| Long-term | (279) | (25) | (304) | (109) | 6 | (103) |
| Total borrowed funds | (270) | (11) | (281) | (109) | 6 | (103) |
| Total Interest Expense | (387) | (133) | (520) | (270) | (373) | (643) |
| | | | | | | |
| Net Interest Income | $ 1,209 | $ (2,283) | $ (1,074) | $ (869) | $ (1,622) | $ (2,491) |

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

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

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**NONINTEREST INCOME**

**Years Ended December 31, 2015, 2014 and 2013**

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

**TABLE IV - COMPARISON OF NONINTEREST INCOME**

**(In Thousands)**

| | Years Ended December 31, 2015 | 2014 | $ Change | % Change |
|---|---|---|---|---|
| Service charges on deposit accounts | $4,864 | $5,025 | $(161) | (3.2) |
| Service charges and fees | 494 | 538 | (44) | (8.2) |
| Trust and financial management revenue | 4,626 | 4,490 | 136 | 3.0 |
| Brokerage revenue | 839 | 901 | (62) | (6.9) |
| Insurance commissions, fees and premiums | 109 | 118 | (9) | (7.6) |
| Interchange revenue from debit card transactions | 1,935 | 1,959 | (24) | (1.2) |
| Net gains from sales of loans | 735 | 768 | (33) | (4.3) |
| Decrease in fair value of servicing rights | (162) | (27) | (135) | 500.0 |
| Increase in cash surrender value of life insurance | 386 | 376 | 10 | 2.7 |
| Net (loss) gain from premises and equipment | (1) | 8 | (9) | (112.5) |
| Other operating income | 1,579 | 1,264 | 315 | 24.9 |
| Total other operating income before realized gains on available-for-sale securities, net | $15,404 | $15,420 | $(16) | (0.1) |

| | Years Ended December 31, 2014 | 2013 | $ Change | % Change |
|---|---|---|---|---|
| Service charges on deposit accounts | $5,025 | $5,246 | $(221) | (4.2) |
| Service charges and fees | 538 | 597 | (59) | (9.9) |
| Trust and financial management revenue | 4,490 | 4,087 | 403 | 9.9 |
| Brokerage revenue | 901 | 784 | 117 | 14.9 |
| Insurance commissions, fees and premiums | 118 | 170 | (52) | (30.6) |
| Interchange revenue from debit card transactions | 1,959 | 1,941 | 18 | 0.9 |
| Net gains from sales of loans | 768 | 1,969 | (1,201) | (61.0) |
| (Decrease) increase in fair value of servicing rights | (27) | 67 | (94) | (140.3) |
| Increase in cash surrender value of life insurance | 376 | 399 | (23) | (5.8) |

| | | | | |
|---|---|---|---|---|
| Net gain (loss) from premises and equipment | 8 | (16 ) | 24 | (150.0 ) |
| Other operating income | 1,264 | 1,207 | 57 | 4.7 |
| Total other operating income before realized gains on available-for-sale securities, net | $15,420 | $16,451 | $(1,031 ) | (6.3 ) |

Total noninterest income, excluding realized gains on available-for-sale securities, decreased $16,000 in 2015 compared to 2014. In 2014, total noninterest income decreased $1,031,000 (6.3%) from 2013. Changes of significance are discussed in the narrative that follows.

**2015 vs. 2014**

Service charges on deposit accounts were $161,000 lower in 2015 than 2014. Total consumer and business overdraft and uncollected funds fees decreased $387,000 in 2015 as compared to 2014. These decreases were partially offset by adjustments to the existing fee structure of certain checking products in April 2015.

The fair value of servicing rights decreased $162,000 in 2015 as compared to a decrease of $27,000 in 2014. The greater decline in fair value in 2015 reflected the impact of a reduction in the outstanding balance of mortgage loans sold and serviced in 2015, as compared to an increase in the balance of loans serviced in 2014 over 2013.

Included in the $315,000 increase in other operating revenue in 2015 is the effect of a $212,000 gain recognized from a life insurance arrangement in which the benefits were split between Corporation and the heirs of the former employee.

In 2015, Trust and financial management revenue increased $136,000, or 3.0%. This increase was primarily in retirement services revenue.

**2014 vs. 2013**

Net gains from sales of loans decreased $1,201,000 in 2014. Since December 2009, the Corporation has sold a significant amount of residential mortgage loans into the secondary market through the MPF Xtra and Original programs administered by the Federal Home Loan Banks of Pittsburgh and Chicago. Volume remained brisk throughout most of 2013, slowing somewhat in the fourth quarter 2013 with a continued slowdown throughout 2014 reflecting a decrease in refinancing activity.

Service charges on deposit accounts were $221,000 lower in 2014 than 2013. Consumer and business overdraft fees decreased $543,000 in 2014 as compared to 2013. Changes made as a result of recommendations made by a consulting firm in 2013 resulted in service charges on deposit accounts of $611,000 in 2014 as compared to $229,000 in 2013, as most of the recommendations were implemented in the fourth quarter 2013.

In 2014, Trust and financial management revenue increased $403,000, or 9.9%. The increase in trust revenue in 2014 reflects the impact of new business obtained as well as higher valuations of U.S. equity securities throughout most of the period. Assets under management by the Corporation's Trust and financial management group totaled $825,918,000 at December 31, 2014, an increase of 3.7% over the total one year earlier.

As a result of increased annuity sales, brokerage revenue increased $117,000 or 14.9% in 2014 over 2013.

**NONINTEREST EXPENSE**

**Years Ended December 31, 2015, 2014 and 2013**

As shown in Table V below, total noninterest expense increased $1,372,000, or 4.0%, in 2015 as compared to 2014; however, excluding losses from prepayment of debt, noninterest expense decreased $1,201,000 (3.5%) in 2015 as compared to 2014. Excluding losses from prepayment of debt, total noninterest expense was $686,000 (2.0%) higher in 2014 as compared to 2013. In 2015, the Corporation incurred losses totaling $2,573,000 and, in 2013, losses totaling $1,023,000 from prepayment of borrowings (repurchase agreements). There were no losses from prepayment of borrowings incurred in 2014. Changes of significance (other than the previously discussed losses on prepayment of debt) are discussed in the narrative that follows.

**TABLE V - COMPARISON OF NONINTEREST EXPENSE**

**(In Thousands)**

| | 2015 | 2014 | $ Change | % Change |
|---|---|---|---|---|
| Salaries and wages | $14,682 | $15,121 | $(439) | (2.9) |
| Pensions and other employee benefits | 4,420 | 4,769 | (349) | (7.3) |
| Occupancy expense, net | 2,574 | 2,628 | (54) | (2.1) |
| Furniture and equipment expense | 1,860 | 1,859 | 1 | 0.1 |
| FDIC Assessments | 603 | 600 | 3 | 0.5 |
| Pennsylvania shares tax | 1,174 | 1,350 | (176) | (13.0) |
| Professional fees | 538 | 699 | (161) | (23.0) |
| Automated teller machine and interchange expense | 988 | 924 | 64 | 6.9 |
| Software subscriptions | 876 | 784 | 92 | 11.7 |
| Loss on prepayment of debt | 2,573 | 0 | 2,573 | 100.0 |
| Other operating expense | 5,241 | 5,423 | (182) | (3.4) |
| Total Other Expense | $35,529 | $34,157 | $1,372 | 4.0 |

| | 2014 | 2013 | $ Change | % Change |
|---|---|---|---|---|
| Salaries and wages | $15,121 | $14,206 | $915 | 6.4 |
| Pensions and other employee benefits | 4,769 | 4,150 | 619 | 14.9 |
| Occupancy expense, net | 2,628 | 2,473 | 155 | 6.3 |
| Furniture and equipment expense | 1,859 | 1,948 | (89) | (4.6) |
| FDIC Assessments | 600 | 604 | (4) | (0.7) |
| Pennsylvania shares tax | 1,350 | 1,402 | (52) | (3.7) |
| Professional fees | 699 | 1,534 | (835) | (54.4) |
| Automated teller machine and interchange expense | 924 | 1,020 | (96) | (9.4) |
| Software subscriptions | 784 | 836 | (52) | (6.2) |
| Loss on prepayment of debt | 0 | 1,023 | (1,023) | (100.0) |
| Other operating expense | 5,423 | 5,298 | 125 | 2.4 |
| Total Other Expense | $34,157 | $34,494 | $(337) | (1.0) |

**2015 vs 2014**

Salaries and wages decreased $439,000, or 2.9%. As noted in the Earnings Overview section, this decrease is primarily the result of severance benefits incurred and paid in 2014. The decrease from severance benefits was partially offset by annual merit-based pay increases, an increase in incentive and other bonuses of $168,000 and the addition of new lending and other personnel. At December 31, 2015, the Corporation had 283 full-time equivalent employees, up from 278 a year earlier.

Pensions and other employee benefits decreased $349,000, or 7.3%. Health care expense decreased $342,000 as the amount of claims incurred during 2015 was lower than in 2014. The Corporation is self-insured for health insurance, up to a cap for catastrophic levels of losses, which are insured by a third party. In addition, pension expense decreased $111,000 as the result of a charge in 2014 related to a distribution from a defined benefit plan. These decreases were partially offset by annual increases in other benefit and administrative costs.

Pennsylvania shares tax decreased $176,000, including the effects of increased participation in state tax credit programs.

Professional fees decreased $161,000 as a result of nonrecurring executive search expenses that were incurred in 2014.

Included in other operating expense is a $191,000 decrease in loan collection expenses as well as an $86,000 decrease in other real estate expenses.

**2014 vs. 2013**

Salaries and wages increased $915,000, or 6.4%. As noted in the Earnings Overview section, this increase is primarily the result of severance benefits incurred and paid in 2014.

Pensions and other employee benefits increased $619,000, or 14.9%. Health care expense increased $415,000 as the amount of claims incurred during 2014 was higher than in 2013. The Corporation is self-insured for health insurance, up to a cap for catastrophic levels of losses, which are insured by a third party In addition, the Corporation incurred a $196,000 charge related to a distribution from a defined benefit plan.

Occupancy expense increased $155,000, or 6.3%, primarily due to increased weather related costs such as snow removal, fuel, utilities and maintenance.

Professional fees decreased $835,000, or 54.4%. The Corporation incurred professional fee expense of $1,039,000 in 2013 for two large consulting engagements. Similar size engagements did not occur during 2014.

Automated teller machine and interchange expenses decreased $96,000, or 9.4%, mainly resulting from benefits derived from a consulting project related to electronic funds processing that took place in 2013.

**INCOME TAXES**

The effective income tax rate was approximately 24.5% of pre-tax income in 2015, and 25% of pre-tax income in 2014 and 2013. 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 basis of assets and liabilities. At December 31, 2015, the net deferred tax asset was $3,115,000, an increase from the balance at December 31, 2014 of $1,668,000. The largest changes in temporary difference components were as follows:

- Primarily as a result of the realization of $2,861,000 in gains on the sale of available-for-sale securities, the deferred tax liability resulting from net unrealized gains on available-for-sale securities decreased to $1,342,000 at December 31, 2015 from $2,844,000 at December 31, 2014.

- There was no deferred tax asset representing a credit for alternative minimum tax paid at December 31, 2015 as the Corporation's federal taxable income in 2015 exceeded alternative minimum taxable income sufficiently to utilize the available credit. At December 31, 2014 the related deferred tax asset amounted to $537,000.

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. Management believes the recorded net deferred tax asset at December 31, 2015 is fully realizable; however, if management determines the Corporation will be unable to realize all or part of the net deferred tax asset, the Corporation would adjust the deferred tax asset, which would negatively impact earnings.

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

**SECURITIES**

Table VI shows the composition of the investment portfolio at December 31, 2015, 2014 and 2013. Comparison of the amortized cost totals of available-for-sale securities at each year-end presented reflects an increase of $24,479,000 to $508,682,000 at December 31, 2014 from December 31, 2013. This change was followed by a decrease of

$92,227,000 to $416,455,000 at December 31, 2015. After experiencing an increase in securities in 2014 as a result of a reduction in the balances of loans outstanding, the Corporation saw a reversal of that trend in 2015. The decrease in securities in 2015 reflects, in part, using cash generated from the investment portfolio to fund the increase in loans outstanding. Over the last year, the Corporation saw a decrease in almost all categories of investments, with the largest decrease being a $46,475,000 reduction in collateralized mortgage-backed obligations (CMOs) issued or guaranteed by U.S. Government agencies. As discussed in more detail in Note 7 to the financial statements, the Corporation reported net realized gains from available-for-sale securities of $2,861,000 in 2015, including realized gains from sales of equity securities (bank stocks) of $2,220,000. In comparison, net realized gains from available-for-sale securities totaled $1,104,000 in 2014 and $1,718,000 in 2013.

As reflected in Table VI, the fair value of available-for-sale securities as of December 31, 2015 was $3,835,000, or 0.92%, higher than the total amortized cost basis. The aggregate unrealized gain position at December 31, 2015 was down from $8,125,000 at December 31, 2014, mainly due to sales of a significant portion of the Corporation's equity securities with substantial market appreciation in 2015. The aggregate unrealized gain position at December 31, 2015 included an unrealized gain of $3,129,000 on debt securities as well as an unrealized gain of $706,000 on marketable equity securities. Changes in intermediate-term and long-term interest rates have a significant impact on changes in fair values of debt securities. The aggregate unrealized gain on debt securities at December 31, 2015 was 0.75% of the amortized cost basis, down slightly from 1.01% at December 31, 2014 and up from a net unrealized loss on debt securities of 0.93% of amortized cost at December 31, 2013.

Management has reviewed the Corporation's holdings as of December 31, 2015 and concluded that unrealized losses on all of the securities in an unrealized loss position are considered temporary. Notes 6 and 7 to the consolidated financial statements provide more detail concerning the Corporation's processes for evaluating securities for other-than-temporary impairment. Management will continue to closely monitor the status of impaired securities in 2016.

TABLE VI - INVESTMENT SECURITIES

| (In Thousands) | 2015 Amortized Cost | 2015 Fair Value | 2014 Amortized Cost | 2014 Fair Value | 2013 Amortized Cost | 2013 Fair Value |
|---|---|---|---|---|---|---|
| | As of December 31, | | | | | |
| AVAILABLE-FOR-SALE SECURITIES: | | | | | | |
| Obligations of U.S. Government agencies | $10,663 | $10,483 | $27,221 | $26,676 | $47,382 | $45,877 |
| Obligations of states and political subdivisions: | | | | | | |
| Tax-exempt | 103,414 | 107,757 | 120,086 | 124,839 | 127,748 | 128,426 |
| Taxable | 34,317 | 34,597 | 33,637 | 33,878 | 35,154 | 34,471 |
| Mortgage-backed securities | 73,227 | 73,343 | 82,479 | 83,903 | 84,849 | 86,208 |
| Collateralized mortgage obligations, Issued by U.S. Government agencies | 193,145 | 191,715 | 239,620 | 238,823 | 182,372 | 178,092 |
| Other collateralized debt obligations | 9 | 9 | 34 | 34 | 660 | 660 |
| Total debt securities | 414,775 | 417,904 | 503,077 | 508,153 | 478,165 | 473,734 |
| Marketable equity securities | 1,680 | 2,386 | 5,605 | 8,654 | 6,038 | 8,924 |
| Total | $416,455 | $420,290 | $508,682 | $516,807 | $484,203 | $482,658 |

The following table presents the contractual maturities and the weighted-average yields (calculated based on amortized cost) of investment securities as of December 31, 2015. Yields on tax-exempt securities are presented on a nominal basis, that is, the yields are not presented on a fully taxable-equivalent basis. Actual maturities may differ from contractual maturities because counterparties may have the right to call or prepay obligations with or without call or prepayment penalties.

| (In Thousands, Except for Percentages) | Within One Year | Yield | One-Five Years | Yield | Five-Ten Years | Yield | After Ten Years | Yield | Total | Yield |
|---|---|---|---|---|---|---|---|---|---|---|
| AVAILABLE-FOR-SALE SECURITIES: | | | | | | | | | | |
| Obligations of U.S. Government agencies | $1,006 | 3.32% | $6,650 | 1.35% | $3,007 | 1.53% | $0 | 0.00% | $10,663 | 1.59% |
| Obligations of states and political subdivisions: | | | | | | | | | | |
| Tax-exempt | 4,645 | 2.83% | 36,609 | 2.48% | 28,666 | 2.70% | 33,494 | 4.74% | 103,414 | 3.29% |
| Taxable | 3,436 | 2.03% | 17,381 | 2.02% | 13,500 | 2.91% | 0 | 0.00% | 34,317 | 2.37% |
| Other collateralized debt obligations | 0 | 0.00% | 0 | 0.00% | 0 | 0.00% | 9 | 0.00% | 9 | 0.00% |
| Subtotal | $9,087 | 2.58% | $60,640 | 2.23% | $45,173 | 2.69% | $33,503 | 4.73% | $148,403 | 2.95% |
| Mortgage-backed securities | | | | | | | | | 73,227 | 2.17% |
| | | | | | | | | | 193,145 | 2.01% |

| | | |
|---|---|---|
| Collateralized mortgage obligations, Issued by U.S. Government agencies | | |
| Total | $414,775 | 2.38% |

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

**FINANCIAL CONDITION**

Gross loans outstanding (excluding mortgage loans held for sale) were $704,880,000 at December 31, 2015, up 11.8% from $630,545,000 at December 31, 2014. The outstanding balance of tax-exempt municipal loans totaled $40,007,000 at December 31, 2015, an increase of $22,473,000 from December 31, 2014, and total participation loans outstanding amounted to $33,059,000 at December 31, 2015, an increase of $28,113,000 from December 31, 2014. The increase in municipal loans in 2015 includes loans to two school districts in the Corporation's market area with outstanding balances totaling $15,947,000 at December 31, 2015. Participation loans represent portions of larger commercial transactions for which other institutions are the "lead banks". Although not the lead bank, the Corporation conducts detailed underwriting and monitoring of participation loan opportunities. Participation loans are included in the "Commercial and industrial" and "Commercial loans secured by real estate" classes in the loan tables presented in this Form 10-K. At December 31, 2015, the balance of participation loans outstanding includes $8,860,000 to a business based in the Corporation's market area, $10,000,000 to an entity located outside of the Corporation's market area and $10,020,000 from participations in loans originated through the Corporation's membership in a network that originates loans throughout the U.S. The Corporation's participation loans originated through the network consist of loans to businesses that are larger than the Corporation's typical commercial customer base. The loans originated through the network are considered "leveraged loans," meaning the businesses typically have minimal tangible book equity and the extent of collateral available is limited, though the businesses have demonstrated strong cash flow performance in their recent histories.

The balance of available-for-sale securities fell $96,517,000 to $420,290,000 at December 31, 2015 from $516,807,000 at December 31, 2014. As discussed in the Earnings Overview section, the reduction included sales of securities for which the proceeds were used to pre-pay long-term debt with a book value of $34 million prior to the pay-down. The reduction also included use of proceeds from calls and maturities of securities to fund the increase in loans receivable and to offset some of the impact of the decrease in deposits in the second half of 2015, as the Pennsylvania state budget impasse led to reduced deposit balances held by municipal entities such as school districts, local governments and human service agencies.

Other significant changes in the average balances of the Corporation's earning assets and interest-bearing liabilities are described in the Net Interest Income section of Management's Discussion and Analysis. The discussion provides useful information regarding changes in the Corporation's balance sheet over the 3-year period ended December 31, 2015, including discussions related to available-for-sale securities, loans, deposits and borrowings. Other significant balance sheet items - the allowance for loan losses and stockholders' equity - are discussed in separate sections of Management's Discussion and Analysis.

Table VIII presents loan maturity data as of December 31, 2015. The interest rate simulation model classifies certain loans under different categories than they appear in Table VII. Fixed-rate loans are shown in Table VIII based on their contractually scheduled principal repayments, and variable-rate loans are shown based on the date of the next change in rate. Table VIII shows that fixed-rate loans are approximately 39% of the loan portfolio. Of the 61% of the portfolio made up of variable-rate loans, a significant portion (42%) will re-price after more than one year. Variable-rate loans re-pricing after more than one year include significant amounts of residential and commercial real estate loans. The Corporation's substantial investment in long-term, fixed-rate loans and variable-rate loans with extended periods until re-pricing is one of the concerns management attempts to address through interest rate risk management practices. See Part II, Item 7A for a more detailed discussion of the Corporation's interest rate risk.

Since 2009, the Corporation has originated and sold residential mortgage loans to the secondary market through the MPF Xtra program administered by the Federal Home Loan Banks of Pittsburgh and Chicago. Residential mortgages originated and sold through the MPF Xtra program consist primarily of conforming, prime loans sold to the Federal National Mortgage Association (Fannie Mae), a government agency. In 2014, the Corporation began to originate and sell residential mortgage loans to the secondary market through the MPF Original program, which is also administered by the Federal Home Loan Banks of Pittsburgh and Chicago. Residential mortgages originated and sold through the MPF Original program consist primarily of conforming, prime loans sold to the Federal Home Loan Bank of Pittsburgh. For loans sold under the Original program, the Corporation provides a credit enhancement whereby the Corporation would assume credit losses in excess of a defined First Loss Account ("FLA") balance, up to specified amounts. The FLA is funded by the Federal Home Loan Bank of Pittsburgh based on a percentage of the outstanding balance of loans sold. The Corporation does not provide a credit enhancement for loans sold through the Xtra program.

For loan sales originated under the MPF Xtra and Original programs, the Corporation provides customary representations and warranties to investors that specify, among other things, that the loans have been underwritten to the standards established by the investor. The Corporation may be required to repurchase a loan and reimburse a portion of fees received, or reimburse the investor for a credit loss incurred on a loan, if it is determined that the representations and warranties have not been met. Such repurchases or reimbursements generally result from an underwriting or documentation deficiency. At December 31, 2015, the total outstanding balance of loans the Corporation has repurchased as a result of identified instances of noncompliance amounted to $1,968,000, and the corresponding total outstanding balance repurchased at December 31, 2014 was $1,802,000.

At December 31, 2015, outstanding balances of loans sold and serviced through the two programs totaled $152,448,000, including loans sold through the MPF Xtra program of $125,571,000 and loans sold through the Original program of $26,877,000. At December 31, 2014, outstanding balances of loans sold and serviced through the two programs totaled $152,505,000, including loans sold through the MPF Xtra program of $144,743,000 and loans sold through the Original program of $7,762,000. Based on the fairly limited volume of required repurchases to date, and of sales through the Original program with credit enhancement, no allowance had been established for representation and warranty exposures, or for credit losses on loan sales through the Original program as of December 31, 2015 and 2014.

Total future capital purchases in 2016 are estimated at approximately $2.8 million. Management does not expect capital expenditures to have a material, detrimental effect on the Corporation's financial condition during 2016.

**TABLE VII - Five-year Summary of Loans by Type**

**(In Thousands)**

| | 2015 | % | 2014 | % | 2013 | % | 2012 | % | 2011 | % |
|---|---|---|---|---|---|---|---|---|---|---|
| Residential mortgage: | | | | | | | | | | |
| Residential mortgage loans - first liens | $304,783 | 43.2 | $291,882 | 46.3 | $299,831 | 46.5 | $311,627 | 45.6 | $331,015 | 46.7 |
| Residential mortgage loans - junior liens | 21,146 | 3.0 | 21,166 | 3.4 | 23,040 | 3.6 | 26,748 | 3.9 | 28,851 | 4.1 |
| Home equity lines of credit | 39,040 | 5.5 | 36,629 | 5.8 | 34,530 | 5.4 | 33,017 | 4.8 | 30,037 | 4.2 |
| 1-4 Family residential construction | 21,121 | 3.0 | 16,739 | 2.7 | 13,909 | 2.2 | 12,842 | 1.9 | 9,959 | 1.4 |
| Total residential mortgage | 386,090 | 54.8 | 366,416 | 58.1 | 371,310 | 57.6 | 384,234 | 56.2 | 399,862 | 56.5 |
| Commercial: | | | | | | | | | | |
| Commercial loans secured by real estate | 154,779 | 22.0 | 145,878 | 23.1 | 147,215 | 22.8 | 158,413 | 23.2 | 156,388 | 22.1 |
| Commercial and industrial | 75,196 | 10.7 | 50,157 | 8.0 | 42,387 | 6.6 | 48,442 | 7.1 | 57,191 | 8.1 |
| Political subdivisions | 40,007 | 5.7 | 17,534 | 2.8 | 16,291 | 2.5 | 31,789 | 4.6 | 37,620 | 5.3 |
| Commercial construction | 5,122 | 0.7 | 6,938 | 1.1 | 17,003 | 2.6 | 28,200 | 4.1 | 23,518 | 3.3 |
| Loans secured by farmland | 7,019 | | | | | | | | | |