CITIZENS & NORTHERN CORP
Form 10-K
February 16, 2017

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, 2016

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. x

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, 2016, the registrant’s most recently completed second fiscal quarter, was $237,079,156.

The number of shares of common stock outstanding at February 9, 2017 was 12,143,776.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the registrant’s proxy statement for the annual meeting of its shareholders to be held April 20, 2017 are incorporated by reference into Parts III and IV of this report.

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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 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 ongoing increases in revenues from service charges on deposit accounts, starting primarily in the fourth quarter 2013, and ongoing reductions in electronic funds processing expenses;
- in 2014, approved a treasury stock repurchase program for 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. In the first four months of 2016, the Corporation repurchased the remainder of the shares authorized under the program. In total, 622,500 shares were repurchased for a total cost of $12,140,000, at an average price of $19.50 per share;
- 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 additional lending personnel to provide more access to commercial and mortgage lending opportunities;

- in April 2016, approved a new treasury stock repurchase program authorizing repurchase of up to 600,000 shares of the Corporation's common stock or slightly less than 5% of the Corporation's issued and outstanding shares at April 19, 2016; and

- in 2016, submitted application for regulatory approval to establish a loan production office in Elmira, New York. Formal approval has been received, and the office is scheduled to open in the first quarter 2017.

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, 2016, 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, 2016, C&N Bank had total assets of $1,228,026,000, total deposits of $990,241,000, net loans outstanding of $743,362,000 and 291 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, 2016, total residential mortgages sold and serviced through the two programs amounted to $163,296,000. 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, 2016, the total outstanding balance of residential mortgage loans the Corporation has repurchased as a result of identified instances of noncompliance amounted to $1,852,000. 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.

Securities Markets – The fair value of the Corporation's available-for-sale securities, as well as the revenues the Corporation earns from its Trust and Financial Management and brokerage services, are sensitive to price fluctuations and market events.

Declines in the values of the Corporation’s securities holdings, combined with adverse changes in the expected cash flows from these investments, could result in other-than-temporary impairment charges.

A portion of the Corporation's securities portfolio consists of obligations of states and political subdivisions (also known as municipal bonds). As discussed in more detail in the “Income Taxes” section of Management’s Discussion and Analysis, the Trump Administration and the U.S. Congress have recently been discussing the possibility of lowering corporate income tax rates. If corporate income tax rates were lowered, fully taxable-equivalent yields on tax-exempt securities (municipal bonds) would decrease from their recent levels, which may result in a reduction in the fair value of such securities held at December 31, 2016.

For additional information regarding debt securities, see the “Securities” section of Management’s Discussion and Analysis and Note 7 to the consolidated financial statements.

The Corporation's Trust and Financial Management revenue is determined, in part, from the value of the underlying investment portfolios. Accordingly, if the values of those investment portfolios decrease, whether due to factors influencing U.S. or international securities markets, in general, or otherwise, the Corporation's revenue could be negatively impacted. In addition, the Corporation's ability to sell its brokerage services is dependent, in part, upon consumers' level of confidence in securities markets.

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. As a result of lowering assessment levels for the Corporation and other US banks, the Corporation’s 2016 FDIC assessment expense decreased to $488,000 from $603,000 in 2015. Although the Corporation’s total expenses from FDIC assessments have steadily decreased from $2,092,000 in 2009, the Corporation is generally unable to control the cost of the premiums. If a significant number of bank or financial institution failures occur, the Corporation may be required to pay higher FDIC premiums. Future increases in FDIC insurance premiums or additional special assessments may materially adversely affect the Corporation’s 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 or 10 Nichols Street
Wellsboro, PA 16901 Wellsboro, PA 16901

Branch offices – Citizens & Northern Bank:

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

Loan production office of Citizens & Northern Bank (opening first quarter 2017):

250 East Water Street

Elmira, NY 14901

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, 2016, there were 2,260 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 2016 and 2015.

	2016			2015		
	High	Low	Dividend Declared per Quarter	High	Low	Dividend Declared per Quarter
First quarter	$20.99	$19.26	$ 0.26	$21.50	$19.01	$ 0.26
Second quarter	21.00	19.40	0.26	21.17	19.16	0.26
Third quarter	22.67	20.00	0.26	20.73	19.25	0.26
Fourth quarter	26.57	20.54	0.26	21.45	19.07	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 established a treasury stock repurchase program authorizing repurchase of 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 program could be made from time to time in the open market at prevailing prices, or through privately negotiated transactions. In the first four months of 2016, the Corporation repurchased the remainder of the shares authorized under the program. In total, 622,500 shares were repurchased for a total cost of $12,140,000, at an average price of $19.50 per share.

Effective April 21, 2016, the Corporation's Board of Directors approved a new treasury stock repurchase program. Under the newly approved stock repurchase program, the Corporation is authorized to repurchase up to 600,000 shares of the Corporation's common stock or slightly less than 5% of the Corporation's issued and outstanding shares at April 19, 2016. Consistent with the previous program, the Board of Directors' April 21, 2016 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. To date, no purchases have been made under this repurchase program.

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The following table sets forth a summary of purchases by the Corporation, in the open market, of its equity securities during the fourth quarter 2016:

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, 2016	0	$ -	0	600,000
November 1 - 30, 2016	0	$ -	0	600,000
December 1 - 31, 2016	0	$ -	0	600,000

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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, 2011 and ended December 31, 2016. 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	12/31/11	12/31/12	12/31/13	12/31/14	12/31/15	12/31/16
Citizens & Northern Corporation	100.00	106.83	122.52	129.48	138.55	181.75
Russell 2000	100.00	116.35	161.52	169.43	161.95	196.45
CZNC Peer Group Index*	100.00	124.14	157.02	172.35	180.02	253.70

The Corporation's peer group consists of all publicly traded (who file financial statements with the Securities & Exchange Commission) commercial banks and thrifts within New Jersey, New York, Ohio and Pennsylvania with total assets between $750 million and $3.5 billion as of September 30, 2016.

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, 2016.

	Number of Securities to be Issued Upon Exercise of Outstanding Options	Weighted-average Exercise Price of Outstanding Options	Number of Securities Remaining for Future Issuance Under Equity Compen-sation Plans
Equity compensation plans approved by shareholders	202,037	$ 18.58	302,550
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)	2016	2015	2014	2013	2012
Interest and fee income	$44,098	$44,519	$46,009	$48,914	$56,632
Interest expense	3,693	4,602	5,122	5,765	9,031
Net interest income	40,405	39,917	40,887	43,149	47,601
Provision for loan losses	1,221	845	476	2,047	288
Net interest income after provision for loan losses	39,184	39,072	40,411	41,102	47,313
Noninterest income excluding securities gains	15,511	15,478	15,420	16,451	16,383
Net impairment losses recognized in earnings from available-for-sale securities	0	0	0	(25)	(67)
Net realized gains on available-for-sale securities	1,158	2,861	1,104	1,743	2,749
Loss on prepayment of debt	0	2,573	0	1,023	2,333
Noninterest expense excluding loss on prepayment of debt	34,744	33,030	34,157	33,471	32,914
Income before income tax provision	21,109	21,808	22,778	24,777	31,131
Income tax provision	5,347	5,337	5,692	6,183	8,426
Net income	$15,762	$16,471	$17,086	$18,594	$22,705
PER COMMON SHARE:					
Basic earnings per share	$1.30	$1.35	$1.38	$1.51	$1.86
Diluted earnings per share	$1.30	$1.35	$1.38	$1.50	$1.85
Cash dividends declared per share	$1.04	$1.04	$1.04	$1.00	$0.84
Book value per common share at period-end	$15.36	$15.39	$15.34	$14.49	$14.89
Tangible book value per common share at period-end	$14.37	$14.41	$14.36	$13.51	$13.91
Weighted average common shares outstanding - basic	12,098,129	12,211,941	12,390,067	12,352,383	12,235,748
Weighted average common shares outstanding - diluted	12,128,364	12,233,773	12,412,050	12,382,790	12,260,208
END OF PERIOD BALANCES (Dollars In Thousands)					
Available-for-sale securities	$395,077	$420,290	$516,807	$482,658	$472,577
Gross loans	751,835	704,880	630,545	644,303	683,910
Allowance for loan losses	8,473	7,889	7,336	8,663	6,857
Total assets	1,242,292	1,223,417	1,241,963	1,237,695	1,286,907
Deposits	983,843	935,615	967,989	954,516	1,006,106
Borrowings	64,629	92,263	78,597	96,723	89,379
Stockholders' equity	186,008	187,487	188,362	179,472	182,786
Common shares outstanding	12,113,228	12,180,623	12,279,980	12,390,063	12,274,035

AVERAGE BALANCES (In Thousands)					
Total assets	1,229,866	1,243,209	1,239,897	1,237,096	1,305,163
Earning assets	1,147,549	1,159,298	1,155,401	1,145,340	1,199,538
Gross loans	723,076	657,727	627,753	656,495	700,241
Deposits	970,447	968,201	965,418	964,031	1,008,469
Stockholders' equity	188,373	188,905	185,469	181,412	175,822

ITEM 6. SELECTED FINANCIAL DATA (Continued)

	As of or for the Year Ended December 31,				
	2016	2015	2014	2013	2012
KEY RATIOS					
Return on average assets	1.28 %	1.32 %	1.38 %	1.50 %	1.74 %
Return on average equity	8.37 %	8.72 %	9.21 %	10.25%	12.91%
Average equity to average assets	15.32%	15.19%	14.96%	14.66%	13.47%
Net interest margin (1)	3.76 %	3.69 %	3.80 %	4.05 %	4.26 %
Efficiency (2)	59.22%	56.66%	57.59%	53.27%	48.82%
Cash dividends as a % of diluted earnings per share	80.00%	77.04%	75.36%	66.67%	45.41%
Tier 1 leverage	14.27%	14.31%	13.89%	13.78%	12.53%
Tier 1 risk-based capital	22.48%	23.29%	26.26%	25.15%	22.86%
Total risk-based capital	23.60%	24.40%	27.60%	26.60%	24.01%
Tangible common equity/tangible assets	14.15%	14.49%	14.34%	13.66%	13.39%
Nonperforming assets/total assets	1.43 %	1.31 %	1.34 %	1.53 %	0.82 %
Nonperforming loans/total loans	2.07 %	2.09 %	2.45 %	2.80 %	1.41 %
Allowance for loan losses/total loans	1.13 %	1.12 %	1.16 %	1.34 %	1.00 %
Net charge-offs/average loans	0.09 %	0.04 %	0.29 %	0.04 %	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 2016, net income totaled $15,762,000, or $1.30 per common share - basic and diluted, as compared to $1.35 per share – basic and diluted in 2015 and $1.38 per share - basic and diluted in 2014. The results for 2016 represented a return on average assets of 1.28% and a return on average equity of 8.37%.

2016 vs. 2015

Net income per share – diluted for 2016 was 3.7% lower than in 2015. Some of the more significant highlights related to annual earnings in 2016 as compared to 2015 are as follows:

- Net interest income was $488,000 (1.2%) higher than the comparable total for 2015. The net interest margin was 3.76%, which was 0.07% higher than the margin for 2015, reflecting the benefits of a lower cost of borrowed funds and a more favorable mix of earning assets. The average balance of total borrowed funds was $62,516,000 at an average interest rate of 2.57% in 2016, down from average borrowings of $77,642,000 at an average interest rate of 3.45% in 2015. Average total loans outstanding were higher by $65.3 million (9.9%) in 2016 as compared to 2015, while average total available-for-sale securities were lower by $74.2 million. Average total deposits increased $2.2 million (0.2%).

- The provision for loan losses was $1,221,000 in 2016, an increase of $376,000 over 2015. In 2016, the provision included the impact of increasing the allowance for loan losses for the effects of loan growth and slight increases in net charge-off experience and qualitative factors used in determining the collectively evaluated portion of the allowance. In comparison, in 2015 the provision also reflected the effects of loan growth, but the qualitative factors used in determining a portion of the collectively determined allowance decreased slightly during the period. Also in 2016, the provision included an increase of $148,000 as compared to 2015 from changes in specific allowances on loans individually identified as impaired, adjusted for the impact of net charge-offs.

- Total noninterest revenue for 2016 increased $33,000 (0.2%) over 2015. Net gains from sales of loans increased $294,000 (40.0%), reflecting higher volume of sales, and Trust and Financial Management revenue increased $134,000 (2.9%). Other operating income increased $35,000 (2.1%), including an increase of $148,000 from redemptions of tax credits and increases in lending-related fees of $80,000, while this category included a gain of $212,000 from a split-dollar life insurance policy in 2015. Service charges on deposit accounts decreased $169,000 (3.5%) in 2016, reflecting a reduction in consumer overdraft volume. The fair value of mortgage servicing rights decreased $282,000 in 2016, which was a larger decrease by $120,000 as compared to 2015. Brokerage revenue decreased $83,000 (9.9%), as the volume of sales of annuities declined.

- In 2016, realized gains from securities totaled $1,158,000, including gains from sales of bank stocks of $1,125,000. In 2015, the Corporation generated gains from sales of securities totaling $2,861,000, including gains from sales of bank stocks of $2,220,000, and also incurred losses of $2,573,000 from prepayments of a borrowing in the second and fourth quarters totaling $34 million. In the fourth quarter 2016, the Corporation completed its program of bank stock sales that had begun in 2015, and had no remaining investments in bank stocks at December 31, 2016.

- Noninterest expenses, excluding losses on prepayment of borrowings, in 2016 exceeded the amount for 2015 by $1,714,000 (5.2%). Salaries and wages expense increased $729,000 (5.0%). Several new positions were established in the latter portion of 2015 and early 2016, including new positions established for lending, lending support, information technology, training, human resources and marketing functions. Professional fees expense increased $488,000, including increases related to employee sales and service training, information technology and marketing. Other operating expense increased $399,000 (7.8%), including increases in other real estate expenses of $123,000, donations and public relations-related expenses of $94,000 and education and training-related expenses of $60,000. Also, other operating expense was reduced in 2015 by $69,000 as a result of a recovery of sales tax previously paid.

- The provision for income tax totaled $5,347,000 in 2016, or an effective tax rate of 25.3% of pre-tax income. In comparison, the provision for income tax of $5,337,000 in 2015 represented a 24.5% effective rate. The higher effective tax rate in 2016 included the impact of a $300,000 reduction in tax-exempt interest income and an increase in the provision for state income tax of $64,000 that resulted mainly from a catch-up adjustment to increase New York State taxes for the effect of changes in the tax methodology that first became effective in 2015.

2015 vs. 2014

Basic and diluted net income of $1.35 per share 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 $15,478,000, which was up 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 $380,000, 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.

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%.

- In 2015, noninterest expenses, excluding losses on prepayment of borrowings; totaled $33,030,000, which was $1,127,000 (3.3%) 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 professional fees expense of $161,000, as 2014 included expenses associated with an executive search; (4) a reduction in Pennsylvania shares tax expense of $102,000; and (5) a reduction in other expenses of $282,000, including reductions in expenses from loan collections and other real estate properties.

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 2016, 2015, and 2014. 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.

The calculations of fully taxable-equivalent yields on tax-exempt loans and securities in Tables I, II and III reflect inherent tax benefit based on the Corporation's marginal federal income tax rate of 35% for all periods presented. As discussed in more detail in the "Income Taxes" section of Management's Discussion and Analysis, the Trump Administration and the U.S. Congress have recently been discussing the possibility of lowering corporate income tax rates. If corporate income tax rates were lowered, fully taxable-equivalent yields on tax-exempt loans and securities held at December 31, 2016 would decrease from their recent levels.

2016 vs. 2015

Fully taxable equivalent net interest income was $43,157,000 in 2016, which was $338,000 (0.8%) higher than in 2015. As shown in Table III, in 2016 compared to 2015, net changes in volume had the effect of increasing net interest income $2,754,000, and interest rate changes had the effect of decreasing net interest income $2,416,000. The most significant components of the volume-related increase in net interest income in 2016 was an increase in interest income of $3,255,000 attributable to an increase in the balance of loans receivable and a decrease in interest expense of $991,000 attributable to a reduction in the balance of borrowed funds, partially offset by a volume-related decrease in interest income on available-for-securities of $1,542,000. The most significant components of the rate-related change in net interest income in 2016 were a decrease in interest income of $1,560,000 attributable to lower rates earned on loans receivable and a decrease of $758,000 in interest income on available-for-sale securities. As presented in Table II, the “Interest Rate Spread” (excess of average rate of return on earning assets over average cost of funds on interest-bearing liabilities) was 3.63% in 2016 as compared to 3.54% in 2015.

INTEREST INCOME AND EARNING ASSETS

Interest income totaled $46,850,000 in 2016, a decrease of 1.2% from 2015. Although yields on securities and loans fell, overall yield on earning assets dropped only 0.01% due to a change in mix of earning assets to increase loans and decrease securities. Interest and fees on loans receivable increased $1,695,000, or 5.0%, while interest on available-for-sale securities decreased $2,300,000, or 17.1%. The average balance of gross loans receivable increased 9.9% to $723,076,000 in 2016 from $657,727,000 in 2015. The Corporation experienced significant growth in all loan categories, particularly in participation loans purchased of $19,664,000, residential mortgages of $16,405,000, commercial real estate loans of $13,452,000, and tax free municipal loans of $6,351,000. The Corporation’s average rate of return on loans receivable declined to 4.92% in 2016 from 5.15% in 2015 as average interest rates on new loans are lower, reflecting recent market conditions.

As indicated in Table II, average available-for-sale securities (at amortized cost) totaled $404,979,000 in 2016, a decrease of $74,169,000 (15.5%) from 2015. Funds generated from the net decrease in the Corporation’s available-for-sale securities portfolio were used, in part, to fund the loan growth described above. The Corporation’s yield on securities was lower in 2016 than in 2015, primarily due to higher-yielding securities maturing as the portfolio size was reduced. The average rate of return on available-for-sale securities was 2.75% in 2016 and 2.81% in 2015.

The average balance of interest-bearing due from banks decreased to $19,022,000 in 2016 from $22,201,000 in 2015. 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 $909,000, or 19.8%, to $3,693,000 in 2016 from $4,602,000 in 2015. Table II shows that the overall cost of funds on interest-bearing liabilities fell to 0.45% in 2016 from 0.55% in 2015.

Total average deposits (interest-bearing and noninterest-bearing) increased slightly (0.2%) to $970,447,000 in 2016 from $968,201,000 in 2015. Decreases in the average balances of certificates of deposit and Individual Retirement Accounts were offset by increases in average balances of interest checking, money market accounts, savings accounts and noninterest-bearing demand deposits. The average rate paid on interest-bearing deposits increased slightly to 0.28% in 2016 from 0.26% in 2015.

Total average borrowed funds decreased $15,126,000 to $62,516,000 in 2016 from $77,642,000 in 2015. The average rate on borrowed funds was 2.57% in 2016 compared to 3.45% in 2015, reflecting a $27,604,000 reduction in the average balance of higher-rate, long-term borrowings resulting from prepayment in the second and fourth quarters of 2015 of a long-term repurchase agreement borrowing with an interest rate of 4.265%. The average balance of short-term borrowings increased $12,478,000 in 2016 over 2015, as average overnight borrowings were higher in 2016 and the Corporation funded the pay-off of the long-term repurchase agreement with a series of short-term advances from the FHLB-Pittsburgh that matured over the course of 2016.

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 at an average rate of 0.86%.

TABLE I - ANALYSIS OF INTEREST INCOME AND EXPENSE

	Years Ended December 31,			Increase/(Decrease)	
(In Thousands)	2016	2015	2014	2016/2015	2015/2014
INTEREST INCOME					
Available-for-sale securities:					
Taxable	$5,916	$7,587	$8,028	$(1,671)	$(441)
Tax-exempt	5,240	5,869	6,577	(629)	(708)
Total available-for-sale securities	11,156	13,456	14,605	(2,300)	(1,149)
Interest-bearing due from banks	116	93	125	23	(32)
Loans held for sale	27	16	16	11	0
Loans receivable:					
Taxable	32,827	31,311	32,127	1,516	(816)
Tax-exempt	2,724	2,545	2,142	179	403
Total loans receivable	35,551	33,856	34,269	1,695	(413)
Total Interest Income	46,850	47,421	49,015	(571)	(1,594)
INTEREST EXPENSE					
Interest-bearing deposits:					
Interest checking	293	214	216	79	(2)
Money market	342	299	286	43	13
Savings	133	128	121	5	7
Certificates of deposit	882	831	1,069	51	(238)
Individual Retirement Accounts	434	451	470	(17)	(19)
Other time deposits	1	1	1	0	0
Total interest-bearing deposits	2,085	1,924	2,163	161	(239)
Borrowed funds:					
Short-term	155	32	9	123	23
Long-term	1,453	2,646	2,950	(1,193)	(304)
Total borrowed funds	1,608	2,678	2,959	(1,070)	(281)
Total Interest Expense	3,693	4,602	5,122	(909)	(520)
Net Interest Income	$43,157	$42,819	$43,893	$338	$(1,074)

(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 $1,000,000 in 2016, $1,004,000 in 2015, and $1,013,000 in 2014.

TABLE II - ANALYSIS OF AVERAGE DAILY BALANCES AND RATES

(Dollars in Thousands)

	Year Ended 12/31/2016 Average Balance	Rate of Return/ Cost of Funds %	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 %
EARNING ASSETS						
Available-for-sale securities, at amortized cost:						
Taxable	$293,636	2.01 %	$366,448	2.07 %	$371,125	2.16 %
Tax-exempt	111,343	4.71 %	112,700	5.21 %	123,809	5.31 %
Total available-for-sale securities	404,979	2.75 %	479,148	2.81 %	494,934	2.95 %
Interest-bearing due from banks	19,022	0.61 %	22,201	0.42 %	32,510	0.38 %
Federal funds sold	0	0.00 %	0	0.00 %	0	0.00 %
Loans held for sale	472	5.72 %	222	7.21 %	204	7.84 %
Loans receivable:						
Taxable	662,769	4.95 %	603,771	5.19 %	589,120	5.45 %
Tax-exempt	60,307	4.52 %	53,956	4.72 %	38,633	5.54 %
Total loans receivable	723,076	4.92 %	657,727	5.15 %	627,753	5.46 %
Total Earning Assets	1,147,549	4.08 %	1,159,298	4.09 %	1,155,401	4.24 %
Cash	16,570		16,639		16,865	
Unrealized gain/loss on securities	7,166		8,871		6,350	
Allowance for loan losses	(8,082)		(7,380)		(7,992)	
Bank premises and equipment	15,413		15,911		16,789	
Intangible Asset - Core Deposit Intangible	24		41		70	
Intangible Asset – Goodwill	11,942		11,942		11,942	
Other assets	39,284		37,887		40,472	
Total Assets	$1,229,866		$1,243,209		$1,239,897	
INTEREST-BEARING LIABILITIES						
Interest-bearing deposits:						
Interest checking	$201,357	0.15 %	$195,940	0.11 %	$183,874	0.12 %
Money market	199,405	0.17 %	196,585	0.15 %	198,990	0.14 %
Savings	132,679	0.10 %	128,355	0.10 %	121,685	0.10 %
Certificates of deposit	117,130	0.75 %	121,803	0.68 %	134,732	0.79 %
Individual Retirement Accounts	103,467	0.42 %	110,659	0.41 %	120,016	0.39 %
Other time deposits	1,036	0.10 %	1,031	0.10 %	1,039	0.10 %
Total interest-bearing deposits	755,074	0.28 %	754,373	0.26 %	760,336	0.28 %
Borrowed funds:						

Short-term	23,906	0.65	%	11,428	0.28	%	6,744	0.13	%
Long-term	38,610	3.76	%	66,214	4.00	%	73,196	4.03	%
Total borrowed funds	62,516	2.57	%	77,642	3.45	%	79,940	3.70	%
Total Interest-bearing Liabilities	817,590	0.45	%	832,015	0.55	%	840,276	0.61	%
Demand deposits	215,373			213,828			205,082		
Other liabilities	8,530			8,461			9,070		
Total Liabilities	1,041,493			1,054,304			1,054,428		
Stockholders' equity, excluding accumulated other comprehensive income	183,671			183,125			181,271		
Accumulated other comprehensive income	4,702			5,780			4,198		
Total Stockholders' Equity	188,373			188,905			185,469		
Total Liabilities and Stockholders' Equity	$1,229,866			$1,243,209			$1,239,897		
Interest Rate Spread		3.63	%		3.54	%		3.63	%
Net Interest Income/Earning Assets		3.76	%		3.69	%		3.80	%
Total Deposits (Interest-bearing and Demand)	$970,447			$968,201			$965,418		

(1) Annualized 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.

(3) Rates of return on earning assets and costs of funds are presented on an annualized basis.

TABLE III - ANALYSIS OF VOLUME AND RATE CHANGES

(In Thousands)

	Year Ended 12/31/16 vs. 12/31/15			Year Ended 12/31/15 vs. 12/31/14		
	Change in Volume	Change in Rate	Total Change	Change in Volume	Change in Rate	Total Change
EARNING ASSETS						
Available-for-sale securities:						
Taxable	$(1,472)	$(199)	$(1,671)	$(100)	$(341)	$(441)
Tax-exempt	(70)	(559)	(629)	(581)	(127)	(708)
Total available-for-sale securities	(1,542)	(758)	(2,300)	(681)	(468)	(1,149)
Interest-bearing due from banks	(14)	37	23	(42)	10	(32)
Loans held for sale	15	(4)	11	1	(1)	0
Loans receivable:						
Taxable	2,965	(1,449)	1,516	786	(1,602)	(816)
Tax-exempt	290	(111)	179	758	(355)	403
Total loans receivable	3,255	(1,560)	1,695	1,544	(1,957)	(413)
Total Interest Income	1,714	(2,285)	(571)	822	(2,416)	(1,594)
INTEREST-BEARING LIABILITIES						
Interest-bearing deposits:						
Interest checking	6	73	79	14	(16)	(2)
Money market	4	39	43	(3)	16	13
Savings	4	1	5	7	0	7
Certificates of deposit	(33)	84	51	(97)	(141)	(238)
Individual Retirement Accounts	(30)	13	(17)	(38)	19	(19)
Other time deposits	0	0	0	0	0	0
Total interest-bearing deposits	(49)	210	161	(117)	(122)	(239)
Borrowed funds:						
Short-term	56	67	123	9	14	23
Long-term	(1,047)	(146)	(1,193)	(279)	(25)	(304)
Total borrowed funds	(991)	(79)	(1,070)	(270)	(11)	(281)
Total Interest Expense	(1,040)	131	(909)	(387)	(133)	(520)
Net Interest Income	$2,754	$(2,416)	$338	$1,209	$(2,283)	$(1,074)

(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.

NONINTEREST INCOME

Years Ended December 31, 2016, 2015 and 2014

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, 2016	2015	$ Change	% Change
Service charges on deposit accounts	$4,695	$4,864	$(169)	(3.5)
Service charges and fees	439	494	(55)	(11.1)
Trust and financial management revenue	4,760	4,626	134	2.9
Brokerage revenue	756	839	(83)	(9.9)
Insurance commissions, fees and premiums	102	109	(7)	(6.4)
Interchange revenue from debit card transactions	1,943	1,935	8	0.4
Net gains from sales of loans	1,029	735	294	40.0
Decrease in fair value of servicing rights	(282)	(162)	(120)	74.1
Increase in cash surrender value of life insurance	382	386	(4)	(1.0)
Other operating income	1,687	1,652	35	2.1
Total other operating income before realized gains on available-for-sale securities, net	$15,511	$15,478	$33	0.2

	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
Other operating income	1,652	1,272	380	29.9

Total other operating income before realized gains on available-for-sale securities, net	$15,478	$15,420	$ 58	0.4

Total noninterest income, excluding realized gains on available-for-sale securities, increased $33,000 in 2016 compared to 2015. In 2015, total noninterest income increased $58,000 from 2014. Changes of significance are discussed in the narrative that follows.

2016 vs. 2015

Net gains from sales of loans increased $294,000 (40.0%), reflecting higher volume of sales. The increase in volume in 2016 included the impact of employing one additional mortgage lender in a dedicated, full-time capacity throughout most of 2016 as compared to 2015.

Trust and Financial Management revenue increased $134,000 (2.9%). The increase in Trust revenue in 2016 reflected, in part, the effect of higher value of U.S. equity markets in the latter portion of the year.

Other operating income increased $35,000 (2.1%), including an increase of $148,000 from redemptions of tax credits and increases in lending-related fees of $80,000, while this category included a gain of $212,000 from a split-dollar life insurance policy in 2015.

Service charges on deposit accounts decreased $169,000 (3.5%) in 2016, including a $131,000 reduction in consumer overdraft fees due to a lower volume of overdrafts.

The fair value of mortgage servicing rights decreased $282,000 in 2016, as their valuation was negatively impacted by a reduction in demand by banks for purchasing servicing rights resulting from regulatory changes that have generally increased their risk-based capital weighting. In comparison, the fair value of mortgage servicing rights decreased $162,000 in 2015.

Brokerage revenue decreased $83,000 (9.9%), as the volume of sales of annuities declined.

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 revenues resulting from 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 $380,000 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 addition, dividend income from Federal Home Loan Bank of Pittsburgh stock increased $36,000, and revenue from merchant services increased $28,000, in 2015 as compared to 2014.

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

NONINTEREST EXPENSE

Years Ended December 31, 2016, 2015 and 2014

Total noninterest expense decreased $859,000, or 2.4%, in 2016 as compared to 2015; however, excluding losses from prepayment of borrowings in 2015, noninterest expense was $1,714,000 (5.2%) higher in 2016 as compared to 2015. Excluding losses from prepayment of debt in 2015, total noninterest expense decreased $1,127,000 (3.3%) in 2015 as compared to 2014. In 2015, the Corporation incurred losses totaling $2,573,000 from prepayment of borrowings (repurchase agreements). There were no losses from prepayment of borrowings incurred in 2016 or 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)

	Years Ended December 31,			
	2016	2015	$ Change	% Change
Salaries and wages	$15,411	$14,682	$729	5.0
Pensions and other employee benefits	4,717	4,420	297	6.7
Occupancy expense, net	2,340	2,574	(234)	(9.1)
Furniture and equipment expense	1,730	1,860	(130)	(7.0)
FDIC Assessments	488	603	(115)	(19.1)
Pennsylvania shares tax	1,274	1,248	26	2.1
Professional fees	1,126	638	488	76.5
Automated teller machine and interchange expense	1,137	988	149	15.1
Software subscriptions	981	876	105	12.0
Loss on prepayment of borrowings	0	2,573	(2,573)	(100.0)
Other operating expense	5,540	5,141	399	7.8
Total Other Expense	$34,744	$35,603	$(859)	(2.4)

	Years Ended December 31, 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	1,248	1,350	(102)	(7.6)
Professional fees	638	699	(61)	(8.7)
Automated teller machine and interchange expense	988	924	64	6.9
Software subscriptions	876	784	92	11.7
Loss on prepayment of borrowings	2,573	0	2,573	100.0
Other operating expense	5,141	5,423	(282)	(5.2)
Total Other Expense	$35,603	$34,157	$1,446	4.2

2016 vs 2015

Salaries and wages expense increased $729,000 (5.0%), reflecting an increase in number of employees. The average number of full-time equivalent employees was 287 in 2016, up from 281 in 2015, including new positions established for lending, lending support, information technology, training and marketing functions.

Pension and other employee benefits expense increased $297,000 (6.7%). The increase resulted mainly from an increase of $214,000 in healthcare expense as a result of increased healthcare claims. The Corporation is self-insured for health insurance, up to a cap for catastrophic levels of losses, which are insured by a third party. Payroll taxes and other expenses within this category increased in 2016, as well, due to the increase in number of employees described above.

Professional fees expense increased $488,000, including increases related to employee sales and service training, information technology and marketing.

Automated teller machine and interchange expense increased $149,000, including the costs of purchasing new debit cards with EMV functionality.

Software subscriptions increased $105,000 as a result of enhancements and new applications initiated in 2015 and continuing into 2016 including costs associated with the network operating system, automated document signatures and marketing-related functionality.

Other operating expense increased $399,000 (7.8%), including increases in other real estate expenses of $123,000, donations and public relations-related expenses of $94,000 and education and training-related expenses of $60,000. Also, other operating expense was reduced in 2015 by $69,000 as a result of a recovery of sales tax previously paid.

Occupancy expenses in 2016 were $234,000 under 2015 primarily as a result lower depreciation costs as well as lower winter-related expenses such as snow removal and fuel costs.

Furniture and equipment expenses in 2016 were $130,000 under 2015 primarily as a result lower depreciation costs.

FDIC insurance decreased $115,000 in 2016 reflecting lower assessment levels beginning in the third quarter of 2016.

2015 vs 2014

Salaries and wages decreased $439,000 (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.

Pensions and other employee benefits decreased $349,000 (7.3%). Health care expense decreased $342,000 as the amount of claims incurred during 2015 was lower than in 2014. 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.

Other operating expense decreased $282,000 (5.2%). The reduction included a $191,000 decrease in loan collection expenses and an $86,000 decrease in other real estate expenses.

INCOME TAXES

The effective income tax rate was 25.3% of pre-tax income in 2016, 24.5% in 2015 and 25.0% in 2014. 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, 2016, the net deferred tax asset was $5,117,000, an increase from the balance at December 31, 2015 of $3,115,000. The largest change in temporary difference components was a change to a deferred tax asset of $512,000 on the aggregate unrealized loss on available-for-sale securities at December 31, 2016 from a deferred tax liability of $1,342,000 on the aggregate unrealized gain on available-for-sale securities at December 31, 2015. The decline in fair values of available-for-sale securities was mainly due to an increase in interest rates in the last few months of 2016.

The Corporation uses currently enacted tax rates to value deferred tax assets and liabilities. The Trump Administration and the U.S. Congress are in the process of evaluating possible tax changes which may include a reduction in U.S. corporate income tax rates. If corporate tax rates were reduced, management expects the Corporation would record an initial charge against earnings to lower the carrying amount of the net deferred tax asset, and then would record a lower tax provision going forward on an ongoing basis.

The following schedule estimates the amount of initial reduction in the net deferred tax asset that would be recognized, at varying marginal federal income tax rates, based on the Corporation's temporary difference components at December 31, 2016. The schedule also shows the pro forma impact on the 2016 provision for income taxes, assuming the alternative tax rates presented had been in effect throughout the year, without adjustment for reinvestment of additional funds and assuming no other changes in the composition of the Corporation's assets and liabilities.

(Dollars in Thousands)

	Valuation at Marginal Federal Tax Rate of:			
	35% (Actual)	25%	20%	15%
Carrying Value of Deferred Tax Asset at 12/31/16:				
Accumulated Other Comprehensive Items, Net	$ 485	$ 347	$ 278	$ 207
Other Items, Net	4,632	3,309	2,647	1,985
Total	$ 5,117	$ 3,656	$ 2,925	$ 2,192
Pro Forma Reduction in Carrying Value of Deferred Tax Asset from 12/31/16:				
Accumulated Other Comprehensive Items, Net		$ (138)	$ (207)	$ (278)
Other Items, Net (Initial Charge to Earnings)		(1,323)	(1,985)	(2,647)
Total		$ (1,461)	$ (2,192)	$ (2,925)

	For the Year Ended 12/31/16 at Marginal Federal Tax Rate of:			
	35% (Actual)	25%	20%	15%
Income Tax Provision	$5,347	$3,797	$3,025	$2,250
Income Tax Provision as % of Pre-tax Income	25.3 %	18.0 %	14.3 %	10.7 %
Pro Forma Reduction in 2016 Annual Income Tax Provision if Alternative Rate Were in Effect Throughout 2016		$(1,550)	$(2,322)	$(3,097)

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. Further, as discussed above, realization of deferred tax assets would be impacted if income tax rates are lowered from currently enacted levels.

Management believes the recorded net deferred tax asset at December 31, 2016 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, 2016, 2015 and 2014. Comparison of the amortized cost totals of available-for-sale securities at each year-end presented reflects a decrease of $92,227,000 to $416,455,000 at December 31, 2015 from December 31, 2014. This change was followed by a decrease of $19,917,000 to $396,538,000 at December 31, 2016. The continued decrease in securities in 2016 reflects the use of cash generated from the investment portfolio to help fund the increase in loans outstanding. The Corporation’s holdings of mortgage-backed securities issued or guaranteed by U.S. Government agencies or sponsored agencies have decreased to $237,654,000 at December 31, 2016 from $266,372,000 at December 31, 2015 and $322,099,000 at December 31, 2014. Within that overall category, in 2016, the Corporation added some commercial mortgage-backed securities for which the underlying collateral consists of multi-family properties. The total amortized cost of commercial mortgage-backed securities held at December 31, 2016 was $30,817,000.

As reflected in Table VI, the fair value of available-for-sale securities as of December 31, 2016 was $1,461,000, or 0.37%, less than the total amortized cost basis. The aggregate unrealized loss position at December 31, 2016 was down from an unrealized gain of $3,835,000 at December 31, 2015, partly due to an increase in interest rates in the last few months of 2016. Changes in intermediate-term and long-term interest rates have a significant impact on changes in fair values of debt securities. The fair values of tax-exempt municipal bonds at December 31, 2016 may have been negatively impacted, as well, by the market’s perception that U.S. corporate income tax rates may be reduced within the next 1-2 years. The aggregate unrealized gain on tax-exempt municipal bonds was $897,000, or 0.8% of amortized cost, at December 31, 2016. In comparison, the aggregate unrealized gain on tax-exempt municipal bonds held at December 31, 2015 was $4,343,000, or 4.2%. The aggregate unrealized loss on debt securities at December 31, 2016 was 0.36% of the amortized cost basis, down from net unrealized gains on debt securities of 0.75% at December 31, 2015 and 1.01% at December 31, 2014. Also contributing to the reduction in aggregate unrealized gain (loss) was the liquidation of the bank stock portfolio in 2015 and 2016 as the Corporation realized gains from the sale of bank stocks. As discussed in more detail in Note 7 to the consolidated financial statements, the Corporation reported net realized gains from available-for-sale securities of $1,158,000 in 2016, including realized gains from sales of equity securities (bank stocks) of $1,125,000. In comparison, net realized gains from available-for-sale securities totaled $2,861,000 in 2015 and $1,104,000 in 2014.

Management has reviewed the Corporation’s holdings as of December 31, 2016 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 2017.

TABLE VI - INVESTMENT SECURITIES

	As of December 31,					
	2016		2015		2014	
(In Thousands)	Amortized Cost	Fair Value	Amortized Cost	Fair Value	Amortized Cost	Fair Value
AVAILABLE-FOR-SALE SECURITIES:						
Obligations of U.S. Government agencies	$9,671	$9,541	$10,663	$10,483	$27,221	$26,676
Obligations of states and political subdivisions:						
Tax-exempt	118,140	119,037	103,414	107,757	120,086	124,839
Taxable	30,073	30,297	34,317	34,597	33,637	33,878
Mortgage-backed securities issued or guaranteed by U.S. Government agencies or sponsored agencies:						
Residential pass-through securities	58,922	58,404	73,227	73,343	82,479	83,903
Residential collateralized mortgage obligations	147,915	146,608	193,145	191,715	239,620	238,823
Commercial mortgage-backed securities	30,817	30,219	0	0	0	0
Other collateralized debt obligations	0	0	9	9	34	34
Total debt securities	395,538	394,106	414,775	417,904	503,077	508,153
Marketable equity securities	1,000	971	1,680	2,386	5,605	8,654
Total	$396,538	$395,077	$416,455	$420,290	$508,682	$516,807

The following table presents the contractual maturities and the weighted-average yields (calculated based on amortized cost) of investment securities as of December 31, 2016. 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	$1,637	1.36%	$8,034	1.42%	$0	0.00%	$0	0.00%	$9,671	1.41%
Obligations of states and political subdivisions:										
Tax-exempt	13,429	3.13%	43,417	2.80%	36,175	2.22%	25,119	3.77%	118,140	2.86%
Taxable	3,613	1.81%	18,108	2.25%	8,352	3.07%	0	0.00%	30,073	2.43%

Sub-total	$18,679	2.72%	$69,559	2.50%	$44,527	2.38%	$25,119	3.77%	157,884	2.69%
Mortgage-backed securities issued or guaranteed by U.S. Government agencies or sponsored agencies:										
Residential pass-through securities									58,922	2.07%
Residential collateralized mortgage obligations									147,915	1.96%
Commercial mortgage-backed securities									30,817	2.34%
Total									$395,538	2.12%

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 $751,835,000 at December 31, 2016, up 6.7% from $704,880,000 at December 31, 2015. The total outstanding balances of residential mortgage segment loans at December 31, 2016 increased $34,683,000 (9.0%) as compared to December 31, 2015, and the total outstanding balances of commercial segment loans at December 31, 2016 increased $9,206,000 (3.0%) as compared to December 31, 2015. The 2016 loan growth followed significant growth in loans outstanding in 2015, as gross loans outstanding at December 31, 2015 were up 11.8% from December 31, 2014. Total outstanding commercial loans were higher by $54,239,000 (21.4%), and residential mortgage segment loans were up $19,674,000 (5.4%), at December 31, 2015 as compared to December 31, 2014.

The increases in loans outstanding in 2015 and 2016 included increases in commercial participation loans. 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,” “Commercial loans secured by real estate” and “Political subdivisions” classes in the loan tables presented in this Form 10-K. Total participation loans outstanding amounted to $47,508,000 at December 31, 2016, up from $44,456,000 at December 31, 2015. At December 31, 2016, the balance of participation loans outstanding includes a total of $34,890,000 to businesses located outside of the Corporation’s market area, including $11,967,000 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. At December 31, 2016, total leveraged participation loans, including loans originated through the network and two loans to one borrower originated through another lead institution, totaled $15,207,000.

Table VIII presents loan maturity data as of December 31, 2016. The interest rate simulation model classifies certain loans under different categories from the categories that 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 38% of the loan portfolio. Of the 62% of the portfolio made up of variable-rate loans, a significant portion (36%) will re-price after more than one year. Variable-rate loans re-pricing after more than one year include residential and commercial real estate secured 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.

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. Other significant balance sheet items, including securities, the allowance for loan losses and stockholders' equity, are discussed in separate sections of Management's Discussion and Analysis.

Total purchases of bank premises and equipment in 2017 are estimated at approximately $2.5 million. Management does not expect the amount of purchases of bank premises and equipment to have a material, detrimental effect on the Corporation's financial condition in 2017.

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 quasi-government entity. 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 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, 2016, the total outstanding balance of loans the Corporation has repurchased as a result of identified instances of noncompliance amounted to $1,852,000, and the corresponding total outstanding balance repurchased at December 31, 2015 was $1,968,000.

At December 31, 2016, outstanding balances of loans sold and serviced through the two programs totaled $163,296,000, including loans sold through the MPF Xtra program of $116,978,000 and loans sold through the Original program of $46,318,000. 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. Based on the fairly limited volume of required repurchases to date, no allowance has been established for representation and warranty exposures as of December 31, 2016 and December 31, 2015.

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. At December 31, 2016, the Corporation's maximum credit enhancement obligation under the MPF Original Program was $4,664,000, and the Corporation has recorded a related allowance for credit losses in the amount of $196,000 which is included in "Accrued interest and other liabilities" in the accompanying consolidated balance sheets. There was no allowance recorded at December 31, 2015. The Corporation does not provide a credit enhancement for loans sold through the Xtra program.

Table VII – Summary of Loans by Type
(In Thousands)

	2016	%	2015	%	2014	%	2013	%	2012	%
Residential mortgage:										
Residential mortgage loans - first liens	$334,102	44.4	$304,783	43.2	$291,882	46.3	$299,831	46.5	$311,627	45.6
Residential mortgage loans - junior liens	23,706	3.2	21,146	3.0	21,166	3.4	23,040	3.6	26,748	3.9