



# CITIZENS & NORTHERN CORPORATION

CITIZENS & NORTHERN BANK      FIRST STATE BANK  
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March 2, 2009

Mr. Neil M. Barofsky  
Special Inspector General  
Office of the Special Inspector General  
Troubled Asset Relief Program  
1500 Pennsylvania Avenue, N.W., Suite 1064  
Washington, D. C. 20220

RE: Information requested in letter dated February 6, 2009

Dear Mr. Barofsky:

This is our response to your request for information in your letter dated February 6, 2009.

**1. Use of TARP funds:**

- a) **Anticipated Use of TARP Funds:** We applied to be considered for the U. S. Treasury investment in our financial institution in the form of senior preferred stock because we had concerns related to remaining well-capitalized due to illiquid investment securities we own in the Citizens & Northern Bank portfolio. Those securities are in the form of pooled trust preferreds that were approved and appropriate investments from a regulatory perspective and that were investment grade when they were purchased. Due to FAS 157 Fair Market accounting requirements, the carrying value on those securities has been dramatically depressed. At the time we applied for the funds, we had already written off as other-than-temporarily-impaired (OTTI) over \$4 million. For all of 2008, we have taken a total of about \$9.8 million in OTTI on those investments and other equity securities. Additionally, the reduced market value has significantly impacted our equity position due to the large negative other-comprehensive income figure related to unrealized losses due primarily to the pooled trust preferreds and bank stocks held in our portfolios. Since the proceeds from the issue of preferred stock is considered equity for accounting purposes and Tier 1 from a bank regulatory standpoint, we consider the funds to be equity capital that will sustain our capital levels above the "well-capitalized" level to permit us to continue to attract and book deposits and to make loans and investments as we have for 145 years of our existence.
- b) As capital, the TARP CPP funds are not segregated from any other funds.
- c) As stated in (a) above, the funds are considered equity capital for the purpose of sustaining our position as a well-capitalized institution that will allow us to continue doing the business of banking (taking deposits, making loans and making investments).

- d) Since TARP CPP funds are equity capital, we have not spent any of the funds. Equity capital supports our ability to raise deposits and take risks inherent in making business and consumer loans and in investment.

As mentioned above, we have a portfolio of illiquid securities (pooled trust preferreds) in the portfolio of our major subsidiary, Citizens & Northern Bank ("Bank"). At this moment, the CPP funds reside in the balance sheet of Citizens & Northern Corporation. The Risk-Based Capital treatment of those securities at the Bank, threatens the Bank's regulatory well-capitalized position and could threaten our ability to increase our loans outstanding. Our plans are to transfer the CPP funds to the Citizens & Northern Investment subsidiary, which will use the funds to purchase the illiquid securities from Citizens & Northern Bank. Those securities will then be held in the investment portfolio of Citizens & Northern Corporation. This transaction will have a positive effect on the Bank's Risk-Based Capital position. In effect, the CPP funds will be transferred to the Bank and will enhance the bank's Tier 1 capital. On a holding company consolidated basis, the effect on regulatory capital ratios will be unchanged by the transaction.

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We are currently engaged in a loan campaign, which includes billboard, newspaper and radio advertising that we hope will generate more opportunities for loan origination. The campaign began the week of February 16<sup>th</sup>. Since receipt of the CPP funds, we have originated nearly \$8.7 million in commercial and consumer loans and nearly \$1 million in letters of credit. Last year Citizens & Northern Corporation had net income of over \$10 million. No CPP funds are allocated for operating expenses. The CPP funds are and will be treated as equity capital to strengthen our regulatory capital ratios. With strong capital ratios we are better positioned to gather more deposits and originate more loans.

## 2. Executive Compensation

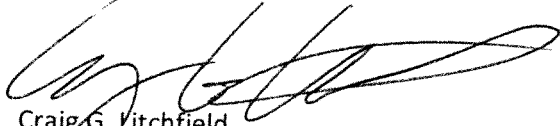
In January 2009, all five (5) of the most highly compensated executive officers signed Letter Agreements in order to ensure the satisfaction of the Company's commitment under Section 1.2(d) (iv) (A) of the Securities Purchase Agreement to that certain Capital Purchase Program Letter Agreement dated January 16, 2009 between the Company and United States Department of the Treasury ("Treasury"). Our Compensation Committee and Board of Directors adopted resolutions to insure that we are in compliance with the limitations on executive compensation and that they will be implemented to comply with Department of Treasury guidelines. There presently is no intention or provision for the impact of said limitations to be offset by other changes to other, longer-term or deferred forms of executive compensation.

We have attached a copy of a communiqué related to our participation in the CPP that we forwarded to our shareholders along with our fourth quarter report. We are also enclosing a copy of an internal "Talking Points" memo that was emailed to employees and directors regarding our participation in the CPP. Also, enclosed is a "confidential" copy of our 2009 projected year-end budgeted balance sheet that projects increases in loans of approximately \$28 million. This budget was approved by our board of directors at the January monthly meeting. **We ask that the copy of the budget be afforded confidential treatment.** Of course, our ability to originate prudently underwritten loans in that volume will depend upon demand,

which at this point is limited. We have also shared with our employees and directors copies of white papers about the TARP and CPP authored by the American Bankers Association. (Copies enclosed.)

If you require any additional information, we will provide it upon request.

Sincerely,

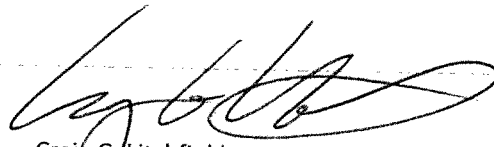


Craig G. Litchfield  
Chairman, President & CEO

**CERTIFICATION**

I, Craig G. Litchfield, Chairman, Chief Executive Officer and President of Citizens & Northern Corporation, certify, subject to the requirements and penalties set forth in 18 U.S.C. §1001, that the foregoing statements, representations and supporting information are true and correct to the best of my knowledge, information and belief.

Date March 2, 2009



Craig G. Litchfield  
Chairman, President and CEO

# CITIZENS & NORTHERN CORPORATION

## C&N Insures Its Future

On January 16<sup>th</sup>, 2009, Citizens & Northern Corporation (C&N) received a \$26.44 million government investment (from the United States Department of the Treasury) in senior preferred stock as part of the TARP Capital Purchase Program (CPP). C&N's board and management believe that this is a prudent thing to do given the scope of the current national and global economic uncertainties. As a result of the incredible national and world-wide economic and financial crisis, the CPP was developed and designed to provide capital directly to healthy U.S. financial services companies, like C&N, as well as some of the more troubled big banks.

Although the program has been popularly and inaccurately described as a "bailout," the funds received are an investment by the U.S. government that C&N expects to repay in full with dividends. Until the investment is repaid, C&N will pay the government dividends of 5%, or more than \$1.3 million per year for up to the first five years, or 9% per year after the first 5 years. Currently, the U.S. government is borrowing money for five years at a rate of about 1.63%, which results in a profit for the government of nearly 3.4%. In other words, unless we are able to redeem the preferred stock sooner, the government will net sizeable profit each year on its investment in C&N. Additionally, as a condition of the investment, the government was issued a right to purchase (Warrant) 194,794 shares of C&N stock. This Warrant has a 10-year life and provides the government with the ability to further profit from the CPP investment by purchasing C&N stock at a fixed price anytime during that period.

C&N is participating in the CPP to insure that we are able to absorb and withstand any unexpected, negative impacts during this period of economic crisis and uncertainty. In this difficult economic environment, management is concerned that our capital position could be negatively impacted by loan or securities losses. The government's preferred stock investment will be treated as Tier 1 capital, and will further strengthen C&N's consolidated total risk-based capital ratio from its estimated level of 15.0% at December 31, 2008 to approximately 17.8%, both of which exceed the 10% regulatory requirement for banks to be deemed "well-capitalized." We will use the funds to insure C&N's continued financial strength and well-capitalized position. Among other things, our strong capital position will assure our ability to continue to make prudent loans to consumers and businesses in our market. With the additional capital, as the economic climate stabilizes and improves, we will be in a position to expand by extending more loans and making more investments. We expect these additional assets will add to the bottom line even as we pay the government a good return on its investment.

While there has been much misinformation spread by the media and by some in Congress about the CPP, the program will provide C&N, and other community banks, with the capital to assure our ability to do what we do best: lend and invest in the people and communities we serve.

**Safe Harbor Statement:** Except for historical information contained herein, the matters discussed in this release are forward-looking statements. Investors are cautioned that all forward-looking statements involve risks and uncertainty, including without limitation, 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 management's assessment of realization of securities and other assets; and changes in accounting principles, or the application of generally accepted accounting principles. The Company disclaims any intention or obligation to publicly update or revise any forward-looking statements, whether as a result of events or circumstances after the date hereof or to reflect the occurrence of unanticipated events.

# CITIZENS & NORTHERN BANK

## TARP Capital Purchase Program

### Talking Points

- All banks are being encouraged by their regulators to participate in the program due to the turbulent economic environment we are presently in.

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- The U.S. Treasury expects the funds will be used to strengthen the banking industry's ability to continue to supply credit and financing to businesses and consumers and help the economy grow out of the current credit crisis. To accomplish the tasks, banks that have received the funds will be in a better position to absorb credit losses from loans and securities that they have on their books, and will be in positions to acquire troubled institutions.
- The issuance of the preferred stock will not dilute the voting rights of existing shareholders.
- Participating in the CPP requires the company to place restrictions on executive compensation; however, those restrictions will not have a meaningful impact on C&N's current compensation structure.
- The issuance of the preferred stock may dilute earnings per share. However, the impact is not expected to be material, and the board and senior management believe it to be a necessary cost of insuring against the unexpected in the current economy.
- Among the most significant restrictions are that we may not increase dividends, or repurchase shares (with limited exceptions), without permission from the U.S. Treasury Department. Again, senior management and the board believe the benefits associated with taking on additional capital – including provision of funds to help us guard against losses in the loan or securities portfolio that could arise in these difficult economic times – exceed the costs, in the form of being required to ask permission for increasing dividends or repurchasing C&N shares.
- C&N expects to redeem the preferred stock after three (3) years, as allowed by the terms, and once the economy is back on a solid growth track.

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