FIRST NATIONAL COMMUNITY BANCORP INC
Form 10-K
August 10, 2012
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-K

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

For the fiscal year ended December 31, 2011

OR

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

For the transition period from to

Commission File No. 000-53869

FIRST NATIONAL COMMUNITY BANCORP, INC.

(Exact Name of Registrant as Specified in Its Charter)

Pennsylvania (State or Other Jurisdiction of Incorporation or Organization)	**23-2900790** (I.R.S. Employer Identification No.)
102 E. Drinker St., Dunmore, PA (Address of Principal Executive Offices)	**18512** (Zip Code)

Registrant s telephone number, including area code **(570) 346-7667**

Securities registered pursuant to Section 12(b) of the Act: **NONE**

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

Common Stock, $1.25 par value

(Title of Class)

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

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

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. o

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 definition of large accelerated filer , accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act. (Check one)

Large Accelerated Filer o	Accelerated Filer ¨
Non-Accelerated Filer x (Do not check if a smaller reporting company)	Smaller reporting company o

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

The aggregate market value of the voting and non-voting common stock of the registrant, held by non-affiliates was $38,465,949 at June 30, 2011

APPLICABLE ONLY TO CORPORATE REGISTRANTS

State the number of shares outstanding of each of the registrant s classes of common stock, as of the latest practicable date: 16,442,119 shares of common stock as of August 6, 2012

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PART 1

Item 1. Business

Unless the context otherwise requires, we use the terms Company, we, us, and our to refer to First National Community Bancorp, Inc. and its subsidiaries. In certain circumstances, however, First National Community Bancorp, Inc. uses the term Company to refer to itself.

Overview

The Company

The Company is a Pennsylvania corporation, incorporated in 1997 and is registered as a bank holding company under the Bank Holding Company Act (BHCA) of 1956, as amended. The Company became an active bank holding company on July 1, 1998 when it acquired ownership of First National Community Bank (the Bank). The Bank is a wholly-owned subsidiary of the Company.

The Company s primary activity consists of owning and operating the Bank, which provides customary retail and commercial banking services to individuals and businesses. The Bank provides practically all of the Company s earnings as a result of its banking services.

The Bank

The Bank was established as a national banking association in 1910 as The First National Bank of Dunmore. The Bank changed its name to First National Community Bank effective March 1, 1988. The Bank s operations are conducted from 21 branches located in Lackawanna, Luzerne, Wayne, and Monroe Counties, Pennsylvania.

The Bank offers many traditional banking services to its customers which are further detailed below.

As a result of criticism received from banking regulators in connection with their examination process during 2010, the Company took steps to remediate and improve its lending policies and its credit administration function. The Company has also been advised by its regulators that it must increase its regulatory capital.

Retail Banking

The Bank provides many retail banking services and products to individuals and businesses including Image Checking and E-Statement. Deposit products include various checking, savings and certificate of deposit products, as well as a variety of preferred products for higher balance customers. The Bank also participates in the Certificate of Deposit Account Registry program, which allows customers to secure Federal Deposit Insurance Corporation (FDIC) insurance on balances in excess of the standard limitations.

The Bank also offers customers the convenience of 24-hour banking, seven days a week, through FNCB Online and its Bill Payment service via the Internet and its automated teller machine (ATM) network. The Bank has ATMs in all 21 branch offices and 10 other locations.

Telephone Banking (Account Link), Loan by Phone, and Mortgage Link services are available to customers. These services provide consumers the ability to access account information, perform related account transfers, and apply for a loan through the use of a touch tone telephone. The Bank offers overdraft Bounce Protection which provides consumers with an added level of protection against unanticipated cash flow emergencies and account reconciliation errors.

FNCB Business Online is a menu driven product that allows the Bank s business customers direct access to their account information and the ability to perform internal and external transfers and process Direct Deposit payroll transactions for employees, 24 hours a day, 7 days a week, from their place of business.

Lending Activities

The Bank offers a full range of products to individuals and businesses generally within its market area. The Bank offers a variety of loans, including residential real estate loans, construction, land acquisition and development loans, commercial real estate loans, commercial and industrial loans, loans to state and political subdivisions, and consumer loans.

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The Bank strives to mitigate risks in the event of unforeseen threats to the loan portfolio as a result of an economic downturn or other negative influences. Plans for mitigating inherent risks in managing loan assets include carefully enforcing loan policies and procedures, evaluating each borrower s industry and business plan during the underwriting process, identifying and monitoring primary and alternative sources for repayment and obtaining collateral that is margined to minimize loss in the event of liquidation. Management actively monitors the loan portfolio. As part of prudent credit risk management, the Bank identifies and manages concentration risk. Concentration risk may exist with one borrower, an affiliated group of borrowers, borrowers engaged in or dependent on an industry, or other borrower characteristics which create a concentration. Concentrations of credit are not necessarily undesirable and may occur as a result of market characteristics, or the existence of a particular Bank program, or expertise with respect to the type of particular Bank program or expertise with respect to the type of customer being served. These pools of loans having similar characteristics are analyzed by management while considering the Bank s portfolio objectives and risk tolerances. Concentration limits are established based upon an assessment of size and risk.

Residential Mortgage Loans

The Bank offers fixed and variable rate one-to-four-family residential loans. Residential first lien mortgages are generally subject to an 80% loan to value ratio based on the appraised value of the property. The Bank will generally require the mortgagee to purchase Private Mortgage Insurance (PMI) if the amount of the loan exceeds the 80% loan to value ratio. The interest rates for the variable rate loans are adjusted to a percentage above the one year treasury rate. The Bank may sell loans and retain servicing when warranted by market conditions. The Bank also offers a rate lock product that allows the borrower to lock in their interest rate at the time of application as well as at the time of commitment. Residential mortgage loans are generally smaller in size and have homogeneous characteristics. During 2011 and 2010, the volume of customers who exercised the option to lock the rate was minimal. At December 31, 2011, one-to-four family residential mortgage loans totaled $80.1 million, or 11.8%, of our total loan portfolio.

Construction, Land Acquisition and Development Loans

The Bank offers interim construction financing secured by residential property for the purpose of constructing one-to-four family homes. The Bank also offers interim construction financing for the purpose of constructing residential developments and various commercial properties including shopping centers, office complexes and single purpose owner occupied structures and for land acquisition. At December 31, 2011, construction, land acquisition and development loans of $33.5 million represented 4.9% of the total loan portfolio. The Bank s construction program offers either short-term interest only loans that require the borrower to pay interest only during the construction phase with a balloon payment of the principal outstanding at the end of the construction period, or interest-only during construction with a conversion to amortizing principal and interest when the construction is complete. Loans for undeveloped real estate are subject to a loan-to-value ratio not to exceed 65%. Construction loans are treated similarly to the developed real estate loans and are generally subject to an 80% loan to value ratio based upon an as-completed appraised value.

Construction loans generally yield a higher interest rate than residential mortgage loans but also carry more risk. If a construction loan defaults, the Bank would have to take control of the property, obtain title to it and categorize it as Other Real Estate Owned (OREO). In such case the Bank would either need to find another contractor to complete the project if possible, which may be at a higher cost, or seek to sell the property.

Although the Bank believes its initial loan underwriting was sound, the Commercial Loan portfolio, and in particular, the commercial real estate, construction, land acquisition and development segments, were negatively impacted during 2009 and 2010 as a result of the recession. Both the national and local economies experienced a prolonged severe economic downturn, with rising unemployment levels and erosion in consumer confidence. These factors contributed to a number of loan defaults. Additionally, the related softening of the real estate market resulted in a decline in the value of the real estate securing the loans in this portfolio. In particular, loans for land development and subdivisions were substantially impacted and create greater risk of collectability than other types of commercial mortgage loans.

Commercial Real Estate Loans

At December 31, 2011, commercial real estate loans totaled $256.5 million, or 37.7%, of the Bank s total loan portfolio. Commercial real estate mortgage loans represent the largest portion of the Bank s total loan portfolio and loans in this portfolio generally have larger loan balances.

The commercial real estate loan portfolio is secured by a broad range of real estate, including but not limited to, office complexes, shopping centers, hotels, warehouses, gas stations, convenience markets, residential care facilities, nursing care facilities, restaurants, multifamily housing, farms and land subdivisions. The Bank s commercial real estate portfolio consists of owner occupied properties and non-owner occupied properties and includes the personal guarantees of the principals when deemed necessary. Owner occupied properties of $123.7 million represents 48.2% of the commercial real estate mortgage loan portfolio, and non-owner occupied properties of $122.8 million represents 47.9% of the commercial real estate mortgage loan portfolio. The remaining $10.0 million, or 3.9%, of the commercial real estate portfolio is comprised of loans secured by multifamily properties and farm land.

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The Bank offers various rates and terms for commercial loans secured by real estate. The interest rates associated with these types of loans are primarily underwritten as adjustable rate loans that adjust every three or five years or floating rate loans that adjust to a spread over the National Prime Rate (NPR) index. Loan pricing for most floating rate commercial loans generally has a minimum interest rate. The terms for commercial real estate loans typically do not exceed 20 years.

Commercial real estate loans are originated under a comprehensive lending policy. In particular, these types of loans are subject to specific loan to value guidelines prior to the time of closing. The policy limits for developed real estate loans are subject to a maximum loan-to-value ratio of 80%. Commercial loans must also meet specific criteria that include the capacity, capital, credit worthiness and cash flow of the borrower and the project being financed. In order to make a decision on whether or not to make a commercial loan, the borrower(s) and guarantor(s) must provide the Bank with historical and current financial data. The Bank performs a review of the cash flow analysis of the borrower(s), guarantor(s) and the project. The Bank also considers the borrower s expertise, credit history, net worth and the value of the underlying property. The Bank generally requires that borrowers for loans secured by real estate have a debt service coverage ratio of at least 1.20 times.

Commercial and Industrial Loans

The Bank offers commercial loans to individuals and businesses located in our primary market area. The commercial loan portfolio includes lines of credit, dealer floor plan lines, equipment loans, vehicle loans, improvement loans and term loans. These loans are primarily secured by vehicles, machinery and equipment, inventory, accounts receivable, marketable securities, deposit accounts and real estate. At December 31, 2011, commercial and industrial loans totaled $174.2 million, or 25.6%, of the Bank s total loan portfolio. With respect to industry concentrations in our commercial and industrial loans, loans to borrowers in the solid waste landfill industry totaled $42.3 million, of which 96.0% is to related parties and is secured by cash.

The Bank offers various rates and terms for commercial loans. These loans also generally require the personal guarantee of the principals when deemed necessary. Most lines of credit are primarily issued for one year time periods and are renewable annually thereafter at the discretion of the Bank. Most other commercial loans range in terms from one year to seven years.

The interest rates associated with these types of loans are primarily underwritten as fixed rate loans based upon the term of the loan or floating rate loans that adjust to a spread over the NPR index. Loan pricing for most floating rate commercial loans generally have a minimum interest rate floor. The interest rate for most lines of credit is issued on a floating rate basis. Finally, loans secured by deposit accounts are primarily underwritten at a spread over the interest rate of the deposit instrument used as collateral for the loan.

Consumer Loans

Consumer loans include both secured and unsecured installment loans, personal lines of credit and overdraft protection loans. The Bank is also in the business of underwriting indirect auto loans which are originated through various auto dealers in northeastern Pennsylvania and dealer floor plan loans. At December 31, 2011, consumer indirect auto loans totaled $63.7 million, or 9.4%, of the Bank s total loan portfolio. The Bank also offers VISA personal credit cards, although it does not underwrite these VISA personal credit cards and assumes no credit risk.

The Bank offers home equity loans and lines of credit with a maximum combined loan-to-value ratio of 90% based on the appraised value of the property. Home equity loans have fixed rates of interest and are for terms up to 15 years. Equity lines of credit have adjustable interest rates and are based upon the prime interest rate. Consumer loans are generally smaller in size and exhibit homogeneous characteristics. The Bank holds a first or second mortgage position on the homes that secure its home equity loans and lines of credit. At December 31, 2011, consumer installment home equity loans totaled $48.1 million, or 7.1%, of the total loan portfolio.

State and Political Subdivision Loans

The Bank originates loans to state and political subdivisions primarily to municipalities in the Bank s market area. At December 31, 2011, state and political subdivision loans totaled $23.5 million, or 3.5%, of the Bank s loan portfolio.

Loan Originations, Sales, Purchases and Participations

Loan originations generally are from the Bank s market area and are originated by the Bank; however, from time to time the Bank participates in loans originated by other banks that supplement its loan portfolio. As of December 31, 2011, the Bank participated in approximately 19 loans with a total outstanding balance of $14.5 million and total commitments of $30.3 million. Over the past seven years, the Bank participated in seven commercial real estate loans with a financial institution headquartered in Minneapolis, Minnesota and the majority of those participations related to loans for projects located outside of the Company s general market area. As of December 31, 2011, the Company had outstanding participations in two out-of-area loans secured by commercial real estate, one located in Florida and one in western Pennsylvania. The Florida loan is now held in OREO, and the Pennsylvania loan is classified as an accruing substandard loan. Two other such loans were paid in full prior to 2011. During 2011, two additional loans were paid off and one of the properties, which had been held in OREO, was sold. The Bank is not usually the lead lender in these participations but underwrites these loans using the same criteria it uses for market loans it originates. The Bank does not service the loans in these purchased participations and is subject to the policies and practices of the lead lender with regard to monitoring delinquencies, pursuing collections and instituting foreclosure proceedings.

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The Bank originates one-to-four family mortgage loans for sale in the secondary market. During the year ended December 31, 2011, the Bank sold $28.1 million of one-to-four family mortgages. The Bank retains servicing rights on these mortgages.

Out of Area Lending Activity

The Company attempts to limit its exposure to concentrations of credit risk by diversifying its loan portfolio and closely monitoring any concentrations of credit risk. As of December 31, 2011, as referenced above, the commercial real estate portfolio included $42.1 million, or 6.2%, of total loans secured by real estate located outside Pennsylvania, including loan participations previously noted. Geographic concentrations exist because the Company provides a full range of banking services, including commercial, consumer, and mortgage loans to individuals and corporate customers in its market areas in Pennsylvania. Management believes that its current underwriting guidelines and ongoing review by loan review mitigates risk of geographic concentrations.

Asset Management

Asset management services are available at the Bank. Customers are able to access alternative products such as mutual funds, annuities, stocks, and bonds directly for purchase from an outside provider.

Deposit Activities

In general, deposits, borrowings and loan repayments are the major sources of our funds for lending and other investment purposes. The Bank grows its deposits within our market area primarily by offering a wide selection of deposit accounts. Deposit account terms vary according to the minimum balance required, the time periods the funds must remain on deposit and the interest rate, among other factors. In determining the terms of our deposit accounts, the Bank considers the interest rates offered by the competition, the interest rates available on borrowings, its liquidity needs and customer preferences. The Bank regularly reviews its deposit mix and deposit pricing. The Bank s deposit pricing strategy generally has been to remain competitive in its market area, and to offer special rates in order to attract deposits of a specific type or term to satisfy the Bank s asset and liability requirements.

Competition

The Bank faces substantial competition in originating loans and in attracting deposits. The competition comes principally from other banks, savings institutions, credit unions, mortgage banking companies and, with respect to deposits, institutions offering investment alternatives, including money market funds. As a result of consolidation in the banking industry, some of the Bank s competitors and their respective affiliates may enjoy advantages such as greater financial resources, a wider geographic presence, a wider array of services, or more favorable pricing alternatives and lower origination and operating costs.

Supervision and Regulation

We participate in a highly regulated industry and are subject to a variety of statutes, regulations and policies, as well as ongoing regulatory supervision and review. These laws, regulations and policies are subject to frequent change and we take measures to comply with applicable requirements.

Supervisory Actions

In 2010, the Company and the Bank entered into regulatory agreements with their respective federal regulators. Set forth below is a summary description of the material terms of the regulatory agreements. The Company and the Bank have made significant efforts to comply with each of the provisions of the Order and Agreement. Based on their discussions with the OCC and the Reserve Bank and their efforts to date, the Company and the Bank believe they have achieved full compliance, and made substantial progress towards compliance, with certain of the requirements of the Consent Order dated September 1, 2010 (the Order) issued by the Office of the Comptroller of the Currency (the OCC) and the Written Agreement (the Agreement) with the Federal Reserve Bank of Philadelphia (the Reserve Bank), but, as of the date of this report, neither the Company nor the Bank is yet in full compliance with all of the requirements. Furthermore, there can be no assurance that the OCC or the FRB will deem their actions to be adequate, that further compliance actions will not be required, or that they will be able to satisfy all of the requirements.

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OCC Consent Order. The Bank, pursuant to a Stipulation and Consent to the Issuance of a Consent Order dated September 1, 2010 without admitting or denying any wrongdoing, consented and agreed to the issuance of the Order by the Office of the Comptroller of the Currency (OCC), the Bank s primary regulator. The Order requires the Bank to undertake certain actions within designated timeframes, and to operate in compliance with the provisions thereof during its term. The Order is based on the results of an examination of the Bank as of March 31, 2009. Since the examination, management has engaged in discussions with the OCC and has taken steps to improve the condition, policies and procedures of the Bank. Compliance with the Order is to be monitored by a committee (the Committee) of at least three directors, none of whom is an employee or controlling shareholder of the Bank or its affiliates or a family member of any such person. The Committee is required to submit written progress reports on a monthly basis and the Agreement requires the Bank to make periodic reports and filings with the OCC. The members of the Committee are John P. Moses, Joseph Coccia, Joseph J. Gentile and Thomas J. Melone. The material provisions of the Order are as follows:

(i) By October 31, 2010, the Board of Directors of the Bank (the Board) is required to adopt and implement a three-year strategic plan which must be submitted to the OCC for review and prior determination of no supervisory objection; the strategic plan must establish objectives for the Bank s overall risk profile, earnings performance, growth, balance sheet mix, off-balance sheet activities, liability structure, capital adequacy, reduction in the volume of nonperforming assets, product line development, and market segments that the Bank intends to promote or develop, and is to include strategies to achieve those objectives; if the strategic plan involves the sale or merger of the Bank, it must address the timeline and steps to be followed to provide for a definitive agreement within 90 days after the receipt of a determination of no supervisory objection;

(ii) by October 31, 2010, the Board is required to adopt and implement a three year capital plan, which must be submitted to the OCC for review and prior determination of no supervisory objection;

(iii) by November 30, 2010, the Bank is required to achieve and thereafter maintain a total risk-based capital equal to at least 13% of risk-weighted assets and a Tier 1 capital equal to at least 9% of adjusted total assets;

(iv) the Bank may not pay any dividend or capital distribution unless it is in compliance with the higher capital requirements required by the Order, the Capital Plan, applicable legal requirements and, then only after receiving a determination of no supervisory objection from the OCC;

(v) by November 15, 2010, the Committee must review the Board and the Board s committee structure; by November 30, 2010, the Board must prepare or cause to be prepared an assessment of the capabilities of the Bank s executive officers to perform their past and current duties, including those required to respond to the most recent examination report, and to perform annual performance appraisals of each officer;

(vi) by October 31, 2010, the Board must adopt, implement and thereafter ensure compliance with a comprehensive conflict of interest policy applicable to the Bank s and the Company s directors, executive officers, principal shareholders and their affiliates and such person s immediate family members and their related interests, employees, and by November 30, 2010, conduct a review of existing relationships with such persons to identify those, if any, not in compliance with the policy; and review all subsequent proposed transactions with such persons or modifications of transactions;

(vii) by October 31, 2010, the Board must develop, implement and ensure adherence to policies and procedures for Bank Secrecy Act (BSA) compliance; and account opening and monitoring procedures compliance;

(viii) by October 31, 2010, the Board must ensure the BSA audit function is supported by an adequately staffed department or third party firm; adopt, implement and ensure compliance with an independent BSA audit; and assess the capabilities of the BSA officer and supporting staff to perform present and anticipated duties;

(ix) by October 31, 2010, the Board is required to adopt, implement and ensure adherence to a written credit policy, including specified features, to improve the Bank s loan portfolio management;

(x) the Board is required to take certain actions to resolve certain credit and collateral exceptions;

(xi) by October 31, 2010, the Board is required to establish an effective, independent and ongoing loan review system to review, at least quarterly, the Bank s loan and lease portfolios to assure the timely identification and categorization of problem credits; by October 31,

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2010, to adopt and adhere to a program for the maintenance of an adequate allowance for loan and lease losses (ALLL), and to review the adequacy of the Bank s ALLL at least quarterly;

(xii) by October 31, 2010, the Board must adopt and the Bank implement and adhere to a program to protect the Bank s interest in criticized assets; and the Bank may only extend additional credit (including renewals) to a borrower whose loans are criticized under specified circumstances;

(xiii) by October 31, 2010, the Board must adopt and ensure adherence to action plans for each piece of other real estate owned;

(xiv) by November 30, 2010, the Board is required to develop, implement and ensure adherence to a policy for effective monitoring and management of concentrations of credit;

(xv) by October 31, 2010, the Board must revise and implement the Bank s other than temporary impairment policy;

(xvi) by October 31, 2010, the Board must take action to maintain adequate sources of stable funding and liquidity and a contingency funding plan; by October 31, 2010, the Board is required to adopt, implement and ensure compliance with an independent, internal audit program; and

(xvii) take actions to correct cited violations of law; and adopt procedures to prevent future violations and address compliance management.

Federal Reserve Agreement. On November 24, 2010, the Company entered into a written Agreement (the Agreement) with the Federal Reserve Bank of Philadelphia (the Reserve Bank). The Agreement requires the Company to undertake certain actions within designated timeframes, and to operate in compliance with the provisions thereof during its term. The material provisions of the Agreement include the following:

(i) the Company s Board must take appropriate steps to fully utilize the Company s financial and managerial resources to serve as a source of strength to the Bank, including taking steps to ensure that the Bank complies with its Consent Order entered into with the OCC;

(ii) the Company may not declare or pay any dividends without the prior written approval of the Reserve Bank and the Director of the Division of Banking Supervision and Regulation (the Director) of the Federal Reserve Board;

(iii) the Company may not take dividends or other payments representing a reduction of the Bank s capital without the prior written approval of the Reserve Bank;

(iv) the Company and its nonbank subsidiary may not make any payment of interest, principal or other amounts on the Company s subordinated debentures or trust preferred securities without the prior written approval of the Reserve Bank and the Director;

(v) the Company may not make any payment of interest, principal or other amounts on debt owed to insiders of the Company without the prior written approval of the Reserve Bank and Director;

(vi) the Company and its nonbank subsidiary may not incur, increase or guarantee any debt without the prior written approval of the Reserve Bank;

(vii) the Company may not purchase or redeem any shares of its stock without the prior written approval of the Reserve Bank;

(viii) the Company must submit to the Reserve Bank, by January 23, 2011, an acceptable written plan to maintain sufficient capital at the Company on a consolidated basis. Thereafter, the Company must notify the Reserve Bank within 45 days of the end of any quarter in which the Company s capital ratios fall below the approved capital plan s minimum ratios, and submit an acceptable written plan to increase the Company s capital ratios above the capital plan s minimums;

(ix) the Company must immediately take all actions necessary to ensure that: (1) each regulatory report accurately reflects the Company s condition on the date for which it is filed and all material transactions between the Company and its subsidiaries; (2) each such report is prepared in accordance with its instructions; and (3) all records indicating how the report was prepared are maintained for supervisory review;

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(x) the Company must submit to the Reserve Bank, by January 23, 2011, acceptable written procedures to strengthen and maintain internal controls to ensure all required regulatory reports and notices filed with the Board of Governors are accurate and filed in accordance with the instructions for preparation;

(xi) the Company must submit to the Reserve Bank, by January 8, 2011, a cash flow projection for 2011, reflecting the Company s planned sources and uses of cash, and submit a cash flow projection for each subsequent calendar year at least one month prior to the beginning of such year;

(xii) the Company must comply with: (1) the notice provisions of Section 32 of the FDI Act and Subpart H of Regulation Y in appointing any new director or senior executive officer or changing the duties of any senior executive officer; and (2) the restrictions on indemnification and severance payments of Section 18(k) of the FDI Act and Part 359 of the FDIC s regulations; and

(xiii) the Board must submit written progress reports within 30 days of the end of each calendar quarter.

Since entering into the Order and the Agreement, the Company has incurred expenses in an effort to comply with the terms of these agreements. In particular, the Company has incurred expenses in connection with developing and implementing policies and procedures and hiring additional personnel as required by the Order and the Agreement.

During the years ended December 31, 2011 and December 31, 2010, the Company incurred approximately $1.0 million and $1.4 million, respectively, of expenses related to entering into and complying with these regulatory agreements, consisting primarily of professional and consulting fees. In addition, the Order and the Agreement place restrictions on the Company s ability to borrow funds and to pay interest and dividends to its security holders. In the future, the Company expects to continue to experience increased costs related to compliance with these regulatory agreements, primarily as a result of increased head count and also expects to face certain restrictions on its operations for as long as it continues to operate under the Order and the Agreement. The Company expects, however, that future compliance expenses will decrease from the 2011 level, because the majority of the expenses incurred to date are related to development and implementation of processes and policies that, once those policies and processes are finalized and implemented, are not expected to recur.

The Order and the Agreement have not and are not expected to have an impact on the Company s ability to attract and maintain deposits or the Company s cost of funds. In order to meet the increased capital requirements imposed under the Order and the Agreement, however, unless the Company is able to raise additional capital, the Company could be limited in the aggregate amount of loans it can have outstanding, which may constrain loan growth. While it is not anticipated that the Order and the Agreement will have an immediate impact on the Company s net interest margin, the overall cost of compliance with the Order and the Agreement will continue to impact profitability at least through the end of 2012.

The Company

The Company is a bank holding company registered with, and subject to regulation by, the Reserve Bank and the Federal Reserve Board (FRB). The Bank Holding Company Act of 1956, as amended (the BHCA) and other federal laws subject bank holding companies to restrictions on the types of activities in which they may engage, and to a range of supervisory requirements and activities, including regulatory enforcement actions for violations of laws and regulations and unsafe and unsound banking practices.

The BHCA requires approval of the FRB for, among other things, the acquisition by a proposed bank holding company of control of more than five percent (5%) of the voting shares, or substantially all the assets, of any bank or the merger or consolidation by a bank holding company with another bank holding company. The BHCA also generally permits the acquisition by a bank holding company of control or substantially all the assets of any bank located in a state other than the home state of the bank holding company, except where the bank has not been in existence for the minimum period of time required by state law; but if the bank is at least 5 years old, the FRB may approve the acquisition.

With certain limited exceptions, a bank holding company is prohibited from acquiring control of any voting shares of any company which is not a bank or bank holding company and from engaging directly or indirectly in any activity other than banking or managing or controlling banks or furnishing services to or performing services for its authorized subsidiaries. A bank holding company may, however, engage in, or acquire an interest in a company that engages in, activities that the FRB has determined by order or regulation to be so closely related to banking or managing or controlling banks as to be properly incident thereto. In making such a determination, the FRB is required to consider whether the performance of such activities can reasonably be expected to produce benefits to the public, such as convenience, increased competition or gains in efficiency, which outweigh possible adverse effects, such as undue concentration of resources, decreased or unfair competition, conflicts of interest or unsound banking practices. The FRB is also empowered to differentiate between activities commenced *de novo* and activities commenced by the acquisition, in whole or in part, of a going concern. Some of the activities that the FRB has determined by regulation to be closely related to banking include making or servicing

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loans, performing certain data processing services, acting as a fiduciary or investment or financial advisor, and making investments in corporations or projects designed primarily to promote community welfare.

Subsidiary banks of a bank holding company are subject to certain restrictions imposed by the Federal Reserve Act on any extensions of credit to the bank holding company or any of its subsidiaries, or investments in the stock or other securities thereof, and on the taking of such stock or securities as collateral for loans to any borrower. Further, a holding company and any subsidiary bank are prohibited from engaging in certain tie-in arrangements in connection with the extension of credit. A subsidiary bank may not extend credit, lease or sell property, or furnish any services, or fix or vary the consideration for any of the foregoing on the condition that: (i) the customer obtain or provide some additional credit, property or services from or to such bank other than a loan, discount, deposit or trust service; (ii) the customer obtain or provide some additional credit, property or service from or to the bank holding company or any other subsidiary of the bank holding company; or (iii) the customer not obtain some other credit, property or service from competitors, except for reasonable requirements to assure the soundness of credit extended.

The Gramm Leach-Bliley Act of 1999 (the GLB Act) allows a bank holding company or other company to certify status as a financial holding company, which allows such company to engage in activities that are financial in nature, that are incidental to such activities, or are complementary to such activities without further approval. The Company has not elected to become a financial holding company. The GLB Act enumerates certain activities that are deemed financial in nature, such as underwriting insurance or acting as an insurance principal, agent or broker, underwriting, dealing in or making markets in securities, and engaging in merchant banking under certain restrictions. It also authorizes the FRB to determine by regulation what other activities are financial in nature, or incidental or complementary thereto.

The Bank

The Bank, as a national bank, is a member of the Federal Reserve System and its accounts are insured up to the maximum legal limit by the Deposit Insurance Fund of the Federal Deposit Insurance Corporation (FDIC). The Bank is subject to regulation, supervision and regular examination by the OCC. The regulations of these agencies and the FDIC govern most aspects of the Bank s business, including required reserves against deposits, loans, investments, mergers and acquisitions, borrowing, dividends and location and number of branch offices. State laws may also apply to the Bank to the extent that federal law does not preempt the state law. The laws and regulations governing the Bank generally have been promulgated to protect depositors and the Deposit Insurance Fund, and not for the purpose of protecting shareholders.

Branching and Interstate Banking. The federal banking agencies are authorized to approve interstate bank merger transactions without regard to whether such transactions are prohibited by the law of any state, unless the home state of one of the banks has opted out of the interstate bank merger provisions of the Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994 (the Riegle-Neal Act) by adopting a law after the date of enactment of the Riegle-Neal Act and before June 1, 1997 that applies equally to all out-of-state banks and expressly prohibits merger transactions involving out-of-state banks. Interstate bank mergers are also subject to the nationwide and statewide insured deposit concentration limitations described in the Riegle-Neal Act.

The Dodd-Frank Act authorizes national and state banks to establish *de novo* branches in other states to the same extent as a bank chartered by that state would be so permitted. Previously, banks could only establish branches in other states if the host state expressly permitted out-of-state banks to establish branches in that state. Pennsylvania law had previously permitted banks chartered in Pennsylvania to branch in other states without limitation, thereby permitting national banks in Pennsylvania to establish branches anywhere in the state, but only permitted out of state banks to branch in Pennsylvania if the home state of the out of state bank permits Pennsylvania banks to establish *de novo* branches. The branching provisions of the Dodd-Frank Act could result in more banks from other states establishing *de novo* branches in the Bank s market area.

USA Patriot Act and Bank Secrecy Act (BSA). Under the BSA, a financial institution is required to have systems in place to detect certain transactions, based on the size and nature of the transaction. Financial institutions are generally required to report cash transactions involving more than $10,000 to the United States Treasury. In addition, financial institutions are required to file suspicious activity reports for transactions that involve more than $5,000 and that the financial institution knows, suspects or has reason to suspect, involves illegal funds, is designed to evade the requirements of the BSA or has no lawful purpose. Under the Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism Act, commonly referred to as the USA Patriot Act or the Patriot Act, financial institutions are subject to prohibitions against specified financial transactions and account relationships, as well as enhanced due diligence standards intended to detect, and prevent, the use of the United States financial system for money laundering and terrorist financing activities. The Patriot Act requires financial institutions, including banks, to establish anti-money laundering programs, including employee training and independent audit requirements, meet minimum standards specified by the act, follow minimum standards for customer identification and maintenance of customer identification records, and regularly compare customer lists against lists of suspected terrorists, terrorist organizations and money launderers.
The OCC has required the Bank to

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strengthen its internal policies and procedures with respect to BSA compliance, and the Bank continues to develop and implement policies designed to satisfy this requirement.

Capital Adequacy Guidelines. The FRB and OCC have adopted risk based capital adequacy guidelines pursuant to which they assess the adequacy of capital in examining and supervising banks and bank holding companies and in analyzing bank regulatory applications. Risk-based capital requirements determine the adequacy of capital based on the risk inherent in various classes of assets and off-balance sheet items.

National banks are expected to meet a minimum ratio of total qualifying capital (the sum of core capital (Tier 1) and supplementary capital (Tier 2) to risk weighted assets of 8%. At least half of this amount (4%) must be core capital. Tier 1 Capital generally consists of the sum of common shareholders equity and perpetual preferred stock (subject in the case of the latter to limitations on the kind and amount of such stock which may be included as Tier 1 Capital), less goodwill, without adjustment for changes in the fair value of securities classified as available for sale in accordance with Accounting Standards Codification (ASC) Topic 320, Investments-Debt and Equity Securities. Tier 2 Capital consists of the following: hybrid capital instruments; perpetual preferred stock that is not otherwise eligible to be included as Tier 1 Capital; term subordinated debt and intermediate-term preferred stock; and, subject to limitations, general ALLL. Assets are adjusted under the risk-based guidelines to take into account different risk characteristics, with the categories ranging from 0% (requiring no risk-based capital) for assets such as cash, to 100% for the bulk of assets that are typically held by a bank, including certain multi-family residential and commercial real estate loans, commercial business loans and consumer loans. Residential first mortgage loans on one-to-four family residential real estate and certain seasoned multi-family residential real estate loans, which are not 90 days or more past-due or non-performing and which have been made in accordance with prudent underwriting standards are assigned a 50% level in the risk-weighing system, as are certain privately-issued mortgage-backed securities representing indirect ownership of such loans. Off-balance sheet items also are adjusted to take into account certain risk characteristics.

In addition to the risk-based capital requirements, the OCC has established a minimum 3.0% leverage capital ratio (Tier 1 Capital to total adjusted assets) requirement for the most highly-rated banks, with an additional cushion of at least 100 to 200 basis points for all other banks, which effectively increases the minimum leverage capital ratio for such other banks to 4.0% - 5.0% or more. The highest-rated banks are those that are not anticipating or experiencing significant growth and have well diversified risk, including no undue interest rate risk exposure, excellent asset quality, high liquidity, good earnings and, in general, those which are considered a strong banking organization. A bank having less than the minimum leverage capital ratio requirement is required, within 60 days of the date as of which it fails to comply with such requirement, to submit a reasonable plan describing the means and timing by which the bank will achieve its minimum leverage capital ratio requirement. A bank that fails to file such plan is deemed to be operating in an unsafe and unsound manner, and could subject the bank to a cease-and-desist order. Any insured depository institution with a leverage capital ratio that is less than 2.0% is deemed to be operating in an unsafe or unsound condition pursuant to Section 8(a) of the Federal Deposit Insurance Act (the FDIA) and is subject to potential termination of deposit insurance. However, such an institution will not be subject to an enforcement proceeding solely on account of its capital ratios, if it has entered into and is in compliance with a written agreement to increase its leverage capital ratio and to take such other action as may be necessary for the institution to be operated in a safe and sound manner. The capital regulations also provide, among other things, for the issuance of a capital directive, which is a final order issued to a bank that fails to maintain minimum capital or to restore its capital to the minimum capital requirement within a specified time period. Such a directive is enforceable in the same manner as a final cease-and-desist order.

The Bank s total capital to risk weighted assets ratio at December 31, 2011 and 2010 was 11.73% and 9.83%, respectively. The Tier I capital to risk weighted assets ratio at December 31, 2011 and 2010 was 10.46% and 8.56% respectively. The Tier I capital to average assets ratio at December 31, 2011 and 2010 was 7.20% and 6.06%, respectively. Under the Order, the Bank is required to achieve a total capital ratio of 13% and a Tier I capital to average assets ratio of 9% by November 30, 2010. As of December 31, 2011, the Bank had not achieved these ratios. On January 27, 2011, the Company announced that its Board of Directors retained Sandler O Neill + Partners, L.P. as its financial adviser to assist the Company in evaluating possible capital and strategic alternatives.

The Company s total capital ratio at December 31, 2011 and 2010 was 11.35% and 10.13%, respectively. The Tier I capital to risk weighted assets at December 31, 2011 and 2010 was 6.85% and 6.03%, respectively. The Tier I capital to average assets at December 31, 2011 and 2010 was 4.72% and 4.27%, respectively.

Proposed Changes in Capital Requirements. In December 2010, the Basel Committee released its final framework for strengthening international capital and liquidity regulation (Basel III). Basel III, when implemented by the U.S. banking agencies and fully phased-in, will require bank holding companies and their bank subsidiaries to maintain more capital, with a greater emphasis on common equity. Implementation is presently scheduled to be phased in between 2013 and 2019, although it is possible that implementation may be delayed as a result of multiple factors including the current condition of the banking industry within the U.S. and abroad.

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The Basel III final capital framework, among other things, (i) introduces as a new capital measure Common Equity Tier 1 (CET1), (ii) specifies that Tier 1 capital consists of CET1 and Additional Tier 1 capital instruments meeting specified requirements, (iii) defines CET1 narrowly by requiring that most adjustments to regulatory capital measures be made to CET1 and not to the other components of capital and (iv) expands the scope of the adjustments as compared to existing regulations.

When fully phased-in, Basel III requires banks to maintain (i) as a newly adopted international standard, a minimum ratio of CET1 to risk-weighted assets of at least 4.5%, plus a capital conservation buffer of 2.5 %; (ii) a minimum ratio of Tier 1 capital to risk-weighted assets of at least 6.0%, plus the capital conservation buffer; (iii) a minimum ratio of Total (Tier 1 plus Tier 2) capital to risk-weighted assets of at least 8.0% plus the capital conservation buffer and (iv) as a newly adopted international standard, a minimum leverage ratio of 3%, calculated as the ratio of Tier 1 capital to balance sheet exposures plus certain off-balance sheet exposures (computed as the average for each quarter of the month-end ratios for the quarter).

Basel III also provides for a countercyclical capital buffer, generally to be imposed when national regulators determine that excess aggregate credit growth becomes associated with a buildup of systemic risk that would be a CET1 add-on to the capital conservation buffer in the range of 0% to 2.5% when fully implemented. The capital conservation buffer is designed to absorb losses during periods of economic stress.

Banking institutions with a ratio of CET1 to risk-weighted assets above the minimum but below the conservation buffer (or below the combined capital conservation buffer and countercyclical capital buffer, when the latter is applied) may face constraints on dividends, equity repurchases and compensation based on the amount of the shortfall.

The Basel III final framework provides for a number of new deductions from and adjustments to CET1. These include, for example, the requirement that mortgage servicing rights, deferred tax assets dependent upon future taxable income and significant investments in non-consolidated financial entities be deducted from CET1 to the extent that any one such category exceeds 10% of CET1 or all such categories in the aggregate exceed 15% of CET1.

Implementation of the deductions and other adjustments to CET1 will begin on January 1, 2014 and will be phased-in over a five-year period (20% per year). The implementation of the capital conservation buffer will begin on January 1, 2016 at 0.625% and be phased in over a four-year period (increasing by that amount on each subsequent January 1, until it reaches 2.5% on January 1, 2019).

The FRB, the FDIC and the OCC issued a joint Notice of Proposed Rulemaking in June 2012 (the Basel III Notice), which proposes to implement Basel III under regulations substantially consistent with the above. One additional proposed change from current practice proposed in the Basel III Notice, included as part of the definition of CET1 capital, would require banking institutions to generally include the amount of Additional Other Comprehensive Income (which primarily consists of unrealized gains and losses on available for sale securities which are not required to be treated as OTTI, net of tax) in calculating regulatory capital. The Basel III Notice also proposes a 4% minimum leverage ratio.

Additionally, the FRB, the FDIC and the OCC issued a second Notice of Proposed Rulemaking in June 2012 (the Standardized Approach Notice) which would change the manner of calculating risk weighted assets. Under this Notice, new methodologies for determining risk-weighted assets in the general capital rules are proposed, including revisions to recognition of credit risk mitigation, including a greater recognition of financial collateral and a wider range of eligible guarantors. They also include risk weighting of equity exposures and past due loans, potential changes in the weighting of residential mortgage loans depending on the risk characteristics of the loan; and higher (greater than 100%) risk weighting for certain commercial real estate exposures that have higher credit risk profiles, including higher loan to value and equity components.

The components of the Basel III framework remain subject to revision or amendment, as are the rules proposed by the U.S. regulatory agencies in the Basel III Notice and Standardized Approach Notice. Accordingly, the regulations ultimately applicable to us may be substantially different from the Basel III final framework as published in December 2010, and as proposed in the Basel III Notice and Standardized Approach Notice. Requirements to maintain higher levels of capital or to maintain higher levels of liquid assets, and changes in the manner of calculating risk weighted assets, could adversely impact our net income and return on equity.

Prompt Corrective Action. Under Section 38 of the FDIA, each federal banking agency is required to implement a system of prompt corrective action for institutions which it regulates. The federal banking agencies have promulgated substantially similar regulations to implement the system of prompt corrective action established by Section 38 of the FDIA. Under the regulations, a bank will be deemed to be: (i) well capitalized if it has a total risk based capital ratio of 10.0% or more, a Tier 1 risk based capital ratio of 6.0% or more, a leverage capital ratio of 5.0% or more and is not subject to any written capital order or directive; (ii) adequately capitalized if it has a total risk based capital ratio of 8.0% or more, a Tier 1 risk based capital ratio of 4.0% or more and a Tier 1 leverage capital ratio of 4.0% or more (3.0% under certain circumstances) and does not meet the definition of well capitalized; (iii) undercapitalized if it has a total risk based capital ratio that is less than 8.0%, a Tier 1 risk based capital ratio that is less than 4.0% or a leverage capital ratio that is

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less than 4.0% (3.0% under certain circumstances); (iv) significantly undercapitalized if it has a total risk based capital ratio that is less than 6.0%, a Tier 1 risk based capital ratio that is less than 3.0% or a leverage capital ratio that is less than 3.0%; and (v) critically undercapitalized if it has a ratio of tangible equity to total assets that is equal to or less than 2.0%.

The Basel III Notice also proposes a change in the prompt corrective action capital requirements, effective in 2015. Under the proposal, an institution would be deemed to be: (i) well capitalized if it has a total risk based capital ratio of 10.0% or more, a Tier 1 risk based capital ratio of 8.0% or more, a CET1 risk based capital ratio of 6.5% or more, and a leverage capital ratio of 5.0% or more; (ii) adequately capitalized if it has a total risk based capital ratio of 8.0% or more, a Tier 1 risk based capital ratio of 6.0% or more, a CET1 risk based capital ratio of 4.5% or more, and a leverage capital ratio of 4.0% or more; (iii) undercapitalized if it has a total risk based capital ratio of less than 8.0%, a Tier 1 risk based capital ratio of less than 6.0%, a CET1 risk based capital ratio of less than 4.5%, and a leverage capital ratio of less than 4.0%; (iv) significantly undercapitalized if it has a total risk based capital ratio of less than 6.0%, a Tier 1 risk based capital ratio of less than 4.0%, a CET1 risk based capital ratio of less than 3.0%, and a leverage capital ratio of less than 3.0%; and (v) critically undercapitalized if it has a ratio of tangible equity to total assets that is less than or equal to 2.0%. Tangible equity would be defined for this purpose as Tier 1 capital (common equity tier 1 capital plus any additional Tier 1 capital elements) plus any outstanding perpetual preferred stock that is not already included in Tier 1 capital.

An institution generally must file a written capital restoration plan which meets specified requirements with an appropriate federal banking agency within 45 days of the date the institution receives notice or is deemed to have notice that it is undercapitalized, significantly undercapitalized or critically undercapitalized. A federal banking agency must provide the institution with written notice of approval or disapproval within 60 days after receiving a capital restoration plan, subject to extensions by the applicable agency.

An institution that is required to submit a capital restoration plan must concurrently submit a performance guaranty by each company that controls the institution. Such guaranty will be limited to the lesser of (i) an amount equal to 5.0% of the institution s total assets at the time the institution was notified or deemed to have notice that it was undercapitalized or (ii) the amount necessary at such time to restore the relevant capital measures of the institution to the levels required for the institution to be classified as adequately capitalized. Such a guaranty will expire after the federal banking agency notifies the institution that it has remained adequately capitalized for each of four consecutive calendar quarters. An institution that fails to submit a written capital restoration plan within the requisite period, including any required performance guaranty, or fails in any material respect to implement a capital restoration plan, will be subject to the restrictions in Section 38 of the FDIA applicable to significantly undercapitalized institutions.

A critically undercapitalized institution is to be placed in conservatorship or receivership within 90 days unless the FDIC formally determines that forbearance from such action would better protect the deposit insurance fund. Unless the FDIC or other appropriate federal banking regulatory agency makes specific further findings and certifies that the institution is viable and is not expected to fail, an institution that remains critically undercapitalized on average during the fourth calendar quarter after the date it becomes critically undercapitalized must be placed in receivership. The general rule is that the FDIC will be appointed as receiver within 90 days after a bank becomes critically undercapitalized unless extremely good cause is shown and an extension is agreed to by the federal regulators. In general, good cause is defined as capital which has been raised and is imminently available for infusion into the bank except for certain technical requirements which may delay the infusion for a period of time beyond the 90 day time period.

Immediately upon becoming undercapitalized, an institution becomes subject to the provisions of Section 38 of the FDIA, which (i) restrict payment of capital distributions and management fees; (ii) require that the appropriate federal banking agency monitor the condition of the institution and its efforts to restore its capital; (iii) require submission of a capital restoration plan; (iv) restrict the growth of the institution s assets; and (v) require prior approval of certain expansion proposals. The appropriate federal banking agency for an undercapitalized institution also may take any number of discretionary supervisory actions if the agency determines that any of these actions is necessary to resolve the problems of the institution at the least possible long-term cost to the Deposit Insurance Fund, subject in certain cases to specified procedures. These discretionary supervisory actions include: requiring the institution to raise additional capital; restricting transactions with affiliates; requiring divestiture of the institution or the sale of the institution to a willing purchaser; and any other supervisory action that the agency deems appropriate. These and additional mandatory and permissive supervisory actions may be taken with respect to significantly undercapitalized and critically undercapitalized institutions.

Additionally, under Section 11(c)(5) of the FDIA, a conservator or receiver may be appointed for an institution if: (i) an institution s obligations exceed its assets; (ii) there is substantial dissipation of the institution s assets or earnings as a result of any violation of law or any unsafe or unsound practice; (iii) the institution is in an unsafe or unsound condition; (iv) there is a willful violation of a cease-and-desist order; (v) the institution is unable to pay its obligations in the ordinary course of business; (vi) losses or threatened losses deplete all or substantially all of an institution s capital, and there is no reasonable prospect of becoming adequately capitalized without assistance; (vii) there is any violation of law or unsafe or unsound practice or condition that is likely to cause insolvency or substantial dissipation of assets or earnings, weaken the institution s condition, or otherwise seriously prejudice the interests of depositors or the insurance fund; (viii) an institution ceases to be insured; (ix) the institution is undercapitalized and has no reasonable prospect that it

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will become adequately capitalized, fails to become adequately capitalized when required to do so, or fails to submit or materially implement a capital restoration plan; or (x) the institution is critically undercapitalized or otherwise has substantially insufficient capital.

Regulatory Enforcement Authority. Federal banking law grants substantial enforcement powers to federal banking regulators. This enforcement authority includes, among other things, the ability to assess civil money penalties, to issue cease-and-desist or removal orders and to initiate injunctive actions against banking organizations and institution-affiliated parties. In general, these enforcement actions may be initiated for violations of laws and regulations and unsafe or unsound practices. Other actions or inactions may provide the basis for enforcement action, including misleading or untimely reports filed with regulatory authorities.

The Bank and its institution-affiliated parties, including its management, employees, agents, independent contractors, consultants such as attorneys and accountants and others who participate in the conduct of the financial institution s affairs, are subject to potential civil and criminal penalties for violations of law, regulations or written orders of a governmental agency. In addition, regulators are provided with greater flexibility to commence enforcement actions against institutions and institution-affiliated parties. Possible enforcement actions include the termination of deposit insurance and cease-and-desist orders. Such orders may, among other things, require affirmative action to correct any harm resulting from a violation or practice, including restitution, reimbursement, indemnifications or guarantees against loss. A financial institution may also be ordered to restrict its growth, dispose of certain assets, rescind agreements or contracts, or take other actions as determined by the ordering agency to be appropriate.

Under provisions of the federal securities laws, a determination by a court or regulatory agency that certain violations have occurred at a company or its affiliates can result in fines, restitution, a limitation of permitted activities, disqualification to continue to conduct certain activities and an inability to rely on certain favorable exemptions. Certain types of infractions and violations can also affect a public company in its timing and ability to expeditiously issue new securities into the capital markets.

The regulatory structure also gives the regulatory authorities extensive discretion in connection with their supervisory and enforcement activities and examination policies, including policies with respect to the classification of assets and the establishment of adequate loan loss allowances for regulatory purposes.

As a result of the volatility and instability in the financial system in recent years, Congress, the bank regulatory authorities and other government agencies have called for or proposed additional regulation and restrictions on the activities, practices and operations of banks and their holding companies. While many of these proposals relate to institutions that have accepted investments from, or sold troubled assets to, the Department of the Treasury or other government agencies, or otherwise participate in government programs intended to promote financial stabilization, Congress and the federal banking agencies have broad authority to require all banks and holding companies to adhere to more rigorous or costly operating procedures, corporate governance procedures, or to engage in activities or practices which they might not otherwise elect. Any such requirement could adversely affect the Company s business and results of operations. The Company did not accept an investment by the Treasury Department in its preferred stock or warrants to purchase common stock, and except for the temporary increases in deposit insurance for customer accounts, has not participated in any of the programs adopted by the Treasury Department, FDIC or Federal Reserve.

The Dodd-Frank Act. The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the Dodd-Frank Act) makes significant changes to the current bank regulatory structure and affects the lending, deposit, investment, trading and operating activities of financial institutions and their holding companies. The Dodd-Frank Act requires a number of federal agencies to adopt a broad range of new rules and regulations, and to prepare various studies and reports for Congress. The federal agencies are given significant discretion in drafting these rules and regulations, and consequently, many of the details and much of the impact of the Dodd-Frank Act may not be known for some time.

Although it is not possible to determine the ultimate impact of this statute until the extensive rulemaking is complete, the following provisions are considered to be of greatest significance to the Company:

- Expands the authority of the FRB to examine bank holding companies and their subsidiaries, including insured depository institutions;

- Requires a bank holding company to be well capitalized and well managed to receive approval of an interstate bank acquisition;

- Changes standards for federal preemption of state laws related to national banks and their subsidiaries;

- Provides mortgage reform provisions regarding a customer s ability to pay and making more loans subject to provisions for higher-cost loans and new disclosures;

- Creates a new Bureau of Consumer Financial Protection that will have rulemaking authority for a wide range of consumer protection laws that would apply to all banks and would have broad powers to supervise and enforce consumer protection laws;

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- Creates the Financial Stability Oversight Council with authority to identify institutions and practices that might pose a systemic risk;

- Introduces additional corporate governance and executive compensation requirements on companies subject to the Securities and Exchange Act of 1934, as amended;

- Permits FDIC-insured banks to pay interest on business demand deposits;

- Requires that holding companies and other companies that directly or indirectly control an insured depository institution to serve as a source of financial strength;

- Makes permanent the $250 thousand limit for federal deposit insurance and provides unlimited federal deposit insurance until January 1, 2013 for non-interest bearing demand transaction accounts at all insured depository institutions; and

- Permits national and state banks to establish interstate branches to the same extent as the branch host state allows establishment of in-state branches.

Consumer Financial Protection Bureau. The Dodd-Frank Act created a new, independent federal agency, the Consumer Financial Protection Bureau (CFPB) having broad rulemaking, supervisory and enforcement powers under various federal consumer financial protection laws, including the Equal Credit Opportunity Act, Truth in Lending Act, Real Estate Settlement Procedures Act, Fair Credit Reporting Act, Fair Debt Collection Act, the Consumer Financial Privacy provisions of the Gramm-Leach-Bliley Act and certain other statutes. The CFPB will have examination and primary enforcement authority with respect to depository institutions with $10 billion or more in assets. Smaller institutions, including the Bank, will be subject to rules promulgated by the CFPB but will continue to be examined and supervised by federal banking regulators for consumer compliance purposes. The CFPB will have authority to prevent unfair, deceptive or abusive practices in connection with the offering of consumer financial products. The Dodd-Frank Act authorizes the CFPB to establish certain minimum standards for the origination of residential mortgages including a determination of the borrower s ability to repay. In addition, Dodd-Frank will allow borrowers to raise certain defenses to foreclosure if they receive any loan other than a qualified mortgage as defined by the CFPB. The Dodd-Frank Act permits states to adopt consumer protection laws and standards that are more stringent than those adopted at the federal level and, in certain circumstances, permits state attorneys general to enforce compliance with both the state and federal laws and regulations.

It is difficult to predict at this time the specific impact the Dodd-Frank Act will have on our business. The changes resulting from the Dodd-Frank Act may impact the profitability of our business activities, require us to change certain of our business practices, impose upon us more stringent capital, liquidity and leverage ratio requirements or otherwise adversely affect our business. The changes may also require us to dedicate significant management attention and resources to evaluate and make necessary changes to comply with the new statutory and regulatory requirements.

FDIC Insurance Premiums. The FDIC maintains a risk-based assessment system for determining deposit insurance premiums. Four risk categories (I-IV), each subject to different premium rates, are established based upon an institution s status as well capitalized, adequately capitalized or undercapitalized, and the institution s supervisory rating.

The Dodd-Frank Act permanently increased the maximum deposit insurance amount for banks, savings institutions and credit unions to $250,000 per depositor, and extended unlimited deposit insurance to non-interest bearing transaction accounts through December 31, 2012. The Dodd-Frank Act also broadened the base for FDIC insurance assessments. Assessments are now based on a financial institution s average consolidated total assets less tangible equity capital. The Dodd-Frank Act requires the FDIC to increase the reserve ratio of the Deposit Insurance Fund from 1.15% to 1.35% of insured deposits by 2020 and eliminates the requirement that the FDIC pay dividends to insured depository institutions when the reserve ratio exceeds certain thresholds. The Dodd-Frank Act eliminated the statutory prohibition against the payment of interest on business checking accounts, effective in July 2011.

An insured institution is required to pay deposit insurance premiums on its assessment base in accordance with its risk category. There are three adjustments that can be made to an institution s initial base assessment rate: (1) a potential decrease for long-term unsecured debt, including senior and subordinated debt and, for small institutions, a portion of Tier 1 capital; (2) a potential increase for secured liabilities above a threshold amount; and (3) for non-Risk Category I institutions, a potential increase for brokered deposits above a threshold amount. The FDIC may also impose special assessments from time to time.

Additionally, the Bank has elected to participate in the FDIC program whereby noninterest-bearing transaction account deposits will be insured without limitation through at least December 31, 2012. At December 31, 2010, the Bank was required to pay an additional premium to the FDIC of .25 basis points on the amount of balances in noninterest-bearing transaction accounts that exceed the existing deposit insurance limit of $250,000. During the nine months ended September 30, 2011, the assessment rate was .3191 basis points. Effective for the quarter ended December 31, 2011, the assessment base changed to average

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consolidated total assets less average tangible equity during the assessment period. The assessment rate during the quarter ended December 31, 2011 was .23 basis points.

Dividend Restrictions

The Company is a legal entity separate and distinct from the Bank. The Company s revenues (on a parent company only basis) result almost entirely from dividends paid by its subsidiary, the Bank, to the Company. The right of the Company, and consequently the right of creditors and shareholders of the Company, to participate in any distribution of the assets or earnings of any subsidiary through the payment of such dividends or otherwise is necessarily subject to the prior claims of creditors of the subsidiary (including depositors) except to the extent that claims of the Company, in its capacity as a creditor, may be recognized. Additionally, the ability of the Bank to pay dividends to the Company is subject to various regulatory restrictions. The Order currently prohibits the Bank from paying dividends to the Company and the Agreement further prohibits the Company from taking dividend payments from the Bank.

Federal and state laws regulate the payment of dividends by the Company. Federal banking regulators have the authority to prohibit banks and bank holding companies from paying a dividend if the regulators deem such payment to be an unsafe or unsound practice. Currently the Agreement with the Federal Reserve Bank prohibits the Company from paying dividends without prior approval from the Reserve Bank.

Employees

As of December 31, 2011, the Company and the Bank employed 336 persons, including 58 part-time employees.

Available Information

The Company files reports, proxy and information statements and other information electronically with the SEC. You may read and copy any materials that the Company files with the SEC at the SEC s Public Reference Room at 100 F Street, NE, Washington, DC 20549. Information may be obtained on the operation of the Public Reference Room by calling the SEC at 1-800-SEC-0330. The SEC maintains an Internet site that contains reports, proxy and information statements, and other information regarding issuers that file electronically with the SEC. The SEC s website site address is http://www.sec.gov. The Company s web site address is http://www.fncb.com. The Company makes its Annual Report on Form 10-K, Quarterly Reports on Form 10-Q and Current Reports on Form 8-K and amendments thereto available on its website at www.fncb.com. They may also be obtained free of charge as soon as practicable after filing or furnishing them to the SEC upon request by sending an email to fncb@fncb.com. Further, the Company will provide electronic or paper copies of the Company s filings free of charge upon request. Information may also be obtained via written request to First National Community Bancorp, Inc. Attention: Chief Financial Officer, 102 East Drinker Street, Dunmore, PA 18512.

Item 1A. Risk Factors.

We are subject to extensive government regulation, supervision and possible regulatory enforcement actions, which may subject us to higher costs and lower shareholder returns.

The banking industry is subject to extensive regulation and supervision that govern almost all aspects of its operations. The extensive regulatory framework is primarily intended to protect the federal deposit insurance fund and depositors, not shareholders. The Company and Bank are regulated and supervised by the OCC and the FRB. Compliance with applicable laws and regulations can be difficult and costly and puts banks at a competitive disadvantage compared to less regulated competitors such as finance companies, mortgage banking companies and leasing companies. The Company s regulatory authorities have extensive discretion in connection with their supervisory and enforcement activities, including with respect to the imposition of restrictions on the operation of a bank or a bank holding company, the imposition of significant fines, the ability to delay or deny merger or other regulatory applications, the classification of assets by a bank, and the adequacy of a bank s allowance for loan losses, among other matters. The Company s industry is facing increased regulation and scrutiny as a result of the financial crisis in the banking and financial markets. The Company and the Bank are subject to the requirements of the Order and the Agreement, which regulatory agreements require that we take extra actions and meet certain standards by the dates set forth in these agreements. Neither the Bank nor the Company is yet in compliance with all the requirements. Any failure to comply with the Order or the Agreement and any failure to comply with, or any change in, any other applicable regulation and supervisory requirement, or change in regulation or enforcement by such authorities, whether in the form of policies, regulations, legislation, rules, orders, enforcement actions, or decisions, could have a material impact on the Company, its subsidiary bank and other affiliates, and its operations. Federal economic and monetary policy may also affect our ability to attract deposits and other funding sources, make loans and investments, and achieve satisfactory interest spreads. Any failure to comply with such regulation or supervision could result in sanctions by regulatory agencies, civil money penalties and/or reputation damage, which could have a material adverse effect on the Company s business, financial condition and results of operations.

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The impact of recent legislation, proposed legislation, and government programs designed to stabilize the financial markets cannot be predicted at this time, and such legislation is subject to change. In addition, the failure of financial markets to stabilize and a continuation or worsening of current financial market conditions could materially and adversely affect the Company s business, financial condition and results of operations.

New or changed legislation or regulation and regulatory initiatives could subject us to increased regulation, increase our costs of doing business and adversely affect us.

Changes in federal and state legislation and regulation may affect our operations. New and modified regulation, such as the Dodd-Frank Act and Basel III, may have unforeseen or unintended consequences on our industry. The Dodd-Frank Act has implemented, and is expected to further implement, significant changes to the U.S. financial system, including providing for the creation of a consumer protection division at the FRB that will have broad authority to issue regulations governing the services and products we provide to consumers. This additional regulation could increase our compliance costs and otherwise adversely affect our operations. The potential also exists for additional federal or state laws or regulations, or changes in policy or interpretations, affecting many of our operations, including capital levels, lending and funding practices, insurance assessments, and liquidity standards. The effect of any such changes and their interpretation and application by regulatory authorities cannot be predicted, may increase the Company s cost of doing business and otherwise affect our operations, may significantly affect the markets in which the Company does business, and could have a materially adverse effect on the Company.

In addition, recent government responses to the condition of the global financial markets and the banking industry has, among other things, increased our costs and may further increase our costs for items such as federal deposit insurance. The FDIC insures deposits at FDIC-insured institutions, such as the Bank, up to applicable limits. The FDIC charges the insured financial institutions premiums to maintain the Deposit Insurance Fund at a certain level. Current economic conditions have increased bank failures and expectations for further failures, in which case the FDIC would pay all deposits of a failed bank up to the insured amount from the Deposit Insurance Fund. Increases in deposit insurance premiums could adversely affect the Company s net income.

We may not be able to successfully compete with others for business.

The Company competes for loans, deposits and investment dollars with numerous regional and national banks and other community banking institutions, online divisions of banks located in other markets as well as other kinds of financial institutions and enterprises, such as securities firms, insurance companies, savings associations, credit unions, mortgage brokers, and private lenders. Many competitors have substantially greater resources than the Company does, and operate under less stringent regulatory environments. The differences in available resources and applicable regulations may make it harder for the Company to compete profitably, reduce the rates that it can earn on loans and investments, increase the rates it must offer on deposits and other funds, and adversely affect its overall financial condition and earnings.

The current economic environment poses significant challenges for us and could adversely affect our financial condition and results of operations.

The Company is operating in a challenging and uncertain economic environment. Financial institutions continue to be affected by sharp declines in the real estate market and constrained financial markets. Dramatic declines in the housing market over the past years, with falling home prices and high levels of foreclosures and unemployment, have resulted in significant write-downs of asset values by financial institutions. Continued declines in real estate values, home sales volumes, and financial stress on borrowers as a result of the uncertain economic environment could have an adverse effect on our borrowers or their customers, which could adversely affect our financial condition and results of operations. A worsening of these conditions would likely exacerbate the adverse effects on us and others in the financial institutions industry. For example, non-performing assets, which are comprised of non-performing investments, non-performing loans and other real estate owned, totaled $30.7 million and represented 76.9% of shareholders equity as of December 31, 2011 as compared to $41.0 million and 127.9% of equity as of December 31, 2010. Although non-performing assets as a percentage of shareholders equity decreased, the percentage remains elevated, and further deterioration in economic conditions in our markets could drive loan losses beyond that which is provided for in the Company s ALLL, which would necessitate further increases in the provision for loan and lease losses, which, in turn, would reduce the Company s earnings and capital. In addition, further deterioration in general economic conditions could also negatively impact the financial condition of the banks and insurance companies on whose ability to pay interest on their debt that collateralizes our investment in trust preferred securities, which would necessitate further increases in impairment charges, which in turn, would also reduce the Company s earnings and capital. The Company may also face the following risks in connection with the economic environment:

- economic conditions that negatively affect housing prices and the job market have resulted, and may continue to result, in a deterioration in credit quality of our loan portfolios, and such deterioration in credit quality has had, and could continue to have, a negative impact on our business;

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- market developments may affect consumer confidence levels and may cause adverse changes in payment patterns, causing increases in delinquencies and default rates on loans and other credit facilities;

- the methodologies the Company used to establish the ALLL rely on complex judgments, including forecasts of economic conditions, that are inherently uncertain and may be inadequate;

- continued turmoil in the market, and loss of confidence in the banking system, could require the Bank to pay higher interest rates to obtain deposits to meet the needs of its depositors and borrowers, resulting in reduced margin and net interest income. If conditions worsen, it is possible that banks such as the Bank may be unable to meet the needs of their depositors and borrowers, which could, in the worst case, result in the Bank being placed into receivership; and

- compliance with increased regulation of the banking industry may increase our costs, limit our ability to pursue business opportunities, and divert management efforts.

If these conditions or similar ones continue to exist or worsen, the Company could experience continuing or increased adverse effects on its financial condition.

We have identified material weaknesses in our internal controls.

Management determined that the Company s internal control over financial reporting was not effective at December 31, 2011. Management previously determined that disclosure controls and procedures and internal control over financial reporting were not effective as of December 31, 2010.

A material weakness is a deficiency, or a combination of deficiencies, in internal control over financial reporting, such that there is a reasonable possibility that a material misstatement of the Company s annual or interim financial statements will not be prevented or detected on a timely basis.

In 2011, management identified a material weakness with respect to the financial close process. Management detected errors with respect to accounting for other real estate owned (OREO) property taxes and the evaluation of subsequent events related to OREO valuation. Corrections for these errors resulted in adjustments to increase expenses by approximately $1.2 million. As a result of these errors, management concluded that the Company did not maintain effective controls over the financial close process.

The Company s remediation efforts with respect to the material weakness at December 31, 2011 are underway and are expected to be completed in the near future, however, the Company s material weakness will not be considered remediated until new internal controls are operational for a period of time and are tested, and management concludes that these controls are operating effectively. Additionally, although the Company has taken steps to make the necessary improvements to remediate the deficiencies it has identified, we cannot be certain that other deficiencies will not be identified or that our remediation efforts will ensure that our management designs, implements and maintains adequate controls over our financial processes and reporting in the future. Any additional deficiencies or material weaknesses that may be identified in the future could, among other things, have a material adverse effect on our business, results of operations and financial condition, as well as impair our ability to meet our quarterly, annual and other reporting requirements under the 1934 Act in a timely manner, and require us to incur additional costs and to divert management resources.

Additionally, any further ineffective internal controls over financial reporting could result in restatements in the future and further increased regulatory scrutiny as well as cause investors to lose confidence in our reported financial information, which could have a negative effect on the trading value of our securities and our ability to raise capital.

The Company is subject to lending risk.

As of December 31, 2011, approximately 42.7% of the Company s loan portfolio consisted of commercial real estate loans and construction, land acquisition and development loans. These types of loans are generally viewed as having more risk of default than residential real estate loans or consumer loans. These types of loans are also typically larger than residential real estate loans and consumer loans. Because the Company s loan portfolio contains a significant number of commercial real estate loans with relatively large balances, the deterioration of one or a few of these loans could cause a significant increase in non-performing loans. All non-performing loans totaled $19.9 million, or 2.9% of total gross loans, as of December 31, 2011, and $28.3 million, or 3.7% of total gross loans, as of December 31, 2010. An increase in non-performing loans could result in an increase in the provision for possible loan losses and an increase in loan charge-offs, both of which could have a material adverse effect on the Company s financial condition and results of operations. The lending activities in which the Bank engages carry the risk that the borrowers will be unable to perform on their obligations. As such, general economic conditions, nationally and in our primary market area, will have a significant impact on our results of operations. To the extent that economic conditions deteriorate, business and individual borrowers may be less able to meet their obligations to the Bank in full, in a timely manner, resulting in decreased earnings or losses to the Bank. To the extent that loans are secured by real estate, adverse conditions in the real estate market may reduce the ability of the borrower to generate the necessary cash flow for repayment of the loan, and reduce our ability to collect the full amount of the loan upon a default. To the extent that the Bank makes fixed rate loans, general increases in interest rates will tend to reduce our spread as the interest rates the Company must pay for deposits increase while interest income is flat. Economic conditions and interest rates may also adversely affect the value of property pledged as security for loans.

Our concentrations of loans, including those to insiders and related parties, may create a greater risk of loan defaults and losses.

A substantial portion of our loans are secured by real estate in the Northeastern Pennsylvania market, and substantially all of our loans are to borrowers in that area. The Company also has a significant amount of commercial real estate, commercial and industrial, construction, land acquisition and development loans and land related loans for residential and commercial developments. At December 31, 2011, $416.7 million, or 61.3%, of our gross loans were secured by real estate, primarily commercial real estate. Management has taken steps to mitigate the Company s commercial real estate concentration risk by diversification among the types and characteristics of real estate collateral properties, sound underwriting practices, and ongoing portfolio monitoring and market analysis. Of total gross loans, $33.5 million, or 4.9%, were construction, land acquisition and development loans. Construction, land acquisition and development loans have the highest risk of uncollectability. An additional $174.2 million, or 25.6%, of portfolio loans were commercial and industrial loans not secured by real estate. Historically, commercial and industrial loans generally have had a higher risk of default than other categories of loans, such as single family residential mortgage loans. The repayments of these loans often depend on the successful operation of a business and are more likely to be adversely affected by adverse economic conditions. With respect to industry concentrations, in our commercial and industrial loans, loans to borrowers in the solid waste landfill industry totaled $42.3 million of which 96.0% constitutes loans to related parties and is secured by cash. While the Company believes that our loan portfolio is well diversified in terms of borrowers and industries, these concentrations expose the Company to the risk that adverse developments in the real estate market, or in the general economic conditions in the Company s general market area, could increase the levels of non-performing loans and charge-offs, and reduce loan demand. In that event, the Company would likely experience lower earnings or losses. Additionally, if, for any reason, economic conditions in our market area deteriorate, or there is significant volatility or weakness in the economy or any significant sector of the area s economy, the Company s ability to develop our business relationships may be diminished, the quality and collectability of our loans may be adversely affected, the value of collateral may decline and loan demand may be reduced.

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Commercial real estate, commercial and industrial and construction, land acquisition and development loans tend to have larger balances than single family mortgages loans and other consumer loans. Because the loan portfolio contains a significant number of commercial and industrial loans, commercial real estate loans and construction, land acquisition and development loans with relatively large balances, the deterioration of one or a few of these loans may cause a significant increase in non-performing assets. An increase in non-performing loans could result in: a loss of earnings from these loans, an increase in the provision for loan losses, or an increase in loan charge-offs, which could have an adverse impact on our results of operations and financial condition.

Guidance adopted by federal banking regulators provides that banks having concentrations in construction, land development or commercial real estate loans are expected to have and maintain higher levels of risk management and, potentially, higher levels of capital, which may adversely affect shareholder returns, or require us to obtain additional capital sooner than the Company otherwise would. Excluded from the scope of this guidance are loans secured by non-farm nonresidential properties where the primary source of repayment is the cash flow from the ongoing operations and activities conducted by the party, or affiliate of the party, who owns the property.

Outstanding loans and line of credit balances to directors, officers and their related parties totaled $87.4 million as of December 31, 2011, of which approximately 74.8% were secured by cash. Of those, loans in the amount of $244 thousand were not performing in accordance with the terms of the loan agreements. Also, as of December 31, 2011, additional loans to directors, officers and their related parties in the amount of $702 thousand were categorized as criticized loans within the Bank s risk rating system, meaning they are considered to present a higher risk of collection than other loans. (Please refer to Note 14 Related Party Transactions to our consolidated financial statements included in Item 8 of this report and Transactions with Related Persons included in Item 13 of this report for more detail.)

Our financial condition and results of operations would be adversely affected if our ALLL is not sufficient to absorb actual losses or if we are required to increase our ALLL.

The lending activities in which the Bank engages carry the risk that the borrowers will be unable to perform on their obligations, and that the collateral securing the payment of their obligations may be insufficient to assure repayment. The Company may experience significant credit losses, which could have a material adverse effect on its operating results. The Company makes various assumptions and judgments about the collectability of its loan portfolio, including the creditworthiness of its borrowers and the value of the real estate and other assets serving as collateral for the repayment of many of its loans, which it uses as a basis to estimate and establish its reserves for losses. In determining the amount of the ALLL, the Company reviews its loans and its loss and delinquency experience, and the Company evaluates economic conditions. If these assumptions prove to be incorrect, the ALLL may not cover inherent losses in its loan portfolio at the date of its financial statements. Material additions to the Company s allowance would materially decrease its net income. At December 31, 2011, the ALLL totaled $20.8 million, representing 3.1% of total loans.

Although the Company believes it has underwriting standards to manage normal lending risks, it is difficult to assess the future performance of our loan portfolio due to the current economic environment and the state of the real estate market. The assessment of future performance of the loan portfolio is inherently uncertain. The Company can give no assurance that non-performing loans will not increase or that non-performing or delinquent loans will not adversely affect the Company s future performance.

In addition, federal regulators periodically review the Company s ALLL and may require increases to the ALLL or further loan charge-offs. In 2009, as a result of regulatory review, the Company revised its ALLL methodology and increased the ALLL. Any increase in ALLL or loan charge-offs as required by these regulatory agencies could have a material adverse effect on the Company s results of operations and financial condition.

If we conclude that the decline in value of any of our investment securities is other than temporary, we are required to write-down the security, to reflect its credit-related impairments through a charge to earnings.

The Company reviews its investment securities portfolio at each quarter-end reporting period to determine whether the fair value is below the current carrying value. When the fair value of any of the Company s investment securities has declined below its carrying value, the Company is required to assess whether the decline is other than temporary (OTTI). If the Company concludes that the decline is other than temporary, it is required to write-down the value of that security, to reflect its credit-related impairments through a charge to earnings. As of December 31, 2011, the Company s investment portfolio included four pooled trust preferred collateralized debt obligations (PreTSLs) with an amortized cost of $10.6 million and an estimated fair value of $3.8 million. Changes in the expected cash flows of these securities and/or prolonged price declines may result in additional impairment of these securities that is other than temporary in future periods, which would require a charge to earnings to write-down theses securities to their fair value. Due to the complexity of the calculations and assumptions used in determining whether an asset, such as pooled trust preferred securities, is impaired, the impairment disclosed may not accurately reflect the actual impairment in the future. In addition, to the extent that the

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value of any of the Company s investment securities is sensitive to fluctuations in interest rates, any increase in interest rates may result in a decline in the value of such investment securities.

The Company recognized total OTTI charges of $798 thousand on its PreTSL securities for 2011 primarily as a result of market developments, some of which became evident through subsequent events analyses after December 31, 2011.

The Company holds approximately $8.4 million in capital stock of the Federal Home Loan of Pittsburgh (FHLB) as of December 31, 2011. The Company must own such capital stock to qualify for membership in the Federal Home Loan Bank system which enables it to borrow funds under the FHLB advance program. If FHLB were to cease operations, the Company s business, financial condition, liquidity, capital and results of operations may be materially and adversely affected.

Changes in interest rates could reduce our income, cash flows and asset values.

The Company s earnings and cash flows are largely dependent upon its net interest income. Net interest income is the difference between interest income earned on interest-earning assets such as loans and securities and interest expense paid on interest-bearing liabilities such as deposits and borrowed funds. Interest rates are highly sensitive to many factors that are beyond the Company s control, including general economic conditions and policies of various governmental and regulatory agencies and, in particular, the FRB. Changes in monetary policy, including changes in interest rates, could influence not only the interest the Company receives on loans and securities and the amount of interest it pays on deposits and borrowings, but such changes could also affect (i) the Company s ability to originate loans and obtain deposits, (ii) the fair value of the Company s financial assets and liabilities, and (iii) the average duration of the Company s mortgage-backed securities portfolio.

If the interest rates paid on deposits and other borrowings increase at a faster rate than the interest rates received on loans and other investments, the Company s net interest income, and therefore earnings, could be adversely affected. Earnings could also be adversely affected if the interest rates received on loans and other investments fall more quickly than the interest rates paid on deposits and other borrowings. Any substantial, unexpected, prolonged change in market interest rates could have a material adverse effect on the Company s financial condition and results of operations.

The Company will need to raise additional capital in the future, but that capital may not be available when it is needed and on terms favorable to current shareholders.

Laws, regulations and banking regulators require the Company and Bank to maintain adequate levels of capital to support their operations. In addition, capital levels are also determined by the Company s management and Board of Directors based on capital levels that they believe are necessary to support the Company s business operations. Also, pursuant to the Order and the Agreement, the Company and the Bank are required to maintain increased capital levels in compliance with the Company s revised capital plan. The Company is evaluating its present and future capital requirements and needs and is also analyzing capital raising alternatives and options. Even if the Company succeeds in meeting the current regulatory capital requirements, the Company may need to raise additional capital in the future to support possible loan losses during future periods or to meet future regulatory capital requirements.

The Board of Directors may determine from time to time that the Company needs to raise additional capital by issuing additional common shares or other securities. The Company is not restricted from issuing additional common shares, including securities that are convertible into or exchangeable for, or that represent the right to receive, common shares. Because the Company s decision to issue securities in any future offering will depend on market conditions and other factors beyond its control, the Company cannot predict or estimate the amount, timing or nature of any future offerings, or the prices at which such offerings may be affected. Such offerings will likely be dilutive to common shareholders from ownership, earnings and book value perspectives. New investors also may have rights, preferences and privileges that are senior to, and that adversely affect, our then current common shareholders. Additionally, if the Company raises additional capital by making additional offerings of debt or preferred equity securities, upon liquidation, holders of the Company s debt securities and shares of preferred shares, and lenders with respect to other borrowings, will receive distributions of the Company s available assets prior to the holders of the Company s common shares. Additional equity offerings may dilute the holdings of our existing shareholders or reduce the market price of the Company s common shares, or both. Holders of the Company s common shares are not entitled to preemptive rights or other protections against dilution.

The Company cannot assure that additional capital will be available on acceptable terms or at all. Any occurrence that may limit the Company s access to the capital markets may adversely affect the Company s capital costs and its ability to raise capital and, in turn, its liquidity. Moreover, if the Company needs to raise capital, it may have to do so when many other financial institutions are also seeking to raise capital and would have to compete with those institutions for investors. An inability to raise additional capital on acceptable terms when needed could have a material adverse effect on our business, financial condition and results of operations.

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Interruptions or security breaches of our information systems could negatively affect our financial performance or reputation.

In conducting its business, the Company relies heavily on its information systems. Maintaining and protecting those systems is difficult and expensive, as is dealing with any failure, interruption or breach of those systems. Any damage, failure or breach could cause an interruption in the Company s operations. Computer break-ins, phishing and other disruptions could also jeopardize the security of information stored in and transmitted through the Company s computer systems and network infrastructure. The occurrence of any failures, interruptions or breaches could damage the Company s reputation, cause the Company to incur additional expenses, result in a loss of customer business and data, or expose the Company to liability, any of which could have a material adverse effect on the Company s business, financial condition and results of operations.

As of the date of this report, we are not currently able to pay dividends on the common shares, or repurchase common shares.

The Company conducts its principal business operations through the Bank and the cash that it uses to pay dividends is derived from dividends paid to the Company by the Bank; therefore, its ability to pay dividends is dependent on the performance of the Bank and on the Bank s capital requirements. The Bank s ability to pay dividends to the Company and the Company s ability to pay dividends to its shareholders are also limited by certain legal and regulatory restrictions. In particular, pursuant to the supervisory agreements that the Company and the Bank have entered into with their regulators, the Company and the Bank are prohibited from declaring or paying any dividends and the Company is also prohibited from taking dividends or other payments representing a reduction of the Bank s capital without prior regulatory approval.

Our profitability depends significantly on economic conditions in the Commonwealth of Pennsylvania specifically in Lackawanna, Luzerne, Wayne and Monroe counties.

The Company s success depends primarily on the general economic conditions in the Commonwealth of Pennsylvania and the specific local markets in which the Company operates. Unlike larger national or other regional banks that are more geographically diversified, the Company provides banking and financial services to customers primarily in the Lackawanna, Luzerne, Wayne and Monroe County markets. The local economic conditions in these areas have a significant impact on the demand for the Company s products and services as well as the ability of the Company s customers to repay loans, the value of the collateral securing loans, and the stability of the Company s deposit funding sources. A significant decline in general economic conditions, caused by inflation, recession, acts of terrorism, outbreak of hostilities or other international or domestic occurrences, unemployment, changes in securities markets or other factors could impact these local economic conditions and, in turn, have a material adverse effect on the Company s financial condition and results of operations.

We rely on our management and other key personnel and the loss of any of them and the increased turnover of management may adversely affect our operations.

The Company hired its current President and Chief Executive Officer (CEO) in December 2011. From the first quarter of 2010, when the Company s President and CEO resigned, until December 2011, the Company operated without a permanent CEO. In May 2012, the Company announced that its current Chief Financial Officer (CFO), who has been CFO since he was hired in September 2010, gave notice of his intention to resign, though he also agreed to remain in his position while the Company completes certain regulatory filings, including the filing of this report. The Company is in the process of searching for his replacement. In addition, since August 2010, the Company hired a Chief Credit Officer, a Chief Risk Officer, an Internal Audit Manager, as well as numerous additional personnel. As a result of the senior management turnover, until the Company integrates its new personnel, and such personnel are able to perform successfully their designated functions, it may be unable to successfully manage and grow the business and its financial condition and profitability may suffer. The Company believes each member of the senior management team is important to the Company s success and the unexpected loss of any of these persons could impair our day-to-day operations as well as its strategic direction.

The Company s success depends, in large part, on its ability to attract and retain key people. Competition for the best people in most activities engaged in by the Company can be intense and the Company may not be able to hire people or retain them. The unexpected loss of services of one or more of the Company s key personnel could have a material adverse impact on the Company s business due to the loss of their skills, knowledge of the Company s market, years of industry experience and to the difficulty of promptly finding qualified replacement personnel. The Company does not currently have employment agreements or non-competition agreements with any of its senior officers.

We are subject to claims and litigation pertaining to fiduciary responsibility.

From time to time, customers and shareholders make claims and take legal action pertaining to the Company s performance of its fiduciary responsibilities. Whether customer and shareholder claims and legal action related to the Company s performance of its fiduciary responsibilities are founded or unfounded, if such claims and legal actions are not resolved in a manner favorable to the

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Company they may result in significant financial liability and/or adversely affect the market perception of the Company and its products and services as well as impact customer demand for those products and services. Moreover, as a result of the restatement of its financial statements and revisions to many of its policies made for the periods ended December 31, 2009, March 31, 2010 and June 30, 2010, the Company may be at increased risk for such litigation. For example, on May 24, 2012, a putative shareholder by the name of Lori Gray filed a complaint in the Court of Common Pleas in Lackawanna County against certain present and former directors of the Company (including all of the current directors except Steven R. Tokach and Thomas J. Melone) and Demetrius & Company, LLC (Demetrius) alleging, inter alia, breach of fiduciary duty, abuse of control, corporate waste, unjust enrichment and, in the case of Demetrius, professional negligence, negligent misrepresentation, breach of contract and aiding and abetting breach of fiduciary duty. The Company has been named as a nominal defendant.

Any financial liability or reputation damage could have a material adverse effect on the Company s business, which, in turn, could have a material adverse effect on the Company s financial condition and results of operations.

The price of our common shares may fluctuate significantly, which may make it difficult for investors to resell common shares at a time or prices they find attractive.

The Company s share price may fluctuate significantly as a result of a variety of factors, many of which are beyond our control. These factors include, in addition to those described above:

- actual or anticipated quarterly fluctuations in our operating results and financial condition;
- changes in financial estimates or publication of research reports and recommendations by financial analysts or actions taken by rating agencies with respect to the Company or other financial institutions;
- speculation in the press or investment community generally or relating to the Company s reputation or the financial services industry;
- strategic actions by the Company or its competitors, such as acquisitions, restructurings, dispositions or financings;
- fluctuations in the stock price and operating results of the Company s competitors;
- future sales of the Company s equity or equity-related securities;
- proposed or adopted regulatory changes or developments;
- anticipated or pending investigations, proceedings, audits or litigation that involve or affect us;
- domestic and international economic factors unrelated to the Company s performance; and
- general market conditions and, in particular, developments related to market conditions for the financial services industry.

In addition, in recent years, the stock market in general has experienced extreme price and volume fluctuations. This volatility has had a significant effect on the market price of securities issued by many companies, including for reasons unrelated to their operating performance. These broad market fluctuations may adversely affect the Company s share price, notwithstanding the Company s operating results. The Company expects that the market price of its common shares will continue to fluctuate and there can be no assurances about the levels of the market prices for our common shares.

An active public market for our common stock does not currently exist. As a result, shareholders may not be able to quickly and easily sell their common shares.

The Company s common shares were quoted, through December 17, 2010, on the over the counter bulletin board market, and are currently quoted on OTC Markets Group, Inc. During the year ended December 31, 2011, an average of 1,758 shares traded on a daily basis. There can be no assurance that an active and liquid market for the Company s common shares will develop, or if one develops that it can be maintained. The absence of an active trading market may make it difficult to subsequently sell the Company s common shares at the prevailing price, particularly in large quantities. For a further discussion, see Item 5- Market for Registrant s Common Equity, Related Shareholder Matters, and Issuer Purchases of Equity Securities of this report.

Item 1B. Unresolved Staff Comments.

None.

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Item 2. Properties.

The Company currently conducts business from its main office located at 102 East Drinker Street, Dunmore, Pennsylvania, 18512 and from its additional 21 branches located throughout Lackawanna, Luzerne, Wayne and Monroe counties. At December 31, 2011, aggregate net book value of premises and equipment was $18.8 million. With the exception of potential remodeling of certain facilities to provide for the efficient use of work space and/or to maintain an appropriate appearance, each property is considered reasonably adequate for current and anticipated needs.

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Property	Location	Ownership	Type of Use
1	102 East Drinker Street Dunmore, PA	Own	Main Office/Branch
2	419-421 Spruce Street Scranton, PA	Own	Scranton Branch
3	934 Main Street Dickson City, PA	Own	Dickson City Branch
4	1743 North Keyser Avenue Scranton, PA	Lease	Keyser Village Branch
5	23 West Market Street Wilkes-Barre, PA	Lease	Wilkes-Barre Branch
6	1700 North Township Blvd. Pittston, PA	Lease	Pittston Plaza Branch
7	754 Wyoming Avenue Kingston, PA	Lease	Kingston Branch
8	1625 Wyoming Avenue Exeter, PA	Lease	Exeter Branch
9	Route 502 & 435 Daleville, PA	Lease	Daleville Branch
10	27 North River Road Plains, PA	Lease	Plains Branch
11	169 North Memorial Highway Shavertown, PA	Lease	Back Mountain Branch
12	269 East Grove Street Clarks Green, PA	Own	Clarks Green Branch
13	734 Sans Souci Parkway Hanover Township, PA	Lease	Hanover Township Branch

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14	194 South Market Street Nanticoke, PA	Own	Nanticoke Branch
15	330-352 West Broad Street Hazleton, PA	Own	Hazleton Branch
16	3 Old Boston Road Pittston, PA	Lease	Route 315 Branch
17	1001 Main Street Honesdale, PA	Own	Honesdale Branch
18	301 McConnell Street Stroudsburg, PA	Own	Stroudsburg Branch
19	1127 Texas Palmyra Highway Honesdale, PA	Lease	Honesdale Route 6 Branch
20	5120 Milford Road East Stroudsburg, PA	Own	Marshalls Creek Branch
21	200 South Blakely Street Dunmore, PA	Lease	Administrative Center
22	107-109 South Blakely Street Dunmore, PA	Own	Parking Lot
23	114-116 South Blakely Street Dunmore, PA	Own	Parking Lot
24	1708 Tripp Avenue Dunmore, PA	Own	Parking Lot
25	119-123 South Blakely Street Dunmore, PA	Own	Parking Lot
26	Rt. 940 Blakeslee, PA	Own	Land
27	Route 611 Paradise Township, PA	Own	Land
28	Main Street Taylor, PA	Own	Land
29	Milford Road East Stroudsburg, PA	Own	Land

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30	1219 Wheeler Avenue Dunmore, PA	Lease	Wheeler Ave. Branch
31	280 Mundy Street Wilkes-Barre, PA	Own	Bank offices
32	785 Keystone Industrial Park Road Throop, PA	Lease	Bank Offices

Item 3. Legal Proceedings.

Periodically, the Company has been subject to tax audits and there have been various claims and lawsuits against the Company, such as claims to enforce liens, condemnation proceedings on properties in which the Company holds security interests, claims involving the making and servicing of real property loans and other issues incident to its business. On August 8, 2011, the Company announced that it had received document subpoenas from the SEC. The information requested generally relates to disclosure and financial reporting by the Company and the restatement of the Company s financial statements for the year ended December 31, 2009, and the quarters ended March 31, 2010 and June 30, 2010. The Company is presently cooperating with the SEC in this matter.

On May 24, 2012, a putative shareholder by the name of Lori Gray filed a complaint in the Court of Common Pleas in Lackawanna County against certain present and former directors of the Company (including all of the current directors except Steven R. Tokach and Thomas J. Melone) and Demetrius & Company, LLC (Demetrius) alleging, inter alia, breach of fiduciary duty, abuse of control, corporate waste, unjust enrichment and, in the case of Demetrius, professional negligence, negligent misrepresentation, breach of contract and aiding and abetting breach of fiduciary duty. The Company has been named as a nominal defendant. In January 2012, the Board appointed a special litigation committee to investigate the matters raised in the Gray complaint. The special litigation committee retained independent counsel to assist with its investigation. This matter is in a preliminary stage and the Company cannot determine the outcome or potential range of loss at this time.

The Company is also a party to routine litigation involving various aspects of its business, and is party to a trademark infringement claim, none of which is expected to have a material adverse impact on the consolidated financial condition, results of operations or liquidity of the Company.

Item 4. Mine Safety Disclosures.

Not Applicable

PART II

Item 5. Market for Registrant s Common Equity, Related Shareholder Matters and Issuer Purchases of Equity Securities.

Market Prices of Stock and Dividends Paid

The Company s common shares are not actively traded. The principal market area for the Company s shares is northeastern Pennsylvania, although shares are held by residents of other states across the country. In the fourth quarter of 2010, the Company was notified by the Financial Industry Regulatory Authority (FINRA) that the Company s common shares would cease to be eligible for continued quotation on the Over the Counter (OTC) Bulletin Board after December 17, 2010. This determination was based on the Company s delay in filing its quarterly report on Form 10-Q for the third quarter of 2010. The Company s common shares are currently quoted on the OTC Markets Group, Inc. (formerly referred to as the Pink Sheets) under the symbol FNCB . The Company intends to petition FINRA to return to full quotation status on the OTC Bulletin Board after becoming current with its reporting requirements under the Securities Exchange Act of 1934, as amended (the 1934 Act). Quarterly market highs and lows and dividends paid for each of the past two years are presented below. These prices represent actual transactions.

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QUARTER	MARKET PRICE HIGH 2011	LOW	DIVIDENDS PAID PER SHARE
First	$ 4.80	$ 3.20	$ 0.00
Second	3.99	3.05	0.00
Third	3.50	2.50	0.00
Fourth	2.99	2.00	0.00

QUARTER	2010		
First	$ 5.80	$ 4.51	$ 0.00
Second	5.34	4.00	0.00
Third	4.15	3.00	0.00
Fourth	4.05	3.00	0.00

Holders

As of August 6, 2012 there were 1,619 holders of record of the Company s common shares.

Dividend Calendar

Dividends on the Company s common shares, if approved by the Board of Directors, are customarily paid on or about March 15, June 15, September 15 and December 15. Record dates for dividends are customarily on or about March 1, June 1, September 1, and December 1. The Company did not pay any cash dividends in 2011 or 2010. As of February 26, 2010, the Company has suspended paying dividends indefinitely and, as a result of the Order and the Agreement, will not resume paying dividends without prior permission from the OCC and the Reserve Bank.

Equity Compensation Plan

The following table summarizes our equity compensation plan information as of December 31, 2011. These plans expired on August 30, 2010, and as such, no new grants of awards have been or will be made pursuant to these plans. Options, however, can be exercised up to ten years following their date of grant, accordingly, exercisable options remain outstanding. Information is included for both equity compensation plans approved by First National Community Bancorp, Inc. shareholders and equity compensation plans not approved by First National Community Bancorp, Inc. shareholders.

Plan Category	Number of shares to be issued upon exercise of outstanding options, warrants and rights (1) (2)	Weighted-average exercise price of outstanding options, warrants and rights (1) (2)	Number of shares remaining available for future issuance under equity compensation plans (excluding securities reflected in column (a)) (2)

	(a)	(b)	(c)
Equity compensation plans approved by First National Community Bancorp, Inc. shareholders	188,193	$ 12.62	0
Equity compensation plans not approved by First National Community Bancorp, Inc. shareholders	0	0	0
Totals	188,193	$ 12.62	0

(1) The number of shares to be issued upon exercise of outstanding options and the weighted average exercise price includes any options that become exercisable within sixty (60) days after December 31, 2011.

(2) The Company s equity compensation plans include the 2000 Independent Directors Stock Option Plan and the 2000 Employee Stock Incentive Plan which were approved by shareholders on May 16, 2001. All share and per share information has been adjusted to reflect prior stock dividends paid.

Performance Graph

The following graph compares the cumulative total shareholder return (i.e. price change, reinvestment of cash dividends and stock dividends received) on our common shares against the cumulative total return of the NASDAQ Stock Market (U.S. Companies) Index

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and the SNL Bank Index. The stock performance graph assumes that $100 was invested on December 31, 2006. The graph further assumes the reinvestment of dividends into additional shares of the same class of equity securities at the frequency with which dividends are paid on such securities during the relevant fiscal year. The yearly points marked on the horizontal axis correspond to December 31 of that year. The Company calculates each of the referenced indices in the same manner. All are market-capitalization-weighted indices, so companies judged by the market to be more important (i.e. more valuable) count for more in all indices.

	Period Ending					
Index	**12/31/06**	**12/31/07**	**12/31/08**	**12/31/09**	**12/31/10**	**12/31/11**
First National Community Bancorp, Inc.	100.00	83.83	49.57	28.05	14.05	11.67
NASDAQ Composite	100.00	110.66	66.42	96.54	114.06	113.16
SNL Bank $1B-$5B	100.00	72.84	60.42	43.31	49.09	44.77

(*) Source: SNL Financial LC, Charlottesville, VA © 2011. SNL Securities is a research and publishing firm specializing in the collection and dissemination of data on the banking, thrift and financial services industries.

Purchase of Equity Securities by the Issuer or Affiliates Purchasers

None

Item 6. Selected Financial Data

The selected consolidated financial and other data and management s discussion and analysis of financial condition and results of operations set forth below and in Item 7 hereof is derived in part from, and should be read in conjunction with, the consolidated financial statements and notes thereto contained elsewhere herein. Certain reclassifications have been made to prior years consolidated financial statements to conform to the current year s presentation. Those reclassifications did not impact net income.

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FIRST NATIONAL COMMUNITY BANCORP, INC. AND SUBSIDIARIES

SELECTED FINANCIAL DATA

	For the Years Ended December 31,				
(In thousands, except share data)	**2011**	**2010**	**2009**	**2008**	**2007**
Total assets	$ 1,102,639	$ 1,167,298	$ 1,366,332	$ 1,313,759	$ 1,297,553
Securities, available-for-sale	185,475	251,072	252,946	245,900	295,727
Securities, held-to-maturity	2,094	1,994	1,899	1,808	1,722
Net loans	659,044	735,813	917,516	956,674	897,665
Total deposits	957,136	982,436	1,071,608	952,892	945,517
Borrowed funds	83,571	137,604	217,467	202,243	135,942
Shareholders equity	39,925	32,055	63,084	100,342	107,142
Interest income	42,936	55,471	64,398	73,451	81,886
Interest expense	13,867	21,868	25,196	33,242	42,572
Net interest income before provision for loan and lease losses	29,069	33,603	39,202	40,209	39,314
Provision for loan and lease losses	523	25,041	42,089	1,804	2,200
Non-interest income (loss)	12,949	1,282	(12,001)	7,812	6,345
Non-interest expenses	41,830	41,564	38,022	26,530	23,797
Income (loss) before income taxes	(335)	(31,720)	(52,910)	19,687	19,662
Provision (credit) for income taxes			(8,594)	4,604	4,966
Net income (loss)	(335)	(31,720)	(44,316)	15,083	14,696
Cash dividends paid			2,738	7,294	6,614
Per share data (1):					
Earnings per share - basic	$ (0.02)	$ (1.94)	$ (2.74)	$ 0.95	$ 0.94
Earnings per share - diluted	$ (0.02)	$ (1.94)	$ (2.74)	$ 0.95	$ 0.93
Cash dividends (2)	$	$	$ 0.17	$ 0.46	$ 0.42
Book value per share	$ 2.43	$ 1.95	$ 3.87	$ 5.59	$ 6.25
Weighted average number of shares outstanding - basic	16,439,508	16,354,245	16,169,777	15,862,335	15,601,377
Weighted average number of shares outstanding - diluted	16,439,508	16,354,245	16,169,777	15,946,149	15,786,028
Average equity to average assets	3.04%	4.10%	6.89%	8.12%	8.23%

(1) All common share amounts reflect a 25% common stock dividend issued December 27, 2007.

(2) Cash dividends per share have been adjusted to reflect the 25% stock dividend paid December 27, 2007.

The following table identifies financial performance ratios for the years ended:

	December 31,		
	2011	**2010**	**2009**
Return on average assets	(0.03)%	(2.44)%	(3.29)%
Return on average equity	(0.98)%	(59.44)%	(47.78)%
Equity to assets ratio	3.04%	4.10%	6.89%

Dividend payout ratio	0.00%	0.00%	(6.18)%

Item 7. Management s Discussion and Analysis of Financial Condition and Results of Operations

Management s discussion and analysis represents an overview of the financial condition and results of operations and should be read in conjunction with our consolidated financial statements and notes thereto included in Item 8 of this report and Risk Factors detailed in Item 1A of Part I of this report.

The Company plans to file in the near term its quarterly reports on Form 10-Q for the quarterly periods ended March 31, 2012 and June 30, 2012. This report should be read in conjunction with such reports and all such reports should be read in their entirety.

We are in the business of providing customary retail and commercial banking services to individuals and businesses. Our core market is northeastern Pennsylvania.

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FORWARD-LOOKING STATEMENTS

The Company may from time to time make written or oral forward-looking statements, including statements contained in the Company s filings with the SEC, in its reports to shareholders, and in other communications by the Company, which are made in good faith by the Company pursuant to the safe harbor provisions of the Private Securities Litigation Reform Act of 1995.

These forward-looking statements include statements with respect to the Company s beliefs, plans, objectives, goals, expectations, anticipations, estimates and intentions, that are subject to significant risks and uncertainties, and are subject to change based on various factors (some of which are beyond the Company s control). The words may, could, should, would, believe, anticipate, estimate, expect, intend, plan expressions are intended to identify forward-looking statements. The following factors, among others, could cause the Company s financial performance to differ materially from the plans, objectives, expectations, estimates and intentions expressed in such forward-looking statements: the strength of the United States economy in general and the strength of the local economies in the Company s markets; the effects of, and changes in trade, monetary and fiscal policies and laws, including interest rate policies of the Board of Governors of the Federal Reserve System; inflation, interest rate, market and monetary fluctuations; the timely development of and acceptance of new products and services; the impact of the Company s ability to comply with its regulatory agreements and orders; the effectiveness of the Company s revised system of internal controls; the ability of the Company to attract additional capital investment; the impact of changes in financial services laws and regulations (including laws concerning taxes, banking, securities and insurance); technological changes; changes in consumer spending and saving habits; the nature, extent, and timing of governmental actions and reforms, and the success of the Company at managing the risks involved in the foregoing.

The Company cautions that the foregoing list of important factors is not all inclusive. Readers are also cautioned not to place undue reliance on any forward-looking statements, which reflect management s analysis only as of the date of this report, even if subsequently made available by the Company on its website or otherwise. The Company does not undertake to update any forward-looking statement, whether written or oral, that may be made from time to time by or on behalf of the Company to reflect events or circumstances occurring after the date of this report.

CRITICAL ACCOUNTING POLICIES

In preparing the consolidated financial statements, management has made estimates, judgments and assumptions that affect the reported amounts of assets and liabilities as of the date of the consolidated statements of condition and results of operations for the periods indicated. Actual results could differ significantly from those estimates.

The Company s accounting policies are fundamental to understanding management s discussion and analysis of its financial condition and results of operations. The Company s significant accounting policies are presented in Note 2 to the consolidated financial statements. Management has identified the policies on the Allowance for Loan and Lease Losses (ALLL), securities valuation, goodwill and other intangible assets and income taxes to be critical as management is required to make subjective and/or complex judgments about matters that are inherently uncertain and could be most subject to revision as new information becomes available.

The judgments used by management in applying the critical accounting policies discussed below may be affected by a further and prolonged deterioration in the economic environment, which may result in changes to future financial results. Specifically, subsequent evaluations of the loan portfolio, in light of the factors then prevailing, may result in significant changes in the ALLL in future periods, and the inability to collect on outstanding loans could result in increased loan losses. In addition, the valuation of certain securities in the Company s investment portfolio could be negatively impacted by illiquidity or dislocation in marketplaces resulting in significantly depressed market prices thus leading to further impairment losses.

Allowance for Loan and Lease Losses

The ALLL is established as losses are estimated to have occurred through a provision for loan losses charged to earnings, and is maintained at a level that management considers adequate to absorb losses in the loan portfolio. Loans are charged against the ALLL when management believes the uncollectability of a loan balance is confirmed. Subsequent recoveries, if any, are credited to the ALLL.

The ALLL represents management s estimate of probable loan losses inherent in the loan portfolio. Determining the amount of the ALLL is considered a critical accounting estimate because it requires significant judgment and the use of estimates related to the amount and timing of expected future cash flows on impaired loans, estimated losses on pools of homogeneous loans based on historical loss experience, qualitative factors, and consideration of current economic trends and conditions, all of which may be susceptible to significant change. Various banking regulators, as an integral part of their examination of the Company, also review the ALLL. Such regulators may require, based on their judgments about information available to them at the time of their examination, that certain loan

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balances be charged off or require that adjustments be made to the ALLL. Additionally, the ALLL is determined, in part, by the composition and size of the loan portfolio.

The ALLL consists of specific and general components. The specific component relates to loans that are classified as impaired. For such loans an allowance is established when the discounted cash flows, collateral value or observable market price of the impaired loan is lower than the carrying value of that loan. The general component covers all other loans and is based on historical loss experience adjusted by qualitative factors. The general reserve component of the ALLL is based on pools of unimpaired loans segregated generally by loan type and risk rating categories of Pass , Special Mention or Substandard and Accruing, and historical loss factors and varied qualitative factor basis point allocations are applied based on the risk profile in each pool to determine the appropriate reserve related to those loans. Substandard loans on nonaccrual status are included in impaired loans.

See Note 2- Summary of Significant Accounting Policies and Note 5- Loans of the consolidated financial statements included in Item 8- Financial Statements and Supplementary Data for additional information about the ALLL.

Securities Valuation

Management utilizes various inputs to determine the fair value of its investment portfolio. To the extent they exist, unadjusted quoted market prices in active markets (level 1) or quoted prices on similar assets or models using inputs that are observable, either directly or indirectly (level 2) are utilized to determine the fair value of each investment in the portfolio. In the absence of observable inputs or if markets are illiquid, valuation techniques would be used to determine fair value of any investments that require inputs that are both unobservable and significant to the fair value measurement (level 3). For level 3 inputs, valuation techniques are based on various assumptions, including, but not limited to cash flows, discount rates, adjustments for nonperformance and liquidity, and liquidation values. A significant degree of judgment is involved in valuing investments using level 3 inputs. The use of different assumptions could have a positive or negative effect on the consolidated financial condition or results of operations. See Note 4- Securities and Note 18- Fair Value Measurements of the consolidated financial statements included in Item 8 hereof for more information about our securities valuation techniques.

Management must periodically evaluate if unrealized losses (as determined based on the securities valuation methodologies discussed above) on individual securities classified as held-to-maturity or available-for-sale in the investment portfolio are considered to be OTTI. The analysis of OTTI requires the use of various assumptions, including but not limited to, the length of time an investment s fair value is less than book value, the severity of the investment s decline, any credit deterioration of the issuer, whether management intends to sell the security, and whether it is more-likely-than-not that the Company will be required to sell the security prior to recovery of its amortized cost basis. Debt investment securities deemed to be OTTI are written down by the impairment related to the estimated credit loss and the non-credit related impairment loss is recognized in other comprehensive income. The Company recognized OTTI charges on securities of $0.8 million, $4.3 million, and $20.6 in 2011, 2010, and 2009, respectively, within the consolidated statements of operations. For 2011, the OTTI charges relate to estimated credit losses on pooled trust preferred securities. See Note 4- Securities included in Item 8- Financial Statements and Supplementary Data to the consolidated financial statements for additional information about our OTTI charges.

Other Real Estate Owned

Other real estate owned (OREO) consists of property acquired by foreclosure or deed in-lieu of foreclosure. It is held for sale and is initially recorded at fair value less cost to sell at the date of foreclosure, which establishes a new cost basis. Subsequent to foreclosure, valuations are periodically performed by management and the assets are carried at the lower of carrying amount or fair value less cost to sell. Upon acquisition of the property, any write-down to fair value less estimated selling costs is charged to the ALLL. This determination is made on an individual asset basis. Fair value is determined through external appraisals, current letters of intent, broker price opinions or executed agreements of sale. Costs relating to the development and improvement of the OREO properties may be capitalized; holding period costs and subsequent changes to the valuation allowance are charged to expense.

Goodwill Impairment

The Company records all assets, liabilities, and non-controlling interests in purchase acquisitions, including goodwill and other intangible assets, at fair value as of the acquisition date, and expenses all acquisition related costs as incurred. Goodwill is not amortized but is subject to annual tests for impairment or more often if events or circumstances indicate it may be impaired. Other intangible assets are amortized over their estimated useful lives and are subject to impairment tests if events or circumstances indicate a possible inability to realize the carrying amount. The initial recording of goodwill and other intangible assets requires subjective judgments concerning estimates of the fair value of the acquired assets.

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On an annual basis, if the Company has goodwill on its books, management evaluates goodwill for impairment. If circumstances are present that would indicate potential impairment of its goodwill, such as the trading value of the Company s common shares below its book value, adverse changes in the business or legal climate, actions by regulators, or loss of key personnel, management would test the carrying value of goodwill for impairment at an interim date.

The goodwill impairment test is performed in two phases. The first step compares the fair value of the reporting unit with its carrying amount, including goodwill. If the fair value of the reporting unit exceeds its carrying amount, goodwill of the reporting unit is not considered impaired; however, if the carrying amount of the reporting unit exceeds its fair value, an additional procedure must be performed.

In the second step, management calculates the implied value of goodwill by simulating a business combination for each reporting unit. This step subtracts the estimated fair value of net assets in the reporting unit from the step one estimated fair value to determine the implied value of goodwill. If the implied value of goodwill exceeds the carrying value of goodwill allocated to the reporting unit, goodwill is not impaired, but if the implied value of goodwill is less than the carrying value of the goodwill allocated to the reporting unit, a goodwill impairment charge for the difference is recognized in the consolidated statement of operations with a corresponding reduction to goodwill on the consolidated statement of financial condition.

In performing its evaluation of goodwill impairment, management makes significant judgments, particularly with respect to estimating the fair value of each reporting unit and if the second step test is required, estimating the fair value of net assets. The Company utilizes a third-party specialist who assists with valuation techniques to evaluate each reporting unit and estimate a fair value as though it were an acquirer. The estimate utilizes historical data, cash flows, and market and industry data. Industry and market data is used to develop material assumptions such as transaction multiples, required rates of return, control premiums, transaction costs and synergies of a transaction, and capitalization.

The impairment test in 2009 resulted in $8.1 million of impairment, which reduced income by such amount and eliminated goodwill as of December 31, 2009. The Company did not have any goodwill and therefore did not perform a goodwill impairment valuation in 2010 or 2011.

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Income Taxes

The objectives of accounting for income taxes are to recognize the amount of taxes payable or refundable for the current year and deferred tax liabilities and assets for the future tax consequences of events that have been recognized in an entity s financial statements or tax returns. Judgment is required in assessing the future tax consequences of events that have been recognized in our consolidated financial statements or tax returns. Fluctuations in the actual outcome of these future tax consequences could impact our consolidated financial condition or results of operations.

We record income tax provision or benefit based on the amount of tax currently payable or receivable and the change in deferred tax assets and liabilities. Deferred income taxes reflect the net tax effects of temporary differences between the carrying amounts of assets and liabilities for financial and tax reporting purposes. We conduct quarterly assessments of all available evidence to determine the amount of deferred tax assets that are more-likely-than-not to be realized. The available evidence used in connection with these assessments includes taxable income in current and prior periods, cumulative losses in prior periods, projected future taxable income, potential tax-planning strategies, and projected future reversals of deferred tax items. Our assumptions and estimates take into consideration our interpretation of tax laws and possible outcomes of current and future audits conducted by tax authorities. These assessments involve a certain degree of subjectivity which may change significantly depending on the related circumstances.

In connection with determining our income tax provision or benefit, the Company considers maintaining liabilities for uncertain tax positions and tax strategies that management believes contain an element of uncertainty. Periodically, the Company evaluates each of its tax positions and strategies to determine whether a liability for uncertain tax benefits is required. As of December 31, 2011 and 2010, the Company determined that it did not have any uncertain tax positions or tax strategies and that no liability was required to be recorded. Note 2- Summary of Significant Accounting Policies and Note 13 Income Taxes to the consolidated financial statements include additional discussion on the accounting for income taxes.

New Authoritative Accounting Pronouncements

In January 2010, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) No. 2010-06, Fair Value Measurements and Disclosures (Topic 820) - Improving Disclosures About Fair Value Measurements, which requires new disclosures and clarifies certain existing disclosure requirements about fair value measurement. Specifically, the update requires an entity to disclose separately the amounts of significant transfers in and out of Level 1 and Level 2 fair value measurements and to describe the reasons for such transfers. A reporting entity is required to present separately information about purchases, sales, issuances, and settlements in the reconciliation of fair value measurements using Level 3 inputs. In addition, the update clarifies the following requirements of the existing disclosures: (i) for the purposes of reporting fair value measurement for each class of assets and liabilities, a reporting entity needs to use judgment in determining the appropriate classes of assets; and (ii) a reporting entity is required to include disclosures about the valuation techniques and inputs used to measure fair value for both recurring and nonrecurring fair value measurements. The amendments were effective for interim and annual reporting periods beginning after December 15, 2009, except for the separate disclosures of purchases, sales, issuances, and settlements in the roll forward of activity in Level 3 fair value measurements. Those disclosures were effective for fiscal years beginning after December 15, 2010, and for interim periods within those fiscal years. The disclosures required by ASU No. 2010-06 are included in Note 18 Fair Value Measurements to the consolidated financial statements.

In July 2010, the FASB issued ASU No. 2010-20, Receivables (Topic 310) - Disclosures about the Credit Quality of Financing Receivables and the Allowance for Credit Losses , which required significant new disclosures about the credit quality of financing receivables and the allowance for credit losses. The objective of these disclosures is to improve financial statement users understanding of (i) the nature of an entity s credit risk associated with its financing receivables and (ii) the entity s assessment of that risk in estimating its allowance for credit losses as well as changes in the allowance and the reasons for those changes. The disclosures should be presented at the level of disaggregation that management uses when assessing and monitoring the portfolio s risk and performance. The required disclosures include, among other things, a roll forward of the allowance for credit losses as well as information about modified, impaired, non-accrual and past due loans and credit quality indicators. ASU No. 2010-20 disclosures related to period-end information (e.g., credit-quality information and the ending financing receivables balance segregated by impairment method) were required in all interim and annual reporting periods ending on or after December 15, 2010. Disclosures of activity that occurs during a reporting period (e.g., the roll forward of the allowance for credit losses by portfolio segment) were required in interim or annual periods beginning on or after December 15, 2010. Comparative disclosures for reporting periods ending after initial adoption are required. Since the provisions of ASU No. 2010-20 are only disclosure related, our adoption of this guidance did not have an impact on our consolidated financial statements. The disclosures required by ASU No. 2010-20 are included in Note 5 Loans to the consolidated financial statements.

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In January 2011, the FASB issued ASU No. 2011-01, Receivables (Topic 310) - Deferral of the Effective Date of Disclosures about Troubled Debt Restructurings in Update No. 2010-20, which postponed the effective date of new disclosure requirements for troubled debt restructurings. The new effective date for these disclosures about troubled debt restructurings was aligned with the finalization of the effective date of the exposure drafts Clarifications to Accounting for Troubled Debt Restructurings by Creditors , which was effective for interim and annual periods ending on or after June 15, 2011.

In April 2011, the FASB issued ASU No. 2011-02, A Creditor s Determination of Whether a Restructuring Is a Troubled Debt Restructuring (ASU 2011-02), an update to ASC Topic 310- Receivables. ASU No. 2011-02 provides guidance in evaluating whether a restructuring constitutes a troubled debt restructuring. In order to meet the requirements for a troubled debt restructuring, a creditor must separately conclude that both the restructuring constitutes a concession and the debtor is experiencing financial difficulties. The amendments clarify the guidance on a creditor s evaluation of whether it has granted a concession and also clarify the guidance on a creditor s evaluation of whether a debtor is experiencing financial difficulties. ASU No. 2011-02 was effective for the first interim or annual period beginning on or after June 15, 2011 and was applied retrospectively to the beginning of the annual period of adoption. The adoption of ASU No. 2011-02 did not have a material impact on the Company s financial condition, results of operations or cash flows.

In May 2011, the FASB issued ASU No. 2011-04, - Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and International Financial Reporting Standards (IFRS), an update to ASC Topic 820 - Fair Value Measurement. ASU 2011-04 results in common fair value measurement and disclosure requirements under U.S. generally accepted accounting principles (GAAP) and IFRS. The amendments in ASU 2011-04 include clarifications about the application of existing fair value measurement requirements and changes to principles for measuring fair value. ASU 2011-04 also requires additional disclosures about fair value measurements. ASU 2011-04 is required to be applied prospectively and is effective for interim and annual periods beginning after December 15, 2011. The Company is currently evaluating the impact of adoption of ASU 2011-04 on the Company s financial condition, results of operations and cash flows.

In June 2011, the FASB issued ASU No. 2011-05, - Presentation of Comprehensive Income an update to ASC Topic 220 - Comprehensive Income. ASU No. 2011-05 was issued to improve the comparability, consistency and transparency of financial reporting. The amendment provides the entity an option to present the total of comprehensive income either in a single continuous statement of comprehensive income or in two separate but consecutive statements. The amendments do not change the items that must be reported in other comprehensive income. ASU No. 2011-05 is required to be applied retrospectively and is effective for interim and annual periods beginning after December 15, 2011. ASU No. 2011-05 is an update only for presentation and as such will not impact the Company s financial position, results of operations or cash flows.

In December 2011, the FASB issued ASU No. 2011-12 - Comprehensive Income (Topic 220) Deferral of the Effective Date for Amendments to the Presentation of Reclassifications of Items Out of Accumulated Other Comprehensive Income in ASU No. 2011-05. This update defers only those changes in ASU No. 2011-05 that relate to the presentation of reclassification adjustments, the paragraphs in this update supersede certain pending paragraphs in ASU No. 2011-05. All other requirements in ASU No. 2011-05 are not affected by this update, including the requirement to report comprehensive income either in a single continuous financial statement or in two separate but consecutive financial statements and is effective for fiscal years, and interim periods within those years, beginning after December 15, 2011.

In December 2011, the FASB issued ASU No. 2011-11 - Balance Sheet (Topic 210) - Disclosures about Offsetting Assets and Liabilities. The objective of this update is to provide enhanced disclosures that will enable users of its financial statements to evaluate the effect or potential effect of netting arrangements on an entity s financial position. This includes the effect or potential effect of rights of setoff associated with an entity s recognized assets and recognized liabilities within the scope of the update. The amendments require enhanced disclosures by requiring improved information about financial instruments and derivative instruments that are either (1) offset in accordance with either ASC 210-20-45 or ASC 815-10-45 or (2) subject to an enforceable master netting arrangement or similar agreement, irrespective of whether they are offset in accordance with either ASC 210-20-45 or ASC 815-10-45. An entity is required to apply the amendments for annual reporting periods beginning on or after January 1, 2013, and interim periods within those annual periods. An entity should provide the disclosures required by those amendments retrospectively for all comparative periods presented.

SUMMARY OF PERFORMANCE

The Company reported a net loss of $0.3 million in 2011 compared to a $31.7 million net loss in 2010. Basic loss per share was $(0.02) per share, a decrease of $1.92 from the $(1.94) per share loss reported in 2010.

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The Company recorded a $0.5 million provision for loan and lease losses in 2011 as compared to the $25.0 million provision recorded in 2010. The substantially reduced provision, needed to establish the ALLL at the amount the Company believes is adequate to absorb probable loan losses, resulted primarily from an $8.4 million or 29.6% decrease in non-performing loans, a $3.6 million increase in loan recoveries in 2011, and an overall reduction of the loan portfolio. The reduction in delinquent and non-performing loans is attributable to the Company s aggressive write-downs and liquidation of impaired assets during 2009 and 2010, a favorable interest rate environment and stabilizing real estate values that enabled an increased number of borrowers to service their debt during 2011. Other key items contributing to the 2011 results included an $11.7 million increase in non-interest income, which increased from $1.3 million in 2010 to $13.0 million in 2011, and a $0.3 million increase in non-interest expense. The $11.7 million increase in non-interest income resulted from (i) a $5.1 million gain on the sale of investment securities in 2011 compared to the $1.7 million loss on the sale of investment securities in 2010, (ii) a $3.5 million reduction in OTTI losses incurred on investment securities to $0.8 million in 2011 from the $4.3 million the Company recorded in 2010, and (iii) a $2.1 million increase in net gains on the sale of OREO to $2.5 million in 2011 from $0.4 million in 2010. The $0.3 million increase in non-interest expense resulted primarily from a $3.8 million decrease in the OREO expense and a $1.8 million decrease in other operating expenses partially offset by $3.4 million increase in professional fees and a $1.8 million increase in legal fees, both primarily attributable to increased audit, regulatory compliance, and restatement expenses, and a $1.0 million increase in salary and benefits expenses.

The Company s return on average assets for the years ended December 31, 2011 and 2010 was (0.03%) and (2.44%), respectively, while the return on average equity was (0.98%) and (59.44%), respectively.

Net Interest Income

Net interest income consists of interest income and fees on interest-earning assets less interest expense on deposits and borrowed funds. It represents the largest component of the Company s operating income and, as such, is the primary determinant of profitability. The net interest margin on a fully tax-equivalent basis is calculated by dividing tax-equivalent net interest income by average interest-earning assets and is a key measurement used in the banking industry to measure income from earning assets. The net interest margin was 3.10% for the year ended December 31, 2011, an increase of 3 basis points compared to the same period in 2010. This increase in the net interest margin was primarily due to a 15.9% decrease in interest-bearing liabilities, partially offset by a 14.8% decrease in interest-earning assets. Rate spread, the difference between the average yield on interest-earning assets and the average cost of interest-bearing liabilities shown on a fully tax-equivalent basis was 3.0% for 2011, an increase of 6 basis points versus 2010.

Net interest income on a tax-equivalent basis decreased $5.2 million to $32.5 million for 2011 compared with $37.7 million for 2010. During 2011, lower average securities and loan balances and lower yields on interest-earning assets negatively impacted our net interest income. The yield on loans and investments declined 31 basis points and 21 basis points, respectively, partially offset by a 47 basis point decline in the cost of average interest-bearing liabilities and lower average interest-bearing liabilities as compared to 2010. The Federal Reserve kept interest rates stable during 2011 leaving the Federal Funds rate at an historic low of 25 basis points. The Company s floating rate loans are largely indexed to the national prime rate and many of these loans are now at their floors and will remain there until the prime rate moves up enough for their rates to move above their floors. In addition, most of the time deposits in the Company s funding portfolio matured and renewed at lower market rates in 2011.

Average loans totaled $723.7 million for the year ended December 31, 2011, a decrease of $155.3 million, or 17.7%, compared to the same period for 2010. The reduction is primarily due to the net pay downs of real estate loans and commercial and industrial loans of $51.6 million and $23.5 million, respectively; the transfer of $4.0 million of foreclosed loans into OREO; and a smaller portfolio at the onset of 2011. During 2011, loan satisfactions continued to outpace originations and the Company continued to focus its efforts on reducing exposure to higher risk construction, land acquisition and development loans by allowing $43.9 million of this segment of the portfolio to pay-off. Interest income on a tax equivalent basis for loans decreased $10.3 million due to the decrease in average loans and a 31 basis point decrease in the average loan yield as loans continued to reset at lower rates and new business was originated at lower market rates compared with 2010.

The interest income that would have been earned on non-accrual and restructured loans outstanding at December 31, 2011, 2010 and 2009 in accordance with their original terms approximated $2.2 million, $2.9 million, and $2.8 million, respectively. Interest income on impaired loans of $238 thousand, $619 thousand, and $976 thousand was recognized based on payments received in 2011, 2010 and 2009.

Average investment securities totaled $232.8 million, a decrease of $49.2 million, or 17.5%, in 2011 compared to 2010. Interest income on a tax equivalent basis for investment securities decreased $2.9 million primarily due to reinvestment of pay downs and maturities into more liquid lower yielding securities. Average interest-bearing deposits in other banks increased $23.0 million as the Company increased its holdings of liquid assets. Interest income on interest-bearing deposits in other banks increased $17 thousand as the increase in volume more than offset the 4 basis point decline in yield earned.

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Average interest-bearing liabilities totaled $969.6 million for the year ended December 31, 2011, a decrease of $182.8 million, or 15.9%, during 2011 compared to the same period in 2010 due to a decrease in interest-bearing deposits of $97.9 million, or 10.2%, and a decrease in borrowings of $84.9 million, or 43.2%.

Average interest-bearing demand deposits, savings deposits, time deposits over $100 thousand, and other time deposits decreased $18.4 million, $4.1 million, $44.3 million and $31.1 million, respectively. During 2011, the Company implemented a pricing strategy to reduce its cost of funds and to concentrate deposit growth on short-term maturities. The Company repositioned maturing longer term time deposits into short-term products, whenever possible, and allowed the residual to run-off. The Company used the net proceeds from the sale of investment securities and a portion of the funds provided from loan repayments to fund deposit withdrawals and the maturities of the higher cost time deposits. The cost of interest-bearing demand deposits, savings deposits, time deposits over $100 thousand, and other time deposits decreased 49, 22, 31 and 56 basis points respectively, from the same period in 2010. The average cost of interest-bearing deposits decreased by 46 basis points to 1.02% in 2011 from 1.48% in 2010. The decrease in the rate on interest-bearing deposits was driven primarily by the pricing decreases that resulted from the Company s pricing strategy. and an overall decrease in market rates. Average borrowed funds and other interest-bearing liabilities totaled $111.7 million for the year ended December 31, 2011, a decrease of $84.9 million, or 43.2%, compared to 2010. During 2011, the Company continued to employ its funds management plan implemented in 2010 and to pay off term borrowings. The Company used a portion of the funds provided from loan repayments to pay off $53.6 million of term borrowings. The Company did not enter into any new term borrowings in 2011. The Company borrowed and repaid short-term borrowings in the amount of $60.0 million during 2011. The 67 basis point increase in the cost of borrowed funds for the year ended December 31, 2011 is primarily attributable to the repayment during 2011 of maturing FHLB advances that were at lower rates, resulting in higher- rate borrowings becoming a larger percentage of total borrowings and an increase in the cost of borrowed funds.

Average loans totaled $879.0 million for the year ended December 31, 2010, a decrease of $91.8 million, or 9.5%, compared to the same period for 2009 primarily due to the net pay downs of commercial real estate loans of $62.6 million, sale of indirect auto loans of $36.7 million and the transfer of $9.9 million of foreclosed loans into Other Real Estate Owned (OREO). Interest income on a tax-equivalent basis for loans decreased $6.9 million due to the decrease of $91.8 million in average loans and a 22 basis point decrease in the average loan yield as loans continued to reset at lower rates and new business was originated at lower market rates compared with 2009. Average investment securities totaled $282.1 million, an increase of $6.7 million, or 2.4 %, in 2010 compared to 2009. Interest income on a tax-equivalent basis for investment securities decreased $1.8 million primarily due to reinvestment of pay downs and maturities into more liquid lower yielding securities. Average federal funds sold increased $30.1 million as the Company increased its holdings of liquid assets. Interest income on federal funds sold increased $63 thousand as the increase in volume more than offset the 2 basis point decline in yield earned.

Average interest-bearing liabilities totaled $1.15 billion for the year ended December 31, 2010, a decrease of $6.8 million, or 0.6%, compared to the same period in 2009 primarily due to a decrease in time deposits over $100,000 of $32.8 million, or 12.7%, and a decrease in borrowings of $39.0 million, or 16.5%. These decreases were partially offset by an increase in interest-bearing demand deposits of $41.3 million, or 13.2%, an increase in savings deposits of $12.5 million, or 15.3%, and an increase in other time deposits of $11.2 million, or 4.1%. The cost of interest-bearing demand deposits, savings deposits, time deposits over $100 thousand, and other time deposits decreased 22, 19, 46, and 53 basis points respectively, from the same period in 2009. The average cost of interest-bearing deposits decreased by 41 basis points to 1.48% in 2010 from 1.89% in 2009. The decrease in the rate on interest-bearing deposits was driven primarily by pricing decreases from money markets and time deposits, which are sensitive to interest rate changes. The pricing decreases for these products resulted from an overall decrease in market rates. The rate paid for savings deposits decreased from 0.73% in 2009 to 0.54% in 2010 and the rate paid on time deposits decreased from 2.47% during 2009 to 2.01% during 2010.

Average borrowed funds and other interest-bearing liabilities totaled $196.6 million for the year ended December 31, 2010 a decrease of $39.0 million, or 16.5%, compared to 2009. The Company used the funds provided from loan repayments primarily to pay off borrowings. The 60 basis point increase in the cost of borrowed funds for the year ended December 31, 2010 was primarily attributable to the interest expense on the $25 million of subordinated debentures the Company issued during the fourth quarter of 2009 and the first quarter of 2010.

The following table reflects the components of net interest income for each of the three years ended December 31, 2011, 2010 and 2009:

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	Year ended December 31, 2011			Year ended December 31, 2010			Year ended December 31, 2009		
(amounts in thousands)	Average Balance	Interest	Yield/ Cost	Average Balance	Interest	Yield/ Cost	Average Balance	Interest	Yield/ Cost
ASSETS									
Earning Assets (2)(3)									
Loans-taxable (4)	$ 688,546	$ 32,831	4.77%	$ 826,188	$ 42,016	5.09%	$ 919,560	$ 49,015	5.33%
Loans-tax free (4)	35,150	2,479	7.05%	52,794	3,582	6.78%	51,206	3,520	6.87%
Total Loans (1)(2)	723,696	35,310	4.88%	878,982	45,598	5.19%	970,766	52,535	5.41%
Securities-taxable	123,854	3,198	2.58%	160,690	5,340	3.32%	161,094	7,759	4.82%
Securities-tax free	108,955	7,717	7.08%	121,367	8,470	6.98%	114,298	7,883	6.90%
Total Securities (1)(5)	232,809	10,915	4.69%	282,057	13,810	4.90%	275,392	15,642	5.68%
Interest-bearing deposits in other banks and federal funds sold	91,932	178	0.19%	68,949	161	0.23%	38,863	98	0.25%
Total Earning Assets	1,048,437	46,403	4.43%	1,229,988	59,569	4.84%	1,285,021	68,275	5.31%
Non-earning assets	103,685			97,793			73,911		
Allowance for loan and lease losses	(24,108)			(25,587)			(12,770)		
Total Assets	$ 1,128,014			$ 1,302,194			$ 1,346,162		
LIABILITIES AND SHAREHOLDERS EQUITY									
Interest-bearing Liabilities									
Interest-bearing demand deposits	335,201	1,615	0.48%	353,579	3,442	0.97%	312,285	$ 3,725	1.19%
Savings deposits	89,494	287	0.32%	93,598	502	0.54%	81,149	589	0.73%
Time deposits over $100,000	181,146	2,193	1.21%	225,446	3,416	1.52%	258,275	5,097	1.97%
Other time deposits	252,081	4,664	1.85%	283,214	6,832	2.41%	272,001	8,010	2.94%
Total Interest-bearing Deposits	857,922	8,759	1.02%	955,837	14,192	1.48%	923,710	17,421	1.89%
Borrowed funds and other interest-bearing liabilities	111,709	5,108	4.57%	196,606	7,676	3.90%	235,559	7,775	3.30%
Total Interest-Bearing Liabilities	969,631	13,867	1.43%	1,152,443	21,868	1.90%	1,159,269	25,196	2.17%
Demand deposits	107,763			82,400			81,081		
Other liabilities	16,301			13,982			13,070		
Shareholders equity	34,319			53,369			92,742		
Total Liabilities and Shareholders Equity	$ 1,128,014			$ 1,302,194			$ 1,346,162		
Net Interest Income/Interest Rate Spread (6)		32,536	3.00%		37,701	2.94%		43,079	3.14%
Tax equivalent adjustment		(3,467)			(4,098)			(3,877)	
Net interest income as reported		$ 29,069			$ 33,603			$ 39,202	
Net Interest Margin (7)			3.10%			3.07%			3.35%

(1) Interest income is presented on a tax-equivalent basis using a 34% rate for 2011, 2010 and 2009.

(2) Loans are stated net of unearned income.

(3) Nonaccrual loans are included in loans within earning assets.

(4) Loan fees included in interest income are not significant.

(5) The yields for securities that are classified as available-for-sale is based on the average historical amortized cost.

(6) Interest rate spread represents the difference between the average yield on interest earning assets and the cost of interest-bearing liabilities and is presented on a tax-equivalent basis.

(7) Net interest income on a tax-equivalent basis as a percentage of total average interest-earning assets.

Rate Volume Analysis

The most significant impact on net income between periods is derived from the interaction of changes in the volume and rates earned or paid on interest-earning assets and interest-bearing liabilities. The volume of earning dollars in loans and investments, compared to the volume of interest-bearing liabilities represented by deposits and borrowings, combined with the spread, produces the changes in net interest income between periods. Components of interest income and interest expense are presented on a tax-equivalent basis using the statutory federal income tax rate of 34%.

The following table shows the effect of changes in volume and interest rates on net interest income. The variance in interest income or expense due to the combination of rate and volume has been allocated proportionately.

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	December 31, 2011 vs. 2010 Increase (Decrease) Due to Volume	Due to Rate	Total Change	December 31, 2010 vs. 2009 Increase (Decrease) Due to Volume	Due to Rate	Total Change
Interest Income:						
Loans - taxable	$ (6,682)	$ (2,503)	$ (9,185)	$ (4,820)	$ (2,179)	$ (6,999)
Loans - tax free	(1,239)	136	(1,103)	108	(46)	62
Total loans	(7,921)	(2,367)	(10,288)	(4,712)	(2,225)	(6,937)
Securities - taxable	(1,086)	(1,056)	(2,142)	(19)	(2,400)	(2,419)
Securities - tax free	(877)	124	(753)	492	95	587
Total securities	(1,963)	(932)	(2,895)	473	(2,305)	(1,832)
Interest-bearing deposits in other banks and federal funds sold	48	(31)	17	71	(8)	63
Total interest income	(9,836)	(3,330)	(13,166)	(4,168)	(4,538)	(8,706)
Interest Expense:						
Interest-bearing demand deposits	(4)	(1,823)	(1,827)	455	(738)	(283)
Savings deposits	(21)	(194)	(215)	82	(169)	(87)
Time deposits over $100,000	(605)	(618)	(1,223)	(595)	(1,086)	(1,681)
Other time deposits	(695)	(1,473)	(2,168)	319	(1,497)	(1,178)
Total interest-bearing deposits	(1,325)	(4,108)	(5,433)	261	(3,490)	(3,229)
Borrowed funds and other interest-bearing liabilities	(3,721)	1,153	(2,568)	(1,398)	1,299	(99)
Total interest expense	(5,046)	(2,955)	(8,001)	(1,137)	(2,191)	(3,328)
Net Interest Income	$ (4,790)	$ (375)	$ (5,165)	$ (3,031)	$ (2,347)	$ (5,378)

(1) Changes in interest income and interest expense attributable to changes in both volume and rate have been allocated proportionately to changes due to volume and changes due to rate.

Goodwill Impairment

In connection with the purchase of the Honesdale branch completed in 2006, the Company acquired intangible assets of $9.8 million. Of that amount, $1.7 million resulted from core deposit premium subject to periodic amortization over the useful life of 10 years. Goodwill of $8.1 million, which is not subject to amortization, arose in connection with the acquisition. In response to the significant loss reported by the Company in 2009 and the reduction in the market capitalization of the Company s common shares, the Company s goodwill was evaluated for impairment as of December 31, 2009. The analysis included a combination of a market approach based analysis of comparable transactions, change of control premium to peer market price approach, a discounted cash flow analysis of the potential dividends of the Company and the assessment of the fair value of the Company s statement of financial condition as of the measurement date. As a result of the analysis, the entire Goodwill balance of $8.1 million was written off as of December 31, 2009.

The following table displays the changes in the carrying amount of goodwill, during the years ended December 31:

(in thousands)	2011	2010	2009
Balance as of January 1,	$	$	$ 8,134
Impairment write-off			(8,134)

Balance as of December 31,	$	$	$

The Company has determined that the core deposit premium was not impaired. Accordingly, the Company has not recorded any impairment charge on this asset in 2011, 2010 or 2009. For a further discussion, refer to Note 9- Goodwill and Intangibles to the consolidated financial statements.

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Provision for Loan and Lease Losses

Management closely monitors the loan portfolio and the adequacy of the ALLL considering underlying borrower financial performance and collateral values and increasing credit risks. Future material adjustments may be necessary to the provision for loan and lease losses and the ALLL if economic conditions or loan performance differ substantially from the assumptions management used in making its evaluation of the ALLL. The provision for loan and lease losses is an expense charged against net interest income to provide for estimated losses attributable to uncollectible loans and is based on management s analysis of the adequacy of the ALLL.

The provision for loan and lease losses was $0.5 million in 2011 as compared to $25.0 million in 2010. The decrease was primarily related to (i) the substantial provision taken in 2010, (ii) the $78.4 million, or 10.3% reduction in gross loans, and (iii) a reduction in the number and volume of adversely classified credits in 2011.

The provision for loan and lease losses was $25.0 million in 2010 as compared to $42.1 million in 2009. The decrease was primarily related to (i) a reduction in charge-offs of classified credits, (ii) the $181.6 million, or 19.3% reduction in gross loans, and (iii) a reduction in the number and volume of adversely classified credits in 2010.

Non-Interest Income (in thousands)		**2011**		**2010**		**2009**
Deposit service charges	$	3,105	$	3,274	$	3,503
Net gain (loss) on the sale of securities		5,114		(1,714)		890
Other-than-temporary impairment loss on securities		(798)		(4,271)		(20,649)
Net gain on the sale of loans held for sale		755		1,198		1,481
Net gain on the sale of other real estate		2,528		403		309
Net gain (loss) on the sale of other assets		20		(60)		
Loan related fees		673		1,009		1,035
Income on bank-owned life insurance		787		740		321
Other		765		703		1,109
Total non-interest income (loss)	$	12,949	$	1,282	$	(12,001)

During 2011, total non-interest income increased by $11.7 million to $13.0 million from $1.3 million in 2010. The $11.7 million increase in non-interest income primarily resulted from (i) a $5.1 million gain on the sale of investment securities in 2011 compared to the $1.7 million loss on the sale of investment securities in 2010, (ii) a $3.5 million reduction in OTTI losses incurred on investment securities to $0.8 million in 2011 from the $4.3 million the Company recorded in 2010, and (iii) a $2.1 million increase in net gains on the sale of OREO to $2.5 million in 2011 from $0.4 million in 2010.

During 2011, the Company recorded a $5.1 million net gain on the sale of investment securities with an amortized cost of $117.5 million. The sale was comprised of mortgage-backed securities in the amount of $77.9 million, municipal securities in the amount of $39.0 million and pooled trust preferred collateralized debt obligation securities (PreTSLs) in the amount of $0.6 million. The Company sold these securities to improve the Bank s capital ratios as required by the Order and to reduce exposure to prepayment risk in the mortgage-backed securities portfolio and call risk in the municipal securities portfolio.

During 2011, the Company recorded a $2.5 million net gain on the sale of 16 OREO properties. The net gain was primarily attributable to a $1.8 million gain from the sale of a property in Florida as well as a $0.7 million gain resulting from the bulk sale of a 129-lot land development property the Company acquired through foreclosure in 2010. The Company continues to aggressively seek buyers for its OREO properties. The Company did not provide financing for any of the properties that it sold during 2011.

During 2010, total non-interest income was $1.3 million, a $13.3 million increase from the $12.0 million loss in 2009. The $13.3 million increase in non-interest income resulted primarily from a $16.4 million reduction in OTTI losses incurred on investment securities to $4.3 million in 2010 from the $20.6 million the Company recorded in 2009, partially offset by a $2.6 million reduction in gains on the sale of investment securities from a $900 thousand gain in 2009 to a $1.7 million loss in 2010 and a $283 thousand reduction in gains recognized on the sale of loans.

During 2010, the Company recorded a $2.9 million loss on the sale of its entire portfolio of private label collateralized mortgage obligations (PLCMOs). The Company sold the PLCMOs during the third quarter of 2010 to better manage and improve credit risk in its investment portfolio. The loss on the PLCMOs was partially offset by net gains of $1.2 million on the sale of agency mortgage-backed securities and municipal securities.

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Non-Interest Expense (in thousands)	**2011**	**2010**	**2009**
Salaries and employee benefits	$ 14,117	$ 13,077	$ 12,155
Occupancy expense	2,890	3,228	2,218
Equipment expense	1,654	1,763	1,828
Advertising expense	629	712	713
Data processing expense	2,036	2,023	1,928
FDIC assessment	2,657	2,828	2,506
Bank shares tax	1,103	1,020	898
Expense of other real estate	3,720	7,521	1,250
Provision for off-balance sheet commitments	(423)	(678)	604
Legal expense	2,905	1,075	591
Professional fees	5,439	2,066	388
Goodwill impairment			8,134
Insurance expense	695	362	301
Loan collection expenses	242	647	236
Other operating expenses	4,166	5,920	4,272
Total non-interest expense	$ 41,830	$ 41,564	$ 38,022

During 2011, total non-interest expense increased by $0.3 million or 0.6%, from 2010 primarily due to a $3.8million decrease in the other real estate expense, and a $1.8 million decrease in other operating expenses. These decreases were offset by a $3.4 million increase in professional fees, a $1.8 million increase in legal fees, and a $1.0 million increase in salaries and employee benefits. The increase in professional and legal fees is primarily attributable to increased audit, regulatory compliance, and restatement expenses. The increase in salary and employee benefits expense is primarily attributable to the hiring of new and replacement senior officers, merit increases, and increased insurance costs.

Other real estate expense decreased by $3.8 million, or 50.5%, in 2011 as compared to 2010 primarily due to a $3.6 million reduction in impairment charges and a $0.2 million reduction in property-related operating expenses. The reduction in impairment is primarily attributable to the stabilization of real estate values and the sale of land development properties, which generally have a higher risk of exposure to changes in market value.

Other operating expenses decreased by $1.8 million, or 29.6%, in 2011 as compared to 2010, primarily the result of the $1.2 million fixed asset impairment charge that was recorded in 2010.

The above noted expense reductions were largely offset by the following expense increases:

• Professional fee expense increased $3.4 million in 2011 as compared to 2010. The increase is primarily attributable to the expense incurred to complete the 2010 audit, the restatement of the Company s annual report on Form 10-K for the year ended December 31, 2009 and the Company s quarterly reports on Form 10-Q for the quarterly periods ended March 31, 2010 and June 30, 2010.

• Legal expense increased $1.8 million in 2011 as compared to 2010 primarily related to increased regulatory oversight and compliance expenses.

- Salary and employee benefit costs accounted for 33.8% of total non-interest expenses in 2011 as compared to 31.5% in 2010. The increase in employee costs included a $0.7 million increase in salaries expense primarily attributable to the hiring of new and replacement senior officers and merit increases. As of December 31, 2011, the Company had 336 full-time equivalent employees on staff as compared to 339 on December 31, 2010. Employee benefits expense increased by $0.2 million or 12.0% in 2011 compared to 2010 primarily due to the increased health, social security and unemployment insurance costs.

In 2010, total non-interest expense increased $3.6 million, or 9.4%, from 2009 primarily due to a $6.3 million increase in OREO expense, a $484 thousand increase in legal fees, primarily attributable to loan foreclosures, workouts and OREO sales, a $1.7 million increase in professional fees primarily attributable to increased regulatory compliance expenses, a $922 thousand increase in salary and benefits expenses, a $1.0 million increase in occupancy expense, a $411 thousand increase in loan collection expenses and a $1.7 million increase in other expenses. These increases were partially offset by an $8.1 million reduction in goodwill impairment expense and a $1.3 million reduction in the provision for off-balance sheet commitments. During 2009, the Company wrote off all of the goodwill associated with its acquisition of its Honesdale branch.

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Salary and employee benefit costs accounted for 31.3% of total operating expenses in 2010 as compared to 31.8% in 2009. The increase in employee costs includes a $1.2 million increase in salaries which reflects the cost of additional staff and merit increases. As of December 31, 2010, the Company had 339 full-time equivalent employees on staff as compared to 326 on December 31, 2009. Employee benefits expense decreased by $194 thousand or 8.9% in 2010 compared to 2009 primarily due to the suspension of profit sharing payments partially offset by increased health insurance costs.

Occupancy expense increased $1.0 million or 45.5% in 2010 as compared to 2009. The increase is primarily attributable to a $612 thousand increase in accrued rent expense and the addition of two locations that were in operation for the full year in 2010 as compared to part of the year in 2009.

FDIC assessment expense increased $322 thousand in 2010 as a result of the change in Bank s risk-profile from Category I to a Category III. This change resulted in an increase to the Bank s annual risk based premium of approximately $1 million. The premium increase became effective October 1, 2010.

The provision for off-balance sheet commitments decreased by $1.3 million in 2010 to a $678 thousand recovery as compared to the $604 thousand charge the Company recorded in 2009. The reduction in the provision is primarily attributable to the $42.2 million reduction in the Bank s commitment to extend credit to $183.6 million in 2010 as compared to $225.8 million in 2009.

Net expense of OREO increased $6.3 million to $7.5 million in 2010 from $1.2 million in 2009. The net increase is primarily attributable to impairment charges in the amount of $5.9 million that were recorded in 2010 compared to $435 thousand in 2009. The impairment charges resulted from the reduction in property values, based on updated appraisals. The impairment charge on two land development properties totaled $3.2 million, or 54.6% of the total $5.9 million dollar charge. Insurance, real estate taxes and other expenses associated with the operation of OREO totaled $1.6 million in 2010 and $815 thousand in 2009, respectively.

Loan collection expenses increased $411 thousand to $647 thousand in 2010 from $236 thousand in 2009. Loan collection expenses primarily consist of real estate taxes the Company pays to protect its lien position in mortgage loans that are in the process of collection or workout.

Provision for Income Taxes

For the year ended December 31, 2011, the Company did not record a provision or benefit for income taxes. In 2011, the Company recorded a $2.5 million valuation charge against its deferred tax assets increasing the valuation allowance to $27.8 million at December 31, 2011 from $25.3 million at December 31, 2010. In future periods, the Company anticipates that it will have a minimal tax provision or benefit until such time as it is able to reverse the deferred tax asset valuation allowance.

For the year ended December 31, 2010, the Company did not record a provision or benefit for income taxes as compared to the income tax benefit of $(8.6) million recorded in 2009. In 2010, the Company recorded a $13 million valuation charge against its deferred tax assets increasing the valuation allowance to $25.3 million at December 31, 2010 from $12.1 million at December 31, 2009.

The Company calculates its current and deferred tax provision based on estimates and assumptions that could differ from actual results reflected in income tax returns filed during the subsequent year. Any adjustments required based on filed returns are recorded when identified in the subsequent year.

FINANCIAL CONDITION

Total assets decreased $64.7 million, or 5.5% during 2011, primarily due to a $76.8 million, or 10.4% decline in net loans, a $65.6 million, or 26.1% decline in available-for-sale investment securities and a $7.3 million, or 39.1% decline in other assets partially offset by a $94.1 million or 126.4% increase in cash and cash equivalents. The Company did not pay any dividends in 2011 or 2010 as compared to the $0.17 per share dividend paid in 2009. The Company suspended paying dividends in 2010 to conserve capital and comply with regulatory requirements.

Securities

The Company holds debt securities primarily for liquidity, interest rate risk management needs, and to provide a source of interest income. Securities are classified as held-to-maturity and carried at amortized cost when the Company has the positive intent and ability to hold them to maturity. Securities not classified as held-to-maturity are classified as available-for-sale and are carried at fair value,

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with unrealized holding gains and losses reported in other comprehensive income, net of tax. The Company determines the appropriate classification of securities at the time of purchase. The decision to purchase or sell securities is based upon the current assessment of long- and short-term economic and financial conditions, including the interest rate environment and other statement of financial condition components. Securities with limited marketability and/or restrictions, such as Federal Home Loan Bank and Federal Reserve Bank stocks, are carried at cost. Federal Reserve Bank stock is included in other assets.

At December 31, 2011, the Company s investment portfolio was comprised of U.S Government agency securities, taxable and tax-exempt obligations of states and political subdivisions, government sponsored agency collateralized mortgage obligations, private label collateralized mortgage obligations, residential mortgage-backed securities, pooled trust preferred securities (PreTSLs) principally collateralized by bank holding companies (bank issuers) and insurance companies, and corporate debt and equity securities.

Among other securities, the Company s investments in PreTSLs may pose a higher risk of future impairment charges by the Company as a result of the current downturn in the U.S. economy and its potential negative effect on the future performance of the bank issuers. Many of the bank issuers of PreTSLs within the Company s investment portfolio remain participants in the U.S. Treasury s TARP CPP. For TARP participants, dividend payments to trust preferred security holders are currently senior to and payable before dividends can be paid on the preferred stock issued under the TARP CPP. Some bank issuers may elect to defer future payments of interest on such securities either based upon recommendations by the U.S. Treasury and the banking regulators or management decisions driven by potential liquidity needs. Such elections by issuers of securities within our investment portfolio could adversely affect securities valuations and result in future impairment charges if collection of deferred and accrued interest (or principal upon maturity) is deemed unlikely by management. See the Other-Than-Temporary-Impairment section below for further details.

The following table sets forth the carrying value of available-for-sale securities, which are carried at fair value, and held-to-maturity securities, which are carried at amortized cost, at the dates indicated:

			December 31,			
(in thousands)		**2011**		**2010**		**2009**
Obligations of U.S. government agencies	$	8,048	$	8,307	$	27,089
Obligation of state and political subdivisions		98,255		113,347		120,569
Collateralized mortgage obligations						
Government sponsored agency		8,468		77,816		53,495
Private label		36,256				21,059
Residential mortgage-backed securities						
Government sponsored agency		31,393		49,120		27,442
Pooled trust preferred senior class		1,604		1,422		1,391
Pooled trust preferred mezzanine class		2,197		1,647		2,419
Corporate debt securities		342		395		356
Equity securities		1,006		1,012		1,025
Total	$	187,569	$	253,066	$	254,845

There was no issuer of securities whose aggregate carrying value exceeded ten percent of Shareholders equity as of December 31, 2011.

In 2011, the Company sold most of its U.S. Government agency collateralized mortgage obligations (CMOs) and reinvested the proceeds in private label CMOs (PLCMOs) to reduce its exposure to prepayments and improve yield. The Company also sold some of its obligations of state and political subdivisions that were callable and reinvested a portion of the proceeds in taxable municipal securities to reduce its interest rate risk.

During 2010, the Company sold its entire portfolio of previously owned PLCMOs. The Company had previously recorded OTTI charges on these instruments and believed there would be further erosion in the credit quality of the underlying collateral which would lead to additional impairment charges. The proceeds from these sales, along with cash provided by operations, were used to purchase U.S. Government guaranteed and Government sponsored agency mortgage-backed securities.

The following table sets forth the maturities of available-for-sale securities and held-to-maturity securities, based on carrying value at December 31, 2011 and the weighted average yields of such securities calculated on the basis of the cost and effective yields weighted for the scheduled maturity of each security.

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(in thousands)	Within One Year	> 1 5 Years	6 - 10 Years	Over 10 Years	Mortgage-Backed Securities and Collateralized Mortgage Obligations	No Fixed Maturity	Total
Available-for-sale securities							
Obligations of U.S. government agencies	$	$	$	$ 8,048	$	$	$ 8,048
Yield				5.62%			5.62%
Obligations of state and political subdivisions (1)		1,629	22,730	71,802			96,161
Yield		6.44%	5.17%	7.02%			6.59%
Corporate debt securities				342			342
Yield				0.99%			0.99%
Collateralized Mortgage Obligations:							
Government sponsored agencies					8,468		8,468
Yield					5.31%		5.31%
Private label					36,256		36,256
Yield					4.29%		4.29%
Residential mortgage-backed securities:							
Government sponsored agencies					31,393		31,393
Yield					4.90%		4.90%
Pooled Trust Preferred Senior Class				1,604			1,604
Yield				0.00%			0.00%
Pooled Trust Preferred Mezzanine Class				2,197			2,197
Yield				0.00%			0.00%
Equity securities (2)						1,006	1,006
Yield						4.72%	4.72%
Total available-for-sale maturities	$	$ 1,629	$ 22,730	$ 83,993	$ 76,117	$ 1,006	$ 185,475
Weighted yield	0.00%	6.44%	5.17%	6.06%	4.65%	4.72%	5.40%
Held-to-maturity securities							
Obligations of state and political subdivisions			2,094				2,094
Yield			4.77%				4.77%
Total held-to-maturity securities	$	$	$ 2,094	$	$	$	$ 2,094
Weighted yield	0.00%	0.00%	4.77%	0.00%	0.00%	0.00%	4.77%

(1) Yields on state and municipal securities have been adjusted to a tax equivalent yields using a 34% federal income tax rate.

(2) Yield represents 2011 actual return.

Other-Than-Temporary Impairment (OTTI)

Management tests the Company s securities for OTTI using the guidance provided in ASC Topic 320, Investments-Debt and Equity Securities. Under this guidance, if management has no intent to sell the security and it is not more likely than not that the Company will be required to sell the security before recovery of its amortized cost, then other-than-temporary declines in the fair value of the debt security that are related to credit losses must be recognized in earnings as realized losses and those that are related to other factors are recognized in other comprehensive income. Numerous factors, including lack of liquidity for re-sales of certain investment securities, absence of reliable pricing information for investment securities, adverse changes in business climate, adverse actions by regulators, or unanticipated changes in the competitive environment could have a negative effect on our investment portfolio and may result in OTTI on the Company s investment securities in future periods.

On a quarterly basis, management evaluates its investment securities for OTTI. Unrealized losses on securities are considered to be other-than-temporary when management believes the security s impairment is due to factors that could include the issuer s inability to pay interest or dividends, its potential for default, and/or other factors. Based on current authoritative guidance, when a held-to-maturity or available-for-sale debt security is assessed for OTTI, management must first consider (a) whether management intends to sell the security and (b) whether it is more likely than not that the Company will be required to sell the security prior to recovery of its amortized cost basis. If one of these circumstances applies to a security, an OTTI loss is recognized in the statement of operations equal to the full amount of the decline in fair value below amortized cost. If neither of these circumstances applies to a security, but the Company does not expect to recover the entire amortized cost basis, an OTTI loss has occurred that must be separated into two categories: (a) the amount related to credit loss and (b) the amount related to other factors such as market risk. In assessing the level of OTTI attributable to credit loss, management compares the present value of cash flows expected to be collected with the amortized cost basis of the security. As discussed above, the portion of the total OTTI related to credit loss is recognized in earnings, while the amount related to other factors is recognized in other comprehensive income. The total OTTI loss is presented in the statement of operations, less the portion

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recognized in other comprehensive income. When a debt security becomes other-than-temporarily-impaired, its amortized cost basis is reduced to reflect the portion of the total impairment related to credit loss.

To determine whether a security s impairment is other-than-temporary, management considers factors that include:

- The causes of the decline in fair value, such as credit problems, interest rate fluctuations, or market volatility;
- The severity and duration of the decline;
- The Company s ability and intent to hold investments until they recover in value, as well as the likelihood of such a recovery in the near term;
- The Company s intent to sell security investments, or if it is more likely than not that the Company will be required to sell such securities before recovery of their individual amortized cost basis less any current-period credit loss.

For debt securities that the Company does not intend to sell or it does not expect it will be required to sell, the primary consideration in determining whether impairment is other-than-temporary is whether or not the Company expects to receive all contractual cash flows.

Based on the management s evaluation at December 31, 2011, management has determined that the decreases in estimated fair value of the securities it holds in its portfolio are temporary with the exception of four PreTSLs. The Company s estimate of discounted projected cash flows it expects to receive was less than the securities carrying value, resulting in a credit-related impairment charge to earnings for the year ending December 31, 2011 of $0.8 million.

OTTI of Pooled Trust Preferred Collateralized Debt Obligations:

As of December 31, 2011, the amortized cost of our PreTSLs totaled $10.6 million with an estimated fair value of $3.8 million and is comprised of four securities each of which is collateralized by debt issued by bank holding companies and insurance companies. The Company holds one senior tranche and three mezzanine tranches. All the tranches possess credit ratings below investment grade. During 2011, all of the pooled issues were downgraded further by either Moody s or Fitch rating services. At the time of initial issue, no more than 5% of any pooled security consisted of a security issued by any one institution. As of December 31, 2011, three of these securities had no excess subordination and one had excess subordination equal to 12.1% of the current performing collateral. Excess subordination is the amount by which the underlying performing collateral exceeds the outstanding bonds in the current class plus all senior classes. It can also be referred to as credit enhancement. As deferrals and defaults of underlying issuers occur, the excess subordination is reduced or eliminated, increasing the risk of the security experiencing principal or interest shortfalls. Conversely, subordination can be increased as collateral transitions from non-performing to performing. The coverage ratio, or overcollateralization, of a specific security measures the rate of performing collateral to a given class of notes. It is calculated by dividing the performing collateral in a transaction by the current balance of the class of notes plus all classes senior to that class.

The following table presents information about the Company s collateral and subordination for its PreTSLs as of December 31, 2011:

Security (in thousands)	Performing Collateral	Bonds Outstanding	Excess/ (Insufficient) Collateral	Coverage Ratio	Excess Subordination	Current Number of Performing Issuers	Actual Deferrals / Defaults as a % of Current Collateral	Expected Future Default Rate
PreTSL IX	$ 303,520	$ 322,024	$ (18,504)	94.25%	N/A	35	31.0%	1.51%
PreTSL XI	388,465	439,829	(51,364)	88.32%	N/A	43	32.3%	1.80%
PreTSL XIX	470,931	537,266	(66,335)	87.65%	N/A	48	27.6%	1.46%
PreTSL XXVI	691,700	617,093	74,607	112.09%	12.09%	55	28.3%	1.31%

The following list details information for each of the Company s investments in PreTSLs as of December 31, 2011:

Security (in thousands)	Class	Amortized Cost	Fair Value	Unrealized Gain/Loss	Moody s / Fitch Ratings	Credit Impairment this period	Cumulative Credit Impairment
PreTSL IX	Mezzanine	$ 1,256	$ 547	$ (709)	Ca/C	$	$ 1,680
PreTSL XI	Mezzanine	1,563	635	(928)	Ca/C		3,426
PreTSL XIX	Mezzanine	3,913	1,015	(2,898)	Ca/CC	798	3,262
PreTSL XXVI	Senior	3,833	1,604	(2,229)	B1/CCC		251
Total		$ 10,565	$ 3,801	$ (6,764)		$ 798	$ 8,619

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The Company s PreTSLs are evaluated for OTTI within the scope of ASC Topic 325 Investments, Other by determining whether an adverse change in estimated cash flows has occurred. The Company uses a third-party service provider to perform this analysis. Determining whether there has been an adverse change in estimated cash flows from the cash flows previously projected involves comparing the present value of remaining cash flows previously projected against the present value of the cash flows estimated at December 31, 2011. The Company considers the discounted cash flow analysis to be its primary evidence when determining whether credit-related OTTI exists.

Results of a discounted cash flow test are significantly affected by variables such as the estimate of the probability of default, discount rates, prepayment rates and the creditworthiness of the underlying issuers. The following provides additional information for each of these variables:

- Probability of Default - An issuer-level approach is used to analyze each security and default and recovery assumptions are based on the credit quality of the underlying issuers (generally, bank holding companies or insurance companies). Each bank issuer is evaluated based upon an examination of the trends in its earnings, net interest margin, operating efficiency, liquidity, capital position, level of non-performing loans to total loans, apparent sufficiency of loan loss reserves, Texas ratio, and whether the bank received TARP monies. From this information, each issuer bank that is currently performing is assigned a category of Good, Average, Weak, or Troubled. Default rates are then assigned based upon the historical performance of each category. Additionally, because the information available to the Company regarding the underlying insurance company issuers is more limited than for bank issuers, rather than performing an analysis of each issuer s results and assigning insurance company issuers to these same categories, the Company uses the Moody s one year long-term default rate assumption for insurance companies. The historical default rates used in this analysis are:

		Default Rate		
Category	**Year 1**	**Year 2**	**Year 3**	**Thereafter**
Good	0.50%	0.60%	0.60%	0.40%
Average	1.80%	2.30%	2.30%	1.50%
Insurance	1.00%	1.20%	1.20%	0.80%
Weak	5.80%	7.20%	7.20%	4.80%
Troubled	9.70%	12.20%	12.20%	8.10%

Each issuer in the collateral pool is assigned a probability of default for each year until maturity. Banks currently in default or deferring interest payments thus far are assumed to default immediately. A zero percent projected recovery rate is applied to both deferring and defaulted issuers. The probability of default is updated quarterly based upon changes in the creditworthiness of each underlying issuer. Timing of defaults and deferrals has a substantial impact on each valuation. As a result of this analysis, each issuer is assigned an expected default rate specific to that issuer.

- Estimates of Future Cash Flows - While understanding the composition and characteristics of each bank issuer is important in evaluating the security, certain issuers have a disproportionate impact (both positive and negative) based upon other attributes, such as the interest rate payable by each issuer. Each credit is assessed independently, and the timing and nature of each issuer s performance is assessed. Once assessed, the expected performance of each issuer is applied to a structural cash flow model. Due to the complexity of these transactions, the expected performance of each unique issuer requires an adherence to the governing documents of the securitization to derive a cash flow. A model produced by a third party is utilized to assist in determining cash flows. Utilization of third party cash flow modeling to derive cash flows from assumptions is a market convention for these types of securities.

- Discount Rate - The Company is discounting projected cash flows based upon its discount margin defined at the time of purchase, which constitutes a spread over 3-month LIBOR plus credit premium, consistent with our pre-purchase yield.

- Prepayment Rate - Lack of liquidity in the market for PreTSL securities, credit rating downgrades and market uncertainties related to the financial industry are factors contributing to the impairment on these securities. During the early years of PreTSL securities, prepayments were common as issuers were able to refinance into lower cost borrowings. Since the middle of 2007, however, this option has all but disappeared and the Company is operating in an environment which makes early redemption of these instruments unlikely. Accordingly, the Company has assumed zero prepayments when modeling the cash flows of these securities. The Company will reevaluate its prepayment assumptions from time to time as appropriate. The Company performed a sensitivity analysis using 1% and 3% prepayment assumptions. As a result of this analysis, the Company determined that employing a 1% and a 3% prepayment assumption rather than assuming zero prepayments would have resulted in an additional credit loss of approximately $15 thousand and $50 thousand, respectively, to the $0.8 million impairment charge taken during 2011. Credit losses would increase as a result of an increase in the prepayment assumption because prepayments reduce the amount of excess subordination that would be available to absorb expected losses.

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• Credit Analysis - A quarterly credit evaluation is performed for each of the securities. While the underlying core component of these securities are the credit characteristics of the underlying issuers , typically banks, other characteristics of the securities and issuers are evaluated and stressed to determine cash flow. These include but are not limited to the interest rate payable by each issuer, certain derivative contracts, default timing, and interest rate volatility. Issuer level credit analysis considers all evidence available to us and includes the nature of the issuer s business, its years of operating history, corporate structure, loan composition, loan concentrations, deposit mix, asset growth rates, geographic footprint and local environment. Depending upon the security, and its place in the capital structure, certain analytical assumptions are isolated with greater scrutiny. The core analysis for each specific issuer focuses on profitability, return on assets, shareholders equity, net interest margin, credit quality ratios, operating efficiency, capital adequacy and liquidity.

The Company has evaluated its PreTSLs considering all available evidence, including information received after the statement of financial condition date but before the filing date and determined that the estimated projected cash flows are less than the securities carrying value, resulting in impairment charges to earnings for the years ended December 31, 2011, 2010, and 2009 of $0.8 million $4.3 million, and $20.6 million, respectively. The cumulative impairment charges for December 31, 2011, 2010 and 2009 amounted to $8.6 million, $22.6 million, and $20.6 million, respectively. The decrease in cumulative impairment charges in 2011 relates to the sale during 2011 of four PreTSLs, on which OTTI had previously been recognized.

The table below provides a cumulative roll forward of credit losses recognized:

Rollforward of Cumulative Credit Loss

(in thousands)	**2011**	**2010**	**2009**
Beginning Balance January 1	$ 22,598	$ 20,649	$
Credit losses on debt securities for which OTTI was not previously recognized			20,649