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, 2012

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

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 x NO o

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 o
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 $37,859,031 at June 30, 2012.

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: 16,457,169 shares of common stock as of March 27, 2013.

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PART 1

Item 1. Business

Overview

The Company

First National Community Bancorp, Inc., incorporated in 1997, is a Pennsylvania business corporation and a registered bank holding company headquartered in Dunmore, Pennsylvania. In this report the terms Company, we, us, and our refer to First National Community Bancorp, Inc. and its subsidiaries, unless the context requires otherwise. In certain circumstances, however, First National Community Bancorp, Inc. uses the term Company to refer to itself.

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 practically all of the Company s earnings as a result of its banking services.

As a result of criticism received from banking regulators in connection with their examination process during 2010, the Company has taken steps to remediate and improve its lending policies and its credit administration function, including developing and implementing new policies and procedures, particularly related to risk management. The Company has also been advised by its regulators that it must increase its regulatory capital. For more information regarding the supervision and regulation of the Company, refer to the section entitled Supervision and Regulation Supervisory Actions, in this Item 1 to the Annual Report on Form 10-K.

The Bank

Established as a national banking association in 1910, the Bank operates 21 full-service branch offices within four contiguous counties, Lackawanna, Luzerne, Wayne and Monroe, its primary market area located in the Northeast section of the state.

Retail Banking

The Bank provides a wide variety of retail banking products and services to individuals and businesses including Image Checking and E-Statements. Deposit products include various checking, savings and certificate of deposit products, as well as a line 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 via a secure website https://www.fncb.com. FNCB Online   s product suite includes Bill Payment, Finance Works, Funds Transfer and POP Money (person to person transfers), and Purchase Rewards. FNCB Online can also be accessed through our mobile application. Customers can also use our automated teller machines (ATMs   ) located in each of our 21 branch offices and 7 other locations.

Through FNCB Online, customers can directly access their accounts, open new accounts and apply for a mortgage through our Mortgage Center. Telephone Banking (Account Link), a service that provides customers with the ability to access account information, perform related account transfers, and apply for a loan through the use of a touch tone telephone, is also available. The Bank offers overdraft Bounce Protection and Instant Money loans which provide customers 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. Remote Deposit Capture allows business customers the ability to process daily check deposits to their accounts through an online image capture environment.

Lending Activities

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, generally to individuals and businesses in its primary market area.

Residential Mortgage Loans

The Bank offers fixed and variable rate one-to-four-family residential loans. 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. During 2012 and 2011, the volume of customers who exercised the option to lock the rate was minimal. At December 31, 2012, one-to-four family residential mortgage loans totaled $90.2 million, or 15.1%, of our total loan portfolio.

One-to-four family mortgage loans are originated generally for sale in the secondary market. During the year ended December 31, 2012, the Bank sold $26.2 million of one-to-four family mortgages. The Bank retains servicing rights on these mortgages.

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, 2012, construction, land acquisition and development loans of $32.5 million represented 5.4% of the total loan portfolio.

Commercial Real Estate Loans

At December 31, 2012, commercial real estate loans totaled $231.8 million, or 38.8%, 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.

Commercial and Industrial Loans

The Bank generally 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, 2012, commercial and industrial loans totaled $110.1 million, or 18.4%, of the Bank s total loan portfolio.

Although the Bank believes its initial loan underwriting was sound, the Commercial Loan portfolio, and in particular, the commercial real estate, and construction, land acquisition and development segments, were negatively impacted as a result of the recent 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.

Consumer Loans

Consumer loans include both secured and unsecured installment loans, 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. Generally, the Bank also 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. At December 31, 2012, consumer loans totaled $109.8 million, or 18.4%, 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, 2012, state and political subdivision loans totaled $23.4 million, or 3.9%, of the Bank s loan portfolio.

For more information regarding the Company s loan portfolio and lending policies, please refer to Note 2 Summary of Significant Accounting Polices to the consolidated financial statements included in Item 8 of this Annual Report on Form 10-K.

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Wealth Management

Wealth management services are available at the Bank. Customers are able to access alternative deposit 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 Company faces substantial competition in originating loans and in attracting deposits from a significant amount of financial institutions operating in its market area, many with a statewide or regional presence, and in some cases, a national presence. 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. The increased competition has resulted from changes in the legal and regulatory guidelines, as well as from economic conditions. The fixed cost of regulatory compliance remains high for community banks as compared to their larger competitors that are able to achieve economies of scale. As discussed above and in Note 7, Regulatory Matters to the consolidated financial statements included in Item 8 to this Annual Report on Form 10-K, the Company and the Bank are subject to extensive regulation and supervision, including regulations that limit the type and scope of activities, such as the Order and Agreement.

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. The Company considers its major competition to be local commercial banks as well as other commercial banks with branches in the Company s market area. Competitors may offer deposits at higher rates and loans with lower fixed rates, more attractive terms and less stringent credit structures than the Company has been able to offer. The growth and profitability of the Company depends on the continued ability to successfully compete.

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 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). Based on their discussions with the OCC and the Reserve Bank and their efforts to date, the Company and the Bank believe they have made substantial progress towards compliance, with certain of the requirements of the Order and Agreement, 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 the Company s and the Bank s actions to be adequate, that further compliance actions will not be required, or that the Company and the Bank will be able to satisfy all of the requirements.

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 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 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

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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) was 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 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 was 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 was 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 was required to review the Board and the Board s committee structure; by November 30, 2010, the Board was required to 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 was required to 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 was required to 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 was required to 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 was 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 was required to take certain actions to resolve certain credit and collateral exceptions;

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

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

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

(xvi) by October 31, 2010, the Board was required to take action to maintain adequate sources of stable funding and liquidity and a contingency funding plan; by October 31, 2010, the Board was 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 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 was required to 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 was required to 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 was required to 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;

(x) the Company was required to 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 was required to 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.

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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, 2012 and 2011, the Company incurred approximately $0.6 million and $1.0 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 may continue to experience increased costs related to compliance with these regulatory agreements 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 2012 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 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 2013.

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 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

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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 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). 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

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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 maintain a strong capital position 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, 2012 and 2011 was 11.79% and 11.73%, respectively. The Tier I capital to risk weighted assets ratio at December 31, 2012 and 2011 was 10.52% and 10.46% respectively. The Tier I capital to average assets ratio at December 31, 2012 and 2011 was unchanged at 7.20%. Under the Order, the Bank was 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, 2012, however, the Bank had not achieved these ratios. The Company continues to explore various options to improve its regulatory capital ratios. The Company s total capital ratio at December 31, 2012 and 2011 was 10.20% and 11.35%, respectively. The Tier I capital to risk weighted assets at December 31, 2012 and 2011 was 5.95% and 6.85%, respectively. The Tier I capital to average assets at December 31, 2012 and 2011 was 4.07% and 4.72%, respectively.

Proposed Changes in Capital Requirements. In December 2010, the Basel Committee on Banking Supervision 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 was to be phased in between 2013 and 2019, but has been delayed pending further review of the proposed implementing regulations discussed below.

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.

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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.

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 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.

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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 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.

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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;

- 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 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 within the Federal Reserve System, 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 Practices Act, the consumer financial privacy provisions of the Gramm-Leach-Bliley Act and certain other statutes. The CFPB, which began operations on July 21, 2011, has examination and primary enforcement authority with respect to depository institutions with $10 billion or more in assets. Smaller institutions, including the Bank, are be subject to rules promulgated by the CFPB but continue to be examined and supervised by federal banking regulators for compliance with federal consumer protection laws and regulations. The CFPB also has authority to prevent unfair, deceptive or abusive practices in connection with the offering of consumer financial products. The Dodd-Frank Act permits states to adopt consumer

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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.

The CFPB has proposed or issued a number of important rules affecting a wide range of consumer financial products. Many of these rules have not been implemented, which has created significant uncertainty for the Company and the financial services industry in general. It is difficult to predict at this time the specific impact the Dodd-Frank Act and CFPB rulemakings will have on our business. The changes resulting from the Dodd-Frank Act and CFPB rulemakings may impact the profitability of our business activities, limit our ability to make, or the desirability of making, certain types of loans, including non-qualified mortgage loans, 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 or profitability. 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, during 2012, the Bank elected to participate in the FDIC program whereby noninterest-bearing transaction account deposits were insured without limitation. This program expired on December 31, 2012.

During the year ended December 31, 2012, the Bank was considered risk category III for deposit insurance assessments and paid an annual assessment rate of 0.0023 basis points on the assessment base of average consolidated total assets less the average tangible equity during the assessment period.

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, 2012, the Company and the Bank employed 298 persons, including 52 part-time employees.

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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 through 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; for instance, areas such as BSA compliance and real estate-secured consumer lending are attracting heightened regulatory expectations and scrutiny. Furthermore, the Company and the Bank are subject to the requirements of the Order and the Agreement, which regulatory agreements require that they 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 of these 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, the 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.

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, results of operations and access to capital.

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 the creation of new regulatory agencies (such as the Financial Stability Oversight Council to oversee systemic risk and the Consumer Financial Protection Bureau (CFPB) to develop and enforce rules for consumer financial products), changes in retail banking regulations, and changes to deposit insurance assessments. Additionally, proposed rules to implement Basel III would revise risk-based and leverage capital requirements and also limit capital distributions and certain discretionary bonuses if a banking organization does not hold a capital conservation buffer. 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

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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.

The CFPB, which has now been in operation for over a year, has concentrated much of its rulemaking efforts on reforms related to residential mortgage transactions. In 2013, the CFPB issued final rules related to a borrower s ability to repay and qualified mortgage standards, mortgage servicing standards, loan originator compensation standards, requirements for high-cost mortgages, appraisal and escrow standards and requirements for higher-priced mortgages. Several of the CFPB s rulemakings were issued in January 2013, and we continue to analyze their requirements to determine the impact of the rules to our businesses. During 2013, we expect the CFPB to focus its rulemaking efforts on integrating disclosure requirements for lenders and settlement agents and expanding the scope of information lenders must report in connection with mortgage and other housing-related loan applications under the Home Mortgage Disclosure Act. These rules include significant regulatory and compliance changes and are expected to have a broad impact on the financial services industry.

On January 10, 2013, the CFPB issued a final rule to implement sections of the Dodd-Frank Act that will require lenders to determine whether a consumer has the ability to repay a mortgage loan. The rule, which goes into effect on January 10, 2014, establishes certain minimum requirements for creditors when making ability to pay determinations, and establishes certain protections from liability for mortgages meeting the definition of qualified mortgages . The rule affords greater legal protections for lenders making qualified mortgages that are not higher priced. Qualified mortgages must generally satisfy detailed requirements related to product features, underwriting standards, and a points and fees requirement whereby the total points and fees on a mortgage loan cannot exceed specified amounts or percentages of the total loan amount. Mandatory features of a qualified mortgage include: (1) a loan term not exceeding 30 years; and (2) regular periodic payments that do not result in negative amortization, deferral of principal repayment, or a balloon payment. The rule creates a special category of qualified mortgages originated by certain smaller creditors that operate in predominantly rural or underserved areas, as defined by the CFPB. Concurrently with the final ability to repay rule, the CFPB released a proposal that, among other things, may define a separate category of qualified mortgages for certain smaller creditors . Our business strategy, product offerings, and profitability may change as the rule become becomes effective and is interpreted by the regulators and courts.

On January 17, 2013, the CFPB issued final rules containing new mortgage servicing standards which will take effect on January 10, 2014. The final rules impose new requirements regarding force-placed insurance, mandate certain notices prior to rate adjustments on adjustable-rate mortgages, and establish requirements for periodic disclosures to borrowers. These requirements will affect notices to be given to consumers as to delinquency, foreclosure alternatives, modification applications, interest rate adjustments and options for avoiding force-placed insurance. Servicers will be prohibited from processing foreclosures when a loan modification is pending, and must wait until a loan is more than 120 days delinquent before initiating a foreclosure action. Servicers must provide direct and ongoing access to its personnel, and provide prompt review of any loss mitigation application. Servicers must maintain accurate and accessible mortgage records for the life of a loan and until one year after the loan is paid off or transferred. These new standards are expected to increase the cost and compliance risks of servicing mortgage loans. We cannot predict the ultimate outcome of these inquiries, actions, or regulatory changes or the impact that they could have on our financial condition, results of operations, or business.

While the full impact of the Dodd-Frank Act and the CFPB rulemakings cannot be assessed until all implementing regulations are released and become effective, the Dodd-Frank Act s extensive requirements may have a significant effect on the financial markets, and may affect the availability or terms of financing from our lender counterparties and the availability or terms of mortgage-backed securities, both of which may have an adverse effect on our financial condition and results of operations. The CFPB s rules are likely to result in increased compliance costs and fees, along with possible restrictions on our operations, any of which may have a material adverse effect on our operating results and financial condition.

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. There is also competition for banking business from competitors outside of its market area. As noted above, the Company and the Bank are subject to extensive regulations and supervision, including, in many cases, regulations that limit the type and scope of activities. Many competitors have substantially greater resources than the Company, may offer certain services that the Bank does not provide, 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. For additional discussion of the Company s competitive environment, see the section entitled Business Competition included in Item 1 of the Annual Report on Form 10-K.

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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 a weak real estate market and constrained financial markets. Dramatic declines in the housing market since 2008, 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 $13.6 million and represented 37.1% of shareholders equity as of December 31, 2012, as compared to $30.7 million and 76.9% of equity as of December 31, 2011. Although non-performing assets as a percentage of shareholders equity decreased, the percentage remains elevated, and deterioration in economic conditions in our markets could drive loan losses beyond that which is provided for in the Company s allowance for loan and lease losses (ALLL), which would necessitate further increases in the provision for loan and lease losses, and, in turn, 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;

- market developments may affect consumer confidence levels and may reduce loan demand and cause adverse changes in payment patterns, leading to a reduced asset base, as well as increases in delinquencies and default rates on loans and other credit facilities;

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

- low market interest rates, which have been projected to continue, may pressure our interest margins as interest-earning assets, such as loans and investments, are reinvested or repriced at lower rates;

- 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 previously identified material weaknesses in our internal control over financial reporting.

Management determined that the Company s internal control over financial reporting was not effective at December 31, 2011, and had also 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 has implemented remediation efforts with respect to the material weakness at December 31, 2011, and management concluded that its new internal controls are operating effectively. Although the Company has not identified any additional material weaknesses in 2012 and has taken steps to make the necessary improvements to remediate the material weaknesses it had identified, we cannot be certain that other weaknesses 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

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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.

Though we have remediated our prior material weaknesses, 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, 2012, approximately 44.2% 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 $9.7 million, or 1.6% of total gross loans, as of December 31, 2012, and $19.9 million, or 2.9% of total gross loans, as of December 31, 2011. An increase in non-performing loans could result in an increase in the provision for loan and lease 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, 2012, $388.2 million, or 64.9%, 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, $32.5 million, or 5.4%, were construction, land acquisition and development loans. Construction, land acquisition and development loans have the highest risk of uncollectability. An additional $110.1 million, or 18.4%, 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. 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.

Commercial real estate, commercial and industrial and construction, land acquisition and development loans tend to have larger balances than single family mortgage 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 and lease losses, or an increase in loan charge-offs, which could have an adverse impact on our results of operations and financial condition.

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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 $33.3 million as of December 31, 2012. Of those, loans in the amount of $196 thousand were not performing in accordance with the terms of the loan agreements. At December 31, 2012, there were no other loans to directors, officers and their related parties that 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. (For more information regarding loans to officers and directors and/or their related parties, please refer to Note 14 Related Party Transactions to our consolidated financial statements included in Item 8 and Item 13, Certain Relationships and Related Transactions, and Director Independence to this Annual Report on Form 10-K.)

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 or extensive charge-offs would materially decrease its net income. At December 31, 2012, the ALLL totaled $18.5 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. 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 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 an other- than- temporary-impairment (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 the credit-related impairments through a charge to earnings. During 2012, the Company s investment portfolio included four pooled trust preferred collateralized debt obligations (PreTSLs) on which the Company recognized total OTTI charges of $96 thousand primarily as a result of market developments. Though the Company sold all of its remaining PreTSLs during 2012 and held no PreTSLs in its investment portfolio as of December 31, 2012, changes in the expected cash flows of securities in its portfolio and/or prolonged price declines in future periods may result in additional impairment of the Company s investment securities that is other than temporary, which would require a charge to earnings. Due to the complexity of the calculations and assumptions used in determining whether an asset is impaired, the impairment disclosed may not accurately reflect the actual impairment in the future. In addition, to the extent that the 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 holds approximately $6.0 million in capital stock of the Federal Home Loan of Pittsburgh (FHLB) as of December 31, 2012. The Company must own such capital stock to qualify for membership in the Federal Home Loan Bank system which enables it to

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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 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 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 may 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 its operations. In addition, capital levels are 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 regularly evaluates its present and future capital requirements and needs and analyzes capital raising alternatives and options. Even if the Company succeeds in meeting its current regulatory capital requirements, it may need to raise additional capital in the future to support possible loan losses during future periods, to meet future regulatory capital requirements or for other reasons.

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.

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

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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.

If our information technology is unable to keep pace with our growth or industry developments, our financial performance may suffer.

Effective and competitive delivery of the Company s products and services increasingly depends on information technology resources and processes, both those provided internally as well as those provided through third party vendors. In addition to better serving customers, the effective use of technology can improve efficiency and help reduce costs. The Company s future success will depend, in part, upon its ability to address the needs of its customers by using technology to provide products and services to enhance customer convenience, as well as to create efficiencies in its operations. Many of the Company s competitors have greater resources to invest in technological improvements. Additionally, as technology in the financial services industry changes and evolves, keeping pace becomes increasingly complex and expensive. There can be no assurance that the Company will be able to effectively implement new technology-driven products and services, which could reduce its ability to compete effectively.

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 and appointed its current Chief Financial Officer (CFO) in August 2012. 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 addition, since August 2010, the Company has experienced turnover at the senior management level. The Company is currently searching for a new Chief Lending Officer and has added other key personnel. As a result of this 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.

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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. Regardless of whether customer and shareholder claims and legal actions 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 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. For additional discussion of the Company s current legal matters, refer to Item 3, Legal Proceedings to this Annual Report on Form 10-K.

The price of our common shares may fluctuate significantly, which may make it difficult for investors to resell common shares at a time or price 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, 2012, an average of 1,845 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 20 branches located throughout Lackawanna, Luzerne, Wayne and Monroe counties. At December 31, 2012, aggregate net book value of premises and equipment was $18.9 million. With the exception of the anticipated relocation of our Wilkes-Barre branch as described below and 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.

In January 2013, the Company received approval from the OCC to relocate its Wilkes-Barre, Pennsylvania branch office. The relocation to the new site, which is less than one mile from the current site, is anticipated to occur by the end of the second quarter of 2013. The lease obligation associated with the current site expires in May 2013. On February 11, 2013 the Company entered into a 12-year lease agreement for the new location, which commences April 1, 2013.

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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.

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. The Board had appointed a special litigation committee in January 2012 to investigate the matters raised in the Gray complaint. The special litigation committee has 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.

On September 5, 2012, Fidelity and Deposit Company of Maryland (F&D) filed an action against the Company and its subsidiary, First National Community Bank, as well as several current and former officers and directors of the Company, in the United States District Court for the Middle District of Pennsylvania. F&D has asserted a claim for the rescission of a directors and officers insurance policy and a bond that it had issued to the Company. On November 9, 2012, the Company and the Bank answered the claim and asserted counterclaims. The Company and the other defendants are defending the claims, specifically all parties have filed pre-discovery motions. The motions have been fully briefed and the parties are awaiting the Judge s rulings on the motions. At this time, the Company cannot reasonably determine the outcome or potential range of loss.

The Company has been subject to tax audits and is also a party to routine litigation involving various aspects of its business, 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, 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 returned to full quotation status on the OTCQB operated by the OTC Markets Group, Inc. on August 24, 2012 when the Company became fully compliant with regard to its regulatory reporting status. Previously, in the fourth quarter of 2010, the Company had been 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 principal market area for the Company s shares is northeastern Pennsylvania, although shares are held by

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residents of other states across the country. Quarterly market highs and lows and dividends paid for each of the past two years are presented below. These prices represent actual transactions.

	MARKET PRICE		DIVIDENDS PAID PER
	HIGH	LOW	SHARE
QUARTER	2012		2012
First	$ 4.35	$ 2.10	$ 0.00
Second	3.85	2.55	0.00
Third	4.00	2.71	0.00
Fourth	4.00	3.00	0.00

QUARTER	2011		2011
First	$ 4.74	$ 3.20	$ 0.00
Second	3.99	3.05	0.00
Third	3.50	2.50	0.00
Fourth	2.99	2.42	0.00

Holders

As of February 28, 2013 there were 1,926 holders of record of the Company s common shares.

Dividends

As of February 26, 2010, as a result of the Order and Agreement, the Company has suspended paying dividends indefinitely and will not resume paying dividends without prior permission from the OCC and the Reserve Bank.

Equity Compensation Plans

For more information regarding the Company s equity compensation plans, see Part III, Item 12 Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters to this Annual Report on Form 10-K.

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, the SNL Bank

Index for banks with $500 million to $1 billion in assets and the SNL Bank Index for banks with $1 billion to $5 billion in assets. The stock performance graph assumes that $100 was invested on December 31, 2007. 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.

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(*) 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.

Recent Sales of Unregistered Securities

On December 17, 2012, the Board of Directors granted 50 shares of the Company s authorized but unissued common shares to each active full and part-time employee in exchange for services provided during the fiscal year. There were 15,050 shares issued under this grant at a cost per share of $3.05, with a total cost of $46 thousand included in salary expense in 2012. This share grant was effected without registration under the Securities Act in reliance upon Section 2(3) of the Securities Act, as a non-sale distribution of securities by the Company. These shares were given to all employees of the Company as a share bonus and not as individual incentive compensation or in lieu of a cash payment, with no investment decision on the part of the recipients or receipt of value by the Company in return. There were no underwriters employed in the issuance of the securities or in connection with this transaction, and no proceeds were received by the Company for this stock grant. There have been no sales of unregistered securities during 2012.

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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.

	For the Years Ended December 31,				
	2012	**2011**	**2010**	**2009**	**2008**
Balance Sheet Data:					
Total assets	$ 968,274	$ 1,102,639	$ 1,167,298	$ 1,366,332	$ 1,313,759
Securities, available-for-sale	185,361	185,475	251,072	252,946	245,900
Securities, held-to-maturity	2,198	2,094	1,994	1,899	1,808
Net loans	579,396	659,044	735,813	917,516	956,674
Total deposits	854,613	957,136	982,436	1,071,608	952,892
Borrowed funds	53,903	83,571	137,604	217,467	245,197
Shareholders equity	36,925	39,925	32,055	63,084	100,342
Income Statement Data:					
Interest income	$ 37,027	$ 42,936	$ 55,471	$ 64,398	$ 73,451
Interest expense	9,218	13,867	21,868	25,196	33,242
Net interest income before provision for loan and lease losses	27,809	29,069	33,603	39,202	40,209
Provision for loan and lease losses	4,065	523	25,041	42,089	1,804
Non-interest income (loss)	4,283	12,949	1,282	(12,001)	7,812
Non-interest expenses	41,738	41,830	41,564	38,022	26,530
Income (loss) before income taxes	(13,711)	(335)	(31,720)	(52,910)	19,687
Provision (credit) for income taxes				(8,594)	4,604
Net income (loss)	(13,711)	(335)	(31,720)	(44,316)	15,083
Earnings per share, basic and diluted	(0.83)	(0.02)	(1.94)	(2.74)	0.95
Capital and Related Ratios:					
Cash dividends declared per share	$	$	$	$ 0.17	$ 0.46
Book value per share	2.24	2.43	1.95	3.87	5.59
Tier I leverage ratio	4.07%	4.72%	4.27%	5.94%	8.99%
Total risk-based capital to risk-adjusted assets	10.20%	11.35%	10.13%	10.54%	11.18%
Average equity to average total assets	3.97%	3.04%	4.10%	6.89%	8.12%
Tangible equity to tangible assets	3.75%	3.55%	2.67%	4.49%	6.94%

Selected Performance Ratios:					
Return on average assets	(1.35)%	(0.03)%	(2.44)%	(3.29)%	1.17%
Return on average equity	(34.09)%	(0.98)%	(59.44)%	(47.78)%	14.35%
Net interest margin	3.28%	3.10%	3.07%	3.35%	3.57%
Noninterest income/operating income (FTE)	9.72%	21.82%	2.42%	(21.00)%	9.24%
Asset Quality Ratios:					
Allowance for loan and lease losses/total loans	3.10%	3.07%	2.98%	2.40%	0.86%
Nonperforming loans/total loans	1.62%	2.93%	3.74%	2.77%	2.43%
Allowance for loan and lease losses/nonperforming loans	190.92%	104.60%	79.58%	86.44%	35.25%
Net charge-offs/average loans	0.97%	0.31%	2.84%	2.87%	0.12%

Note: Average balances were calculated using average daily balances. Average balances for loans included nonaccrual loans. Tax-equivalent adjustments were calculated using the prevailing statutory rate of 34.0 percent.

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

Management s discussion and analysis (MD&A) 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.

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

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, valuation of other real estate owned (OREO) 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.

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Allowance for Loan and Lease Losses

Management continually evaluates the credit quality of the Company s loan portfolio, and performs a formal review of the adequacy of the ALLL on a quarterly basis. The ALLL is established through a provision for loan losses charged to earnings and is maintained at a level management considers adequate to absorb estimated probable losses inherent in the loan portfolio as of the evaluation date. Loans, or portions of loans, determined by management to be uncollectible are charged off against the ALLL, while recoveries of amounts previously charged off are credited to the ALLL.

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 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 segment 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 risk rating category 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 are 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 the Company s securities valuation techniques.

On a quarterly basis, management evaluates individual investment securities classified as held-to-maturity or available-for-sale having unrealized losses to determine whether or not the security is other-than-temporarily-impaired (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 investment securities of $96 thousand, $798 thousand, and $4.3 million in 2012, 2011, and 2010, respectively, within the consolidated statements of operations. For 2012, 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, abandonment or conveyance of 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 acquisition, which establishes a new cost basis. 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. Subsequent to acquisition, valuations are periodically performed by management and the assets are carried at the lower of carrying amount or fair value less cost to sell. Fair value is determined through external

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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 as incurred.

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.

The Company records an 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. Management conducts quarterly assessments of all available evidence to determine the amount of deferred tax assets that will more-likely-than-not 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. Management s assumptions and estimates take into consideration its 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 the 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, 2012 and 2011, 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

Accounting Standards Update (ASU) No. 2011-04, Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRS , an update to ASC Topic 820 - Fair Value Measurement, results in common fair value measurement and disclosure requirements in U.S. GAAP and IFRS. The amendments in ASU No. 2011-04 include clarifications about the application of existing fair value measurement requirements and changes to principles for measuring fair value. ASU No. 2011-04 also requires additional disclosures about fair value measurements. ASU No. 2011-04 is required to be applied prospectively and is effective for interim and annual periods beginning after December 15, 2011. The Company adopted this new guidance for the quarter ended March 31, 2012. The adoption of this guidance did not have a material impact on the Company s consolidated financial statements; however, the adoption did have an impact on the Company s fair value disclosures.

ASU No. 2011-05, Presentation of Comprehensive Income, an update to ASC Topic 220 - Comprehensive Income, 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. The Company adopted this new guidance for the quarter ended March 31, 2012. Accordingly, the Company presents comprehensive income in a separate Statement of Comprehensive Income.

ASU No. 2011-11, Balance Sheet (Topic 210) - Disclosures about Offsetting Assets and Liabilities was issued in December 2011. 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 this 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. The adoption of ASU 2011-11 on January 1, 2013 will not have an effect on the operating results or financial position of the Company.

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ASU No. 2012-02 Intangibles-Goodwill and Other (Topic 350): Testing Indefinite-Lived Intangible Assets for Impairment was issued in July 2012. This update simplifies the guidance for testing the decline in realizable value (impairment) of indefinite-lived intangible assets other than goodwill. The amendment allows an entity the option to first assess qualitative factors to determine whether it is necessary to perform the quantitative impairment test. An organization electing to perform a qualitative assessment is no longer required to calculate the fair value of an indefinite-lived intangible asset unless the organization determines, based on a qualitative assessment, that it is more likely than not that the asset is impaired. This amendment is effective for annual and interim impairment tests performed for fiscal years beginning after September 15, 2012. Early adoption is permitted. The adoption of ASU 2012-02 on January 1, 2013 will not have an effect on the operating results or financial position of the Company.

ASU No. 2013-01 Balance Sheet (Topic 210): Clarifying the Scope of Disclosures about Offsetting Assets and Liabilities was issued in January 2013. This update clarifies the scope of transactions that are subject to the disclosures about offsetting, specifically that ordinary trade receivables and receivables are not in the scope of ASU No. 2011-11. ASU No. 2011-11 applies only to derivatives, repurchase agreements and reverse purchase agreements, and securities borrowing and securities lending transactions that are offset in accordance with specific criteria contained in FASB Accounting Standards Codification or subject to a master netting arrangement or similar agreement. ASU No. 2013-01 is effective for fiscal years beginning on or after January 1, 2013, and interim periods within those annual periods. The adoption of ASU 2013-01 on January 1, 2013 will not have an effect on the operating results or financial position of the Company.

ASU No. 2013-02 Comprehensive Income (Topic 220): Reporting of Amounts Reclassified Out of Accumulated Other Comprehensive Income was issued in February 2013. The objective of this update was to improve the transparency of reporting these reclassifications. The new amendments will require an organization to: present either on the face of the statement where income is presented or in the notes to the financial statements the effects on the line items of net income of significant amounts reclassified out of accumulated other comprehensive income; or cross reference to other disclosures currently required under GAAP for other reclassification items to be reclassified directly to income in their entirety in the same reporting period. The amendments apply to all public and private companies that report other comprehensive income. Public companies are required to comply with these amendments for all reporting periods, both interim and annual periods, beginning after December 15, 2012. The adoption of ASU 2013-02 on January 1, 2013 is not expected to have a material effect on the operating results or financial position of the Company.

EXECUTIVE OVERVIEW

The following overview should be read in conjunction with the MD&A in its entirety.

The Company reached two very important milestones in 2012: (i) returning to current SEC reporting status with the timely filing of its third quarter 2012 Quarterly Report on Form 10-Q; and (ii) its stock returned to open trading on the OTCQB. Reaching these milestones allowed management to focus on strategies and take actions aimed at reducing balance sheet risk and the levels of classified assets, cost control and revenue growth. These actions involved:

- Selling off higher-risk securities in its securities portfolio, including the Company s entire holdings of Pooled Trust Preferred securities (PreTSLs) and private label collateralized mortgage obligations (PLCMOs);
- Reducing levels of classified assets, including nonperforming loans and other real estate owned (OREO);

- Using excess liquidity to reduce borrowings at the Federal Home Loan Bank of Pittsburgh (FHLB); and

- Implementing a Reduction in Force and Voluntary Separation Program. The purpose of these actions was to align the Company s staffing model with its current asset size and transaction volume.

The Company reported a net loss of $13.7 million in 2012 compared to a $0.3 million net loss in 2011. Basic and diluted losses per share were $(0.83) per share in 2012 and $(0.02) per share in 2011. The increase in the net loss resulted primarily from a $8.7 million reduction in non-interest income, a $3.5 million increase in the provision for loan and lease losses and a $1.3 million decrease in net interest income. Non-interest expense decreased $92 thousand. Return on average assets and return on average equity were (1.35%) and (34.09%) in 2012, and (0.03%) and (0.98%) in 2011, respectively.

Total assets decreased $134.4 million, or 12.2%, to $968.3 million, at December 31, 2012, as compared to $1.10 billion at December 31, 2011. The reduction in the balance sheet was driven by a $102.5 million, or 10.7%, decrease in total deposits. In addition, the Company repaid FHLB advances totaling $29.7 million. Net loans decreased $79.6 million or 12.1%, while investment securities were unchanged. These changes caused a $53.4 million or 31.7% reduction in cash and cash equivalents.

Total shareholders equity decreased $3.0 million to $36.9 million at December 31, 2012 from $39.9 million at the end of 2011. The $13.7 million net loss was partially offset by a $10.7 million positive change in other comprehensive income. The total risk-based capital ratios for the Company and the Bank were 10.20% and 11.79%, respectively at December 31, 2012, compared to 11.35% and 11.73%, respectively at December 31, 2011.

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Net Interest Income

2012 compared to 2011

Net interest income is the difference between interest revenue, interest and fees on interest-earning assets and interest expense, interest paid to the Company s depositors and interest paid on external borrowings. Net interest income represents the largest component of the Company s operating income and, as such, is the primary determinant of profitability. Net interest income is impacted by variations in the volume, rate and composition of earning assets and interest-bearing liabilities, changes in general market rates and the level of nonperforming assets. The tax-equivalent net interest margin 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 Company s tax-equivalent net interest margin improved 18 basis points to 3.28% in 2012 from 3.10% in 2011. 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 3.15% in 2012, an increase of 15 basis points compared to 3.00% in 2011.

Net interest income on a tax-equivalent basis decreased $1.9 million to $30.6 million for 2012 compared with $32.5 million for 2011. During 2012, lower average securities and loan balances and lower yields on interest-earning assets negatively impacted our net interest income. The yield on average earning assets declined 16 basis points to 4.27% in 2012 from 4.43% in 2011, which primarily resulted from a 24 basis point decrease in the tax-equivalent yield on the loan portfolio. The effects of the decreased yields were partially offset by a 31 basis point decline in the cost of average interest-bearing liabilities and lower volume of average interest-bearing liabilities as compared to the previous year. The Federal Reserve kept interest rates stable during 2012 leaving the Federal Funds rate at 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 adjust upward. In addition, most of the time deposits in the Company s funding portfolio matured and continued to renew at lower market rates in 2012.

Average loans totaled $653.0 million for the year ended December 31, 2012, a decrease of $70.7 million, or 9.8%, compared to the same period for 2011. The reduction is primarily due to the net pay downs of commercial and industrial loans and real estate loans of $64.2 million and $19.0 million, respectively. During 2012, loan satisfactions continued to outpace originations. Several large commercial loan relationships were lost upon the sale of the businesses. In addition, approximately $56.6 million in commercial loans to a related party, which were fully secured by deposit accounts, were paid off during 2012. Interest income on a tax-equivalent basis for loans decreased $5.0 million due to the decrease in average loans and a 24 basis point decrease in the average loan yield as loans continued to reset at lower rates. In addition, competition within the Company s market area escalated, causing pricing pressures that led to new loans being originated at lower rates as compared to 2011, and the reduction of rates on existing loans in order to retain business.

The interest income that would have been earned on non-accrual and restructured loans outstanding at December 31, 2012, 2011 and 2010 in accordance with their original terms approximated $1.4 million, $2.2 million, and $2.9 million, respectively. Interest income on impaired loans of $376 thousand, $238 thousand, and $619 thousand was recognized based on payments received in 2012, 2011 and 2010.

Average investment securities totaled $199.2 million, a decrease of $33.6 million, or 14.4%, in 2012 compared to 2011. Interest income on a tax equivalent basis for investment securities decreased $1.6 million, primarily due to reinvestment of pay downs and maturities into more lower-yielding securities. Average interest-bearing deposits in other banks declined $12.4 million as the Company decreased its holdings of liquid assets. Interest income on interest-bearing deposits in other banks increased $12 thousand as the 5 basis point increase in the yield more than offset a $12.4 million decrease in volume.

Average interest-bearing liabilities totaled $822.2 million for the year ended December 31, 2012, a decrease of $147.5 million, or 15.2%, during 2012 compared to the same period in 2011, due to a decrease in interest-bearing deposits of $108.3 million, or 12.6%, and a decrease in borrowings of $39.1 million, or 35.0%.

The Company experienced reductions in the average balances for all major deposit categories. Specifically, average interest-bearing demand deposits, savings deposits, time deposits over $100 thousand, and other time deposits decreased $35.3 million, $1.7 million, $10.8 million and $60.6 million, respectively. During 2012, the Company continued its pricing strategy to reduce its cost of funds and to direct deposit growth to short-term maturity products. The Company continued to reposition maturing longer term time deposits into short-term products, whenever possible, and allowed the residual to run-off. The Company used a portion of the net proceeds received from the loan and investment portfolios 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 25, 14, 34, and 26 basis points respectively, from the same period in 2011. The average cost of interest-bearing deposits decreased by 30 basis points to 0.72% in 2012 from 1.02% in 2011. The decrease in the rate on interest-bearing deposits was driven primarily by the pricing decreases that resulted from the Company s pricing strategy. Average borrowed funds and other interest-bearing liabilities totaled $72.6 million for the year ended December 31, 2012, a decrease of $39.1 million, or 35.0%, compared to 2011. During 2012, the Company continued

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to employ its funds management plan implemented in 2010 and to pay off term borrowings. The Company used excess liquidity from loan repayments and sales of investment securities to pay off a portion of its term borrowings. The Company did not enter into any new term borrowings in 2012. The 71 basis point increase in the cost of borrowed funds for the year ended December 31, 2012 is primarily attributable to the repayment during 2012 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 related cost of borrowed funds.

2011 compared to 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.

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.

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

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The following table reflects the components of net interest income for each of the three years ended December 31, 2012, 2011 and 2010:

	Year ended December 31, 2012			Year ended December 31, 2011			Year ended December 31, 2010		
(dollars 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)	$ 619,151	$ 28,153	4.55%	$ 688,546	$ 32,831	4.77%	$ 826,188	$ 42,016	5.09%
Loans-tax free (4)	33,863	2,174	6.42%	35,150	2,479	7.05%	52,794	3,582	6.78%
Total Loans (1)(2)	653,014	30,327	4.64%	723,696	35,310	4.88%	878,982	45,598	5.19%
Securities-taxable	117,800	3,318	2.82%	123,854	3,198	2.58%	160,690	5,340	3.32%
Securities-tax free	81,368	5,956	7.32%	108,955	7,717	7.08%	121,367	8,470	6.98%
Total Securities (1)(5)	199,168	9,274	4.66%	232,809	10,915	4.69%	282,057	13,810	4.90%
Interest-bearing deposits in other banks and federal funds sold	79,571	190	0.24%	91,932	178	0.19%	68,949	161	0.23%
Total Earning Assets	931,753	39,791	4.27%	1,048,437	46,403	4.43%	1,229,988	59,569	4.84%
Non-earning assets	100,979			103,685			97,793		
Allowance for loan and lease losses	(20,526)			(24,108)			(25,587)		
Total Assets	$ 1,012,206			$ 1,128,014			$ 1,302,194		
LIABILITIES AND SHAREHOLDERS EQUITY									
Interest-bearing Liabilities									
Interest-bearing demand deposits	$ 299,938	699	0.23%	$ 335,201	1,615	0.48%	$ 353,579	3,442	0.97%
Savings deposits	87,818	161	0.18%	89,494	287	0.32%	93,598	502	0.54%
Time deposits over $100,000	170,356	1,476	0.87%	181,146	2,193	1.21%	225,446	3,416	1.52%
Other time deposits	191,462	3,048	1.59%	252,081	4,664	1.85%	283,214	6,832	2.41%
Total Interest-bearing Deposits	749,574	5,384	0.72%	857,922	8,759	1.02%	955,837	14,192	1.48%
Borrowed funds and other interest-bearing liabilities	72,593	3,834	5.28%	111,709	5,108	4.57%	196,606	7,676	3.90%
Total Interest-Bearing Liabilities	822,167	9,218	1.12%	969,631	13,867	1.43%	1,152,443	21,868	1.90%
Demand deposits	128,254			107,763			82,400		
Other liabilities	21,568			16,301			13,982		
Shareholders equity	40,217			34,319			53,369		
Total Liabilities and Shareholders Equity	$ 1,012,206			$ 1,128,014			$ 1,302,194		
Net Interest Income/Interest Rate Spread (6)		30,573	3.15%		32,536	3.00%		37,701	2.94%
Tax equivalent adjustment		(2,764)			(3,467)			(4,098)	
Net interest income as reported		$ 27,809			$ 29,069			$ 33,603	
Net Interest Margin (7)			3.28%			3.10%			3.07%

(1) Interest income is presented on a tax-equivalent basis using a 34% rate for 2012, 2011 and 2010.

(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 assets, specifically 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%.

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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.

	December 31, 2012 vs. 2011 Increase (Decrease)			December 31, 2011 vs. 2010 Increase (Decrease)		
(in thousands)	Due to Volume	Due to Rate	Total Change	Due to Volume	Due to Rate	Total Change
Interest Income:						
Loans - taxable	$ (3,204)	$ (1,474)	$ (4,678)	$ (6,682)	$ (2,503)	$ (9,185)
Loans - tax free	(88)	(217)	(305)	(1,239)	136	(1,103)
Total loans	(3,292)	(1,691)	(4,983)	(7,921)	(2,367)	(10,288)
Securities - taxable	(161)	281	120	(1,086)	(1,056)	(2,142)
Securities - tax free	(2,012)	251	(1,761)	(877)	124	(753)
Total securities	(2,173)	532	(1,641)	(1,963)	(932)	(2,895)
Interest-bearing deposits in other banks and federal funds sold	(26)	38	12	48	(31)	17
Total interest income	(5,491)	(1,121)	(6,612)	(9,836)	(3,330)	(13,166)
Interest Expense:						
Interest-bearing demand deposits	(155)	(761)	(916)	(4)	(1,823)	(1,827)
Savings deposits	(5)	(121)	(126)	(21)	(194)	(215)
Time deposits over $100,000	(124)	(593)	(717)	(605)	(618)	(1,223)
Other time deposits	(1,023)	(593)	(1,616)	(695)	(1,473)	(2,168)
Total interest-bearing deposits	(1,307)	(2,068)	(3,375)	(1,325)	(4,108)	(5,433)
Borrowed funds and other interest-bearing liabilities	(1,981)	707	(1,274)	(3,721)	1,153	(2,568)
Total interest expense	(3,288)	(1,361)	(4,649)	(5,046)	(2,955)	(8,001)
Net Interest Income	$ (2,203)	$ 240	$ (1,963)	$ (4,790)	$ (375)	$ (5,165)

(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.

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 associated 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.

2012 compared to 2011

The provision for loan and lease losses was $4.1 million in 2012 as compared to $0.5 million in 2011. The increase primarily resulted from an increase in charge-offs of classified credits, specifically one larger commercial credit totaling $3.1 million that was charged off during the third quarter of 2012.

2011 compared to 2010

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.

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Non-Interest Income:

The following table lists the components of non-interest income for the years ended December 31, 2012, 2011 and 2010:

Non-Interest Income

(in thousands)	2012	2011	2010
Deposit service charges	$ 2,985	$ 3,105	$ 3,274
Net (loss) gain on the sale of securities	(1,712)	5,114	(1,714)
Other-than-temporary-impairment loss on securities	(96)	(798)	(4,271)
Net gain on the sale of loans held for sale	859	755	1,198
Net gain on the sale of other real estate owned	305	2,528	403
Net gain (loss) on the sale of other assets		20	(60)
Loan related fees	514	673	1,009
Income on bank-owned life insurance	692	787	740
Other	736	765	703
Total non-interest income	$ 4,283	$ 12,949	$ 1,282

2012 compared to 2011

Total non-interest income decreased $8.7 million to $4.3 million in 2012 from $12.9 million in 2011. The 66.9% decrease resulted primarily from a $1.7 million loss on the sale of investment securities in 2012 compared to a $5.1 million gain on the sale of investment securities in 2011, coupled with a $2.2 million reduction in net gains on the sale of OREO to $305 thousand in 2012 from $2.5 million in 2011.

During 2012, the Company recorded a $1.7 million net loss on the sale of investment securities with an amortized cost of $47.8 million. Specifically, the Company sold its entire holdings of private label collateralized mortgage obligations (PLCMOs) with an amortized cost of $37.5 million and pooled trust preferred collateralized debt obligation securities (PreTSLs) with an amortized cost of $10.3 million. Management decided to sell these securities as part of its strategy to reduce the amount of market risk and levels of classified assets on the balance sheet.

The Company recorded a $305 thousand net gain on the sale of 17 OREO properties. The Company continues to aggressively seek buyers for its OREO properties.

2011 compared to 2010

During 2011, total non-interest income increased by $11.6 million to $12.9 million from $1.3 million in 2010. The $11.6 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 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.

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Non-Interest Expense

The following table lists the major components of non-interest expense for the years ended December 31, 2012, 2011 and 2010:

Non-Interest Expense

(in thousands)	2012	2011	2010
Salaries and employee benefits	$ 14,702	$ 14,117	$ 13,077
Occupancy expense	2,225	2,508	3,228
Equipment expense	1,723	1,654	1,763
Advertising expense	614	629	712
Data processing expense	2,141	2,036	2,023
FDIC assessment	2,216	2,657	2,828
Bank shares tax	882	1,103	1,020
Expense of other real estate	2,027	3,720	7,521
Provision (credit) for off-balance sheet commitments	358	(423)	(678)
Legal expense	4,233	2,716	1,075
Professional fees	4,385	5,413	2,066
Insurance expense	896	685	362
Loan collection expenses	765	780	647
Other operating expenses	4,571	4,235	5,920
Total non-interest expense	$ 41,738	$ 41,830	$ 41,564

2012 compared to 2011

Total non-interest expense decreased $92 thousand or 0.2%, to $41.7 million in 2012 as compared to 2011. The change in non-interest expense resulted primarily from a $1.7 million decrease in OREO expense, a $1.0 million decrease in professional fees, a $0.4 million decrease in the FDIC assessment, and a $0.3 million decrease in occupancy expense. These decreases were partially offset by increases in legal expenses of $1.5 million, the provision for off-balance sheet commitments of $0.8 million and salaries and benefits expense of $0.6 million.

Other real estate expense decreased by $1.7 million, or 45.5%, in 2012 as compared to 2011 primarily due to a $1.1 million reduction in impairment charges. In addition, real estate taxes and legal expenses decreased $0.4 million and $0.2 million, respectively, comparing 2012 to 2011. The reduction in impairment is primarily attributable to the stabilization of real estate values and a reduction in the number of properties held in OREO.

Professional fee expense decreased $1.0 million in 2012 as compared to 2011. Despite the decrease, professional fee expense remained elevated for the majority of 2012. Upon returning to current SEC reporting status with the filing with the filing of its third quarter 2012 Form 10-Q, the Company began reducing its reliance on outside consulting and professional services and expects these costs to continue to decline in 2013.

FDIC assessment expense decreased $0.4 million in 2012 as a result of the decline in the level of average assets. The Bank s risk-profile remained a Category III in 2012.

Occupancy expense decreased $0.3, or 11.3%, in 2012 as compared to 2011. The decrease was primarily attributable to reductions in repairs and maintenance and utility costs.

Regulatory oversight, SEC compliance-related costs and other legal matters continued to impact legal fees in 2012 and resulted in a $1.5 million increase in legal expense as compared to 2011.

The provision for off-balance sheet commitments increased $0.8 million and resulted in the Company recording a $0.4 million charge in 2012, compared to a $0.4 million credit in 2011. The increase in the provision is primarily attributable to an increase in the Bank s construction loan commitments.

Salary and employee benefit costs, which accounted for 35.2% of total non-interest expense in 2012, increased $0.6 million or 4.1% to $14.7 million in 2012 compared to $14.1 million in 2011. Salary expense increased $0.5 million, which was attributable to annual employee merit increases, a separation agreement entered into with the Company s former Chief Financial Officer, several program

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initiatives implemented in 2012, and an employee stock grant. Employee benefits expense increased $0.1 million, due primarily to the ratification of a 401 (k) feature to the Company s profit sharing plan.

On August 24, 2012, the Bank entered into a Separation Agreement and Release with the former Chief Financial Officer upon his resignation, which became effective August 31, 2012. Pursuant to the Separation Agreement, the Company agreed to pay his salary and health insurance benefits through March 1, 2013. Salary and benefits expense of $91 thousand under this agreement were recognized in 2012.

In October 2012, the Company implemented a reduction in force, which eliminated nine positions, and a voluntary separation program in an effort to better align the number of employees with the reduced asset size of the bank and transaction volumes. The voluntary separation program was offered to full-time employees who have at least ten years of service and who have attained the age of 60 years old by December 31, 2012. As of December 31, 2012, there were a total of 11 employees who had accepted the separation offer. Employees affected by the reduction in force and employees opting for the voluntary separation program received separation packages that included separation pay and medical benefit assistance for a period of time depending on their years of service. The Company recognized $275 thousand in salaries and benefits expense in 2012 upon implementation of these programs. As of December 31, 2012, the Company had 298 full-time equivalent employees on staff as compared to 336 on December 31, 2011.

On December 17, 2012, the Board of Directors granted 50 shares of the Company s common stock to each active full and part time employee. There were 15,050 shares issued under this grant at a cost per share of $3.05, with a total cost of $46 thousand included in salary expense in 2012.

With regard to employee benefits expense, on April 25, 2012, the Board of Directors ratified an amendment to the defined contribution profit sharing plan to include the provisions under section 401(k) of the Internal Revenue Code (401(k)). The 401(k) feature of the plan, which became effective on September 1, 2012, permits employees to make voluntary salary deferrals, either pre-tax or Roth, up to the dollar limit prescribed by law. The Company may make discretionary matching contributions equal to a uniform percentage of employee salary deferrals. Company discretionary matching contributions are determined each year by management. For 2012, the Company matched 50.0% of employee salary deferrals up to 4.0% for each employee. Company matching contributions to the 401(k) Plan totaled $41 thousand in 2012.

2011 compared to 2010

During 2011, total non-interest expense increased by $0.3 million or 0.6%, from 2010 primarily due to a $3.8 million 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

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and replacement senior officers and merit increases. 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.

Provision for Income Taxes

The Company did not record a provision or benefit for income taxes for the years ended December 31, 2012, 2011 and 2010. In 2012, the Company recorded a $6.7 million valuation charge against its deferred tax assets increasing the valuation allowance to $34.5 million at December 31, 2012 from $27.8 million at December 31, 2011. 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.

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.

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 $134.4 million, or 12.2%, to $968.3 million, at December 31, 2012, as compared to $1.10 billion at December 31, 2011. The reduction in the balance sheet was driven by a $102.5 million or 10.7% decrease in total deposits. In addition, the Company repaid FHLB advances totaling $29.7 million. Net loans decreased $79.6 million or 12.1%, while investment securities were unchanged. The decline in deposits, partially offset by the decrease in loans resulted in a $53.4 million or 31.7% reduction in cash and cash equivalents.

Total shareholders   equity decreased $3.0 million to $36.9 million at December 31, 2012 from $39.9 million at the end of 2011. The $13.7 million net loss was partially offset by a $10.7 million positive change in other comprehensive income. The Company did not pay any dividends in 2012 or 2011. The Company suspended paying dividends in 2010 to conserve capital and comply with regulatory requirements.

Securities

The Company   s investment securities portfolio provides a source of liquidity needed to meet expected loan demand and provides a source of interest income to increase our profitability. Additionally, the Company utilizes the investment securities portfolio to meet pledging requirements. Investment 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, with unrealized holding gains and losses reported as a component of shareholders equity in accumulated comprehensive income, net of tax. The Company determines the appropriate classification of investment securities at the time of purchase. The decision to purchase or sell investment 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. Investment 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, 2012, the Company s investment portfolio was comprised principally of taxable and tax-exempt obligations of states and political subdivisions and obligations of U.S. government-sponsored agencies, including residential mortgage-backed securities and collateralized mortgage obligations (CMOs). There was one security issuer, St. Clair County, IL School District, whose aggregate carrying value exceeded 10.0% of Shareholders equity as of December 31, 2012. The aggregate carrying value of the securities of this issuer was $4.0 million.

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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)	**2012**	**2011**	**2010**
Available-for-sale			
Obligations of U.S. government agencies	$ 1,891	$ 8,048	$ 8,307
Obligations of state and political subdivisions	103,501	96,161	111,353
Collateralized mortgage obligations:			
Government-sponsored agency	9,103	8,468	77,816
Private label		36,256	
Residential mortgage-backed securities:			
Government-sponsored agency	69,456	31,393	49,120
Pooled trust preferred senior class		1,604	1,422
Pooled trust preferred mezzanine class		2,197	1,647
Corporate debt securities	410	342	395
Equity securities	1,000	1,006	1,012
Total securities available-for-sale	$ 185,361	$ 185,475	$ 251,072
Held-to-maturity			
Obligations of state and political subdivisions	$ 2,198	$ 2,094	$ 1,994

In 2011, the Company sold most of its holdings of U.S. Government agency 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.

However, during 2012, management aligned its investment strategy with the Company s overall corporate strategy aimed at reducing balance sheet risk and the levels of classified assets. As part of this shift in focus, management decided to sell the Company s investment securities that posed a higher market risk and/or were considered classified assets. Specifically, the Company sold its entire holdings of both Pooled Trust Preferred securities (PreTSLs) and PLCMOs. Management reinvested a portion of the proceeds in pooled home equity conversion mortgages of a U.S. Government agency, which are insured by the U.S. Federal Government.

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The following table sets forth the maturities of available-for-sale securities and held-to-maturity securities, based on carrying value at December 31, 2012 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.

	Decmeber 31, 2012						
(dollars 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	$	$	$	$ 1,891	$	$	$ 1,891
Yield				4.22%			4.22%
Obligations of state and political subdivisions (1)		1,118	31,613	70,770			103,501
Yield		6.15%	5.03%	7.26%			6.56%
Corporate debt securities				410			410
Yield				0.93%			0.93%
Collateralized Mortgage Obligations:							
Government-sponsored agencies					9,103		9,103
Yield					2.42%		2.42%
Residential mortgage-backed securities:							
Government-sponsored agencies					69,456		69,456
Yield					1.92%		1.92%
Equity securities (2)						1,000	1,000
Yield						4.15%	4.15%
Total available-for-sale securities	$	$ 1,118	$ 31,613	$ 73,071	$ 78,559	$ 1,000	$ 185,361
Weighted yield	0.00%	6.15%	5.03%	7.14%	1.98%	4.15%	4.57%
Held-to-maturity securities							
Obligations of state and political subdivisions	$	$	$ 2,198	$	$	$	$ 2,198
Yield			7.33%				7.33%
Total held-to-maturity securities	$	$	$ 2,198	$	$	$	$ 2,198
Weighted yield	0.00%	0.00%	7.33%	0.00%	0.00%	0.00%	7.33%

(1) Yields on state and municipal securities have been adjusted to tax-equivalent yields using a 34.0% federal income tax rate.

(2) Yield represents 2012 actual return.

Other-Than-Temporary Impairment (OTTI)

Management tests the Company s investment securities for OTTI following 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 investment 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 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.

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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, 2012, management has determined that the decreases in estimated fair value of the securities it holds in its portfolio are temporary.

OTTI of Pooled Trust Preferred Collateralized Debt Obligations:

At December 31, 2011, the Company s PreTSLs were comprised of four securities that were collateralized by debt issued by bank holding companies and insurance companies. The Company divested its holdings of PreTSLs during 2012 and held no such securities at December 31, 2012. At December 31, 2011, the PreTSLs, which had an aggregate amortized cost of $10.6 million and an estimated fair value of $3.8 million, had depreciated 81.7% and 64.0% from their current face values and amortized cost, respectively. The Company held one senior tranche and three mezzanine tranches. All of the securities possessed credit ratings below investment grade. 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 12.09% 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. At June 30, 2012, the Company had determined that the estimate of projected discounted cash flows it expected to receive on its PreTSLs was less than the securities carrying value, and as a result an additional credit-related impairment charge to earnings of $96 thousand was recorded, which was the total of OTTI charges recorded during 2012.

During the fourth quarter of 2012, the market for these securities began to improve as some of the bank holding companies and insurance companies that had previously deferred payments had cured. As a result, the Company s unrealized loss position related to these securities improved. In an effort to reduce balance sheet risk and the levels of classified assets, management decided to sell all four PreTSLs in the Company s portfolio. The Company realized gross gains of $848 thousand on the sale of PreTSLs IX and XI and gross losses of $3.0 million on the sale of PreTSLs XIX and XXVI. The $6.8 million that was identified as the non-credit portion of OTTI recorded for PreTSLs in prior years was included in the determination of net income and was reversed from accumulated other comprehensive income.

For the years ended December 31, 2011 and 2010, the Company had 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 were less than the securities carrying value, resulting in impairment charges to earnings for the years ended December 31, 2011 and 2010, of $0.8 million and $4.3 million, respectively. The cumulative impairment charges at December 31, 2011 and 2010 amounted to $8.6 million and $22.6 million, respectively. The decrease in cumulative impairment charges in 2011 related to the sale of four PreTSLs in 2011, 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)		**2012**		**2011**		**2010**
Beginning Balance January 1	$	8,619	$	22,598	$	20,649
Credit losses on debt securities for which OTTI was not previously recognized						
Additional credit losses on debt securities for which OTTI was previously recognized		96		798		4,271
Less: Sale of PLCMOs for which OTTI was previously recognized						(2,322)
Less: Sale of PreTSLs for which OTTI was previously recognized		(8,715)		(14,777)		
Ending Balance, December 31	$		$	8,619	$	22,598

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Investments in FHLB and FRB stock, which have limited marketability, are carried at cost and totaled $7.3 million and $9.7 million at December 31, 2012 and 2011, respectively. Management noted no indicators of impairment for the FHLB of Pittsburgh and the FRB during 2012.

Loans

During 2012, loan payoffs exceeded loan originations, specifically for commercial and industrial and commercial real estate loans, which resulted in a $79.6 million or 12.1% decrease in net loans to $579.4 million at December 31, 2012, from $659.0 million at December 31, 2011. Despite the decrease, net loans represented 59.8% of total assets at December 31, 2012 compared to 59.7% at December 31, 2011. Historically, commercial lending activities have represented a significant portion of the Company s loan portfolio. This includes commercial and industrial loans, commercial real estate loans and construction, land acquisition and development loans.

From a collateral standpoint, a majority of the Company s loan portfolio consisted of loans secured by real estate. Real estate secured loans, which include commercial real estate, construction, land acquisition and development, residential real estate loans and home equity lines of credit (HELOCs), declined by $21.5 million, or 5.2%, to $388.2 million at December 31, 2012, from $409.7 million at December 31, 2011. Despite the decrease, real estate secured loans as a percentage of total gross loans increased to 59.3% of the loan portfolio at December 31, 2012 from 54.5% as of December 31, 2011.

Commercial and industrial loans decreased $64.1 million, or 36.8%, during the year to $110.1 million at December 31, 2012 from $174.2 million at December 31, 2011. Loans secured by commercial real estate decreased $24.7 million, or 9.6%, to $231.8 million at December 31, 2012 from $256.5 million at December 31, 2011. Commercial and industrial loans consist primarily of equipment loans, working capital financing, revolving lines of credit and loans secured by cash and marketable securities. Commercial real estate loans include long-term commercial mortgage financing and are primarily secured by first or second lien mortgages. During 2012, approximately $56.6 million in commercial loans to a related party, which were fully secured by deposit accounts, were paid off. In addition, at the end of 2012, two commercial customers with significant lending relationships sold their businesses. As a result, the loans associated with these relationships were paid off. Construction, land acquisition and development loans decreased $1.0 million, or 3.0%, during the year to $32.5 million at December 31, 2012 from $33.5 million at December 31, 2011. The Company continues to monitor its exposure of this portfolio segment.

Residential real estate loans totaled $90.2 million at December 31, 2012, an increase of $10.2 million or 12.7% from $80.0 million at December 31, 2011. The components of residential real estate loans include fixed rate mortgage loans and home equity loans. Home equity lines of credit (HELOCs) are not included in this category but are included in consumer loans. The Company primarily underwrites fixed-rate purchase and refinance of residential mortgage loans for sale in the secondary market to reduce interest rate risk and provide funding for additional loans. However, during the third quarter of 2012, the Company began holding 15- and 20-year mortgages in the loan portfolio rather than selling these loans in order to provide additional interest income based on underlying yields.

Consumer loans decreased $2.0 million, or 1.8%, during the year to $109.8 million at December 31, 2012 from $111.8 million at December 31, 2011.

Loans to state and municipal governments remained relatively unchanged and totaled $23.4 million at December 31, 2012, compared to $23.5 million at December 31, 2011.

Details regarding the loan portfolio for each of the last five years ended December 31 are as follows:

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Loan Portfolio Detail

(in thousands)	2012	2011	December 31, 2010	2009	2008
Residential real estate	$ 90,228	$ 80,056	$ 87,925	$ 98,517	$ 140,067
Commercial real estate	231,835	256,508	256,327	321,326	320,302
Construction, land acquisition and development	32,502	33,450	77,395	98,383	130,546
Commercial and industrial	110,073	174,233	197,697	219,889	219,821
Consumer	109,783	111,778	110,853	164,670	119,909
State and political subdivisions	23,354	23,496	27,739	36,780	34,334
Total loans, gross	597,775	679,521	757,936	939,565	964,979
Unearned discount	(103)	(159)	(225)	(298)	(380)
Net deferred loan fees and costs	260	516	677	707	329
Allowance for loan and lease losses	(18,536)	(20,834)	(22,575)	(22,458)	(8,254)
Loans, net	$ 579,396	$ 659,044	$ 735,813	$ 917,516	$ 956,674

The following schedule shows the re-pricing distribution of loans outstanding as of December 31, 2012. Also provided are those amounts classified according to sensitivity to changes in interest rates:

Loan Repricing Distribution

	December 31, 2012			
(in thousands)	Within One Year	One to Five Years	Over Five Years	Total
Residential real estate	$ 17,772	$ 15,189	$ 57,267	$ 90,228
Commercial real estate	21,022	34,415	176,398	231,835
Construction, land acquisition and development	3,730	15,511	13,261	32,502
Commercial and industrial	50,819	34,888	24,366	110,073
Consumer	35,476	69,232	5,075	109,783
State and political subdivisions	79	4,527	18,748	23,354
Total	$ 128,898	$ 173,762	$ 295,115	$ 597,775
Loans with predetermined interest rates	$ 10,312	$ 107,085	$ 81,846	$ 199,243
Loans with floating rates	118,586	66,677	213,269	398,532
Total	$ 128,898	$ 173,762	$ 295,115	$ 597,775

Loan Concentrations: At December 31, 2012, 2011 and 2010, the Bank s loan portfolio was concentrated in loans in the following industries.

Loan Concentrations

	December 31,					
	2012		2011		2010	
(in thousands)	Amount	% of Gross Loans	Amount	% of Gross Loans	Amount	% of Gross Loans
Land subdivision	$ 17,658	2.95%	$ 19,626	2.89%	$ 29,518	3.89%
Shopping centers/complexes	21,068	3.52%	18,722	2.76%	26,298	3.47%
Gas stations	5,245	0.88%	17,118	2.52%	18,289	2.41%
Office complexes/units	9,801	1.64%	16,091	2.37%	16,842	2.22%
Solid waste landfills	13,233	2.21%	42,270	6.22%	52,270	6.90%
Hotels	13,596	2.27%	13,771	2.03%	15,357	2.03%

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Asset Quality

Loans that management has the intent and ability to hold for the foreseeable future or until maturity or payoff are stated at the amount of unpaid principal, net of unearned interest, deferred loan fees and costs, and reduced by the ALLL. The ALLL is established through a provision for loan losses charged to earnings.

The Company manages credit risk through the efforts of loan officers, the loan review function, and the Loan Quality and the ALLL management committees, as well as oversight from the Board of Directors, along with the application of policies and procedures designed to foster sound underwriting and credit monitoring practices. The Company continually evaluates this process to ensure it is reacting to problems in the loan portfolio in a timely manner, although, as is the case with any financial institution, a certain degree of credit risk is dependent in part on local and general economic conditions that are beyond the Company s control.

Under the Company s risk rating system, loans rated pass/watch, special mention, substandard, doubtful, or loss are reviewed regularly as part of the Company s risk management practices. The Company s Loan Quality Committee, which consists of key members of senior management and credit administration, meets monthly or more often as necessary to review individual problem credits and workout strategies and reports to the Board of Directors.

A loan is considered impaired when it is probable that the Bank will be unable to collect all amounts due (including principal and interest) according to the contractual terms of the note and loan agreement. For purposes of the Company s analysis, loans that are identified as troubled debt restructurings (TDRs), loans rated substandard and non-accrual, and loans that are identified as doubtful or loss are considered impaired. Impaired loans are analyzed individually for impairment. The Company utilizes the fair value of collateral method for collateral dependent loans, which make up the majority of the Company s impaired loans. A loan is considered to be collateral dependent when repayment of the loan is expected to be provided through the liquidation of the collateral held. For impaired loans that are secured by real estate, external appraisals are obtained annually, or more frequently as warranted, to ascertain a fair value so that the impairment analysis can be updated. Should a current appraisal not be available at the time of impairment analysis, other sources of valuation such as current letters of intent, broker price opinions or executed agreements of sale may be used. For non-collateral dependent loans, the Company measures impairment based on the present value of expected future cash flows, net of disposal costs, discounted at the loan s original effective interest rate.

Loans to borrowers that are experiencing financial difficulty that are modified and result in the Company granting concessions to the borrower are classified as TDRs and are considered to be impaired. Concessions granted under a troubled debt restructuring generally involve an extension of a loan s stated maturity date, a reduction of the stated interest rate, payment modifications, or a combination of these modifications. Non-accrual TDRs are returned to accrual status if principal and interest payments, under the modified terms, are brought current, are performing under the modified terms for six consecutive months, and management believes that collection of the remaining interest and principal is probable.

Non-performing loans are monitored on an ongoing basis as part of the Company s loan review process. Additionally, work-out efforts continue and are actively monitored for non-performing loans and OREO through the Loan Quality Committee. Potential loss on non-performing assets is generally evaluated by comparing the outstanding loan balance to the fair market value of the pledged collateral.

Loans are placed on non-accrual when a loan is specifically determined to be impaired or when management believes that the collection of interest or principal is doubtful. This generally occurs when a default of interest or principal has existed for 90 days or more, unless such loan is well secured and in the process of collection, or when management becomes aware of facts or circumstances that the loan would default before 90 days. The Company determines delinquency status based on the number of days since the date of the borrower s last required contractual loan payment. When the interest accrual is discontinued, all unpaid interest income is reversed and charged back against current earnings. Any cash payments received are applied, first to the outstanding loan amounts, then to the recovery of any charged-off loan amounts. Any excess is treated as a recovery of lost interest. A non-accrual loan is returned to accrual status when the loan is current as to principal and interest payments, is performing according to contractual terms for six consecutive months and future payments are reasonably assured.

Management actively manages impaired loans in an effort to reduce loan balances by working with customers to develop strategies to resolve borrower difficulties, through sale or liquidation of collateral, foreclosure, and other appropriate means. Real estate values appear to have stabilized. However, further real estate devaluations or weakening in economic conditions in our market area could negatively impact asset quality, causing an increase in the provision for loan and lease losses.

Under the fair value of collateral method, the impaired amount of the loan is deemed to be the difference between the loan amount and the fair value of the collateral, less the estimated costs to sell. For the Company s calculations on real estate secured loans, a factor of 10% is generally utilized to estimate costs to sell, which is based on typical cost factors, such as a 6% broker commission, 1% transfer taxes, and 3% various other miscellaneous costs associated with the sales process. If the valuation indicates that the fair value has deteriorated below the carrying value of the loan, either the entire loan is written off or the difference between the fair value and the

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principal balance is charged off. For impaired loans for which the value of the collateral less costs to sell exceeds the loan value, the impairment is considered to be zero.

The following schedule reflects non-performing loans (including non-performing TDRs), OREO and performing TDRs as of December 31 for each of the last five years:

Non-performing Loans, OREO and Performing TDRs

	December 31,				
(in thousands)	**2012**	**2011**	**2010**	**2009**	**2008**
Non-accrual loans	$ 9,652	$ 19,913	$ 28,267	$ 25,865	$ 22,263
Loans past due 90 days or more and still accruing	57	5	99	117	1,151
Total non-performing loans	9,709	19,918	28,366	25,982	23,414
Other real estate owned	3,983	6,958	9,633	11,184	2,308
Total non-performing loans and OREO	$ 13,692	$ 26,876	$ 37,999	$ 37,166	$ 25,722
Performing TDRs	$ 7,517	$ 5,680	$ 2,513	$ 10,743	$
Non-performing loans as a percentage of gross loans	1.62%	2.93%	3.74%	2.77%	2.43%

Management continued to effectively manage problem credits through heightened work-out efforts on nonperforming loans and disposing of its holdings of foreclosed properties. As a result, the Company s asset quality improved significantly in 2012. Total non-performing loans and OREO decreased $13.2 million, or 49.1%, to $13.7 million at December 31, 2012 from $26.9 million at December 31, 2011. At December 31, 2012, the Company s ratio of non-performing loans to total gross loans was 1.62% compared to 2.93% reported at December 31, 2011. Non-performing loans and OREO represented 37.1% of shareholders equity as of December 31, 2012, as compared to 67.3% of shareholders equity as of December 31, 2011. The decrease in non-performing loans and OREO as a percentage of shareholders equity was driven primarily by $8.3 million of charge-offs, the liquidation of several problem credits and the sale of OREO properties. Though non-performing loans as a percentage of shareholders equity decreased, the percentage remains elevated and further deterioration in economic conditions could lead to additional increases in impaired loans.

Changes in Non-performing Loans

The following table presents the changes in non-performing loans for the years ended December 31, 2012 and 2011:

	Year ended December 31,	
(in thousands)	**2012**	**2011**
Balance at beginning of period	$ 19,918	$ 28,266
Newly placed on non-accrual	11,061	14,779
Loans past due 90 days or more and still accruing	53	5

Transferred to OREO	(1,586)	(3,995)
Returning to performing status	(405)	(2,991)
Additional charge-offs	(8,273)	(6,648)
Loan payments	(4,223)	(9,497)
Loans sold	(6,836)	
Balance at end of period	$ 9,709	$ 19,918

Reclassifications of performing loans to non-accrual during 2012 included one large commercial loan in the amount of $4.3 million. A substantial portion of this loan, which is secured by commercial real estate, is guaranteed by a U.S. governmental agency. At December 31, 2012, a specific reserve of $37 thousand has been allocated to this credit in the ALLL.

In addition to this credit, two credits that were placed on non-accrual status prior to 2012, constituted approximately 57% of non-performing loans at December 31, 2012. The two credits are:

- $1.6 million This credit represents a commercial loan secured by a residential real estate property. This credit was paid down to

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$603 thousand as of December 31, 2012. Additionally, $2 thousand of the allowance for loan and lease losses is allocated to this credit.

- $1.4 million   This credit represents a residential mortgage loan and home equity loan secured by a personal residence. The outstanding balance of this credit, which is also a TDR, was $624 thousand at December 31, 2012. This credit has been performing according to the modified terms of the loan agreement. At December 31, 2012 management had specifically allocated $22 thousand of the allowance for loan and lease losses to this credit.

In addition to the non-performing loans identified in the table above, the Bank had potential problem loans consisting of substandard and accruing loans in the amount of $33.4 million at December 31, 2012. The volume of potential problem loans decreased $16.8 million or 33.5% from $50.2 million at December 31, 2011.

In the fourth quarter of 2012, the Company sold three nonperforming loans totaling $6.8 million to a third party. No gain or loss was recognized upon the sale.

The Company has historically participated in loans with other financial institutions, the majority of which have been loans originated by financial institutions located in the Company s general market area. For the past eight years, the Company has participated in seven (7) commercial real estate loans with a financial institution that was headquartered in Minneapolis, Minnesota. The majority of these loans were for out of market commercial real estate projects. Two (2) projects were located in Pennsylvania, one (1) project was located in New York and the remaining four (4) projects were located in Florida. The Company s original aggregate commitment for these various loans totaled approximately $34.0 million. Two of these loans, one local Pennsylvania project and the New York project, were paid in full prior to 2011. During 2011, the two Florida credits rated substandard were paid off and one of the Florida properties held in OREO was sold. The outstanding balance of the two remaining loans, one Florida property held in OREO and the Pennsylvania credit rated substandard, had an aggregate balance of $4.6 million at December 31, 2012. The Florida credit has been written down to the current fair value of the property and the Pennsylvania credit is currently performing.

The following table outlines accruing loan delinquencies and non-accrual loans as a percentage of gross loans at December 31, 2012, 2011 and 2010:

Accruing Loan Delinquencies and Non-accrual Loans

		December 31,	
(in thousands)	**2012**	**2011**	**2010**
Accruing:			
30-59 days	0.44%	0.83%	0.52%
60-89 days	0.06%	0.27%	0.16%
90+ days	0.01%	0.00%	0.01%
Non-accrual	1.61%	2.93%	3.74%
Total Delinquencies	2.13%	4.03%	4.43%

Total delinquencies, as a percent of gross loans, improved substantially in 2012 and was primarily due to the sale of several non-performing loans, the transfers of loans to OREO and more rigorous collection and work-out efforts directed at non-performing loans. Delinquencies for accruing loans improved $4.4 million, or 58.7%, from $7.5 million at December 31, 2011 to $3.1 million at December 31, 2012, primarily due to decreases in residential and commercial real estate loans that were 30 89 days past due. In its evaluation of the ALLL, management considers a variety of qualitative factors including changes in the volume and severity of delinquencies.

The Company continues to acknowledge some weakness in local real estate markets and the local economy in general. In addition, the unemployment rate for the Scranton-Wilkes-Barre metropolitan area, the Company s predominant market area, reached 9.5% in December 2012, the highest rate among Pennsylvania s 14 metropolitan areas. The Company tries to mitigate these factors by emphasizing strict underwriting standards.

At December 31, 2012, there were 22 properties in OREO with an aggregate balance of $4.0 million, compared to 28 properties with an aggregate balance of $7.0 million at December 31, 2011. At December 31, 2012, five properties held in OREO represented approximately 61% of the total. Additionally, $2.6 million, or 65%, of OREO is located in the Pocono Mountains within the Company s primary market area. Property values in this area have been severely affected by the weakened economic environment. At December 31, 2012, there were three properties totaling $331 thousand or 8.3% or OREO that were located outside the Company s general market area.

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The Company actively markets OREO properties for sale through a variety of channels including internal marketing and the use of outside brokers/realtors. The carrying value of OREO is generally calculated at an amount not greater than 90% of the most recent fair market appraised value. A 10% factor is generally used to estimate costs to sell, which is based on typical cost factors, such as 6% broker commission, 1% transfer taxes, and 3% various other miscellaneous costs associated with the sales process. This fair value is updated on an annual basis or more frequently if new valuation information is available. Further deterioration in the real estate market could result in additional losses on these properties.

The Company foreclosed on nine properties with an aggregate carrying value of $1.6 million during the twelve months ended December 31, 2012. There were 15 properties with an aggregate carrying value of $3.1 million that were sold in 2012. In addition there were three partial sales that occurred during 2012 that totaled $0.2 million. Pursuant to new valuation information received during the year, there were subsequent write-downs of properties totaling $1.2 million.

The following schedule presents the activity in OREO:

Changes in OREO

	For the Years Ended December 31,		
(in thousands)	**2012**	**2011**	**2010**
Balance, beginning of year	$ 6,958	$ 9,633	$ 11,184
Additions	1,586	3,995	9,928
Write-downs	(1,206)	(2,318)	(5,906)
Carrying value of OREO sold	(3,355)	(4,352)	(5,573)
Balance, end of year	$ 3,983	$ 6,958	$ 9,633

The following schedule presents a distribution of OREO for the periods presented:

Distribution of OREO

	December 31,				
(in thousands)	**2012**	**2011**	**2010**	**2009**	**2008**
Land / Lots	$ 2,929	$ 4,443	$ 8,357	$ 5,887	$ 2,308
Commercial Real Estate	1,054	1,695	1,086	4,852	
Residential Real Estate		820	190	445	
Total Other Real Estate Owned	$ 3,983	$ 6,958	$ 9,633	$ 11,184	$ 2,308

The expenses related to maintaining OREO, including the subsequent write-downs of the properties related to declines in value since foreclosure amounted to $2.0 million, $3.7 million, and $7.5 million for the years ended December 31, 2012, 2011, and 2010, respectively.

Allowance for Loan and Lease Losses

The ALLL represents management s estimate of probable loan losses inherent in the loan portfolio. The ALLL is analyzed in accordance with GAAP and is maintained at a level that is based on management s evaluation of the adequacy of the ALLL in relation to the risks inherent in the loan portfolio.

As part of its evaluation management considers qualitative and environmental factors including but not limited to:

- Changes in national, local, and business economic conditions and developments, including the condition of various market segments;
- Changes in the nature and volume of the Company s loan portfolio;
- Changes in the Company s lending policies and procedures, including underwriting standards, collection, charge-off and recovery practices and results;
- Changes in the experience, ability and depth of the Company s management and staff;
- Changes in the quality of the Company s loan review system and the degree of oversight by the Company s Board of Directors;
- Changes in the trend of the volume and severity of past due and classified loans, including trends in the volume of non-accrual loans, troubled debt restructurings and other loan modifications;

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- The existence and effect of any concentrations of credit and changes in the level of such concentrations;
- The effect of external factors such as competition and legal and regulatory requirements on the level of estimated credit losses in the Company s current loan portfolio; and
- Analysis of our customers credit quality, including knowledge of their operating environment and financial condition.

Evaluations are intrinsically subjective, as the results are estimated based on management knowledge and experience and are subject to interpretation and modification as information becomes available or as future events occur. Management monitors the loan portfolio on an ongoing basis with emphasis on weakness in both the real estate market and economy in general and its effect on repayment. Adjustments to the ALLL are made based on management s assessment of the factors noted above.

For purposes of its analysis, all loan relationships with an aggregate balance greater than $100 thousand that are rated substandard and non-accrual, identified as doubtful or loss, and all TDRs are considered impaired and are analyzed individually to determine the amount of impairment. Circumstances such as construction delays, declining real estate values, and the inability of the borrowers to make scheduled payments have resulted in these loan relationships being classified as impaired. The Company utilizes the fair value of collateral method for collateral-dependent loans and TDRs for which repayment depends on the sale of collateral. For non-collateral dependent loans and TDRs, the Company measures impairment based on the present value of expected future cash flows discounted at the loan s original effective interest rate. With regard to collateral-dependent loans, appraisals are received at least annually to ensure that impairment measurements reflect current market conditions. Should a current appraisal not be available at the time of impairment analysis, other valuation sources including current letters of intent, broker price opinions or executed agreements of sale may be used. Only downward adjustments are made based on these supporting values. Included in all impairment calculations is a cost to sell adjustment of approximately 10%, which is based on typical cost factors, including a 6% broker commission, 1% transfer taxes and 3% various other miscellaneous costs associated with the sales process. Sales costs are periodically revised based on actual experience. The ALLL analysis is adjusted for subsequent events that may arise after the end of the reporting period but before the financial reports are filed.

The Company s ALLL consists of both specific and general components. At December 31, 2012, the ALLL that related to impaired loans that are individually evaluated for impairment, the guidance for which is provided by ASC 310 *Impairment of a Loan* (ASC 310), was $310 thousand, or 1.7%, of the total ALLL. A general allocation of $18.2 million was calculated for loans analyzed collectively under ASC 450 *Contingencies* (ASC 450), which represented 98.3% of the total ALLL of $18.5 million. The ratio of the ALLL to total loans at December 31, 2012 and December 31, 2011 was 3.10% and 3.07%, respectively, based on total loans of $597.8 million and $679.5 million, respectively.

The following table presents an allocation of the ALLL and percent of loans in each category as of December 31:

Allocation of the Allowance for Loan Losses

[redacted]

Residential Real Estate	$	1,764	15.09% $	1,823	11.78% $	2,176	11.60% $	696	10.49% $	259	15.47%

Commercial Real Estate (1)	8,062	38.78%	11,151	37.75%	9,640	33.82%	8,397	34.20%		45.68%
Construction, Land Acquisition and Development (2)	2,162	5.44%	2,590	4.92%	4,170	10.21%	6,285	10.47%		0.00%
Commercial & Industrial	4,167	18.41%	3,292	25.64%	4,850	26.08%	4,507	23.40%	7,462	22.90%
Consumer	1,708	18.37%	1,526	16.45%	1,173	14.63%	1,980	17.53%	481	12.38%
State & Political	673	3.91%	452	3.46%	566	3.66%	593	3.91%	52	3.57%
Total	$ 18,536	100.00%	$ 20,834	100.00%	$ 22,575	100.00%	$ 22,458	100.00%	$ 8,254	100.00%

(1) Prior to December 31, 2009, the commercial real estate allowance for loan and lease losses was combined with commercial and industrial loans.

(2) Prior to December 31, 2009, the construction, land acquisition and development allowance for loan and lease losses was combined with commercial real estate loans.

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The following table presents a reconciliation of the ALLL and an illustration of charge-offs and recoveries by major loan category for each of the last five years:

Reconciliation of the ALLL

	Year Ended December 31,				
(in thousands)	**2012**	**2011**	**2010**	**2009**	**2008**
Balance, January 1,	$ 20,834	$ 22,575	$ 22,458	$ 8,254	$ 7,569
Charge-Offs:					
Residential Real Estate	683	1,273	221	307	51
Commercial Real Estate	3,298	2,395	5,049	24,980	262
Construction, Land Acquisition and Development	258	1,857	12,893		
Commercial & Industrial	3,389	416	6,883	2,247	466
Consumer	673	739	736	483	548
State & Political Subdivision					
Total Charge-offs	8,301	6,680	25,782	28,017	1,327
Recoveries of Charged-off Loans:					
Residential Real Estate	35	57	32		
Commercial Real Estate	1,035	93	152	33	17
Construction, Land Acquisition & Development	265	2,188	303		
Commercial & Industrial	265	1,852	151	22	6
Consumer	338	226	220	77	185
State & Political Subdivision					
Total Recoveries	1,938	4,416	858	132	208
Net Charge-offs (1)	6,363	2,264	24,924	27,885	1,119
Provision for loan and lease losses	4,065	523	25,041	42,089	1,804
Balance, December 31	$ 18,536	$ 20,834	$ 22,575	$ 22,458	$ 8,254
Ratios:					
Net Charge-Offs as a percentage of average loans outstanding	0.97%	0.31%	2.84%	2.87%	0.12%
Allowance for loan and lease losses as a percentage of gross loans outstanding at end of period	3.10%	3.07%	2.98%	2.40%	0.86%

(1) Prior to December 31, 2009, the charge-offs and recoveries for construction, land acquisition and development allowance for loan and lease losses were combined with commercial real estate loans.

The ALLL equaled $18.5 million at December 31, 2012, a decrease of $2.3 million from $20.8 million at December 31, 2011, as net charge-offs of $6.4 million exceeded the provision for loan and lease losses of $4.0 million. The net decrease of $2.3 million was due mainly to the decrease in total loans and problem loans in 2012 as compared to 2011.

Net charge-offs increased $4.1 million to $6.4 million in 2012 from $2.3 million in 2011. The increase was primarily attributable to one commercial and industrial loan that was charged-off in the amount of $3.2 million. All other charge-off and recovery activity was consistent with the normal course of business. Management is actively pursuing work out and collection efforts to collect on these loans.

Funding Sources

The Company utilizes traditional deposit products, such as demand, savings, negotiable order of withdrawal (NOW), money market, and time as its primary funding sources to support the earning asset base and future growth. Other sources, such as short-term FHLB advances, federal funds purchased, brokered time deposits and long-term FHLB borrowings may be utilized as necessary to support the asset growth and employ asset/liability management strategies. The average balance of interest-bearing liabilities decreased by $147.5 million, or 15.2%, to $822.2 million during 2012 from $969.6 million during 2011. The rate paid on interest-bearing liabilities decreased 31 basis points to 1.12% in 2012 from 1.43% in 2011.

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Deposits

Average interest-bearing deposits decreased $108.3 million, or 12.6%, during 2012 compared to 2011. Although the Company experienced decreases in all major interest-bearing deposits categories, the most significant declines were in other time deposits with balances less than $100 thousand and interest-bearing demand deposits. During 2012, other time deposits averaged $191.5 million, a decrease of $60.6 million, or 24.0%, compared to $252.1 million during 2011. Average interest-bearing demand deposits, which include interest-bearing checking accounts, NOW accounts and money market accounts, decreased $35.3 million, or 10.5%, to $299.9 million in 2012 from $335.2 million in 2011. Time deposits over $100 thousand and savings deposits decreased $10.8 million and $1.7 million, respectively, comparing the years ended December 31, 2012 and 2011. The majority of the decrease in time deposits was attributable to a related party withdrawing $40.6 million to pay off its cash-collateralized solid waste landfill loans.

The rate paid on average interest-bearing deposits decreased 30 basis points to 0.72% in 2012 from 1.02% in 2011. 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 Company elected to allow higher cost time deposits to mature and chose to be more conservative in setting rates on new deposits and renewals. The pricing decreases for these products resulted from the Company s implementation of competitive rates. The rate paid on average interest-bearing demand deposits decreased 25 basis points to 0.23% in 2012 from 0.48% during 2011. The rate paid on time deposits over $100 thousand decreased 34 basis points to 0.87%, while the rate paid on other time deposits decreased 26 basis points to 1.59% during 2012. The rate paid for savings deposits decreased to 0.18% in 2012 from 0.32% in 2011. The decrease in average interest-bearing deposits was partially offset by a $20.5 million increase in non-interest-bearing demand deposits.

The average amount of, and the rate paid on, the major classifications of deposits is summarized for the periods indicated in the following table:

Deposit Distribution

	Year Ended December 31,					
	2012		2011		2010	
(in thousands)	Amount	Rate	Amount	Rate	Amount	Rate
Interest-bearing deposits:						
Interest-bearing demand	$ 299,938	0.23%	$ 335,201	0.48%	$ 353,579	0.97%
Savings	87,818	0.18%	89,494	0.32%	93,598	0.54%
Time	361,818	1.25%	433,227	1.58%	508,660	2.01%
Total interest-bearing deposits	749,574	0.72%	857,922	1.02%	955,837	1.48%
Non-interest-bearing deposits	128,254		107,763		82,400	
Total deposits	$ 877,828		$ 965,685		$ 1,038,237	

The following table presents the maturity distribution of time deposits of $100,000 or more at December 31, 2012 and 2011:

Maturity Distribution of Time Deposits Greater Than $100,000

	December 31,	
(in thousands)	**2012**	**2011**
3 months or less	$ 25,656	$ 95,635
Over 3 through 6 months	22,379	13,455
Over 6 though 12 months	37,065	33,058
Over 12 months	59,744	57,642
Total	$ 144,844	$ 199,790

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Borrowings

The following table presents the maximum amount of the Company s short-term borrowings that were outstanding at any month end during the years ended December 31, 2012, 2011 and 2010:

Short-term Borrowings Outstanding

	For the Years Ended December 31,		
(in thousands)	**2012**	**2011**	**2010**
Federal funds purchased	$	$	$
FHLB advances		40,000	
FRB discount window borrowings			
Total	$	$ 40,000	$

The Company did not have any outstanding short term borrowings at December 31, 2012, 2011, or 2010, respectively.

Average long-term debt decreased by $39.1 million, or 35.0%, to $72.6 million in 2012 from $111.7 million in 2011 which was due to the maturity and repayments of several FHLB advances. The average rate paid for long term debt in 2012 was 5.28%, an increase from 4.57% in 2011. The increase in rate on the long term debt is due primarily to its subordinated debentures comprising a higher percentage of total average long term debt in 2012 than in 2011. For further discussion of the Company s borrowings, see Note 11- Borrowed Funds to the consolidated financial statements included in Item 8 of this Annual Report on Form 10-K.

The average balance of junior subordinated debentures, a component of long-term debt, was $10.3 million for 2012 and 2011. The interest rate on these debentures, resets quarterly at a spread of 1.67% above the current 3-month Libor rate. The average rate paid for junior subordinated debentures in 2012 was 2.18%, compared to 2.00% in 2011.

Short-term borrowings consist of Federal funds purchased which generally represent overnight borrowing transactions. The Company did not have a Federal funds line of credit as of December 31, 2012 and 2011. Long-term debt, which is comprised primarily of FHLB advances, is collateralized by the FHLB stock owned by the Company, certain mortgage-backed securities and a blanket lien on its residential and commercial real estate mortgage loans.

The maximum amount of borrowings outstanding at any month end during the years ended December 31, 2012 and 2011 were $82.3 million and $127.7 million, respectively. Federal funds purchased represent overnight borrowings providing for the short-term funding requirements of the Company s banking subsidiary and generally mature within one business day of the transaction. Federal Reserve Discount Window borrowings also represent overnight funding to meet the short-term liquidity requirements of the Bank and are fully collateralized with investment securities. The Company did not utilize short-term FHLB advances or borrowings from the Discount Window in 2012. During 2011 the average outstanding balance for short-term FHLB advances amounted to $6.6 million and the weighted average rate paid in 2011 was 0.53%.

Liquidity

The term liquidity refers to the ability of the Company to generate sufficient amounts of cash to meet its cash flow needs. Liquidity is required to fulfill the borrowing needs of the Company s credit customers and the withdrawal and maturity requirements of its deposit customers, as well as to meet other financial commitments. The Company s liquidity position is impacted by several factors, which include, among others, loan origination volumes, loan and investment maturity structure and cash flows, deposit demand and certificate of deposit maturity structure and retention. Management monitors the Company s liquidity position and fluctuations daily, so that the Company can adapt accordingly to market influences and balance sheet trends. Management also forecasts liquidity needs and develops strategies to ensure adequate liquidity at all times.

The Company s statements of cash flows present the change in cash and cash equivalents from operating, investing and financing activities. Cash and cash equivalents, cash and due from banks and interest-bearing deposits in other banks, are the Company s most liquid assets. At December 31, 2012, cash and cash equivalents totaled $115.3 million, a decrease of $53.3 million compared to $168.6 million at December 31, 2011. Cash flows from financing and operating activities used $132.2 million and $11.0 million, respectively, in cash and cash equivalents in 2012. These outflows were only partially offset by net cash inflows from investing activities of $89.9 million.

The $132.1 million in cash flows used by financing activities reflected the $102.5 million decrease in total deposits. Total time deposits decreased $90.3 million, while demand, interest-bearing demand and savings accounts in aggregate declined $12.2 million. In addition the Company repaid $29.7 million of FHLB advances.

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With regard to operating activities, the net cash and cash equivalents of $11.01 million used by operating activities primarily pertained to the net loss of $13.7 million, adjusted for the effects of noncash transaction such as depreciation and the provision for loan and lease losses.

Investing activities primarily include transactions related to the Company s lending activities and securities portfolio. The net cash flows of $89.9 million provided by investing activities were largely attributable to the proceeds from maturities, calls and principal payments of investment securities totaling $79.3 million, partially offset by $63.3 million in purchases of investment securities, and a net decrease in loans to customers totaling $67.7 million.

Core deposits, which represent the Company s primary source of liquidity, averaged $688.4 million in 2012, a decrease of $55.8 million, or 7.5%, compared to $744.2 million in 2011. Core deposits are comprised of total deposit liabilities less: brokered deposits, deposits generated through the Certificate of Deposit Account Registry Service (CDARs) and all certificates of deposit accounts with balances greater than $100 thousand.

The Company has other potential sources of liquidity including the ability to borrow on credit lines established at the Federal Home Loan Bank of Pittsburgh and access to the Federal Reserve Discount Window. In addition, the Company has the ability to solicit deposits, primarily certificates of deposit, through QwikRate, a non-brokered marketplace for funding and investing. The Company had $74.1 million and $39.0 million in certificates originated through QwikRate at December 31, 2012 and 2011, respectively.

Financial instruments whose contract amounts represent credit risk at December 31 are as follows:

(in thousands)	**2012**	**2011**
Commitments to extend credit	$ 166,722	$ 138,715
Standby letters of credit	35,277	36,286

Capital

A strong capital base is essential to the continued growth and profitability of the Company and is therefore a management priority. The Company s principal capital planning goals are to provide an adequate return to shareholders while retaining a sufficient base from which to provide for future growth, while at the same time complying with all regulatory standards. As more fully described in Note 17, Regulatory Matters to the consolidated financial statements included in Item 8 of this Annual Report on Form 10-K, regulatory authorities have prescribed specified minimum capital ratios as guidelines for determining capital adequacy to help assure the safety and soundness of financial institutions.

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The following schedules present information regarding the Company s risk-based capital at December 31, 2012, 2011, and 2010 and selected other capital ratios:

Capital Analysis

	December 31,		
(in thousands)	**2012**	**2011**	**2010**
Company			
Tier I Capital:			
Total Tier I Capital	$ 39,587	$ 53,059	$ 53,297
Tier II Capital:			
Subordinated notes	19,796	25,000	25,000
Allowable portion of allowance for loan losses	8,452	9,823	11,201
Total Tier II Capital	28,248	34,823	36,201
Total Risk-Based Capital	67,835	87,882	89,498
Total Risk Weighted Assets	$ 665,323	$ 774,452	$ 883,887
Bank			
Tier I Capital:			
Total Tier I Capital	$ 69,963	$ 80,976	$ 75,659
Tier II Capital:			
Allowable portion of allowance for loan losses	8,447	9,819	11,197
Total Tier II Capital	8,447	9,819	11,197
Total Risk-Based Capital	78,410	90,795	86,856
Total Risk Weighted Assets	$ 664,914	$ 774,097	$ 883,535

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[redacted]

December 31, 2012							
Total Capital (to Risk Weighted Assets)							
Company	$	67,835	10.20% $	53,226	>8.00%	N/A	N/A
Bank	$	78,410	11.79% $	53,193	>8.00% $	66,491	>10.00%
Tier I Capital (to Risk Weighted Assets)							
Company	$	39,587	5.95% $	26,613	>4.00%	N/A	N/A
Bank	$	69,963	10.52% $	26,597	>4.00% $	39,895	>6.00%
Tier I Capital (to Average Assets)							
Company	$	39,587	4.07% $	38,879	>4.00%	N/A	N/A
Bank	$	69,963	7.20% $	38,865	>4.00% $	48,581	>5.00%

[redacted]

December 31, 2011							
Total Capital (to Risk Weighted Assets)							
Company	$	87,882	11.35% $	61,956	>8.00%	N/A	N/A
Bank	$	90,795	11.73% $	61,928	>8.00% $	77,410	>10.00%
Tier I Capital (to Risk Weighted Assets)							
Company	$	53,059	6.85% $	30,978	>4.00%	N/A	N/A
Bank	$	80,976	10.46% $	30,964	>4.00% $	46,446	>6.00%
Tier I Capital (to Average Assets)							
Company	$	53,059	4.72% $	44,992	>4.00%	N/A	N/A
Bank	$	80,976	7.20% $	44,978	>4.00% $	56,227	>5.00%

In 2012, the Company s total regulatory capital decreased $20.0 million, primarily as a result of the $13.7 million net loss. Also affecting total regulatory capital were reductions in the allowable portions of subordinated notes and the allowance for loan and lease losses of $5.2 million and $1.4 million, respectively. As of December 31, 2012, there were 33,542,831 common shares available for future sale or share dividends. The number of shareholders of record at December 31, 2012 was 1,920. Quarterly market highs and lows, dividends paid and known market makers are highlighted in Part I, Item 5 of this report. Refer to Note 17, Regulatory Matters, to the consolidated financial statements included in Item 8 of this Annual Report on Form 10-K for further discussion of our capital requirements and dividend limitations. As a result of the Order, the Bank is required to achieve a total risk-based capital ratio of 13% and Tier I capital to average assets ratio of 9% by November 30, 2010. As of December 31, 2012, the Bank has not yet achieved these ratios. Furthermore, pursuant to the Order and the Agreement, the Bank and the Company are currently prohibited from declaring or paying any dividends without prior regulatory approval.

Additionally, the Company has available 20,000,000 authorized shares of preferred stock. There were no preferred shares issued and outstanding at December 31, 2012 and 2011.

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During 1999, the Company implemented a Dividend Reinvestment Plan (DRIP) which permits participants to automatically reinvest cash dividends on all of their shares and to make voluntary cash contributions under terms of the plan. Under the DRIP, participants purchase, at a 10% discount to the 10-day trading average, common shares that are either newly-issued by the Company or acquired by the plan administrator in the open market or privately.

The Company s operation of the DRIP Plan was suspended in 2011. New capital generated from shares issued under the DRIP totaled $29 thousand and $528 thousand during the years ended December 31, 2011 and 2010, respectively. There was no new capital issued under the DRIP in 2012.

The Board of Directors (the Board) on February 26, 2010 voted to suspend payment of the Company s quarterly dividend indefinitely in an effort to conserve capital. The Board recognizes the importance of preserving cash and, given the challenging economic conditions that continue to impact the health and stability of many businesses within the region we serve, believes dividends should not be paid from current and anticipated earnings to prudently fund operations. Additionally, as a result of the Order and the Agreement, the Company is prohibited from paying dividends without the prior approval of the OCC and the Reserve Bank.

Off-Balance Sheet Arrangements

In the normal course of operations, the Company engages in a variety of financial transactions that, in accordance with U.S. GAAP, are not recorded in our consolidated financial statements, or are recorded in amounts that differ from the notional amounts. These transactions involve, to varying degrees, elements of credit, interest rate and liquidity risk. Such transactions may be used for general corporate purposes or for customer needs. Corporate purpose transactions would be used to help manage credit, interest rate and liquidity risk or to optimize capital. Customer transactions are used to manage customers requests for funding.

For the year ended December 31, 2012, the Company did not engage in any off-balance sheet transactions that would have or would be reasonably likely to have a material effect on its consolidated financial condition. For a further discussion of the Company s off-balance sheet arrangements, refer to Note 15, Commitments, Contingencies, and Concentrations to the consolidated financial statements included in Item 8 of this Annual Report on Form 10-K.

Contractual Obligations

The following table details the Company s contractual obligations and commercial commitments as of December 31, 2012. Payments due by period in the following table are based on final maturity dates without consideration of early redemption.

Contraction Obligations and Commercial Commitments

	Payments Due by Period				
(in thousands)	Total	Less Than one Year	1-3 Years	3-5 Years	More Than 5 Years
Federal Home Loan Bank advances	$ 18,593	$ 11,119	$ 5,000	$	$ 2,474
Subordinated debentures	25,000		5,000	10,000	10,000
Junior subordinated debt	10,310				10,310
Operating lease obligations	2,175	620	729	285	541
Total contractual cash obligations	$ 56,078	$ 11,739	$ 10,729	$ 10,285	$ 23,325

	Amount of Commitment Expirations by Period				
(in thousands)	Total Amounts Commited	Less Than one Year	1-3 Years	3-5 Years	More Than 5 Years
Commitments to extend credit	$ 166,722	$ 149,096	$ 5,234	$ 1,998	$ 10,394
Standby letters of credit	35,277	27,521	7,442		314
Total	$ 201,999	$ 176,617	$ 12,676	$ 1,998	$ 10,708

The Company s Treasury unit proactively monitors the level of unused commitments against the Company s available sources of liquidity from its investment portfolio, from deposit gathering activities as well as available unused borrowing capacity from the FHLB and the Federal Reserve. The Treasury unit regularly reports the results of its actions to two of our management committees, the Asset/Liability Committee and the Senior Management Committee.

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Item 7A. Quantitative and Qualitative Disclosures About Market Risk.

Asset and Liability Management

The major objectives of the Company s asset and liability management are to:

(1) Manage exposure to changes in the interest rate environment by limiting the changes in net interest margin to an acceptable level within a reasonable range of interest rates;

(2) Ensure adequate liquidity and funding;

(3) Maintain a strong capital base; and

(4) Maximize net interest income opportunities.

The Company manages these objectives through its Asset and Liability Management Committee (ALCO) and its Rate and Investment Committee, which consist of the members of senior management and certain members of the finance department. Members of the committees meet regularly to develop balance sheet strategies affecting the future level of net interest income, liquidity and capital. Items that are considered in asset and liability management include balance sheet forecasts, liquidity, the economic environment, the anticipated direction of interest rates and the Company s earnings sensitivity to changes in these rates.

Interest Rate Sensitivity

Market risk is the risk to earnings and/or financial position resulting from adverse changes in market rates or prices, such as interest rates, foreign exchange rates or equity prices. The Company s exposure to market risk is primarily interest rate risk associated with our lending, investing and deposit gathering activities. Changes in interest rates affect earnings by changing net interest income and the level of other interest-sensitive income and operating expenses. In addition, variations in interest rates affect the underlying economic value of our assets, liabilities and off-balance sheet items. The Company analyzes its interest rate sensitivity position to manage the risk associated with interest rate movements through the use of gap analysis and simulation modeling. Interest rate risk arises from mismatches in the re-pricing of assets and liabilities within a given time period. Gap analysis is an approach used to quantify these differences. A positive gap results when the amount of interest-sensitive assets exceeds that of interest-sensitive liabilities within a given time period. A negative gap results when the amount of interest-sensitive liabilities exceeds that of interest-sensitive assets. A positive gap implies that net interest income will be impacted favorably if interest rates rise and adversely if interest rates fall. A negative gap implies an inverse correlation between net interest income and interest rate changes.

While gap analysis is a general indicator of the potential effect that changing interest rates may have on net interest income, the gap report has some limitations and does not present a complete picture of interest rate sensitivity. First, changes in the general level of interest rates do not affect all categories of assets and liabilities equally or simultaneously. Second, assumptions must be made to construct a gap table. For example, non-maturity deposits are assigned a re-pricing interval based on internal assumptions. Management can influence the actual re-pricing of these deposits independent of the gap assumption. Third, the gap table represents a one-day position and cannot incorporate a changing mix of assets and liabilities over time as interest rates change.

Because of the limitations of the gap reports, the Company uses simulation modeling to project future net interest income streams incorporating the current gap position, the forecasted balance sheet mix, and the anticipated spread relationships between market rates and bank products under a variety of interest rate scenarios.

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Interest Rate Gap

The following schedule illustrates the Company s interest rate gap position as of December 31, 2012 which measures sensitivity to interest rate fluctuations for certain interest sensitivity periods:

Interest Rate Sensitivity

				December 31, 2012			
(in thousands)	**1 to 90 Days**	**91 to 180 Days**	**181 to 365 Days**	**1 to 5 Years**	**Beyond 5 Years**	**Not Rate Sensitive**	**Total**
Interest-bearing deposits in other banks	$ 93,561	$	$	$	$	$	$ 93,561
Performing loans, gross	299,666	20,543	40,139	182,076	45,699		588,123
Loans held for sale					1,615		1,615
Securities - taxable	3,778	3,197	5,451	37,813	43,456	10,149	103,844
Securities - tax free	140	760	290	12,595	69,930		83,715
Total securities	3,918	3,957	5,741	50,408	113,386	10,149	187,559
Total earning assets	397,145	24,500	45,880	232,484	160,700	10,149	870,858
Non-earning assets						115,952	115,952
Allowance for loan and lease losses						(18,536)	(18,536)
Total assets	$ 397,145	$ 24,500	$ 45,880	$ 232,484	$ 160,700	$ 107,565	$ 968,274
Interest-bearing demand deposits	$ 321,863	$	$	$	$	$	$ 321,863
Savings deposits	81,770	706	625				83,101
Time deposits ($100,000 and over)	28,252	22,275	37,064	57,150	103		144,844
Other time deposits	36,140	28,793	36,011	71,386	999		173,329
Total interest-bearing deposits	468,025	51,774	73,700	128,536	1,102		723,137
FHLB advances	6,204	86	5,175	6,527	601		18,593
Subordinated debentures				15,000	10,000		25,000
Junior subordinated debt	10,310						10,310
Total borrowed funds	16,514	86	5,175	21,527	10,601		53,903
Total interest-bearing liabilities	484,539	51,860	78,875	150,063	11,703		777,040
Demand deposits						131,476	131,476
Other liabilities						22,833	22,833
Shareholders equity						36,925	36,925
Total liabilities and shareholders equity	$ 484,539	$ 51,860	$ 78,875	$ 150,063	$ 11,703	$ 191,234	$ 968,274
INTEREST RATE SENSITIVITY GAP	$ (87,394)	$ (27,360)	$ (32,995)	$ 82,421	$ 148,997		
CUMULATIVE GAP	$ (87,394)	$ (114,754)	$ (147,749)	$ (65,328)	$ 83,669		

The Company s interest sensitivity was essentially negative at December 31, 2012. Rate-sensitive liabilities re-pricing within a one-year time horizon exceeded rate sensitive assets re-pricing within the same timeframe by $147.7 million. A negative gap implies that net interest income will react inversely to increases in interest rates.

Earnings at risk and economic value at risk simulations

The Company recognizes that more sophisticated tools exist for measuring the interest rate risk in the balance sheet beyond static gap analysis. Although it will continue to measure its static gap position, the Company utilizes additional modeling for identifying and measuring the interest rate risk in the overall balance sheet. ALCO is responsible for focusing on earnings at risk and economic value at risk, and how both relate to the risk-based capital position when analyzing interest rate risk.

Earnings at Risk

Earnings-at-risk simulation measures the change in net interest income and net income should interest rates rise and fall. The simulation recognizes that not all assets and liabilities re-price equally and simultaneously with market rates (i.e., savings rate). ALCO looks at earnings at risk to determine income changes from a base case scenario under an increase and decrease of 200 basis points in the interest rate simulation model.

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Economic Value at Risk

Earnings-at-risk simulation measures the short-term risk in the balance sheet. Economic value (or portfolio equity) at risk measures the long-term risk by finding the net present value of the future cash flows from the Company s existing assets and liabilities. ALCO examines this ratio regularly utilizing a rate shock of +/- 200 basis points in the interest rate simulation model. Management recognizes that, in some instances, this ratio may contradict the earnings at risk ratio.

The following table illustrates the simulated impact of a 200 basis point upward or downward movement in interest rates on net interest income and the change in economic value. This analysis assumed that interest-earning asset and interest-bearing liability levels at December 31, 2012 remained constant. The impact of the rate movements were developed by simulating the effect of rates changing over a twelve-month period from the December 31, 2012 levels.

	RATES + 200	**RATES 200**
Earnings at risk:		
Percent change in net interest income	5.26%	(7.69)%
Economic value at risk:		
Percent change in economic value of equity	(5.70)%	13.05%

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Item 8. Financial Statements and Supplementary Data.

Report of Independent Registered Public Accounting Firm

To the Board of Directors and Shareholders

First National Community Bancorp, Inc. and Subsidiaries

We have audited the accompanying consolidated statements of financial condition of First National Community Bancorp, Inc. and Subsidiaries (the Company) as of December 31, 2012 and 2011, and the related consolidated statements of operations, comprehensive (loss) income, changes in shareholders equity, and cash flows for each of the three years in the period ended December 31, 2012. These financial statements are the responsibility of the Company s management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of First National Community Bancorp, Inc. and Subsidiaries as of December 31, 2012 and 2011, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2012, in conformity with U.S. generally accepted accounting principles.

As explained in Note 17, the Company s subsidiary bank (the Bank) is under a Consent Order from the Office of the Comptroller of the Currency whereby the Bank is required to achieve and maintain certain minimum regulatory capital ratios.

/s/ McGladrey LLP

New Haven, Connecticut

March 28, 2013

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FIRST NATIONAL COMMUNITY BANCORP, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF FINANCIAL CONDITION

(in thousands, except share data)	**December 31, 2012**	**2011**
Assets		
Cash and cash equivalents:		
Cash and due from banks	$ 21,710	$ 18,956
Interest-bearing deposits in other banks	93,561	149,690
Total cash and cash equivalents	115,271	168,646
Securities:		
Available-for-sale, at fair value	185,361	185,475
Held-to-maturity, at amortized cost (fair value $2,483 and $2,245)	2,198	2,094
Stock in Federal Home Loan Bank of Pittsburgh, at cost	5,957	8,399
Loans held for sale	1,615	94
Loans, net of allowance for loan and lease losses of $18,536 and $20,834	579,396	659,044
Bank premises and equipment, net	18,937	18,846
Accrued interest receivable	2,199	2,552
Refundable federal income taxes	11,637	11,612
Intangible assets	632	797
Bank-owned life insurance	27,461	26,769
Other real estate owned	3,983	6,958
Other assets	13,627	11,353
Total Assets	$ 968,274	$ 1,102,639
Liabilities		
Deposits:		
Demand	$ 131,476	$ 124,733
Interest-bearing demand	321,863	336,182
Savings	83,101	87,712
Time ($100,000 and over)	144,844	199,790
Other time	173,329	208,719
Total deposits	854,613	957,136
Borrowed funds:		
FHLB advances	18,593	48,261
Subordinated debentures	25,000	25,000
Junior subordinated debentures	10,310	10,310
Total borrowed funds	53,903	83,571
Accrued interest payable	6,427	4,301
Other liabilities	16,406	17,706
Total liabilities	931,349	1,062,714
Shareholders Equity		
Preferred Shares ($1.25 par)		
Authorized: 20,000,000 shares as of December 31, 2012 and 2011		
Issued and outstanding: 0 shares as of December 31, 2012 and 2011		
Common Shares ($1.25 par)		
Authorized: 50,000,000 shares as of December 31, 2012 and 2011		
Issued and outstanding: 16,457,169 shares as of December 31, 2012 and 16,442,119 as of December 2011	20,571	20,552
Additional paid-in capital	61,584	61,557
Accumulated deficit	(51,928)	(38,217)
Accumulated other comprehensive income (loss):		

Unrealized holding gain on available-for-sale securities, net of taxes		6,698		497
Unrealized non-credit holding loss on OTTI available-for-sale securities, net of taxes				(4,464)
Total accumulated other comprehensive income (loss), net of taxes		6,698		(3,967)
Total shareholders equity		36,925		39,925
Total Liabilities and Shareholders Equity	$	968,274	$	1,102,639

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

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FIRST NATIONAL COMMUNITY BANCORP, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF OPERATIONS

	Year Ended December 31,		
(in thousands, except share data)	**2012**	**2011**	**2010**
Interest income			
Interest and fees on loans	$ 29,588	$ 34,467	$ 44,380
Interest and dividends on securities			
U.S. Treasury and government agencies	1,352	2,852	4,223
State and political subdivisions, tax-free	3,931	5,093	5,590
State and political subdivisions, taxable	482	112	58
Other securities	1,484	234	1,059
Total interest and dividends on securities	7,249	8,291	10,930
Interest on interest-bearing deposits and federal funds sold	190	178	161
Total interest income	37,027	42,936	55,471
Interest expense			
Deposits			
Interest-bearing demand	699	1,615	3,442
Savings	161	287	502
Time ($100,000 and over)	1,476	2,193	3,416
Other time	3,048	4,664	6,832
Total interest on deposits	5,384	8,759	14,192
Interest on borrowed funds			
Interest on FHLB advances	1,322	2,621	5,208
Interest on subordinated debentures	2,288	2,281	2,257
Interest on junior subordinated debentures	224	206	210
Interest on other debt			1
Total interest on borrowed funds	3,834	5,108	7,676
Total interest expense	9,218	13,867	21,868
Net interest income before provision for loan and lease losses	27,809	29,069	33,603
Provision for loan and lease losses	4,065	523	25,041
Net interest income after provision for loan and lease losses	23,744	28,546	8,562
Non-interest income			
Deposit service charges	2,985	3,105	3,274
Net (loss) gain on the sale of securities	(1,712)	5,114	(1,714)
Gross other-than-temporary-impairment (losses) gains	(96)	751	(805)
Portion of (gain) loss recognized in OCI (before taxes)		(1,549)	(3,466)
Other-than-temporary-impairment losses recognized in earnings	(96)	(798)	(4,271)
Net gain on the sale of loans held for sale	859	755	1,198
Net gain on the sale of other real estate owned	305	2,528	403
Net gain (loss) on the sale of other assets		20	(60)
Loan related fees	514	673	1,009
Income from bank owned life insurance	692	787	740
Other	736	765	703
Total non-interest income	4,283	12,949	1,282
Non-interest expense			
Salaries and employee benefits	14,702	14,117	13,077
Occupancy expense	2,225	2,508	3,228
Equipment expense	1,723	1,654	1,763
Advertising expense	614	629	712
Data processing expense	2,141	2,036	2,023
FDIC assessment	2,216	2,657	2,828
Bank shares tax	882	1,103	1,020

Expense of other real estate owned		2,027		3,720		7,521
Provision (credit) for off-balance sheet commitments		358		(423)		(678)
Legal expense		4,233		2,716		1,075
Professional fees		4,385		5,413		2,066
Insurance expense		896		685		362
Loan collection expenses		765		780		647
Other operating expenses		4,571		4,235		5,920
Total non-interest expense		41,738		41,830		41,564
Loss before income taxes		(13,711)		(335)		(31,720)
Provision for income taxes						
Net loss	$	(13,711)	$	(335)	$	(31,720)
Loss Per Share						
Basic	$	(0.83)	$	(0.02)	$	(1.94)
Diluted	$	(0.83)	$	(0.02)	$	(1.94)
Cash Dividends Declared Per Common Share	$		$		$	
WEIGHTED AVERAGE NUMBER OF SHARES OUTSTANDING:						
Basic		16,442,160		16,439,508		16,354,245
Diluted		16,442,160		16,439,508		16,354,245

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

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FIRST NATIONAL COMMUNITY BANCORP, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF COMPREHENSIVE (LOSS) INCOME

	Year Ended December 31,		
(in thousands)	**2012**	**2011**	**2010**
Net loss	$ (13,711)	$ (335)	$ (31,720)
Other Comprehensive income:			
Unrealized gains (losses) on securities available for sale	14,351	15,050	(11,729)
Taxes	(4,880)	(5,117)	3,988
Net of tax amount	9,471	9,933	(7,741)
Non-credit related gains on OTTI securities not expected to be sold		1,655	5,991
Taxes		(563)	(2,037)
Net of tax amount		1,092	3,954
Reclassification adjustment for losses (gains) included in net loss	1,808	(4,316)	5,985
Taxes	(614)	1,467	(2,035)
Net of tax amount	1,194	(2,849)	3,950
Total other comprehensive income	10,665	8,176	163
Comprehensive (loss) income	$ (3,046)	$ 7,841	$ (31,557)

The accompanying note to consolidated financial statements are an integral part of these financial statements

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FIRST NATIONAL COMMUNITY BANCORP, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS EQUITY

For the Years Ended December 31, 2012, 2011 and 2010

(in thousands, except share data)	Number of Common Shares	Common Stock	Additional Paid-in Capital	Accumulated Deficit	Accumulated Other Comprehensive (Loss) Income	Total Shareholders Equity
Balances, December 31, 2009	16,289,970	$ 20,362	$ 61,190	$ (6,162)	$ (12,306)	$ 63,084
Net loss for the year				(31,720)		(31,720)
Other comprehensive income, net of tax of $84					163	163
Proceeds from issuance of common shares through dividend reinvestment plan	143,050	179	349			528
Balances, December 31, 2010	16,433,020	20,541	61,539	(37,882)	(12,143)	32,055
Net loss for the year				(335)		(335)
Other comprehensive income, net of tax of $4,213					8,176	8,176
Proceeds from issuance of common shares through dividend reinvestment plan	9,099	11	18			29
Balances, December 31, 2011	16,442,119	20,552	61,557	(38,217)	(3,967)	39,925
Net loss for the year				(13,711)		(13,711)
Other comprehensive income, net of tax of $5,494					10,665	10,665
Stock-based compensation	15,050	19	27			46
Balances, December 31, 2012	16,457,169	$ 20,571	$ 61,584	$ (51,928)	$ 6,698	$ 36,925

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

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FIRST NATIONAL COMMUNITY BANCORP, INC AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOWS

	For the Years Ended December,		
(in thousands)	**2012**	**2011**	**2010**
Cash Flows from Operating activities:			
Net loss	$ (13,711)	$ (335)	$ (31,720)
Adjustments to Reconcile Net Loss to Net Cash (Used) Provided by Operating Activities:			
Investment securities accretion, net	(1,628)	(1,293)	(2,365)
Equity in trust	(7)	(4)	(6)
Depreciation and amortization	1,249	1,338	1,601
Provision for loan and lease losses	4,065	523	25,041
Provision (credit) for off balance sheet commitments	358	(423)	(678)
Provision for deferred taxes			3,512
Stock-based compensation expense	46		
(Gain) loss on sale of investment securities	1,712	(5,114)	1,714
Other-than temporary impairment losses	96	798	4,271
Gain on the sale of loans held for sale	(859)	(755)	(1,198)
(Gain) loss on disposition of premises and equipment and other assets	142	(20)	60
Gain on the sale of other real estate owned	(305)	(2,528)	(403)
Write-down of other real estate owned	1,206	2,318	5,906
Write-down of premises and equipment			1,196
Income from bank owned life insurance	(692)	(787)	(740)
Proceeds from the sale of loans held for sale	27,017	28,573	44,837
Funds used to originate loans held for sale	(27,679)	(26,638)	(46,754)
Decrease in interest receivable	353	567	1,126
(Increase) decrease in refundable federal income taxes	(25)	797	(187)
(Increase) decrease in prepaid expenses and other assets	(4,520)	4,170	(1,129)
Increase (decrease) in interest payable	2,126	1,538	(117)
Increase in accrued expenses and other liabilities	12	569	1,825
Total adjustments	2,667	3,629	37,512
Net Cash (Used) Provided by Operating Activities	(11,044)	3,294	5,792
Cash Flows from Investing Activities:			
Maturities, calls and principal payments of investment securities available-for-sale	33,170	29,449	51,145
Sales of securities available-for-sale	46,099	122,640	36,619
Purchases of securities available-for-sale	(63,279)	(63,409)	(89,442)
Purchases of Federal Reserve Bank stock	(90)		(336)
Redemption of Federal Home Loan Bank of Pittsburgh stock	2,442	1,912	543
Payment of liability for securities purchased not settled	(5,120)		
Net decrease in loans to customers	67,743	73,540	111,010
Proceeds from the sale of non-performing loans	6,836		
Proceeds from the sale of indirect loans			36,501
Proceeds from the sale of other real estate owned	3,660	6,880	5,996
Purchases of property and equipment	(1,601)	(893)	(1,239)
Proceeds from the sale of property and equipment		32	59
Net Cash Provided by Investing Activities	89,860	170,151	150,856
Cash Flows from Financing Activities:			
Net (decrease) increase in demand deposits, interest-bearing demand and savingsaccounts	(12,187)	16,190	7,981

Net decrease in time deposits		(90,336)		(41,490)		(97,153)
Proceeds from issuance of subordinated debentures						1,900
Proceeds from FHLB advances				60,000		27,000
Repayment of FHLB advances		(29,668)		(113,626)		(108,943)
Proceeds from (repayment of) other borrowed funds				(407)		180
Proceeds from issuance of common shares, net of share issuance costs				29		528
Net Cash Used by Financing Activities		(132,191)		(79,304)		(168,507)
Net (Decrease) Increase in Cash and Cash Equivalents		(53,375)		94,141		(11,859)
Cash & Cash Equivalents at Beginning of Year		168,646		74,505		86,364
Cash & Cash Equivalents at End of Year	$	115,271	$	168,646	$	74,505
Supplemental Cash Flow Information						
Cash paid (received) during the period for:						
Interest	$	7,092	$	12,329	$	21,985
Income taxes				(800)		(3,324)
Other transactions:						
Securities purchased but not settled				5,120		
Principal balance of loans transferred to OREO		1,586		3,995		9,928
Transfer from loans held for sale to loans				(1,289)		
Transfer from loans held for sale to other assets				698		749

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

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Notes to Consolidated Financial Statements

Note 1. Organization

First National Community Bancorp, Inc., is a registered bank holding company under the Bank Holding Company Act of 1956. It was incorporated under the laws of the Commonwealth of Pennsylvania in 1997. It is the parent company of First National Community Bank (the Bank) and the Bank s wholly owned subsidiaries FNCB Realty Company, Inc., FNCB Realty Company I, LLC, and FNCB Realty Company II, LLC. Unless the context otherwise requires, the term Company is used to refer to First National Community Bancorp, Inc., and its subsidiaries. In certain circumstances, however, the term Company refers to First National Community Bancorp, Inc., itself.

The Bank provides customary retail services to individuals and businesses through its twenty-one banking locations located in northeastern Pennsylvania.

FNCB Realty Company, Inc., FNCB Realty Company I, LLC, and FNCB Realty Company II, LLC were formed to hold real estate and/or operate businesses acquired in exchange for debt settlement or foreclosure.

During December 2006 the Bank created First National Community Statutory Trust I (Issuing Trust) which is wholly owned by the Company. The Issuing Trust was formed to provide an additional funding source for the Company through the issuance of pooled trust preferred securities. The Company has adopted Accounting Standards Codification 810-10, Consolidation, for the issuing trust. Accordingly, this trust has not been consolidated with the accounts of the Company, because the Company is not the primary beneficiary of the trust.

Note 2. Summary of Significant Accounting Policies

Basis of Presentation

The consolidated financial statements of the Company include the accounts of First National Community Bancorp, Inc., the Bank, and the Bank s wholly-owned subsidiaries. All inter-company transactions and balances have been eliminated. The accounting and reporting policies of the Company conform to accounting principles general accepted in the United States of America (GAAP) and general practices within the financial services industry.

The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and the disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ significantly from these estimates. Material estimates that are particularly susceptible to change are the allowance for loan and lease losses, investment security valuations, the evaluation of investment securities and other real estate owned for impairment, and the evaluation of deferred income taxes.

Cash Equivalents

For purposes of reporting cash flows, cash equivalents include cash on hand, amounts due from banks and federal funds sold. Generally, federal funds are purchased and sold for one day periods.

Securities

The Company classifies investment securities as either held-to-maturity or available-for-sale at the time of purchase. Investment securities that are classified as held-to-maturity are carried at amortized cost when management has the positive intent and ability to hold them to maturity. Investment securities that are classified as available-for-sale are carried at fair value with unrealized gains and losses recognized as a component of shareholders equity in accumulated other comprehensive income. Gains and losses on sales of investment securities are recognized using the specific identification method on a trade date basis. Interest income on investments includes amortization of premiums and accretion of discounts. Realized gains and losses are derived based on the amortized cost of the security sold.

Quarterly, the Company evaluates its investment securities classified as held-to-maturity or available-for-sale for other-than-temporary-impairment (OTTI). Unrealized losses on securities are considered to be other-than-temporarily- impaired when the Company believes the security s impairment is due to factors that could include the issuer s inability to pay interest or dividends, the issuer s 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, the Company must first consider (a) whether management intends to sell the security and (b) whether it is more

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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, the Company compares the present value of cash flows expected to be collected with the amortized cost basis of the security. The portion of the total OTTI related to credit loss is identified as the amount of principal cash flows not expected to be received over the remaining term of the security as estimated based on cash flow projections discounted at the applicable original yield of the security, and 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 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.

For equity securities, the entire decline in the value that is considered other-than-temporary is recognized in earnings.

Investments in the Federal Reserve Bank and Federal Home Loan Bank stock have limited marketability, are carried at cost and are evaluated for impairment based on the Company s determination of the ultimate recoverability of the par value of the stock. The investment in the Federal Reserve Bank stock is included in other assets.

Loans and Loan Fees

Loans receivable, other than loans held for sale, are stated at the principal outstanding, net of unamortized loan fees and costs, partial charge-offs and the allowance for loan and lease losses. Interest income on all loans is recognized using the effective interest method. Loan origination and commitment fees, as well as certain direct loan origination costs, are deferred and the net amount is amortized as an adjustment of the related loan s yield. The Bank is generally amortizing these amounts over the life of the related loans except for residential mortgage loans, where the timing and amount of prepayments can be reasonably estimated. For these mortgage loans, the net deferred fees or costs are amortized over an estimated average life of five years. Amortization of deferred loan fees or costs is discontinued when a loan is placed on non-accrual status.

Loans are placed on non-accrual status when a loan is specifically determined to be impaired or when management believes that the collection of interest or principal is doubtful. This is generally when a default of interest or principal has existed for 90 days or more, unless such loan is fully secured and in the process of collection, or when management becomes aware of facts or circumstances that the loan would default before 90 days. The Company determines delinquency status based on the number of days since the date of the borrower s last required contractual loan payment. When the interest accrual is discontinued, the balance of any previously accrued but unpaid interest is reversed and charged against interest income. Any cash payments subsequently received are applied, first to the outstanding loan amounts, then to the recovery of any charged-off loan amounts. Any excess amount is treated as a recovery of lost interest. A non-accrual loan is returned to accrual status when the loan is current as to principal and interest payments, is performing according to contractual terms for six consecutive months and future payments are reasonably assured.

In underwriting a loan secured by real property (unless exempt based on legal requirements), the Company requires an appraisal of the property by an independent licensed appraiser approved by the Bank s Board of Directors. The appraisal is either reviewed internally or by an independent third party hired by the Bank. Generally, management obtains updated appraisals when a loan is deemed impaired. These appraisals may be more limited than those prepared for the underwriting of a new loan.

Troubled Debt Restructurings

A troubled debt restructuring (TDR) is a loan for which the Company, for legal or economic reasons related to a debtor s financial difficulties, has granted a concession to the debtor that it otherwise would not have considered. Such concessions granted generally involve a reduction of the stated interest rate, an extension of a loan s maturity date, or payment modifications. Non-accrual TDRs are returned to accrual status if principal and interest payments, under the modified terms, are brought current, are performing under the modified terms for six consecutive months and future payments are reasonably assured.

Loan Impairment

A loan is considered impaired when it is probable that the Bank will be unable to collect all amounts due (including principal and interest) according to the contractual terms of the note and loan agreement. For purposes of the Company s analysis, TDRs, loans rated substandard and on non-accrual status and loans that are identified as doubtful or loss are considered impaired. Impaired loans are analyzed individually for impairment. The Company generally utilizes the fair value of collateral method for collateral dependent loans. A loan is considered to be collateral dependent when repayment of the loan is expected to be provided through the liquidation of the collateral held. For impaired loans that are secured by real estate, external appraisals are obtained annually, or more frequently as warranted, to ascertain a fair value so that the impairment analysis can be updated. Should a current appraisal not be available at the time of impairment analysis, other sources of valuation such as current letters of intent, broker price opinions or executed agreements of

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sale may be used. For non-collateral dependent impaired loans and TDRs, the Company measures impairment based on the present value of expected future cash flows, discounted at the loan s original effective interest rate.

Generally all loans with balances of $100 thousand or less are considered within homogeneous pools and are not individually evaluated for impairment. However, individual loans with balances of $100 thousand or less are individually evaluated for impairment if that loan is part of a larger impaired loan relationship or the loan is considered a TDR.

Impaired loans or portions thereof are charged-off upon determination that all or a portion of the loan balance is uncollectible and exceeds the fair value of the collateral. A loan is considered uncollectible when the borrower is delinquent with respect to principal or interest repayment and it is unlikely that the borrower will have the ability to pay the debt in a timely manner, collateral value is insufficient to cover the outstanding indebtedness and the guarantors (if applicable) do not provide adequate support for the loan.

Allowance for Loan and Lease Losses

Management continually evaluates the credit quality of the Company s loan portfolio, and performs a formal review of the adequacy of the allowance for loan and lease losses (ALLL) on a quarterly basis. Management establishes the ALLL through provisions for loan losses charged to earnings and maintains the ALLL at a level it considers adequate to absorb probable losses inherent in the loan portfolio as of the evaluation date. Loans, or portions of loans, determined by management to be uncollectable are charged off against the ALLL, while recoveries of amounts previously charged off are credited to the ALLL.

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 and 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 examinations 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 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 two components, a specific component and a general component. 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 by loan segment and risk rating categories of Pass , Special Mention or Substandard and Accruing. Historical loss factors and various qualitative factors are applied based on the risk profile in each risk rating category to determine the appropriate reserve related to those loans. As previously mentioned, substandard loans on nonaccrual status are included in impaired loans.

When establishing the ALLL, management categorizes loans into segments generally based on the nature of the collateral and basis of repayment. These risk characteristics of the Company s loan segments are as follows:

Construction, Land Acquisition and Development Loans - These loans consist of loans secured by real estate, with the purpose of constructing one-to-four family homes, residential developments and various commercial properties including, shopping centers, office complexes and single-purpose, owner-occupied structures. Additionally, loans in this category include loans for land acquisition, secured by raw land. 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 other mortgage loans but also carry more risk.

Commercial Real Estate Loans - These loans represent the largest portion of the Bank s total loan portfolio and loans in this portfolio generally carry larger loan balances. The commercial real estate mortgage 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 and multifamily housing. 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 where deemed necessary. The Bank offers various rates and terms for commercial mortgage loans secured by real estate. The interest rates associated with these types of loans are primarily priced as adjustable-rate loans with re-pricing dates extending three through seven years or floating-rate loans that adjust to a spread over the National Prime Rate (NPR) index. Loan pricing for most floating-rate commercial mortgage loans generally has a minimum interest rate. The terms for commercial real estate loans typically do not exceed 20 years. Commercial real estate mortgage loans are originated under a comprehensive lending policy. In particular, these types of loans are subject to specific

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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 mortgage 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 mortgage 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 maintain 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 its 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. The Bank offers various rates and terms for commercial loans. These loans also normally require the personal guarantee of the principals where 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 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.

State and Political Subdivision Loans - The Bank originates general obligation notes and tax anticipation loans to state and political subdivisions, which are primarily municipalities in the Bank s market area.

Residential Real Estate 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 to customers that allow the borrowers to lock in their interest rates at the time of application as well as at time of commitment. Residential mortgage loans are generally smaller in size and are considered homogeneous as they exhibit similar characteristics.

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. The Bank offers home equity loans and home equity 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 carry terms up to 15 years. Home 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.

Liability for Off-Balance-Sheet Credit-Related Financial Instruments

The Company is a party to financial instruments with off-balance sheet risk in the normal course of business to meet the financing need of its customers. These financial instruments include commitments to extend credit, unused portions of lines of credit, including revolving home equity lines of credit, and letters of credit. The Company s exposure to credit loss in the event of nonperformance by the other party to the financial instrument is represented by the contractual notional amount of these instruments. The Company uses the same credit policies in making these commitments as it does for on-balance-sheet instruments. In order to provide for probable losses inherent in these instruments, the Company records a reserve for unfunded commitments, included in other liabilities on the consolidated balance sheet, with the offsetting expense recorded in other operating expenses in the consolidated statements of operations.

Mortgage Banking Activities

Mortgage loans originated by the Bank and intended for sale are carried at the lower of aggregate cost or fair value determined on an individual loan basis. Net unrealized losses are recorded as a valuation allowance and charged to earnings. Gains and losses on sales of mortgage loans are based on the difference between the selling price and the carrying value of the related loan sold and include the value assigned to the rights to service the loan. Gains on the sales of loans for the years ended December 31, 2012, 2011 and 2010 were $0.9 million, $0.8 million and $1.2 million, respectively. Loans held for sale are generally sold with loan servicing rights retained by the Company. At December 31, 2012 and 2011, loans held for sale amounted to $1.6 million and $94 thousand, respectively.

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Servicing

Servicing assets are reported in other assets and amortized in proportion to and over the period during which estimated servicing income will be received. Servicing loans for others consists of collecting mortgage payments, maintaining escrow accounts, disbursing payments to investors, and processing foreclosures. Loan servicing income is recorded when earned and represents servicing fees from investors and certain charges collected from borrowers, such as late payment fees. The Company has fiduciary responsibility for related escrow and custodial funds.

Servicing assets are recognized as separate assets when rights are acquired through purchase or through sale of financial assets. Generally, purchased servicing rights are capitalized at the cost to acquire the rights. For sales of mortgage loans originated by the Bank, a portion of the cost of originating the loan is allocated to the servicing retained right based on fair value. Fair value is based on market prices for comparable mortgage servicing contracts, when available, or alternately, is based on a valuation model that calculates the present value of estimated future net servicing income. The valuation model incorporates assumptions that market participants would use in estimating future net servicing income, such as the cost to service, the discount rate, the custodial earnings rate, an inflation rate, ancillary income, prepayment speeds and default rates and losses. Capitalized servicing rights are amortized into interest income in proportion to, and over the period of, the estimated future net servicing income of the underlying financial assets.

Servicing assets are evaluated for impairment based upon the fair value of the rights as compared to amortized cost. Impairment is determined by stratifying rights into tranches based on predominant risk characteristics, such as interest rate, loan type and investor type. Impairment is recognized through a valuation allowance for an individual tranche, to the extent that fair value is less than the capitalized amount for the tranche. If the Bank later determines that all or a portion of the impairment no longer exists for a particular tranche, a reduction of the allowance may be recorded as an increase to income. Servicing fee income is recorded for fees earned for servicing loans. The fees are based on a contractual percentage of the outstanding principal or a fixed amount per loan and are recorded as income when earned.

Transfers of Financial Assets

Transfers of financial assets are accounted for as sales when control over the assets has been surrendered. Control over transferred assets is deemed to be surrendered when (1) the assets have been isolated from the Company put presumptively beyond the reach of the transferor and its creditors, even in bankruptcy or other receivership, (2) the transferee obtains the right (free of conditions that constrain it from taking advantage of that right) to pledge or exchange the transferred assets, and (3) the transferor does not maintain effective control over the transferred assets through either (a) an agreement that both entitles and obligates the transferor to repurchase or redeem the assets before maturity or (b) the ability to unilaterally cause the holder to return specific assets, other than through a cleanup call.

Other Real Estate Owned

Other real estate owned (OREO) consists of property acquired by foreclosure, abandonment or conveyance of deed in-lieu of foreclosure of a loan and is held for sale. OREO is initially recorded at fair value less costs to sell, which establishes a new cost basis. OREO is subsequently carried on the consolidated statement of financial condition at the lower of cost or the estimated fair value of the real estate less expected costs to sell at the reporting date. Any loss upon reclassification from loans to OREO is recognized as a charge to the ALLL. Any subsequent decline in the value, prior to disposal of the property, is charged to operations. Valuations are determined on an individual asset basis 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, while holding period costs are charged to expense as incurred.

Bank Premises and Equipment

Land is stated at cost. Bank premises, equipment and leasehold improvements are stated at cost less accumulated depreciation. Costs for routine maintenance and repair are expensed as incurred, while significant expenditures for improvements are capitalized. Depreciation expense is computed generally using the straight-line method over the following ranges of estimated useful lives, or in the case of leasehold improvements, to the expected terms of the leases, if shorter.

Buildings and improvements	10 to 40 years
Furniture, fixtures and equipment	3 to 15 years
Leasehold improvements	5 to 30 years

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Intangible Assets

Intangible assets consist entirely of a core deposit intangible which arose in connection with the acquisition of the Bank s Honesdale branch. The core deposit intangible is amortized over an estimated useful life of 10 years.

Long-lived Assets

Intangible assets and bank premises and equipment are reviewed by management at least annually for potential impairment and whenever events or circumstances indicate that carrying amounts may not be recoverable.

Income Taxes

The Bank recognizes income taxes under the asset and liability method. Under this method, deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in income in the period that includes the enactment date. Deferred tax assets are reduced by a valuation allowance when, in the opinion of management, it is more-likely-than-not that all or some portion of the deferred tax assets will not be realized.

The Company files a consolidated Federal income tax return. Under tax sharing agreements, each subsidiary provides for and settles income taxes with the Company as if it would have filed on a separate return basis.

When tax returns are filed, it is highly certain that some positions taken would be sustained upon examination by the taxing authorities, while others are subject to uncertainty about the merits of the position taken or the amount of the position that would be ultimately sustained. The benefit of a tax position is recognized in the financial statements in the period during which, based on all available evidence, management believes it is more-likely-than-not that the position will be sustained upon examination, including the resolution of appeals or litigation processes, if any. Tax positions taken are not offset or aggregated with other positions. Tax positions that meet the more-likely-than-not recognition threshold are measured as the largest amount of tax benefit that is more than 50% likely of being realized upon settlement with the applicable taxing authority. The portion of the benefits associated with tax positions taken that exceeds the amount measured as described above is reflected as a liability for unrecognized tax benefits along with any associated interest and penalties that would be payable to the taxing authorities upon examination. The Company determined that it had no liabilities for uncertain tax positions at December 31, 2012 and 2011.

Interest and penalties related to income taxes, if any, are presented within non-interest expense.

Earnings per Share

Earnings per share is calculated on the basis of the weighted-average number of common shares outstanding during the year. Basic earnings per share excludes dilution and is computed by dividing net income available to common shareholders by the weighted-average common shares outstanding during the period. Diluted earnings per share takes into account the potential dilution that could occur if outstanding stock options were exercised and converted into common stock. The dilutive effect of stock options is calculated using the treasury stock method.

Stock-Based Compensation

The fair value of each option grant is estimated on the date of grant using the Black-Scholes option-pricing model. All options are charged against income at their fair value. The entire expense of the award is recognized over the vesting period. Shares of stock granted are recorded at the fair value of the shares at the grant date, over the vesting period.

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Bank-Owned Life Insurance

Bank-owned life insurance (BOLI) represents the cash surrender value of life insurance policies on certain current and former directors and officers of the Company. The Company purchased the insurance as a future source of funding for the Company s liabilities, including the payment of employee benefits such as health care. BOLI is carried in the consolidated statements of financial condition at its cash surrender value. Increases in the cash value of the policies, as well as proceeds received, are recorded in non-interest income, and are not subject to income taxes. Under some of these policies, the beneficiaries receive a portion of the death benefit. The net present value of the future death benefits scheduled to be paid to the beneficiaries was $99 thousand and $93 thousand at December 31, 2012 and 2011, respectively, and is reflected in Other Liabilities on the consolidated statements of financial condition.

Fair Value Measurement

The Company uses fair value measurements to record fair value adjustments to certain financial assets and liabilities and to determine fair value disclosures. Available-for-sale securities are recorded at fair value on a recurring basis. Additionally, from time to time, the Company may be required to recognize adjustments to other assets at fair value on a nonrecurring basis, such as impaired loans, other securities, and OREO.

Fair value is the price that would be received to sell an asset or paid to transfer a liability in the principal or most advantageous market in an orderly transaction between market participants at the measurement date. An orderly transaction is a transaction that assumes exposure to the market for a period prior to the measurement date to allow for marketing activities that are usual and customary for transactions involving such assets or liabilities: it is not a forced transaction.

Accounting standards define fair value, establish a framework for measuring fair value, establish a three-level hierarchy for disclosure of fair value measurement and provide disclosure requirements about fair value measurements. The valuation hierarchy is based upon the transparency of inputs to the valuation of an asset or liability as of the measurement date.

The three levels of the fair value hierarchy are:

- Level 1 valuation is based upon unadjusted quoted market prices for identical instruments traded in active markets.

- Level 2 valuation is based upon quoted market prices for similar instruments traded in active markets, quoted market prices for identical or similar instruments traded in markets that are not active and model-based valuation techniques for which all significant assumptions are observable in the market or can be corroborated by market data.

• Level 3 valuation is derived from other valuation methodologies including discounted cash flow models and similar techniques that use significant assumptions not observable in the market. These unobservable assumptions reflect estimates of assumptions that market participants would use in determining fair value.

Comprehensive Income

Accounting principles generally require that recognized revenue, expenses, gains and losses be included in net income (loss). Although certain changes in assets and liabilities, such as unrealized gains and losses on available-for-sale securities, are reported as a separate component of the shareholders equity section of the statement of financial condition, such items, along with a net income (loss), are components of comprehensive income (loss).

New Authoritative Accounting Guidance

Accounting Standards Update (ASU) No. 2011-04, Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRS , an update to ASC Topic 820 - Fair Value Measurement, results in common fair value measurement and disclosure requirements in U.S. GAAP and IFRS. The amendments in ASU No. 2011-04 include clarifications about the application of existing fair value measurement requirements and changes to principles for measuring fair value. ASU No. 2011-04 also requires additional disclosures about fair value measurements. ASU No. 2011-04 is required to be applied prospectively and is effective for interim and annual periods beginning after December 15, 2011. The Company adopted this new guidance for the quarter ended March 31, 2012. The adoption of this guidance did not have a material impact on the Company s consolidated financial statements; however, the adoption did have an impact on the Company s fair value disclosures. See Note 18 for the disclosures required by the adoption of this new guidance.

ASU No. 2011-05, Presentation of Comprehensive Income, an update to ASC Topic 220 - Comprehensive Income, 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

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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. The Company adopted this new guidance for the quarter ended March 31, 2012. Accordingly, the Company presents comprehensive income in a separate Statement of Comprehensive Income.

Accounting Guidance to be Adopted In Future Periods

ASU No. 2011-11, Balance Sheet (Topic 210) - Disclosures about Offsetting Assets and Liabilities was issued in December 2011. 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 this 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. The adoption of ASU 2011-11 on January 1, 2013 will not have an effect on the operating results or financial position of the Company.

ASU No. 2012-02 Intangibles-Goodwill and Other (Topic 350): Testing Indefinite-Lived Intangible Assets for Impairment was issued in July 2012. This update simplifies the guidance for testing the decline in realizable value (impairment) of indefinite-lived intangible assets other than goodwill. The amendment allows an entity the option to first assess qualitative factors to determine whether it is necessary to perform the quantitative impairment test. An organization electing to perform a qualitative assessment is no longer required to calculate the fair value of an indefinite-lived intangible asset unless the organization determines, based on a qualitative assessment, that it is more likely than not that the asset is impaired. This amendment is effective for annual and interim impairment tests performed for fiscal years beginning after September 15, 2012. Early adoption is permitted. The adoption of ASU 2012-02 on January 1, 2013 will not have an effect on the operating results or financial position of the Company.

ASU No. 2013-01 Balance Sheet (Topic 210): Clarifying the Scope of Disclosures about Offsetting Assets and Liabilities was issued in January 2013. This update clarifies the scope of transactions that are subject to the disclosures about offsetting, specifically that ordinary trade receivables and receivables are not in the scope of ASU No. 2011-11. ASU No. 2011-11 applies only to derivatives, repurchase agreements and reverse purchase agreements, and securities borrowing and securities lending transactions that are offset in accordance with specific criteria contained in FASB Accounting Standards Codification or subject to a master netting arrangement or similar agreement. ASU 2013-01 is effective for fiscal years beginning on or after January 1, 2013, and interim periods within those annual periods. The adoption of ASU 2013-01 on January 1, 2013 will not have an effect on the operating results or financial position of the Company.

ASU No. 2013-02 Comprehensive Income (Topic 220): Reporting of Amounts Reclassified Out of Accumulated Other Comprehensive Income was issued in February 2013. The objective of this update was to improve the transparency of reporting these reclassifications. The new amendments will require an organization to: present either on the face of the statement where income is presented or in the notes to the financial statements the effects on the line items of net income of significant amounts reclassified out of accumulated other comprehensive income; or cross reference to other disclosures currently required under GAAP for other reclassification items to be reclassified directly to income in their entirety in the same reporting period. The amendments apply to all public and private companies that report other comprehensive income. Public companies are required to comply with these amendments for all reporting periods, both interim and annual periods, beginning after December 15, 2012. The adoption of ASU 2013-02 on January 1, 2013 is not expected to have a material effect on the operating results or financial position of the Company.

Reclassification of Prior Year Financial Statements

Certain reclassifications have been made to the prior year s consolidated financial statements to conform to the current year s presentation. Such reclassifications had no impact on the Company s results of operations.

Note 3. RESTRICTED CASH BALANCES

The Bank is required to maintain certain average reserve balances as established by the Federal Reserve Bank. The amount of those reserve balances for the reserve computation period which included December 31, 2012 and 2011 was $1.4 million and $1.7 million, respectively, which amount was satisfied through the restriction of vault cash and deposits maintained at the Federal Reserve Bank.

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At December 31, 2011, the Bank was required to maintain a compensating balance at the Federal Home Loan Bank of Pittsburgh in the amount of $30 million to collateralize a letter of credit which the Bank had pledged to collateralize certain municipal deposits. The Bank was not required to maintain any such compensating balance at December 31, 2012.

In addition, the Bank maintains compensating balances at correspondent banks, most of which are not required, but are used to offset specific charges for services. At December 31, 2012 and 2011, the amount of these balances was $378 thousand and $775 thousand, respectively.

Note 4. SECURITIES

Securities have been classified in the consolidated financial statements according to management s intent. The amortized cost, gross unrealized gains and losses, and the fair value of the Company s securities are as follows:

	December 31, 2012							
(in thousands)		**Amortized cost**		**Gross unrealized holding gains**		**Gross unrealized holding losses**		**Fair value**
Available-for-sale								
Obligations of U.S. government agencies	$	1,821	$	70	$		$	1,891
Obligations of state and political subdivisions		95,312		8,922		733		103,501
Collateralized mortgage obligations:								
Government-sponsored agency		8,805		311		13		9,103
Residential mortgage-backed securities:								
Government-sponsored agency		67,765		1,920		229		69,456
Corporate debt securities		500				90		410
Equity securities		1,010				10		1,000
Total securities available-for-sale	$	175,213	$	11,223	$	1,075	$	185,361
Held-to-maturity								
Obligations of state and political subdivisions	$	2,198	$	285	$		$	2,483

	December 31, 2011							
(in thousands)		**Amortized cost**		**Gross unrealized holding gains**		**Gross unrealized holding losses**		**Fair value**
Available-for-sale								
Obligations of U.S. government agencies	$	7,893	$	155	$		$	8,048
Obligations of state and political subdivisions		96,392		3,767		3,998		96,161
Collateralized mortgage obligations:								
Government-sponsored agency		8,093		380		5		8,468
Private label		36,607		13		364		36,256
Residential mortgage-backed securities:								

Government-sponsored agency	30,426	967		31,393
Pooled trust preferred senior class	3,833		2,229	1,604
Pooled trust preferred mezzanine class	6,732		4,535	2,197
Corporate debt securities	500		158	342
Equity securities	1,010		4	1,006
Total securities available-for-sale	$ 191,486	$ 5,282	$ 11,293	$ 185,475
Held-to-maturity				
Obligations of state and political subdivisions	$ 2,094	$ 151	$	$ 2,245

At December 31, 2012 and 2011, securities with a carrying amount of $185.0 million and $150.8 million, respectively, were pledged as collateral to secure public deposits.

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The following table shows the approximate fair value of the Company s debt securities at December 31, 2012 using contractual maturities. Expected maturities will differ from contractual maturity because issuers may have the right to call or prepay obligations with or without call or prepayment penalties. Because collateralized mortgage obligations and mortgage-backed securities are not due at a single maturity date, they are not included in the maturity categories in the following maturity summary.

	December 31, 2012			
	Available-for-sale		Held-to-maturity	
(in thousands)	Amortized Cost	Fair Value	Amortized Cost	Fair Value
Amounts maturing in:				
One Year or Less	$	$	$	$
One Year through Five Years	1,165	1,118		
After Five Years through Ten Years	29,394	31,613	2,198	2,483
After Ten Years	67,074	73,071		
Collateralized mortgage obligations	8,805	9,103		
Mortgage-backed securities	67,765	69,456		
Total	$ 174,203	$ 184,361	$ 2,198	$ 2,483

Gross proceeds from the sale of securities for the years ended December 31, 2012, 2011 and 2010 were $46.1 million, $122.6 million and $36.6 million, respectively, with the gross realized gains being $1.4 million, $5.1 million and $1.2 million, respectively, and gross realized losses being $3.1 million, $2 thousand and $2.9 million, respectively.

The tables below indicate the length of time that individual securities held-to-maturity and available-for-sale have been in a continuous unrealized loss position at December 31, 2012 and 2011:

	December 31, 2012					
	Less than 12 Months		12 Months or Greater		Total	
(in thousands)	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses
Obligations of state and political subdivisions	$ 8,649	$ 398	$ 4,139	$ 335	$ 12,788	$ 733
Collateralized mortgage obligations:						
Government-sponsored agency	1,485	13	2		1,487	13
Residential mortgage-backed securities:						
Government-sponsored agency	12,899	229			12,899	229
Corporate debt securities			410	90	410	90
Equity Securities	990	10			990	10
Total	$ 24,023	$ 650	$ 4,551	$ 425	$ 28,574	$ 1,075

	December 31, 2011					
	Less than 12 Months		12 Months or Greater		Total	
(in thousands)	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses
Obligations of state and political subdivisions	$ 11,129	$ 241	$ 25,910	$ 3,757	$ 37,039	$ 3,998

Collateralized mortgage obligations:												
Government-sponsored agency		1,028		5						1,028		5
Private label		30,459		364						30,459		364
Pooled Trust Preferred Senior Class						1,604		2,229		1,604		2,229
Pooled Trust Preferred Mezzanine Class						2,197		4,535		2,197		4,535
Corporate debt securities						342		158		342		158
Equity Securities		996		4						996		4
Total	$	43,612	$	614	$	30,053	$	10,679	$	73,665	$	11,293

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The majority of the Company s securities portfolio is comprised of obligations of states and political subdivisions, residential mortgage-backed securities and collateralized mortgage obligations. The Company held 47 securities that were in an unrealized loss position at December 31, 2012. Substantially all of the unrealized losses relate to debt securities.

In determining whether unrealized losses are other-than-temporary, management considers the following factors:

- 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 the security to allow for recovery in fair value, as well as the likelihood of such a recovery in the near term;
- The Company s intent to sell the security, or if it is more likely than not that the Company will be required to sell the security before recovery of its amortized cost basis less any current-period credit loss.

Management performed a review of the fair values of all securities at December 31, 2012 and determined that movements in the values of the securities were consistent with the change in market interest rates. As a result of its review and considering the attributes of these debt securities, the Company concluded that OTTI did not exist at December 31, 2012. To date, the Company has received all scheduled principal and interest payments and expects to fully collect all future contractual principal and interest payments. The Company does not intend to sell the securities nor is it more likely than not that the Company will be required to sell the securities.

Management does not believe that any individual unrealized loss at December 31, 2012 represents OTTI. The unrealized losses reported for residential mortgage-backed securities and collateralized mortgage obligations relate entirely to securities issued by GNMA, FHLMC and FNMA that are currently rated AAA by Moody s Investor Services or Aaa by Standard & Poor s and are guaranteed by the U.S. government. The obligations of states and political subdivisions are comprised entirely of general-purpose debt obligations. The majority of these obligations have a credit quality rating of A or better and are secured by the unlimited taxing power of issuer. In addition, the Company utilized a third party to perform an independent credit analysis of its state and political subdivision bonds that were either nonrated or had a rating below A. There were two obligations of states and political subdivisions that were either nonrated or had a rating below A. According to this analysis, these two bonds were considered investment grade.

OTTI of Pooled Trust Preferred Collateralized Debt Obligations (PreTSLs):

At December 31, 2011, the Company s PreTSLs were comprised of four securities that were collateralized by debt issued by bank holding companies and insurance companies. The Company divested its holdings of PreTSLs during 2012 and held no such securities at December 31, 2012. At December 31, 2011, the PreTSLs, which had an aggregate amortized cost of $10.6 million and an estimated fair value of $3.8 million, had depreciated 81.7% and 64.0% from their current face values and amortized cost, respectively. The Company held one senior tranche and three mezzanine tranches. All of the securities possessed credit ratings below investment grade. 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 12.09% 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. At June 30, 2012, the Company had determined that the estimate of projected discounted cash flows it expected to receive on its PreTSLs was less than the securities carrying value, and as a result an additional credit-related impairment charge to earnings of $96 thousand was recorded, which was the total of such impairment charge recorded in 2012.

During the fourth quarter of 2012, the market for these securities began to improve as some of the bank holding companies and insurance companies that had previously deferred payments had cured. As a result, the Company s unrealized loss position related to these securities improved. In an effort to reduce balance sheet risk and the levels of classified assets, management decided to sell all four PreTSLs in the Company s portfolio. The Company realized gross gains of $848 thousand on the sale of PreTSLs IX and XI and gross losses of $3.0 million on the sale of PreTSLs XIX and XXVI. The $6.8 million that was identified as the non-credit portion of OTTI recorded for PreTSLs in prior years was included in the determination of net income and was reversed from accumulated other comprehensive income.

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

(in thousands)		2012		2011		2010
Beginning Balance, January 1	$	8,619	$	22,598	$	20,649
Credit losses on debt securities for which OTTI was not previously recognized						
Additional credit losses on debt securities for which OTTI was previously recognized		96		798		4,271
Less: Sale of Private Label CMOs for which OTTI was previously recognized						(2,322)
Less: Sale of PreTSLs for which OTTI was previously recognized		(8,715)		(14,777)		
Ending Balance, December 31	$		$	8,619	$	22,598

Investments in FHLB and FRB stock, which have limited marketability, are carried at cost and totaled $7.3 million and $9.7 million at December 31, 2012 and 2011, respectively. Management noted no indicators of impairment for the FHLB of Pittsburgh and the FRB of Philadelphia during 2012.

Note 5. LOANS

Loans receivable, net, consists of the following at December 31, 2012 and 2011:

	December 31,			
(in thousands)		2012		2011
Residential real estate	$	90,228	$	80,056
Commercial real estate		231,835		256,508
Construction, land acquisition and development		32,502		33,450
Commercial and industrial		110,073		174,233
Consumer		109,783		111,778
State and political subdivisions		23,354		23,496
Total loans, gross		597,775		679,521
Unearned discount		(103)		(159)
Net deferred loan fees and costs		260		516
Allowance for loan and lease losses		(18,536)		(20,834)
Loans, net	$	579,396	$	659,044

The Company has granted loans, letters of credit and lines of credit to certain executive officers and directors of the Company as well as to certain related parties of executive officers and directors. These loans, letters of credit and lines of credit were made on substantially the same terms, including interest rates and collateral, as those prevailing at the time for comparable transactions with unrelated persons and, when made, did not involve more than normal risk of collectability. See Note 14 to these consolidated financial statements for more information about related party transactions.

For information about credit concentrations within the Company s loan portfolio, refer to Note 15 to these consolidated statements.

The Company originates one-to-four family mortgage loans for sale in the secondary market. During the years ended December 31, 2012, 2011 and 2010, the Company sold $26.2 million, $28.1 million and $43.9 million of one-to-four family mortgages, respectively. The Company retains servicing rights on these mortgages.

The Company had $1.6 million and $94 thousand in loans held-for-sale at December 31, 2012 and 2011, respectively. All loans held for sale are one-to-four family residential mortgage loans.

During the year ended December 31, 2010, the Company sold $36.7 million in loans from its Indirect Auto Loan Portfolio. The Company retained the servicing rights to these loans. The Company did not sell any indirect auto loans in 2012 and 2011.

The Company sold three non-performing commercial real estate loans during the year ended December 31, 2012. The three loans had an aggregate recorded investment of $6.8 million at the time of sale, after charge-offs recorded. No gain or loss was recognized upon the sale of these loans.

The Company does not have any lending programs commonly referred to as subprime lending. Subprime lending generally targets borrowers with weakened credit histories typically characterized by payment delinquencies, previous charge-offs, judgments, bankruptcies, or borrowers with questionable repayment capacity as evidenced by low credit scores or high debt-burden ratios.

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The Company provides for loan losses based on the consistent application of its documented ALLL methodology. Loan losses are charged to the ALLL and recoveries are credited to it. Additions to the ALLL are provided by charges against income based on various factors which, in our judgment, deserve current recognition of estimated probable losses. Loan losses are charged-off in the period the loans, or portion thereof, are deemed uncollectible. Generally, the Company will record a loan charge-off (including a partial charge-off) to reduce a loan to the estimated recoverable amount based on the methodology detailed below. The Company regularly reviews the loan portfolio and makes adjustments for loan losses in order to maintain the ALLL in accordance with GAAP. The ALLL consists primarily of the following two components:

(1) Specific allowances are established for impaired loans, which are defined by the Company as all loan relationships with an aggregate outstanding balance greater than $100 thousand that are rated substandard and on non-accrual status, rated doubtful or loss, or are considered a TDR. The amount of impairment provided for as an allowance is represented by the deficiency, if any, between the carrying value of the loan and either (a) the present value of expected future cash flows discounted at the loan s effective interest rate, (b) the loan s observable market price, or (c) the fair value of the underlying collateral, less estimated costs to sell, for collateral dependent loans. Impaired loans that have no impairment losses are not considered for general valuation allowances described below. If the Company determines that collection of the impairment amount is remote, the Company will record a charge-off.

(2) General allowances are established for loan losses on a portfolio basis for loans that do not meet the definition of impaired. The Company divides its portfolio into loan segments, with loans exhibiting similar characteristics. Loans rated special mention or substandard and accruing which are embedded in these loan segments are then separated from these loan segments. These loans are then subject to an analysis placing increased emphasis on the credit risk associated with these loans. The Company applies an estimated loss rate to each loan group. The loss rates applied are based on the Company s own historical loss experience based on the loss rate for each segment of loans with similar risk characteristics in its portfolio. In addition management evaluates and applies certain qualitative or environmental factors that are likely to cause estimated credit losses associated with the Company s existing portfolio that may differ from historical experience, which are discussed below. This evaluation is inherently subjective, as it requires material estimates that may be susceptible to significant revisions based upon changes in economic and real estate market conditions. Actual loan losses may be significantly more than the ALLL that is established, which could have a material negative effect on the Company s financial results.

Management makes adjustments for loan losses based on its evaluation of several qualitative and environmental factors, including but not limited to:

- Changes in national, local, and business economic conditions and developments, including the condition of various market segments;
- Changes in the nature and volume of the Company s loan portfolio;
- Changes in the Company s lending policies and procedures, including underwriting standards, collection, charge-off and recovery practices and results;
- Changes in the experience, ability and depth of the Company s lending management and staff;
- Changes in the quality of the Company s loan review system and the degree of oversight by the Company s Board of Directors;
- Changes in the trend of the volume and severity of past due and classified loans, including trends in the volume of non-accrual loans, troubled debt restructurings and other loan modifications;

- The existence and effect of any concentrations of credit and changes in the level of such concentrations;

- The effect of external factors such as competition and legal and regulatory requirements on the level of estimated credit losses in the Company s current loan portfolio; and

- Analysis of our customers credit quality, including knowledge of their operating environment and financial condition.

Management evaluates the ALLL based on the combined total of the specific and general components. Generally, when the loan portfolio increases, absent other factors, the ALLL methodology results in a higher dollar amount of estimated probable losses. Conversely, when the loan portfolio decreases, absent other factors, the ALLL methodology results in a lower dollar amount of estimated probable losses.

Each quarter, management evaluates the ALLL and adjusts the ALLL as appropriate through a provision for loan losses. While the Company uses the best information available to make evaluations, future adjustments to the ALLL may be necessary if conditions differ substantially from the information used in making the evaluations. In addition, as an integral part of its examination process, the Office of the Comptroller of the Currency (OCC) periodically reviews the Company s ALLL. The OCC may require the Company to adjust the ALLL based on its analysis of information available to it at the time of its examination.

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In the fourth quarter of 2012, the Company changed its loan segment structure to combine the indirect auto loans and installment/HELOC loans, which were previously considered separate classes of consumer loans. Management determined that both loan classes exhibited similar risk characteristics and therefore did not need to be separately evaluated in the ALLL calculation. In addition, the Company no longer segregates solid waste landfill loans from other commercial and industrial loans. During 2012, a significant amount of the solid waste landfill loans were paid off. The remaining balance of these loans was not material to warrant evaluation as a separate class at December 31, 2012.

The following tables present activity in the ALLL, by loan category, the amount of gross loans receivable that are evaluated individually and collectively for impairment, and the related portion of the ALLL that is allocated to each loan portfolio segment for the years ended December 31, 2012, 2011 and 2010:

Allowance for Loan and Lease Losses by Loan Category
December 31, 2012

Allowance for loan losses:							
Beginning Balance, January 1, 2012	$ 1,823	$ 11,151	$ 2,590	3,292	1,526	$ 452	$ 20,834
Charge-offs	(683)	(3,298)	(258)	(3,389)	(673)		(8,301)
Recoveries	35	1,035	265	265	338		1,938
Provisions	589	(826)	(435)	3,999	517	221	4,065
Ending Balance, December 31, 2012	$ 1,764	$ 8,062	$ 2,162	$ 4,167	$ 1,708	$ 673	$ 18,536
Ending balance, December 31, 2012: Individually evaluated for impairment	$ 40	$ 268	$ 2	$	$	$	$ 310
Ending balance, December 31, 2012: Collectively evaluated for impairment	$ 1,724	$ 7,794	$ 2,160	$ 4,167	$ 1,708	$ 673	$ 18,226
Loans receivable:							
Ending balance, December 31, 2012	$ 90,228	$ 231,835	$ 32,502	$ 110,073	$ 109,783	$ 23,354	$ 597,775
Ending balance, December 31, 2012: Individually evaluated for impairment	$ 2,773	$ 11,459	$ 993	$	$	$	$ 15,225
Ending balance, December 31, 2012: Collectively evaluated for impairment	$ 87,455	$ 220,376	$ 31,509	$ 110,073	$ 109,783	$ 23,354	$ 582,550

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Allowance for Loan and Lease Losses by Loan Category
December 31, 2011

	Real Estate			Commercial and Industrial		Consumer			
(in thousands)	**Residential Real Estate**	**Commercial Real Estate**	**Construction, Land Acquisition and Development**	**Solid Waste Landfills**	**Commercial and Industrial**	**Indirect Auto**	**Installment/ HELOC**	**State and Political Subdivisions**	**Total**
Allowance for loan losses:									
Beginning Balance, January 1, 2011	$ 2,176	$ 9,640	$ 4,170	$ 11	$ 4,839	597	$ 576	$ 566	$ 22,575
Charge-offs	(1,273)	(2,395)	(1,857)		(416)	(530)	(209)		(6,680)
Recoveries	57	93	2,188		1,852	219	7		4,416
Provisions	863	3,813	(1,911)	5	(2,999)	516	350	(114)	523
Ending Balance, December 31, 2011	$ 1,823	$ 11,151	$ 2,590	$ 16	$ 3,276	$ 802	$ 724	$ 452	$ 20,834
Ending balance, December 31, 2011: individually evaluated for impairment	$ 65	$ 545	$ 91	$	$	$	$	$	$ 701
Ending balance, December 31, 2011: collectively evaluated for impairment	$ 1,758	$ 10,606	$ 2,499	$ 16	$ 3,276	$ 802	$ 724	$ 452	$ 20,133
Loans receivable:									
Ending balance, December 31, 2011	$ 80,056	$ 256,508	$ 33,450	$ 42,270	$ 131,963	$ 63,722	$ 48,056	$ 23,496	$ 679,521
Ending balance, December 31, 2011: individually evaluated for impairment	$ 3,615	13,012	2,979		4,066		31		$ 23,703
Ending balance, December 31, 2011: collectively evaluated for impairment	$ 76,441	$ 243,496	$ 30,471	$ 42,270	$ 127,897	$ 63,722	$ 48,025	$ 23,496	$ 655,818

Allowance for Loan and Lease Losses by Loan Category
December 31, 2010

	Real Estate			Commercial & Industrial		Consumer			
(in thousands)	**Residential Real Estate**	**Commercial Real Estate**	**Construction, Land Acquisition and Development**	**Solid Waste Landfills**	**Other**	**Indirect Auto**	**Installment/ HELOC**	**State and Political Subdivisions**	**Total**

Allowance for loan losses:									
Beginning Balance, January 1, 2010	$ 696	$ 8,397	$ 6,285		$ 4,507	938	$ 1,069	$ 566	$ 22,458
Charge-offs	(221)	(5,049)	(12,893)		(6,883)	(507)	(229)		(25,782)
Recoveries	32	152	303		151	189	31		858
Provisions	1,669	6,140	10,475	11	7,064	(23)	(295)		25,041
Ending Balance, December 31, 2010	$ 2,176	$ 9,640	$ 4,170	$ 11	$ 4,839	$ 597	$ 576	$ 566	$ 22,575
Ending balance, December 31, 2010: individually evaluated for impairment	$ 785	372	310		339				$ 1,806
Ending balance, December 31, 2010: collectively evaluated for impairment	$ 1,391	$ 9,268	$ 3,860	$ 11	$ 4,500	$ 597	$ 576	$ 566	$ 20,769
Loans receivable:									
Ending balance, December 31, 2010	$ 87,925	$ 256,327	$ 77,395	$ 52,270	$ 145,427	$ 63,509	$ 47,344	$ 27,739	$ 757,936
Ending balance, December 31, 2010: individually evaluated for impairment	$ 2,926	9,477	11,365		6,029		132		$ 29,929
Ending balance, December 31, 2010: collectively evaluated for impairment	$ 84,999	$ 246,850	$ 66,030	$ 52,270	$ 139,398	$ 63,509	$ 47,212	$ 27,739	$ 728,007

Credit Quality Indicators Commercial Loans

The Company continuously monitors the credit quality of its commercial loans. Credit quality is monitored by reviewing certain credit quality indicators. Management has determined that internally assigned credit risk ratings by loan type are the key credit quality indicators that best help management monitor the credit quality of the Company s loans.

The Bank s commercial loan classification and credit grading processes are part of the lending, underwriting, and credit administration functions to ensure an ongoing assessment of credit quality. Accurate and timely loan classification or credit grading is a critical component of loan portfolio management. Loan officers are required to review their loan portfolio risk ratings regularly for accuracy. The loan review function uses the same risk rating system in the loan review process. This allows an independent third party to assess the quality of the portfolio and compare the accuracy of ratings with the loan officer s and management s assessment.

A formal loan classification and credit grading system reflects the risk of default and credit losses. A written description of the risk ratings is maintained that includes a discussion of the factors used to assign appropriate classifications of credit grades to loans. The

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process identifies groups of loans that warrant the special attention of management. The risk grade groupings provide a mechanism to identify risk within the loan portfolio and provide management and the Board with periodic reports by risk category. The credit risk ratings play an important role in the establishment and evaluation of the provision for loan and lease losses and the ALLL. After determining the historical loss factor which is adjusted for qualitative and environmental factors for each portfolio segment, the portfolio segment balances that have been collectively evaluated for impairment are multiplied by the general reserve loss factor for the respective portfolio segments in order to determine the general reserve. Loans that have an internal credit rating of special mention or substandard follow the same process; however, the qualitative and environmental factors are further adjusted for the increased risk.

The Company utilizes a loan rating system that assigns a degree of risk to commercial loans based on relevant information about the ability of borrowers to service their debt such as: current financial information, historical payment experience, credit documentation, public information and current economic trends, among other factors. The Company analyzes these non-homogeneous loans individually by grading the loans as to credit risk and probability of collection for each type of loan. Commercial loans include commercial indirect auto loans which are not individually risk rated, and Construction, Land Acquisition and Development Loans include residential construction loans which are also not individually risk rated. These loans are monitored on a pool basis due to their homogeneous nature as described in Credit Quality Indicators Other Loans below. The Company risk rates certain residential real estate loans and consumer loans that are part of a larger commercial relationship using its credit grading system. These loans are described in Commercial Credit Quality Indicators. The grading system contains the following basic risk categories:

1. Minimal Risk
2. Above Average Credit Quality
3. Average Risk
4. Acceptable Risk
5. Pass - Watch
6. Special Mention
7. Substandard - Accruing
8. Substandard - Non-Accrual
9. Doubtful
10. Loss

This analysis is performed on a quarterly basis using the following definitions for risk ratings:

Pass - Assets rated 1 through 5 are considered pass ratings. These assets show no current or potential problems and are considered fully collectible. All such loans are considered collectively for ALLL calculation purposes. However, accruing TDRs that have been performing for an extended period of time, do not represent a higher risk of loss, and have been upgraded to a pass rating are evaluated individually for impairment.

Special Mention   Assets classified as special mention assets do not currently expose the Company to a sufficient degree of risk to warrant an adverse classification but do possess credit deficiencies or potential weaknesses deserving close attention. Special Mention assets have a potential weakness or pose an unwarranted financial risk which, if not corrected, could weaken the asset and increase risk in the future.

Substandard - Assets classified as substandard have well defined weaknesses based on objective evidence, and are characterized by the distinct possibility that the Company will sustain some loss if the deficiencies are not corrected.

Doubtful - Assets classified as doubtful have all of the weaknesses inherent in those classified substandard with the added characteristic that the weaknesses present make collection or liquidation in full highly questionable and improbable based on current circumstances.

Loss - Assets classified as loss are those considered uncollectible and of such little value that their continuance as assets is not warranted.

The following tables detail the recorded investment in loans receivable by loan type and credit quality indicator at December 31, 2012 and 2011:

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Commercial Credit Quality Indicators

December 31, 2012

(in thousands)	Real Estate: Residential Real Estate	Real Estate: Commercial Real Estate	Real Estate: Construction, Land Acquisition and Development	Commercial and Industrial	Consumer	State and Political Subdivisions	Total
Internal Risk Rating							
Pass	$ 17,138	$ 200,147	$ 23,052	$ 93,864	$ 3,324	$ 17,580	$ 355,105
Special Mention	564	8,587	57	7,437		849	17,494
Substandard	2,309	23,101	7,395	3,395	143	4,925	41,268
Doubtful							
Loss							
Total	$ 20,011	$ 231,835	$ 30,504	$ 104,696	$ 3,467	$ 23,354	$ 413,867

Commercial Credit Quality Indicators

December 31, 2011

(in thousands)	Real Estate: Residential Real Estate	Real Estate: Commercial Real Estate	Real Estate: Construction, Land Acquisition and Development	Commercial and Industrial: Solid Waste Landfills	Commercial and Industrial: Other	Consumer Installment/ HELOC	State and Political Subdivisions	Total
Internal Risk Rating								
Pass	$ 19,267	$ 198,730	$ 15,924	$ 42,270	$ 117,104	$ 2,489	$ 23,464	$ 419,248
Special Mention	313	12,908	256		3,690	288		17,455
Substandard	3,906	44,870	14,090		5,532	144	32	68,574
Doubtful								
Loss								
Total	$ 23,486	$ 256,508	$ 30,270	$ 42,270	$ 126,326	$ 2,921	$ 23,496	$ 505,277

Credit Quality Indicators Other Loans

Residential, consumer, and commercial indirect auto loans are monitored on a pool basis due to their homogeneous nature. Loans that are delinquent 90 days or more are placed on non-accrual status. The Company utilizes accruing vs. non-accruing status as the credit quality indicator for these loan pools. The following tables present the recorded investment in residential, consumer and indirect auto loans based on payment activity at December 31, 2012 and 2011:

Other Loans Credit Quality Indicators

December 31, 2012

(in thousands)	Accruing Loans	Non-accruing Loans	Total
Residential real estate	$ 68,446	$ 1,771	$ 70,217
Construction, land acquisition and development - residential	1,998		1,998
Commercial - indirect auto	5,377		5,377
Consumer	106,272	44	106,316
Total	$ 182,093	$ 1,815	$ 183,908

Other Loans Credit Quality Indicators

December 31, 2011

(in thousands)	Accruing Loans	Non-accruing Loans	Total
Residential real estate	$ 55,112	$ 1,458	$ 56,570
Construction, land acquisition and development - residential	3,180		3,180
Consumer - indirect auto	63,718	4	63,722
Commercial - indirect auto	5,637		5,637
Installment/HELOC	45,103	32	45,135
Total	$ 172,750	$ 1,494	$ 174,244

Included in loans receivable are loans for which the accrual of interest income has been discontinued due to deterioration in the financial condition of the borrowers. The recorded investment of these non-accrual loans was $9.7 million and $19.9 million at December 31, 2012 and 2011, respectively. Generally, loans are placed on non-accruing status when they become 90 days or more delinquent, and remain on non-accrual status until they are brought current, have six months of performance under the loan terms, and factors indicating reasonable doubt about the timely collection of payments no longer exists. Therefore, loans may be current in accordance with their loan

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terms, or may be less than 90 days delinquent and still be on a non-accruing status. Loans past due ninety days or more and still accruing interest were $57 thousand and $5 thousand at December 31, 2012 and 2011, respectively, and consisted of loans that are well secured and in the process of renewal.

The following tables set forth the detail, and payment status, of past due and non-accrual loans at December 31, 2012 and 2011:

Performing and Non-Performing Loan Delinquency Status

		December 31, 2012 Delinquency Status			
(in thousands)	**0-29 Days Past Due**	**30-59 Days Past Due**	**60-89 Days Past Due**	**>/= 90 Days Past Due**	**Total**
Performing (Accruing) Loans:					
Real Estate:					
Residential Real Estate	$ 86,301	$ 422	$ 31	$ 30	$ 86,784
Commercial Real Estate	226,344	194			226,538
Construction, Land Acquisition and Development	31,899	29			31,928
Total Real Estate	344,544	645	31	30	345,250
Commercial and Industrial	109,312	517	20	27	109,876
Consumer	107,821	1,489	333		109,643
State and Political Subdivisions	23,354				23,354
Total Peforming (Accruing) Loans	585,031	2,651	384	57	588,123
Non-Accrual Loans:					
Real Estate:					
Residential Real Estate	953	105	230	2,156	3,444
Commercial Real Estate	250	121	4,352	574	5,297
Construction, Land Acquisition and Development	446			128	574
Total Real Estate	1,649	226	4,582	2,858	9,315
Commercial and Industrial	61	30	11	95	197
Consumer	2		2	136	140
State and Political Subdivisions					
Total Non-Accrual Loans	1,712	256	4,595	3,089	9,652
Total Loans Receivable	$ 586,743	$ 2,907	$ 4,979	$ 3,146	$ 597,775

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Performing and Non-Performing Loan Delinquency Status

	December 31, 2011 Delinquency Status				
(in thousands)	0-29 Days Past Due	30-59 Days Past Due	60-89 Days Past Due	>/= 90 Days Past Due	Total
Performing (Accruing) Loans:					
Real Estate:					
Residential Real Estate	$ 74,379	$ 1,293	$ 248	$	$ 75,920
Commercial Real Estate	243,873	2,381	1,235		247,489
Construction, Land Acquisition and Development	30,945	241			31,186
Total Real Estate	349,197	3,915	1,483		354,595
Commercial and Industrial:					
Solid Waste Landfills	42,270				42,270
Other	126,774	667	91	5	127,537
Total Commercial and Industrial	169,044	667	91	5	169,807
Consumer:					
Indirect Auto	62,753	845	120		63,718
Installment/HELOC	47,617	244	163		48,024
Total Consumer	110,370	1,089	283		111,742
State and Political Subdivisions	23,464				23,464
Total Peforming (Accruing) Loans	652,075	5,671	1,857	5	659,608
Non-Accrual Loans:					
Real Estate:					
Residential Real Estate	1,994	964	94	1,084	4,136
Commercial Real Estate	291	220		8,508	9,019
Construction, Land Acquisition and Development	426			1,838	2,264
Total Real Estate	2,711	1,184	94	11,430	15,419
Commercial and Industrial:					
Solid Waste Landfills					
Other	4,114	4	126	182	4,426
Total Commercial and Industrial	4,114	4	126	182	4,426
Consumer:					
Indirect Auto				4	4
Installment/HELOC				32	32
Total Consumer				36	36
State and Political Subdivisions				32	32
Total Non-Accrual Loans	6,825	1,188	220	11,680	19,913
Total Loans Receivable	$ 658,900	$ 6,859	$ 2,077	$ 11,685	$ 679,521

Impaired Loans

The following tables provide a distribution of the recorded investment, unpaid principal balance and related allowance for the Company s impaired loans, which have been analyzed for impairment under ASC 310, at December 31, 2012 and 2011. Non-accrual loans other than TDRs, with individual balances less than $100 thousand are not evaluated individually for impairment and are accordingly not included in the following tables. However, these loans are evaluated collectively for impairment as homogenous pools in the general allowance under ASC Topic 450. Total non-accrual loans, other than TDRs, with individual balances less than $100 thousand that were evaluated under ASC Topic 450 amounted to $1.9 million at both December 31, 2012 and 2011. At December 31, 2011 the Company held an impaired loan for which 70% of the principal balance outstanding was guaranteed by the U.S. Department of

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Agriculture (USDA). The guaranteed portion is included in the loans with no recorded allowance at December 31, 2011, as the Company believed it would be repaid in full from the USDA guarantee. This loan was sold in 2012.

	December 31, 2012		
(in thousands)	**Recorded Investment**	**Unpaid Principal Balance**	**Related Allowance**
With No Allowance Recorded:			
Real Estate:			
Residential Real Estate	$ 1,276	$ 1,378	$
Commercial Real Estate	389	665	
Construction, Land Acquisition and Development	709	804	
Total Real Estate Loans	2,374	2,847	
Commercial and Industrial			
Consumer			
State and Political Subdivisions			
Total Impaired Loans with No Related Allowance Recorded	**2,374**	**2,847**	
With a Related Allowance Recorded:			
Real Estate:			
Residential Real Estate	1,498	1,512	40
Commercial Real Estate	11,069	11,069	268
Construction, Land Acquisition and Development	285	285	2
Total Real Estate Loans	12,852	12,866	310
Commercial and Industrial			
Consumer			
State and Political Subdivisions			
Total Impaired Loans with a Related Allowance Recorded	**12,852**	**12,866**	**310**
Total of impaired loans			
Real Estate:			
Residential Real Estate	2,773	2,890	40
Commercial Real Estate	11,459	11,734	268
Construction, Land Acquisition and Development	993	1,088	2
Total Real Estate Loans	15,225	15,712	310
Commercial and Industrial			
Consumer			
State and Political Subdivisions			
Total Impaired Loans	**$ 15,225**	**$ 15,712**	**$ 310**

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(in thousands)	December 31, 2011 Recorded Investment	Unpaid Principal Balance	Related Allowance
With No Allowance Recorded:			
Real Estate:			
Residential Real Estate	$ 961	$ 1,097	$
Commercial Real Estate (2)	725	815	
Construction, Land Acquisition and Development	2,058	5,387	
Total Real Estate Loans	3,744	7,299	
Commercial and Industrial:			
Solid Waste Landfills			
Other	4,066	4,601	
Total Commercial and Industrial	4,066	4,601	
Consumer:			
Indirect Auto			
Installment/HELOC	31	35	
Total Consumer	31	35	
State and Political Subdivisions			
Total Impaired Loans with No Related Allowance Recorded	**7,841**	**11,935**	
With a Related Allowance Recorded:			
Real Estate:			
Residential Real Estate	2,654	3,274	65
Commercial Real Estate	12,287	14,187	545
Construction, Land Acquisition and Development	921	984	91
Total Real Estate Loans	15,862	18,445	701
Commercial and Industrial:			
Solid Waste Landfills			
Other			
Total Commercial and Industrial			
Consumer:			
Indirect Auto			
Installment/HELOC			
Total Consumer			
State and Political Subdivisions			
Total Impaired Loans with a Related Allowance Recorded	**15,862**	**18,445**	**701**
Total of impaired loans			
Real Estate:			
Residential Real Estate	3,615	4,371	65
Commercial Real Estate	13,012	15,002	545
Construction, Land Acquisition and Development	2,979	6,371	91
Total Real Estate Loans	19,606	25,744	701
Commercial and Industrial:			
Solid Waste Landfills			
Other	4,066	4,601	
Total Commercial and Industrial	4,066	4,601	
Consumer:			
Indirect Auto			

Installment/HELOC	31	35	
Total Consumer	31	35	
State and Political Subdivisions			
Total Impaired Loans	**$ 23,703**	**$ 30,380**	**$ 701**

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The total recorded investment in impaired loans, which consists of non-accrual loans with an aggregate loan relationship greater than $100,000 and TDRs, amounted to $15.2 million and $23.7 million at December 31, 2012 and 2011, respectively. The related allowance on impaired loans was $0.3 million and $0.7 million as of December 31, 2012 and 2011, respectively.

The following table presents the average balance and the interest income recognized on impaired loans for the years ended December 31, 2012, 2011, and 2010:

	Year Ended December 31,					
	2012		2011		2010	
(in thousands)	Average Balance	Interest Income (1)	Average Balance	Interest Income (1)	Average Balance	Interest Income (1)
Real Estate:						
Residential Real Estate	$ 3,882	$ 11	$ 2,834	$ 7	$ 2,491	$ 13
Commercial Real Estate	14,196	328	12,827	184	13,456	393
Construction, Land Acquisition & Development	2,340	37	6,445	38	21,707	53
Total Real Estate	20,418	376	22,106	229	37,654	459
Commercial and Industrial:						