FIRST NATIONAL COMMUNITY BANCORP INC
Form 10-Q
May 14, 2013
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended March 31, 2013

OR

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

For the transition period from to

Commission File No. 000-53869

FIRST NATIONAL COMMUNITY BANCORP, INC.

(Exact Name of Registrant as Specified in Its Charter)

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

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

(Former Name, Former Address and Former Fiscal Year, if Changed Since Last Report)

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

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

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

Large Accelerated Filer o	Accelerated Filer o
Non-Accelerated Filer x	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

Indicate the number of shares outstanding of each of the issuer s classes of common stock as of the latest practicable date:

Common Stock, $1.25 par value	**16,457,169 shares**

(Title of Class)	(Outstanding at May 14, 2013)

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PART I. Financial Information

Item 1. Financial Statements

FIRST NATIONAL COMMUNITY BANCORP, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF FINANCIAL CONDITION

(unaudited)

(in thousands, except share data)	March 31, 2013	December 31, 2012
Assets		
Cash and cash equivalents:		
Cash and due from banks	$ 11,451	$ 21,710
Interest-bearing deposits in other banks	20,892	93,561
Total cash and cash equivalents	32,343	115,271
Securities		
Available-for-sale at fair value	216,849	185,361
Held-to-maturity at amortized cost (fair value $2,501 and $2,483)	2,225	2,198
Stock in Federal Home Loan Bank of Pittsburgh, at cost	5,081	5,957
Loans held for sale	847	1,615
Loans, net of allowance for loan and lease losses of $18,473 and $18,536	597,682	579,396
Bank premises and equipment, net	18,658	18,937
Accrued interest receivable	2,618	2,199
Refundable federal income taxes	11,637	11,637
Intangible assets	591	632
Bank-owned life insurance	27,633	27,461
Other real estate owned	3,910	3,983
Other assets	9,453	13,627
Total Assets	**$ 929,527**	**$ 968,274**
Liabilities		
Deposits		
Demand (non-interest-bearing)	$ 121,187	$ 131,476
Interest-bearing	702,559	723,137
Total deposits	823,746	854,613
Borrowed funds		
FHLB advances	12,388	18,593
Subordinated debentures	25,000	25,000
Junior subordinated debentures	10,310	10,310
Total borrowed funds	47,698	53,903
Accrued interest payable	7,001	6,427
Other liabilities	14,264	16,406
Total liabilities	892,709	931,349
Shareholders Equity		
Preferred Shares ($1.25 par)		
Authorized: 20,000,000 shares at March 31, 2013 and December 31, 2012 Issued and outstanding: 0 shares at March 31, 2013 and December 31, 2012		

Common Shares ($1.25 par)				
Authorized: 50,000,000 shares at March 31, 2013 and December 31, 2012				
Issued and outstanding: 16,457,169 shares at March 31, 2013 and December 31, 2012		20,571		20,571
Additional paid-in capital		61,584		61,584
Accumulated deficit		(50,197)		(51,928)
Accumulated other comprehensive income		4,860		6,698
Total shareholders equity		36,818		36,925
Total Liabilities and Shareholders Equity	**$**	**929,527**	**$**	**968,274**

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

(unaudited)

	Three months ended March 31,	
(in thousands, except share data)	**2013**	**2012**
Interest income		
Interest and fees on loans	$ 6,607	$ 7,789
Interest and dividends on securities:		
U.S. government agencies	423	380
State and political subdivisions, tax-free	990	980
State and political subdivisions, taxable	116	130
Other securities	35	409
Total interest and dividends on securities	1,564	1,899
Interest on interest-bearing deposits and federal funds sold	39	56
Total interest income	8,210	9,744
Interest expense		
Deposits:		
Interest-bearing demand	159	183
Savings	26	46
Time ($100,000 and over)	317	415
Other time	616	888
Total interest on deposits	1,118	1,532
Interest on borrowed funds:		
Interest on FHLB advances	126	414
Interest on subordinated debentures	562	569
Interest on junior subordinated debentures	51	58
Total interest on borrowed funds	739	1,041
Total interest expense	1,857	2,573
Net interest income before credit for loan and lease losses	6,353	7,171
Credit for loan and lease losses	(1,224)	(136)
Net interest income after credit for loan and lease losses	7,577	7,307
Non-interest income		
Deposit service charges	678	737
Net gain on the sale of securities	842	8
Gross other-than-temporary impairment gains		175
Portion of gain recognized in other comprehensive income (before taxes)		(175)
Other-than-temporary-impairment losses recognized in earnings		
Net gain on the sale of loans held for sale	110	243
Net gain on the sale of other real estate owned	13	9
Loan related fees	108	124
Income from bank-owned life insurance	172	185
Other	536	144
Total non-interest income	2,459	1,450
Non-interest expense		
Salaries and employee benefits	3,320	3,638
Occupancy expense	584	598
Equipment expense	376	420
Advertising expense	77	148
Data processing expense	564	474
FDIC assessment	532	600

Bank shares tax		241		276
Expense of other real estate		218		178
Credit for off-balance sheet commitments		(121)		(65)
Legal expense		615		724
Professional fees		551		1,518
Insurance expense		323		232
Loan collection expense		227		229
Other operating expenses		798		952
Total non-interest expense		8,305		9,922
Income (loss) before income taxes		1,731		(1,165)
Provision for income taxes				
Net income (loss)	$	1,731	$	(1,165)
Income (loss) Per Share:				
Basic	$	0.11	$	(0.07)
Diluted	$	0.11	$	(0.07)
Cash dividends declared per common share				
Weighted average number of shares outstanding:				
Basic		16,457,169		16,442,119
Diluted		16,457,169		16,442,119

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

(unaudited)

	Three months ended March 31,	
(in thousands)	**2013**	**2012**
Net income (loss)	$ 1,731	$ (1,165)
Other comprehensive (loss) income, net of tax:		
Unrealized (losses) gains on securities available-for-sale	(1,943)	3,494
Taxes	661	(1,188)
Net of tax amount	(1,282)	2,306
Non-credit related gains on OTTI securities not expected to be sold		175
Taxes		(60)
Net of tax amount		115
Reclassification adjustment for gains included in net income (loss)	(842)	(8)
Taxes	286	3
Net of tax amount	(556)	(5)
Total other comprehensive (loss) income	(1,838)	2,416
Total comprehensive (loss) income	$ (107)	$ 1,251

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 CHANGES IN SHAREHOLDERS EQUITY

For the Three Months Ended March 31, 2013 and 2012

(unaudited)

(in thousands, except per share data)	Number of Common Shares	Common Stock	Additional Paid-in Capital	Accumulated Deficit	Accumulated Other Comprehensive Loss	Total Shareholders Equity
BALANCES, DECEMBER 31, 2011	16,442,119	$ 20,552	$ 61,557	$ (38,217)	$ (3,967)	$ 39,925
Net loss for the period				(1,165)		(1,165)
Other comprehensive income, net of tax of $1,245					2,416	2,416
Balances, March 31, 2012	16,442,119	$ 20,552	$ 61,557	$ (39,382)	$ (1,551)	$ 41,176
BALANCES, DECEMBER 31, 2012	16,457,169	$ 20,571	$ 61,584	$ (51,928)	$ 6,698	$ 36,925
Net income for the period				1,731		1,731
Other comprehensive loss, net of tax of $947					(1,838)	(1,838)
Balances, March 31, 2013	16,457,169	$ 20,571	$ 61,584	$ (50,197)	$ 4,860	$ 36,818

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

(unaudited)

(in thousands)	Three Months Ended March 31, 2013	2012
Cash flows from operating activities:		
Net income (loss)	$ 1,731	$ (1,165)
Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities:		
Investment securities accretion, net	(207)	(400)
Equity in trust	(1)	(1)
Depreciation and amortization	329	274
Credit for loan and lease losses	(1,224)	(136)
Credit for off balance sheet commitments	(121)	(65)
Gain on sale of investment securities	(842)	(8)
Gain on the sale of loans held for sale	(110)	(243)
Gain on the sale of other real estate owned	(13)	(9)
Recovery of other real estate owned		(26)
Income from bank-owned life insurance	(172)	(185)
Proceeds from the sale of loans held for sale	4,542	8,739
Funds used to originate loans held for sale	(3,664)	(10,188)
Increase in interest receivable	(419)	(109)
Decrease (increase) in prepaid expenses and other assets	4,108	(240)
Increase in interest payable	574	591
(Decrease) increase in accrued expenses and other liabilities	(1,074)	80
Total Adjustments	1,706	(1,926)
Net cash provided by (used in) operating activities	3,437	(3,091)
Cash flows from investing activities:		
Maturities, calls, and principal payments of investment securities available-for-sale	3,581	8,361
Sales of securities available-for-sale	17,121	
Purchases of securities available-for-sale	(53,953)	(19,850)
Redemption of Federal Home Loan Bank of Pittsburgh stock	876	420
Net increase in loans to customers	(16,950)	(8,583)
Proceeds from the sale of other real estate owned	86	1,106
Purchases of property and equipment	(54)	(712)
Net cash used in investing activities	(49,293)	(19,258)
Cash flows from financing activities:		
Net decrease in total deposits	(30,867)	(66,898)
Proceeds from FHLB advances		5,313
Repayment of FHLB advances	(6,205)	(8,988)
Net cash used in financing activities	(37,072)	(70,573)
Net decrease in cash and cash equivalents	(82,928)	(92,922)
Cash & cash equivalents at beginning of period	115,271	168,646
Cash & cash equivalents at end of period	$ 32,343	$ 75,724
Supplemental cash flow information		
Cash paid during the period for:		
Interest	$ 1,283	$ 1,982
Income taxes		25

Other transactions:	
Settlement of security recorded on trade date	5,120
Principal balance of loans transferred to OREO	239
Transfer from loans held for sale to loans, net	95

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

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FIRST NATIONAL COMMUNITY BANCORP, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

Note 1. Basis of Presentation

The consolidated financial statements are comprised of the accounts of First National Community Bancorp, Inc., and its wholly owned subsidiary, First National Community Bank (the Bank), as well as the Bank s wholly owned subsidiaries (collectively, the Company). The accounting and reporting policies of the Company conform to accounting principles generally accepted in the United States of America (GAAP) and general practices within the banking industry. In the opinion of management, all adjustments necessary for a fair presentation of the results for the quarterly period ended March 31, 2013 have been included in the consolidated financial statements. All intercompany balances and transactions have been eliminated in consolidation. Prior period amounts have been reclassified when necessary to conform to the current period s presentation. These reclassifications did not have a material effect on the operating results or financial position of the Company. The operating results and financial position of the Company for the three months ended March 31, 2013, may not be indicative of future results of operations and financial position.

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

These financial statements should be read in conjunction with the consolidated financial statements and notes thereto included in the Company s audited financial statements, included in our Annual Report filed on Form 10-K as of and for the year ended December 31, 2012.

Note 2. New Authoritative Accounting Guidance

Accounting Standards Update (ASU) No. 2011-11, Balance Sheet (Topic 210): Disclosures about Offsetting Assets and Liabilities requires 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 Accounting Standards Codification Topic (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. The Company adopted ASU No. 2011-11 on January 1, 2013. The adoption of this new guidance did 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 simplifies the guidance for testing the decline in realizable value (impairment) of indefinite-lived intangible assets other than goodwill. ASU No. 2012-02 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. The Company adopted ASU 2012-02 on January 1, 2013. The adoption of this new guidance did 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 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. This update 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. The Company adopted ASU 2013-01 on January 1, 2013. The adoption of this new guidance did 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 improves the transparency of reporting these reclassifications. The new amendments 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

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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. The Company adopted ASU 2013-02 on January 1, 2013. The adoption of this new guidance did not have an effect on the operating results or financial position of the Company, however see Note 9 for additional disclosures related to the adoption of ASU No. 2013-02.

Note 3. Regulatory Matters

The Bank is under a Consent Order (the Order) from the Office of the Comptroller of the Currency (OCC) dated September 1, 2010. The Company is also subject to a Written Agreement (the Agreement) with the Federal Reserve Bank of Philadelphia (the Reserve Bank) dated November 24, 2010.

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 required to submit written progress reports on a monthly basis to the OCC and the Agreement requires the Bank to make periodic reports and filings with the Reserve Bank. 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 is to include strategies to achieve those objectives; if the strategic plan involves the sale or merger of the Bank, it must address the timeline and steps to be followed to provide for a definitive agreement within 90 days after the receipt of a determination of no supervisory objection;

(ii) by October 31, 2010, the Board 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 must have reviewed 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, was required to review 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; to adopt, implement and ensure compliance with an independent BSA audit; and to assess the capabilities of the BSA officer and supporting staff to perform present and anticipated duties;

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(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 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;

(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 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.

During the three months ended March 31, 2013, and the year ended December 31, 2012, the Company incurred approximately $45 thousand and $585 thousand, respectively, of expenses related to 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.

The Order and 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.

Banking regulations also limit the amount of dividends that may be paid without prior approval of the Bank s regulatory agency. As of May 14, 2013, the Company and the Bank are restricted from paying any dividends without regulatory approval.

The Company is subject to various regulatory capital requirements administered by the federal banking agencies. Failure to meet minimum capital requirements can initiate certain mandatory and possibly additional discretionary actions by regulators that, if undertaken, could have a direct material adverse effect on the Company s financial statements. Under capital adequacy guidelines and the regulatory framework for prompt corrective action, specific capital guidelines that involve quantitative measures of assets, liabilities, and certain off-balance sheet items as calculated under regulatory accounting practices must be met. Capital amounts and classification are also subject to qualitative judgments by the regulators about components, risk weightings, and other factors.

Quantitative measures established by regulation to ensure capital adequacy require the Company to maintain minimum amounts and ratios (set forth in the table below) of total and Tier I capital (as defined in the regulations) to risk-weighted assets (as defined), and of Tier I capital (as defined) to average assets (as defined).

In accordance with the Order, the Bank is required to achieve and thereafter maintain total risk-based capital equal to at least 13% of risk-weighted assets and Tier 1 capital equal to at least 9% of adjusted total assets. At March 31, 2013 and December 31, 2012, the Bank was not in compliance with these requirements. The minimum capital requirements under the Order take precedence over the standard regulatory capital adequacy definitions described in the tables below. The Company s and the Bank s actual capital positions and ratios at March 31, 2013 and December 31, 2012 are presented in the following table:

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Capital Analysis

(in thousands)		March 31, 2013		December 31, 2012
Company				
Tier I capital:				
Total tier I capital	$	41,356	$	39,587
Tier II capital:				
Subordinated notes		20,679		19,796
Allowable portion of allowance for loan losses		8,367		8,452
Total tier II capital		29,046		28,248
Total risk-based capital		70,402		67,835
Total risk-weighted assets	$	658,621	$	665,323
Bank				
Tier I capital:				
Total tier I capital	$	72,343	$	69,963
Tier II capital:				
Allowable portion of allowance for loan losses		8,362		8,447
Total tier II capital		8,362		8,447
Total risk-based capital		80,705		78,410
Total risk-weighted assets	$	658,210	$	664,914

	Actual			For Capital Adequacy Purposes			To Be Well Capitalized Under Prompt Corrective Action Provision	
(dollars in thousands)		Amount	Ratio	Amount	Ratio		Amount	Ratio
March 31, 2013								
Total capital (to risk-weighted assets)								
Company	$	70,402	10.69% $	>52,690	>8.00%		N/A	N/A
Bank	$	80,705	12.26% $	>52,657	>8.00%	$	>65,821	>10.00%
Tier I capital (to risk-weighted assets)								
Company	$	41,356	6.28% $	>26,345	>4.00%		N/A	N/A
Bank	$	72,343	10.99% $	>26,328	>4.00%	$	>39,493	>6.00%
Tier I capital (to average assets)								
Company	$	41,356	4.42% $	>37,449	>4.00%		N/A	N/A
Bank	$	72,343	7.73% $	>37,434	>4.00%	$	>46,793	>5.00%

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(dollars in thousands)	Actual Amount	Actual Ratio	For Capital Adequacy Purposes Amount	For Capital Adequacy Purposes Ratio	To Be Well Capitalized Under Prompt Corrective Action Provision Amount	To Be Well Capitalized Under Prompt Corrective Action Provision Ratio
December 31, 2012						
Total capital						
[redacted]						
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%

Note 4. LOANS

The following table presents a summary of loans receivable, net, by category at March 31, 2013 and December 31, 2012:

(in thousands)	March 31, 2013	December 31, 2012
Residential real estate	$ 98,273	$ 90,228
Commercial real estate	248,455	231,835
Construction, land acquisition, and development	22,363	32,502
Commercial and industrial loans	112,176	110,073
Consumer loans	109,378	109,783
State and political subdivisions	25,278	23,354
Total loans, gross	615,923	597,775
Unearned discount	(89)	(103)
Net deferred loan fees and costs	321	260
Allowance for loan and lease losses	(18,473)	(18,536)
Loans, net	$ 597,682	$ 579,396

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. See Note 10 to these consolidated financial statements for more information about related party transactions.

The Company originates one-to-four family mortgage loans primarily for sale in the secondary market. During the quarter ended March 31, 2013, the Company sold $3.7 million of one-to-four family mortgages. The Company retains servicing rights on these mortgages.

The Company had $847 thousand and $1.6 million in loans held-for-sale at March 31, 2013 and December 31, 2012, respectively. All loans held for sale are one-to-four family residential mortgage 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.

See Note 2 to the Company s consolidated financial statements included in the 2012 Form 10-K for the risk characteristics related to the Company s loan segments.

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 management s judgment, deserve current recognition of estimated probable losses. Loan losses are charged-

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off in the period the loans, or portions 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 its 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, and all troubled debt restructured loans (TDRs). 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 specific 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 to 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 operating results or financial condition.

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

Management evaluates the ALLL based on the combined total of the impaired 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 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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The following table sets forth activity in the ALLL, by loan category, for the three months ended March 31, 2013 and 2012.

(in thousands)	Real Estate: Residential Real Esate	Real Estate: Commercial Real Estate	Real Estate: Construction, Land Acquisition and Development	Commercial and Industrial	Consumer	State and Political Subdivisions	Total
Three months ended March 31, 2013:							
Allowance for loan losses:							
Beginning balance, January 1, 2013	$ 1,764	$ 8,062	$ 2,162	$ 4,167	$ 1,708	$ 673	$ 18,536
Charge-offs	(159)	(48)	(110)	(45)	(194)		(556)
Recoveries	8	45	5	1,516	143		1,717
Provisions (credits)	271	823	(381)	(2,033)	82	14	(1,224)
Ending balance, March 31, 2013	$ 1,884	$ 8,882	$ 1,676	$ 3,605	$ 1,739	$ 687	$ 18,473
Three months ended March 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	(312)	(154)		(49)	(79)		(594)
Recoveries	19	317	21	125	78		560
Provisions (credits)	269	(573)	234	37	(68)	(35)	(136)
Ending balance, March 31, 2012	$ 1,799	$ 10,741	$ 2,845	$ 3,405	$ 1,457	$ 417	$ 20,664

The following table represents the allocation of the allowance for loan losses and the related loan by loan portfolio segment disaggregated based on the impairment methodology at March 31, 2013 and December 31, 2012:

(in thousands)	Real Estate: Residential Real Esate	Real Estate: Commercial Real Estate	Real Estate: Construction, Land Acquisition and Development	Commercial and Industrial	Consumer	State and Political Subdivisions	Total
March 31, 2013							
Allowance for loan losses:							
Individually evaluated for impairment	$ 26	$ 408	$ 84	$	$	$	$ 518
Collectively evaluated for impairment	1,858	8,474	1,592	3,605	1,739	687	17,955
Total	$ 1,884	$ 8,882	$ 1,676	$ 3,605	$ 1,739	$ 687	$ 18,473
Loans receivable:							
Individually evaluated for impairment	$ 2,158	$ 10,857	$ 943	$	$	$	$ 13,958
Collectively evaluated for impairment	96,115	237,598	21,420	112,176	109,378	25,278	601,965
Total	$ 98,273	$ 248,455	$ 22,363	$ 112,176	$ 109,378	$ 25,278	$ 615,923
December 31, 2012							

Allowance for loan losses:							
Individually evaluated for impairment	$ 40	$ 268	$ 2	$	$	$	$ 310
Collectively evaluated for impairment	1,724	7,794	2,160	4,167	1,708	673	18,226
Total	$ 1,764	$ 8,062	$ 2,162	$ 4,167	$ 1,708	$ 673	$ 18,536
Loans receivable:							
Individually evaluated for impairment	$ 2,773	$ 11,459	$ 993	$	$	$	$ 15,225
Collectively evaluated for impairment	87,455	220,376	31,509	110,073	109,783	23,354	582,550
Total	$ 90,228	$ 231,835	$ 32,502	$ 110,073	$ 109,783	$ 23,354	$ 597,775

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 credit risk ratings are the key credit quality indicator that best help management monitor the credit quality of the Company s loan receivables.

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 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 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.

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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 Credit Quality Indicators Commercial Loans. 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 the aforementioned class of loan and credit quality indicator at March 31, 2013 and December 31, 2012.

Commercial Credit Quality Indicators

March 31, 2013

		Real Estate					
(in thousands)	**Residential Real Esate**	**Commercial Real Estate**	**Construction, Land Acquisition and Development**	**Commercial and Industrial**	**Consumer**	**State and Political Subdivisions**	**Total**
Internal risk rating							
Pass	$ 18,943	$ 214,785	$ 13,622	$ 97,101	$ 2,445	$ 19,962	$ 366,858
Special mention	1,234	12,174	56	6,985		819	21,268
Substandard	1,714	21,496	7,221	2,804	171	4,497	37,903
Doubtful							
Loss							
Total	$ 21,891	$ 248,455	$ 20,899	$ 106,890	$ 2,616	$ 25,278	$ 426,029

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Commercial Credit Quality Indicators

December 31, 2012

(in thousands)	Residential Real Esate	Real Estate Commercial 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

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 considered to be non-accrual. The Company utilizes accruing versus non-accruing status as the credit quality indicator for these loan pools. The following table presents the recorded investment in residential, consumer and indirect auto loans based on payment activity as of March 31, 2013 and December 31, 2012.

(in thousands)	March 31, 2013 Accruing Loans	March 31, 2013 Non-Accruing Loans	March 31, 2013 Total	December 31, 2012 Accruing Loans	December 31, 2012 Non-Accruing Loans	December 31, 2012 Total
Construction, land acquisition and development - residential	$ 1,464	$	$ 1,464	$ 1,998	$	$ 1,998
Residential real estate	74,544	1,838	76,382	68,446	1,771	70,217
Commercial - indirect auto	5,268	18	5,286	5,377		5,377
Consumer	106,708	54	106,762	106,272	44	106,316
Total	$ 187,984	$ 1,910	$ 189,894	$ 182,093	$ 1,815	$ 183,908

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 in these non-accrual loans was $8.8 million and $9.7 million at March 31, 2013 and December 31, 2012, respectively. Included in non-accrual loans at March 31, 2013 and December 31, 2012 was one loan in the amount of $4.4 million which was 90.0% guaranteed by a United States government agency. 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 exist. Therefore, loans may be current in accordance with their loan terms, or may be less than 90 days delinquent and still be on a non-accrual status. Loans past due 90 days or more and still accruing interest were $0 and $57 thousand at March 31, 2013 and December 31, 2012, respectively, and consisted of loans that are well secured and are in the process of renewal.

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The following tables set forth the detail, and delinquency status, of past due and non-accrual loans at March 31, 2013 and December 31, 2012:

	March 31, 2013 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	$ 94,950	$ 260	$ 136	$	$ 95,346
Commercial real estate	242,848	481			243,329
Construction, land acquisition and development	21,909				21,909
Total real estate	359,707	741	136		360,584
Commercial and industrial	111,511	503	15		112,029
Consumer	107,487	1,329	384		109,200
State and political subdivisions	25,278				25,278
Total performing (accruing) loans	603,983	2,573	535		607,091
Non-accrual loans					
Real estate:					
Residential real estate	1,194	4		1,729	2,927
Commercial real estate	90	184		4,852	5,126
Construction, land aquisition and development	53	382		19	454
Total real estate	1,337	570		6,600	8,507
Commercial and industrial	48	5	64	30	147
Consumer	95	9	6	68	178
State and political subdivisions					
Total non-accrual loans	1,480	584	70	6,698	8,832
Total loans receivable	$ 605,463	$ 3,157	$ 605	$ 6,698	$ 615,923

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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 performing (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

The total recorded investment in impaired loans, which consists of non-accrual loans with an aggregate loan relationship of greater than $100,000 and performing TDRs, amounted to $14.0 million and $15.2 million at March 31, 2013 and December 31, 2012, respectively. The related allowance on impaired loans was $0.5 million and $0.3 million as of March 31, 2013 and December 31, 2012, respectively.

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The following tables provide a distribution of the recorded investment, unpaid principal balance and the related allowance for the Company s impaired loans, which have been analyzed for impairment under ASC 310, at March 31, 2013 and December 31, 2012. 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 450. Total non-accrual loans, other than TDRs, with individual balances less than $100 thousand that were evaluated under ASC 450 amounted to $1.7 million at March 31, 2013 and $1.9 million at December 31, 2012, respectively.

Impaired Loans

	March 31, 2013		
(in thousands)	**Recorded Investment**	**Unpaid Principal Balance**	**Related Allowance**
With no allowance recorded:			
Real estate			
Residential real estate	$ 1,264	$ 1,376	$
Commercial real estate	4,735	5,012	
Construction, land acquisition & development			
Total real estate	5,999	6,388	
Commercial and industrial			
Consumer			
State and political subdivisions			
Total impaired loans with no allowance recorded	5,999	6,388	
With a related allowance recorded:			
Real estate			
Residential real estate	894	919	26
Commercial real estate	6,122	6,122	408
Construction, land acquisition & development	943	1,044	84
Total real estate	7,959	8,085	518
Commercial and industrial			
Consumer			
State and political subdivisions			
Total impaired loans with a related allowance recorded	7,959	8,085	518
Total impaired loans			
Real estate			
Residential real estate	2,158	2,295	26
Commercial real estate	10,857	11,134	408
Construction, land acquisition & development	943	1,044	84
Total real estate	13,958	14,473	518
Commercial and industrial			
Consumer			

State and political subdivisions			
Total impaired loans	$ 13,958	$ 14,473	$ 518

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Impaired Loans

(in thousands)	December 31, 2012 Recorded Investment	Unpaid Principal Balance	Related Allowance
With no allowance recorded:			
Real estate:			
Residential real estate	$ 1,275	$ 1,378	$
Commercial real estate	389	665	
Construction, land acquisition & development	709	804	
Total real estate	2,373	2,847	
Commercial and industrial			
Consumer			
State and political subdivisions			
Total impaired loans with no allowance recorded	2,373	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 & development	285	285	2
Total real estate	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 impaired loans:			
Real estate:			
Residential real estate	2,773	2,890	40
Commercial real estate	11,459	11,734	268
Construction, land acquisition & development	993	1,088	2
Total real estate	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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The following table presents by loan portfolio class, the average balance and interest income recognized on impaired loans for the three months ended March 31, 2013 and 2012:

	Three Months Ended March 31,			
	2013		2012	
(in thousands)	Average Balance	Interest Income (1)	Average Balance	Interest Income (1)
Residential real estate	$ 2,168	$ 2	$ 2,834	$ 3
Commercial real estate	10,875	93	12,873	70
Construction, land acquisition & development	1,013	9	2,734	12
Total real estate	14,056	104	18,441	85
Commercial and industrial			3,806	
Consumer			31	
State and political subdivisions				
Total impaired loans	$ 14,056	$ 104	$ 22,278	$ 85

(1) Interest income represents income recognized on performing TDRs.

The additional interest income that would have been earned on non-accrual and restructured loans for the quarter ended on March 31, 2013 and 2012 in accordance with their original terms approximated $200 thousand and $405 thousand, respectively.

Troubled Debt Restructured Loans

TDRs at March 31, 2013 and December 31, 2012 were $8.2 million and $8.9 million, respectively. Accruing and non-accruing TDRs were $6.8 million and $1.4 million, respectively at March 31, 2013 and $7.5 million and $1.4 million, respectively at December 31, 2012. Approximately $505 thousand and $257 thousand in specific reserves have been established for these loans as of March 31, 2013 and December 31, 2012, respectively.

The modification of the terms of such loans included one or a combination of the following: a reduction of the stated interest rate of the loan, an extension of the maturity date at a stated rate of interest lower than the current market rate for new debt with similar risk, or a permanent reduction of the recorded investment in the loan.

The following tables show the pre- and post- modification recorded investment in loans modified as TDRs by portfolio segment and class of financing receivable during the three months ended March 31, 2013 and 2012:

(in thousands)	Three Months Ended March 31, 2013 Number of Contracts	Pre-Modification Outstanding Recorded Investments	Post-Modification Outstanding Recorded Investments	Three Months Ended March 31, 2012 Number of Contracts	Pre-Modification Outstanding Recorded Investments	Post-Modification Outstanding Recorded Investments
Troubled Debt Restructuring:						
Residential real estate		$	$		$	$
Commercial real estate	1	477	477			
Construction, land acquisition and development				1	39	39
Commercial and industrial						
Total new troubled debt restructurings	1	$ 477	$ 477	1	$ 39	$ 39

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The one loan modified as a TDR during the three months ended March 31, 2013 increased the ALLL by $1 thousand at March 31, 2013. There was no effect on the ALLL at March 31, 2012 with respect to loans modified as TDRs during the three months ended March 31, 2012.

The following table shows the types of modifications made during the three months ended March 31, 2013 and 2012:

	Three months ended March 31, 2013				Three months ended March 31, 2012			
(in thousands)	**Residential Real Estate**	**Commercial Real Estate**	**Construction, Land Acquistion and Development**	**Total**	**Residential Real Estate**	**Commercial Real Estate**	**Construction, Land Acquistion and Development**	**Total**
Type of modification								
Extension of term	$	$	$	$	$	$	$ 39	$ 39
Principal forebearance		477		477				
Total TDRs	$	$ 477	$	$ 477	$	$	$ 39	$ 39

There were no TDRs which re-defaulted (defined as past due 90 days) during the three months ended March 31, 2013 and 2012 and for which the payment re-default occurred within one year of the modification.

Note 5. Other Real Estate Owned

The following table presents the components of OREO at March 31, 2013 and December 31, 2012:

(in thousands)	**March 31, 2013**	**December 31, 2012**
Land/Lots	$ 2,856	$ 2,929
Commercial Real Estate	1,054	1,054
Total	$ 3,910	$ 3,983

The following table presents the activity in OREO for the three months ended March 31, 2013 and 2012:

	March 31,	
(in thousands)	**2013**	**2012**
Balance, January 1,	$ 3,983	$ 6,958
Additions		239
Valuation adjustments		26
Carrying value of OREO sold	(73)	(1,097)
Balance, March 31,	$ 3,910	$ 6,126

The following table details the components of net expense of OREO for the three months ended March 31, 2013 and 2012:

(in thousands)	Three Months Ended March 31, 2013	2012
Insurance	35	$ 21
Legal fees	33	33
Maintenance	25	16
Income from the operation of foreclosed properties	(7)	(4)
Professional fees	14	11
Real estate taxes	56	98
Utilities	7	4
Other	55	25
Impairment charges (credits)		(26)
Total	$ 218	$ 178

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Note 6. Securities

Securities have been classified as available-for-sale or held-to-maturity 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 at March 31, 2013 and December 31, 2012 are as follows:

	March 31, 2013			
(in thousands)	Amortized Cost	Gross Unrealized Holding Gains	Gross Unrealized Holding Losses	Fair Value
Available-for-sale				
Obligations of U.S. government agencies	$ 1,816	$ 54	$	$ 1,870
Obligations of state and political subdivisions	95,834	7,901	1,026	102,709
Government sponsored agency collateralized mortgage obligations	16,214	306	112	16,408
Government sponsorded agency residential mortgage-backed securities	94,112	664	323	94,453
Corporate debt securities	500		85	415
Equity securities	1,010		16	994
Total available-for-sale securities	$ 209,486	$ 8,925	$ 1,562	$ 216,849
Held-to-maturity				
Obligations of state and political subdivisions	$ 2,225	$ 276	$	$ 2,501

	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
Government sponsored agency collateralized mortgage obligations	8,805	311	13	9,103
Government sponsored agency residential mortgage-backed securities	67,765	1,920	229	69,456
Corporate debt securities	500		90	410
Equity securities	1,010		10	1,000
Total available-for-sale securities	$ 175,213	$ 11,223	$ 1,075	$ 185,361
Held-to-maturity				
Obligations of state and political subdivisions	$ 2,198	$ 285	$	$ 2,483

At March 31, 2013 and December 31, 2012, securities with a carrying amount of $217.1 million and $185.0 million, respectively, were pledged as collateral to secure public deposits and for other purposes.

The following table shows the approximate fair value of the Company s debt securities at March 31, 2013 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 mortgage-backed securities are not due at a single maturity date, they are not included in the maturity categories in the following maturity summary.

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	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	1,025	984		
After five years through ten years	31,541	33,743	2,225	2,501
After ten years	65,584	70,267		
Collateralized mortgage obligations	16,214	16,408		
Mortgage-backed securities	94,112	94,453		
Total	$ 208,476	$ 215,855	$ 2,225	$ 2,501

Gross proceeds from the sale of securities were $17.1 million for the three months ended March 31, 2013, with gross gains of $842 thousand realized upon the sales. The Company did not sell any securities during the three months ended March 31, 2012. The Company recognized gains of $8 thousand on securities called during the three months ended March 31, 2012. There were no gains recognized on securities called during the three months ended March 31, 2013.

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 March 31, 2013 and December 31, 2012:

	March 31, 2013					
	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	$ 14,314	$ 643	$ 3,988	$ 383	$ 18,302	$ 1,026
Government sponsored agency collateralized mortgage obligations	10,166	112			10,166	112
Government sponsored agency residential mortgage-backed securities	56,504	323			56,504	323
Corporate debt securities			415	85	415	85
Equity securities	984	16			984	16
Total	$ 81,968	$ 1,094	$ 4,403	$ 468	$ 86,371	$ 1,562

	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
Government sponsored agency collateralized mortgage obligations	1,485	13	2		1,487	13
Government sponsored agency residential mortgage-backed securities	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

The majority of the Company s securities portfolio is comprised of obligations of states and political subdivisions, residential mortgage-backed securities, including home equity conversion mortgages, and collateralized mortgage obligations. The Company held 71 securities that were in an unrealized loss position at March 31, 2013. 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;

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- 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 March 31, 2013 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 other than temporary impairment (OTTI) did not exist at March 31, 2013. 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 March 31, 2013 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 state 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 the 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 non-rated or had a rating below A. There were two obligations of state and political subdivisions that were either non-rated 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 March 31, 2012, the Company s PreTSLs were comprised of four securities that were collateralized by debt issued by bank holding companies and insurance companies with an aggregate amortized cost of $10.5 million and an estimated fair value of $4.0 million. The Company divested its entire holdings of PreTSLs during 2012 and held no such securities at March 31, 2013.

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

(in thousands)	**2013**	**2012**
Beginning Balance, January 1	$	$ 8,619
Credit losses on debt securities for which OTTI was not previously recognized		
Additional credit losses on debt securities for which OTTI was previously recognized		
Less: Sale of PreTSLs for which OTTI was previously recognized		
Ending Balance, March 31	$	$ 8,619

Investments in FHLB and FRB stock, which have limited marketability, are carried at cost and totaled $6.4 million and $7.3 million at March 31, 2013 and December 31, 2012, respectively. FRB stock of $1.3 million is included in Other Assets at March 31, 2013 and December 31, 2012. Management noted no indicators of impairment for the FHLB of Pittsburgh and FRB of Philadelphia at March 31, 2013.

Note 7. Fair Value Measurements

In determining fair value, the Company uses various valuation approaches, including market, income and cost approaches. Accounting standards establish a hierarchy for inputs used in measuring fair value that maximizes the use of observable inputs and minimizes the use of unobservable inputs by requiring that observable inputs be used when available. Observable inputs are inputs that market participants would use in pricing the asset or liability, which are developed based on market data obtained from sources independent of the Company. Unobservable inputs reflects the Company s assumptions about the assumptions the market participants would use in pricing an asset or liability, which are developed based on the best information available in the circumstances.

The fair value hierarchy gives the highest priority to unadjusted quoted market prices in active markets for identical assets or liabilities (Level 1 measurement) and the lowest priority to unobservable inputs (Level 3 measurement). A financial asset or liability s level within the fair value hierarchy is based on the lowest level of input that is significant to the fair value measurement. The fair value hierarchy is broken down into three levels based on the reliability of inputs as follows:

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

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- 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.

A description of the valuation methodologies used for assets recorded at fair value, and for estimating fair value of financial instruments not recorded at fair value, is set forth below.

Cash, Short-term Investments, Accrued Interest Receivable and Accrued Interest Payable

For these short-term instruments, the carrying amount is a reasonable estimate of fair value.

Securities

The estimated fair values of available-for-sale equity securities are determined by obtaining quoted prices on nationally recognized exchanges (Level 1 inputs). The estimated fair values for the Company s investments in obligations of U.S. government agencies, obligations of state and political subdivisions, government sponsored agency collateralized mortgage obligations, government- sponsored agency residential mortgage backed securities, and corporate debt securities are obtained by the Company from a nationally-recognized pricing service. This pricing service develops estimated fair values by analyzing like securities and applying available market information through processes such as benchmark curves, benchmarking of like securities, sector groupings and matrix pricing (Level 2 inputs), to prepare valuations. Matrix pricing is a mathematical technique widely used in the industry to value debt securities without relying exclusively on quoted prices for the specific securities, but rather by relying on the securities relationship to other benchmark quoted securities. The fair value measurements consider observable data that may include dealer quotes, market spreads, cash flows, the U.S. Treasury yield curve, live trading levels, trade execution data, market consensus prepayment speeds, credit information and the bond s terms and conditions, among other things and are based on market data obtained from sources independent from the Company. The Level 2 investments in the Company s portfolio are priced using those inputs that, based on the analysis prepared by the pricing service, reflect the assumptions that market participants would use to price the assets. The Company has determined that the Level 2 designation is appropriate for these securities because, as with most fixed-income securities, those in the Company s portfolio are not exchange-traded, and such non-exchange-traded fixed income securities are typically priced by correlation to observed market data. The Company has reviewed the pricing service s methodology to confirm its understanding that such methodology results in a valuation based on quoted market prices for similar instruments traded in active markets, quoted markets for identical or similar instruments traded in markets that are not active and model-based valuation techniques for which the significant assumptions can be corroborated by market data as appropriate to a Level 2 designation.

For those securities for which the inputs used by an independent pricing service were derived from unobservable market information, the Company evaluated the appropriateness and quality of each price. The Company reviewed the volume and level of activity for all classes of securities and attempted to identify transactions which may not be orderly or reflective of a significant level of activity and volume. For securities meeting these criteria, the quoted prices received from either market participants or an independent pricing service may be adjusted, as necessary, to estimate fair value (fair values based on Level 3 inputs). If applicable, the adjustment to fair value was derived based on present value cash flow model projections prepared by the Company or obtained from third party providers utilizing assumptions similar to those incorporated by market participants. The estimated fair value of the PreTSLs and the private label collateralized mortgage obligations that were previously held in the Company s securities portfolio during 2012 were obtained from third-party service providers that prepared the valuation using a discounted cash flow approach with inputs derived from unobservable market information (Level 3 inputs).

At March 31, 2013, the Company owned two securities issued by state and political subdivisions having an amortized cost of $1.6 million that are valued using Level 3 inputs. These securities had credit ratings that were either withdrawn or downgraded by nationally recognized credit rating agencies, and as a result of the ratings withdrawals and downgrade, the market for these securities at March 31, 2013 is no longer active. These securities were historically priced using Level 2 inputs. The credit ratings withdrawal and downgrade have resulted in a decline in the level of significant other observable inputs for these investment securities at the measurement date. Broker pricing and bid/ask spreads are very limited for these securities. One security was valued based on similar nonrated Pennsylvania Sewer bonds adjusted for coupon and maturity. For the other security, the Company obtained a bid indication from a third-party municipal trading desk to determine the fair value of this security.

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Loans

Except for collateral dependent impaired loans, fair values are estimated by discounting the projected future cash flows using market discount rates that reflect the credit, liquidity, and interest rate risk inherent in the loan. Projected future cash flows are calculated based upon contractual maturity or call dates, projected repayments and prepayments of principal. The estimated fair value of collateral dependent impaired loans is based on the appraised loan value or other reasonable offers less estimated costs to sell. The Company does not record loans at fair value on a recurring basis. However from time to time, a loan is considered impaired and an allowance for credit losses is established. The specific reserves for collateral dependent impaired loans are based on the fair value of the collateral less estimated costs to sell. The fair value of the collateral is based on appraisals. In some cases, adjustments are made to the appraised values due to various factors including age of the appraisal, age of comparables included in the appraisal, and known changes in the market and in the collateral. When significant adjustments are based on unobservable inputs, the resulting fair value measurement is categorized as a Level 3 measurement.

Loans Held For Sale

Fair values of mortgage loans held for sale are based on commitments on hand from investors or prevailing market prices.

Mortgage Servicing Rights

The fair value of mortgage servicing rights is estimated using a discounted cash flow model that applies current estimated prepayments derived from the mortgage-backed securities market and utilizes a current market discount rate for observable credit spreads. The Bank does not record mortgage servicing rights at fair value on a recurring basis.

Federal Home Loan Bank (FHLB) and Federal Reserve Bank (FRB) Stock

Ownership in equity securities of FHLB of Pittsburgh and the FRB is restricted and there is no established market for their resale. The carrying amount is a reasonable estimate of fair value.

Deposits

The fair value of demand deposits, savings deposits, and certain money market deposits is the amount payable on demand at the reporting date. The fair value of fixed-maturity certificates of deposit is estimated based on discounted cash flows using FHLB advance rates currently offered for similar remaining maturities.

Borrowed funds

The Bank uses discounted cash flows using rates currently available for debt with similar terms and remaining maturities to estimate fair value.

Commitments to extend credit and standby letters of credit

The fair value of commitments to extend credit and standby letters of credit are estimated using the fees currently charged to enter into similar agreements, taking into account the remaining terms of the agreements and the present creditworthiness of the counterparties. For fixed-rate loan commitments, fair value also considers the difference between current levels of interest rates and the committed rates. The fair value of off-balance sheet commitments is insignificant and therefore not included in the table for non-recurring assets and liabilities.

Assets measured at fair value on a recurring basis

The following tables detail the financial asset amounts that are carried at fair value and measured at fair value on a recurring basis at March 31, 2013 and December 31, 2012, and indicate the fair value hierarchy of the valuation techniques utilized by the Company to determine the fair value:

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		Fair value measurements at March 31, 2013		
(in thousands)	**Fair value**	**Quoted prices in active markets for identical assets (Level 1)**	**Significant other observable inputs (Level 2)**	**Significant other unobservable inputs (Level 3)**
Available-for-sale securities:				
Obligations of U.S. government agencies	$ 1,870	$	$ 1,870	$
Obligations of political and state subdivisions	102,709		101,105	1,604
Government sponsored agency CMOs	16,408		16,408	
Residential mortgage-backed securities	94,453		94,453	
Corporate debt securities	415		415	
Equity securities	994	994		
Total securities available-for-sale	$ 216,849	$ 994	$ 214,251	$ 1,604

		Fair value measurements at December 31, 2012		
(in thousands)	**Fair value**	**Quoted prices in active markets for identical assets (Level 1)**	**Significant other observable inputs (Level 2)**	**Significant other unobservable inputs (Level 3)**
Available-for-sale securities:				
Obligations of U.S. government agencies	$ 1,891	$	$ 1,891	$
Obligations of state and political subdivisions	103,501		101,762	1,739
Government sponsored agency CMO	9,103		9,103	
Residential mortgage-backed securities	69,456		69,456	
Corporate debt securities	410		410	
Equity securities	1,000	1,000		
Total securities available-for-sale	$ 185,361	$ 1,000	$ 182,622	$ 1,739

The table below presents reconciliation and statement of operations classifications of gains and losses for all assets measured at fair value on a recurring basis using significant unobservable inputs (Level 3) for the three month periods ended March 31, 2013 and 2012:

Fair Value Measurements

Using Significant Unobservable Inputs (Level 3)

(in thousands)	**State and Political Subdivisions**
Balance at December 31, 2012	$ 1,739
Amortization	
Accretion	
Payments received	(140)
Purchases	
Total gains or losses (realized/unrealized):	
Included in earnings	
Included in other comprehensive income	5
Balance at March 31, 2013	$ 1,604

Fair Value Measurements

Using Significant Unobservable Inputs (Level 3)

(in thousands)	PreTSLs	State and Political Subdivisions	Private Label CMOs	Total
Balance at December 31, 2011	$ 3,801	$ 2,811	$ 36,256	$ 42,868
Amortization			(119)	(119)
Accretion			29	29
Payments received	(27)	(135)	(3,065)	(3,227)
Purchases			14,730	14,730
Total gains or losses (realized/unrealized):				
Included in earnings				
Included in other comprehensive income	201	47	79	327
Balance at March 31, 2012	$ 3,975	$ 2,723	$ 47,910	$ 54,608

There were no transfers between levels within the fair value hierarchy during the periods ended March 31, 2013 and 2012.

Assets measured at fair value on a non-recurring basis

Assets and liabilities measured at fair value on a non-recurring basis are summarized below:

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(in thousands)	Fair Value (1)	Fair Value Measurements at March 31, 2013 Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Other Unobservable Inputs (Level 3)
Collateral-dependent impaired loans	$ 7,039			$ 7,039

(in thousands)	Fair Value (1)	Fair Value Measurements at December 31, 2012 Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Other Unobservable Inputs (Level 3)
Collateral-dependent impaired loans	$ 7,816			$ 7,816
Other real estate owned	$ 2,455			$ 2,455

(1) Represents carrying value and related write-downs for which adjustments are based on appraised value. Management makes adjustments to the appraised values as necessary to consider declines in real estate values since the time of the appraisal. Such adjustments are based on management s knowledge of the local real estate markets.

Collateral dependent impaired loans are classified as Level 3 assets and the estimated fair value of the collateral is based on independent appraisals of the underlying collateral, which generally include various Level 3 inputs which are not observable. Appraisals are adjusted by management for estimated costs to sell, which equals 10% and is recorded through a valuation allowance. When the measure of the impaired loan is less than the recorded investment in the loan, the impairment is recorded through a valuation allowance or is charged-off. The amount shown is the balance of impaired loans, net of any charge-offs and the related allowance for loan losses.

Other real estate owned properties are recorded at the fair value based on independent appraisals, which generally include various Level 3 inputs which are not observable, less the estimated cost to sell at the date of foreclosure. Subsequent to foreclosure, the balance might be subject to additional write-downs. It is the Company s policy to obtain certified external appraisals of real estate collateral underlying impaired loans, including OREO, and it estimates fair value using those appraisals. Other valuation sources may be used, including broker price opinions, letters of intent and executed sale agreements. The amount in the table above represents the value of OREO properties at December 31, 2012, which were subject to additional write-downs subsequent to foreclosure.

The Company discloses fair value information about financial instruments, whether or not recognized in the Statement of Financial Condition, for which it is practicable to estimate that value. The following estimated fair value amounts have been determined by the Company using available market information and appropriate valuation methodologies. However, management judgment is required to interpret data and develop fair value estimates. Accordingly, the estimates below are not necessarily indicative of the amounts the Company could realize in a current market exchange. The use of different market assumptions and/or estimation methodologies may have a material effect on the estimated fair value amounts. The estimated fair values of the Company s financial instruments are as follows:

(in thousands)	Fair Value Measurement	March 31, 2013 Carrying Value	Fair Value	December 31, 2012 Carrying Value	Fair Value
Financial assets					
Cash and short term investments	Level 1	$ 32,343	$ 32,343	$ 115,271	$ 115,271

Securities	See previous table	219,074	219,350	187,559	187,844
FHLB and FRB Stock	Level 2	6,432	6,432	7,308	7,308
Loans, net	Level 3	597,682	604,311	579,396	592,504
Loans held for sale	Level 2	847	847	1,615	1,615
Accrued interest receivable	Level 2	2,618	2,618	2,199	2,199
Mortgage servicing rights	Level 3	637	915	675	884
Financial liabilities					
Deposits	Level 2	823,746	827,780	854,613	858,970
Borrowed funds	Level 2	47,698	52,357	53,903	59,021
Accrued interest payable	Level 2	7,001	7,001	6,427	6,427

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Note 8. Earnings per Share

For the Company, the numerator of both the basic and diluted earnings per common share is net income available to common shareholders (which is equal to net income less dividends on preferred stock and related discount accretion). The weighted average number of common shares outstanding used in the denominator for basic earnings per common share is increased to determine the denominator used for diluted earnings per common share by the effect of potentially dilutive common share equivalents utilizing the treasury stock method. For the Company, common share equivalents are outstanding stock options to purchase the Company s common shares.

The following table presents the calculation of both basic and diluted earnings per common share for the three months ended March 31, 2013 and 2012:

(in thousands, except share data)	Three months ended March 31, **2013**		**2012**	
Net income (loss)	$	1,731	$	(1,165)
Basic weighted-average number of common shares outstanding		16,457,169		16,442,119
Plus: Common share equivalents				
Diluted weighted-average number of common shares outstanding		16,457,169		16,442,119
Loss per common share:				
Basic	$	0.11	$	(0.07)
Diluted	$	0.11	$	(0.07)

Common share equivalents, in the table above, exclude 129,170 (2013) and 188,193 (2012) stock options with exercise prices that exceed the average market price of the Company s common shares during the periods presented. Inclusion of these stock options would be anti-dilutive to the diluted earnings per common share calculation.

Note 9. Other Comprehensive Income

The following tables summarize the reclassifications out of accumulated other comprehensive income (loss):

(in thousands)		**Three Months Ended March 31, 2013** Amount Reclassified from Accumulated Other Comprehensive Income	**Affected Line Item in the Consolidated Statements of Operations**
Available-for-sale securities:			
Reclassification adjustment for net gains reclassified into net income	$	(842)	Net gain on sale of securities

Taxes		286	Income taxes
Net of tax amount	$	(556)	

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(in thousands)	Three Months Ended March 31, 2012 Amount Reclassified from Accumulated Other Comprehensive Loss	Affected Line Item in the Consolidated Statements of Operations
Available-for-sale securities:		
Reclassification adjustment for net gains reclassified into net loss	$ (8)	Net gain on sale of securities
Taxes	3	Income taxes
Net of tax amount	$ (5)	

The following table summarizes the changes in accumulated other comprehensive income (loss), net of tax:

(in thousands)	Three Months Ended March 31, 2013	2012
Beginning balance	$ 6,698	$ (3,967)
Other comprehensive (loss) income before reclassifications	(1,282)	2,421
Amounts reclassified from accumulated other comprehensive income (loss)	(556)	(5)
Net other comprehensive (loss) income during the period	(1,838)	2,416
Ending balance	$ 4,860	$ (1,551)

Note 10. Related Party Transactions

The Company and the Bank have engaged in and intend to continue to engage in banking and financial transactions in the conduct of its business with directors and executive officers of the Company and the Bank and their related parties.

The Bank has granted loans, letters of credit and lines of credit to directors, executive officers and their related parties. The following table summarizes the changes in the total amounts of such outstanding loans, advances under lines of credit as well as repayments during the three months ended March 31, 2013 and 2012.

(in thousands)	March 31, 2013	2012
Outstanding at beginning of the year	$ 33,296	$ 87,442
New loans and advances	12,188	9,870
Repayments / reductions	(10,853)	$ (10,814)
Other (1)	(256)	
Outstanding at end of period	$ 34,375	$ 86,498

(1) Other represents loans to related parties that ceased being related parties during the period.

At March 31, 2013, loans to directors, executive officers and their related parties which were not performing in accordance with the terms of the loan agreements totaled $190 thousand.

Included in related party loans is $6.6 million outstanding under a commercial line of credit (line) to a company owned by a director. The Company also sold a participation interest in this line to the same director in the amount of $5.2 million, of which $2.6 million is outstanding. The Bank receives a 25 basis point annual servicing fee from this director on the participation balance.

Deposits from directors, executive officers and their related parties held by the Bank at March 31, 2013 and December 31, 2012 amounted to $57.0 million and $66.7 million, respectively. Interest paid on the deposits amounted to $35 thousand and $81 thousand for the three months ended on March 31, 2013 and 2012, respectively.

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In the course of its operations, the Company acquires goods and services from and transacts business with various companies affiliated with related parties. The Company believes these transactions were made on the same terms as those for comparable transactions with unrelated parties. The Company recorded payments for these services of $1.2 million and $217 thousand for the three months ended March 31, 2013 and 2012, respectively.

Subordinated notes held by officers and directors and/or their related parties totaled $10 million at both March 31, 2013 and December 31, 2012. There was no interest paid to directors on these notes for the three months ended on March 31, 2013 and 2012. Interest accrued and unpaid on the notes totaled $2.4 million at March 31, 2013.

Note 11. Stock Compensation Plans

On August 30, 2000, the Company s Board adopted the 2000 Employee Stock Incentive Plan (the Stock Incentive Plan) in which options may be granted to key officers and other employees of the Company. The aggregate number of shares which may be issued upon exercise of the options under the plan cannot exceed 1,100,000 shares. Options and rights granted under the Stock Incentive Plan become exercisable six months after the date the options are awarded and expire ten years after the award date. Upon exercise, the shares are issued from the Company s authorized but unissued stock. The Stock Incentive Plan expired on August 30, 2010, therefore, no further grants will be made under the plan.

The Board also adopted on August 30, 2000, the 2000 Independent Directors Stock Option Plan (the Directors Stock Plan) for directors who are not officers or employees of the Company. The aggregate number of shares issuable under the Directors Stock Plan cannot exceed 550,000 shares and are exercisable six months from the date the awards are granted and expire three years after the award date. Upon exercise, the shares are issued from the Company s authorized but unissued shares. The Directors Stock Plan expired on August 30, 2010, therefore, no further grants will be made under the plan.

On November 28, 2012, the Board of Directors adopted the 2012 Employee Stock Grant Plan (the Employee Stock Plan) under which 16,000 shares of common stock were authorized to be granted to employees. In December, 2012, the Company granted 15,050 shares of the Company s common stock to employees under this plan. There was no compensation expense related to options or stock under the Stock Incentive Plan, the Directors Stock Plan, and the Employee Stock Plan for the three months ended March 31, 2013 and 2012.

In accordance with current accounting guidance, all options are charged against income at their fair value. Awards granted under the plans vest immediately and the entire expense of the award is recognized in the year of grant.

A summary of the status of the Company s stock option plans is presented below:

	Three Months Ended March 31,			
	2013		2012	
		Weighted Average		Weighted Average

	Shares		Exercise Price	Shares		Exercise Price
Outstanding at January 1.	129,170	$	14.26	188,193	$	12.62
Granted						
Exercised						
Forfeited						
Outstanding at March 31,	129,170	$	14.26	188,193	$	12.62
Options exercisable at March 31,	129,170	$	14.26	188,193	$	12.62
Weighted average fair value of options granted during the period		$			$	
Stock-based compensation expense		$			$	

At March 31, 2013 and 2012 the exercisable options had no total intrinsic value and there was no unrecognized compensation expense.

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Information pertaining to options outstanding at March 31, 2013 is as follows:

	Options Outstanding			Options Excercisable	
Range of Exercise Price	Number Outstanding	Weighted Average Remaining Contractual Life	Weighted Average Exercise Price	Number Exercisable	Weighted Average Exercise Price
$ 10.01 - $23.13	129,170	3.2	$ 14.26	129,170	$ 14.26

Item 2 Management s Discussion and Analysis of Financial Condition and Results of Operations (MD&A)

This Quarterly Report should be read in conjunction with the more detailed and comprehensive disclosures included in our Annual Report on Form 10-K for the year ended December 31, 2012. In addition, please read this section in conjunction with our Consolidated Financial Statements and Notes to Consolidated Financial Statements contained herein.

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 Securities and Exchange Commission (SEC) (including this report and exhibits hereto), 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 a 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 ability of the Company to compete with other institutions for business; the composition and concentrations of the Company s lending risk and the adequacy of the Company s reserves to manage those risks; the valuation of the Company s investment securities; the aqbility of the Company to pay dividends of repurchase common shares; the ability of the Company to retain key personnel; the impact of any pending or threatened litigation against the Company; the marketability of shares of the Company and fluctuations in the value of the Company s share price; the impact of the Company s ability to comply with its regulatory agreements and orders; the effectiveness of the Company s system of internal controls; the ability of the Company to attract additional capital investment; the timing of the Company s annual shareholder meeting; the impact of changes in financial services laws and regulations (including laws concerning taxes, banking, securities and insurance); the impact of technological changes and security risks upon the Company s information technology systems; 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.

Readers should carefully review the risk factors described in the Annual Report and other documents that the Company periodically files with the Securities and Exchange Commission, including its Form 10-K for the year ended December 31, 2012.

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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. 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.

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 non-accrual status are included in impaired loans if they are above the $100 thousand loan relationship threshold and not considered TDRs.

See Note 4 - Loans of the consolidated financial statements included in Item 1 hereof 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 7- Fair Value Measurements of the consolidated financial statements included in Item 1 hereof for more information about the Company s securities valuation techniques.

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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 did not recognize OTTI charges on investment securities for the three months ended March 31, 2013 and 2012 within the consolidated statements of operations.

Other Real Estate Owned

Other real estate owned (OREO) consists of property acquired by foreclosure, abandonment or conveyance of deed in-lieu of foreclosure. OREO 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 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 March 31, 2013 and December 31, 2012, the Company did not have any uncertain tax positions or tax strategies and no liability was required to be recorded.

New Authoritative Accounting Guidance

Accounting Standards Update (ASU) No. 2011-11, Balance Sheet (Topic 210) - Disclosures about Offsetting Assets and Liabilities provides 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 Accounting Standards Codification Topic (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. The Company adopted ASU No. 2011-11 on January 1, 2013. The adoption of this new guidance did 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 simplifies the guidance for testing the decline in realizable value (impairment) of indefinite-lived intangible assets other than goodwill. ASU No. 2012-02 allows an entity the option to first assess qualitative factors to determine whether it is necessary to perform the

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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. The Company adopted ASU 2012-01 on January 1, 2013. The adoption of this new guidance did have not 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 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. This update 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. The Company adopted ASU 2013-01 on January 1, 2013. The adoption of this new guidance did 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 improves 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. The Company adopted ASU 2013-02 on January 1, 2013. The adoption of this new guidance did not have an effect on the operating results or financial position of the Company.

Executive Summary

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

The Company recorded net income of $1.7 million, or $0.11 per diluted common share, for the three months ended March 31, 2013, compared to a net loss of $1.2 million, or $(0.07) per diluted common share for the same three months of 2012. The $2.9 million improvement in earnings was due primarily to a $1.6 million decrease in non-interest expense, a $1.1 million increase in a credit for loan and lease loss expense (primarily due to a recovery of $1.5 million on a commercial loan that was previously charged off), and a $1.0 million increase in non-interest income (primarily due to gains on the sale of securities of $842 thousand). Partially offsetting these factors was an $800 thousand reduction in net interest income. Return on average assets and return on average equity were 0.18% and 4.69% for the three months ended March 31, 2013, compared to (0.11)% and (2.79)% for three months ended March 31, 2012. The Company did not pay any dividends during the three months ended March 31, 2013 and 2012.

Total assets decreased $38.7 million, or 4.0%, to $929.5 million, at March 31, 2013 from $968.3 million at December 31, 2012. The balance sheet reduction reflected an $82.9 million decrease in cash and cash equivalents, which was due primarily to increases in loans and investment securities, coupled with a decrease in total deposits and a reduction in borrowed funds. Loans, net of deferred loan origination fees and costs, unearned income and the allowance for loan and lease losses, grew $18.3 million, or 3.2%, while available-for-sale investment securities increased $31.5 million, or 17.0%.

Total deposits decreased $30.9 million, or 3.6%, to $823.7 million at March 31, 2013 as compared to $854.6 million at December 31, 2012. During the same period, non-interest-bearing demand deposits decreased $10.3 million, or 7.8%, and interest-bearing deposits decreased $20.6 million, or 2.9%. The Company repaid $6.2 million in borrowed funds, specifically FHLB advances.

Total shareholders equity decreased $0.1 million, from December 31, 2012, as net income of $1.7 million was more than entirely offset by a decrease in accumulated other comprehensive income of $1.8 million.

Summary of Performance

Net Interest Income

Net interest income is the difference between interest revenue, interest and fees on interest-earning assets on the one hand, and interest expense, interest paid to the Company s depositors and interest paid on external borrowings on the other hand. 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 non-performing 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 for the three months ended March 31, improved 7 basis points to 3.27% in 2013 from 3.20% in 2012. Rate spread, the difference between the average yield on interest-earning assets

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and the average cost of interest-bearing liabilities shown on a fully tax-equivalent basis, was 3.15% for the three months ended March 31, 2013, an increase of 6 basis points compared to 3.09% for the same period of 2012.

Net interest income on a tax equivalent basis was $7.0 million for the first quarter of 2013, a $900 thousand, or 10.8%, decrease from $7.9 million for the first quarter of 2012. The decrease was primarily due to lower yields on earning assets, coupled with a reduction in average earning assets, which was partially offset by a decrease in average interest-bearing liabilities.

Interest income on a tax equivalent basis decreased $1.6 million for the three month period ended March 31, 2013 compared to the same period in 2012. Average earning assets decreased $124.1 million to $861.4 million for the first quarter of 2013, from $985.5 million for the same quarter of 2012, which resulted in a $907 thousand decrease in tax-equivalent interest income due to volume. Accounting for the majority of the decrease was a $75.4 million reduction in average loans. Lower earning asset yields also negatively affected interest income. The tax-equivalent yield on earning assets fell 12 basis points to 4.13% for the three months ended March 31, 2013 from 4.25% for the same three months of 2012, which negatively impacted interest income by $662 thousand. The Company experienced lower yields on both the loan and investment security portfolios. Loan yields were affected by the continued low interest rate environment and increased competition in our market area. With regard to the securities portfolio, sales of higher-risk securities at the end of 2012 were reinvested into lower-risk instruments having lower yields.

Average interest-bearing deposits in other banks and federal funds sold decreased by $47.6 million during the quarter ended March 31, 2013 as compared to the same quarter in 2012. The decrease in the average balance of interest-bearing deposits in other banks and federal funds sold was attributable primarily to a reduction in total deposits.

Interest expense for the three months ended March 31, 2013 decreased $716 thousand to $1.9 million from $2.6 million for the same three months of 2012. The reduction in interest expense largely reflected a $128.3 million, or 14.5% , decrease in average interest-bearing liabilities. Average interest-bearing liabilities totaled $758.8 million for the quarter ended March 31, 2013 compared to $887.1 million for the same period in 2012, which resulted in a $757 thousand decrease in interest expense due to volume. Total deposits averaged $95.7 million lower, while average borrowings decreased $32.6 million. The decrease in average total deposits was due primarily to an $86.6 million, or 21.6%, decrease in total time deposits. The Company did not aggressively compete for time deposits. Longer-term time deposits that matured were repositioned into short-term products, whenever possible. The cost of interest-bearing deposits decreased 13 basis points to 0.63% for the three months ended March 31, 2013 from 0.76% for the same period of 2012. 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. The cost of borrowed funds increased by 90 basis points to 5.98% for the quarter ended March 31, 2013 as compared 5.08% for the same period in 2012, which resulted from the repayment of maturing FHLB advances that were at lower rates and higher-rate borrowings becoming a larger percentage of total borrowings.

Net interest income depends upon the relative amount of interest-earning assets and interest-bearing liabilities and the interest rate earned or paid on them. The following table sets forth certain information relating to our consolidated statements of financial condition and consolidated statements of operations for the three month periods ended March 31, 2013 and 2012, and reflects the average yield on assets and average cost of liabilities for the periods indicated. Such yields and costs are derived by dividing income or expense by the average balance of assets or liabilities, respectively, for the periods shown. Average balances are derived from average daily balances. The yields include amortization of fees which are considered adjustments to yields.

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	Three months ended March 31, 2013			Three months ended March 31, 2012		
(dollars in thousands)	**Average Balance**	**Interest**	**Yield/ Cost**	**Average Balance**	**Interest**	**Yield/ Cost**
ASSETS						
Earning assets (2)(3)						
Loans-taxable (4)	$ 573,833	$ 6,277	4.38%	$ 649,062	$ 7,381	4.55%
Loans-tax free (4)	35,169	500	5.69%	35,328	618	7.00%
Total loans (1)(2)	609,002	6,777	4.45%	684,390	7,999	4.68%
Securities-taxable	116,187	574	1.98%	118,614	919	3.10%
Securities-tax free	81,727	1,500	7.34%	80,356	1,485	7.39%
Total securities (1)(5)	197,914	2,074	4.19%	198,970	2,404	4.83%
Interest-bearing deposits in other banks and federal funds sold	54,466	39	0.29%	102,114	56	0.22%
Total earning assets	861,382	8,890	4.13%	985,474	10,459	4.25%
Non-earning assets	100,955			103,273		
Allowance for loan and lease losses	(19,177)			(21,077)		
Total assets	$ 943,160			$ 1,067,670		
LIABILITIES AND SHAREHOLDERS EQUITY						
Interest-bearing Liabilities						
Interest-bearing demand deposits	311,587	159	0.20%	316,234	183	0.23%
Savings deposits	84,200	26	0.12%	88,696	46	0.21%
Time deposits over $100,000	144,633	317	0.88%	189,065	415	0.88%
Other time deposits	168,943	616	1.46%	211,089	888	1.68%
Total interest-bearing deposits	709,363	1,118	0.63%	805,084	1,532	0.76%
Borrowed funds and other interest-bearing liabilities	49,429	739	5.98%	82,008	1,041	5.08%
Total interest-bearing liabilities	758,792	1,857	0.98%	887,092	2,573	1.16%
Demand deposits	125,394			120,944		
Other liabilities	22,102			17,885		
Shareholders equity	36,872			41,749		
Total liabilities and shareholders equity	$ 943,160			$ 1,067,670		
Net Interest Income/Interest Rate Spread (6)		7,033	3.15%		7,886	3.09%
Tax equivalent adjustment		(680)			(715)	
Net interest income as reported		$ 6,353			$ 7,171	
Net Interest Margin (7)			3.27%			3.20%

(1) Interest income is presented on a tax equivalent basis using a 34% rate.

(2) Loans are stated net of unearned income.

(3) Non-accrual 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 are 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 as a percentage of total average interest earning assets.

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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.

	March 31, 2013 vs. 2012 Increase (Decrease) Due to		
(in thousands)	Due to Volume	Change in Rate	Total Change
Interest Income:			
Loans - taxable	$ (831)	$ (273)	$ (1,104)
Loans - tax free	(3)	(115)	(118)
Total loans	(834)	(388)	(1,222)
Securities - taxable	(18)	(327)	(345)
Securities - tax free	25	(10)	15
Total securities	7	(337)	(330)
Interest-bearing deposits in other banks and federal funds sold	(31)	14	(17)
Total interest income	(858)	(711)	(1,569)
Interest Expense:			
Interest-bearing demand deposits	(3)	(21)	(24)
Savings deposits	(2)	(18)	(20)
Time deposits over $100,000	(97)	(1)	(98)
Other time deposits	(163)	(109)	(272)
Total interest-bearing deposits	(265)	(149)	(414)
Borrowed funds and other interest-bearing liabilities	(464)	162	(302)
Total interest expense	(729)	13	(716)
Net interest income	$ (129)	$ (724)	$ (853)

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.

The Company recorded a credit for loan and lease losses of $1.2 million for the three month period ended March 31, 2013, compared to a credit of $136 thousand for the three months ended March 31, 2012. The credit was directly attributable to a recovery of $1.5 million on a commercial loan that was previously charged-off.

Non-interest Income

For the three months ended March 31, 2013, non-interest income totaled $2.5 million, an increase of $1.0 million, from $1.5 million for the three months ended March 31, 2012. The 66.7% improvement resulted primarily from an increase in net gains from the sale of securities during the quarter. Net gains on the sale of securities amounted to $842 thousand for the first quarter of 2013, compared to $8 thousand for the same quarter of 2012. Also favorably affecting non-interest income was an increase of $392 thousand in other income, which resulted primarily from the settlement of an insurance claim. Partially offsetting these increases was a $133 thousand decrease in the gains on sale of residential mortgage loans held for sale.

Non-interest Expense

Non-interest expense totaled $8.3 million for the three month period ended March 31, 2013, compared to $9.9 million for the same period in 2012. The $1.6 million, or 16.2%, decrease was due primarily to reductions in professional fees and salaries and employee benefits. Professional fees declined $967 thousand, or 63.7%, as the Company continued to reduce its reliance on outside consultants.

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Salaries and employee benefits decreased $318 thousand, or 8.7%, as a result of a reduction in force and voluntary separation program that was implemented in the fourth quarter of 2012.

In addition to the decrease in professional fees, legal fees for the three months ended March 31, 2013 declined $109 thousand compared to the same three months of 2012. Legal and professional fees are expected to continue to decline to more normalized levels for the remainder of 2013, reflecting reduced activity related to outstanding litigation, as well as less reliance on outside advisors and consultants.

Provision for Income Taxes

The Company did not record a provision or benefit for income taxes for the quarters ended March 31, 2013 and 2012. 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 that it recorded in 2009.

FINANCIAL CONDITION

Assets

Total assets were $929.5 million at March 31, 2013, a decrease of $38.8 million, or 4.0%, from $968.3 million at December 31, 2012.

Cash and Cash Equivalents

Cash and cash equivalents decreased $82.9 million, or 71.9% during the three months ended March 31, 2013 to $32.3 million. The decrease resulted primarily from a $30.9 million decrease in total deposits, coupled with increases in cash used for loans and purchases of loans and securities of $18.3 million and $31.5 million, respectively. The Company did not pay any dividends during the quarter ended March 31, 2013 as it suspended paying dividends 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 March 31, 2013, the Company s investment portfolio was comprised principally of taxable and tax-exempt obligations of state and political subdivisions and obligations of U.S. government-sponsored agencies, including residential mortgage-backed securities and collateralized mortgage obligations (CMOs). There were two security issuers, St. Clair County, IL School District and the Commonwealth of Massachusetts, whose aggregate carrying values exceeded 10.0% of Shareholders equity as of March 31, 2013. The aggregate carrying values of the securities of these issuers were $4.2 million and $4.1 million, respectively.

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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:

(in thousands)		**March 31, 2013**		**December 31, 2012**
Available-for-sale				
Obligations of U.S. government agencies	$	1,870	$	1,891
Obligation of state and political subdivisions		102,709		103,501
Collateralized mortgage obligations				
Government-sponsored agency		16,408		9,103
Residential mortgage-backed securities				