FIRST NATIONAL COMMUNITY BANCORP INC
Form 10-Q
August 24, 2012
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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 June 30, 2012

OR

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

For the transition period from to

Commission File No. 000-53869

FIRST NATIONAL COMMUNITY BANCORP, INC.

(Exact Name of Registrant as Specified in Its Charter)

Pennsylvania (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 o NO x

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

Indicate by check mark 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	**16,442,119 shares**
(Title of Class)	(Outstanding at August 20, 2012)

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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)		**June 30, 2012**		**December 31, 2011**
Assets				
Cash and cash equivalents:				
Cash and due from banks	$	22,363	$	18,956
Interest-bearing deposits in other banks		70,397		149,690
Total cash and cash equivalents		92,760		168,646
Securities				
Available-for-sale, at fair value		186,807		185,475
Held-to-maturity, at amortized cost (fair value $2,388 and $2,245)		2,145		2,094
Stock in Federal Home Loan Bank of Pittsburgh, at cost		7,580		8,399
Loans held for sale				94
Loans, net of allowance for loan and lease losses of $19,600 and $20,834		603,053		659,044
Bank premises and equipment, net		19,340		18,846
Accrued interest receivable		2,308		2,552
Refundable federal income taxes		11,612		11,612
Intangible assets		715		797
Bank-owned life insurance		27,122		26,769
Other real estate owned		5,302		6,958
Other assets		9,001		11,353
Total Assets	$	967,745	$	1,102,639
Liabilities				
Deposits:				
Demand	$	139,447	$	134,016
Interest-bearing demand		259,154		326,899
Savings		90,596		87,712
Time ($100,000 and over)		159,401		199,790
Other time		188,101		208,719
Total deposits		836,699		957,136
Borrowed funds:				
FHLB advances		36,001		48,261
Subordinated debentures		25,000		25,000
Junior subordinated debentures		10,310		10,310
Total borrowed funds		71,311		83,571
Accrued interest payable		5,288		4,301
Other liabilities		13,136		17,706
Total liabilities		926,434		1,062,714

Shareholders Equity				
Common Shares ($1.25 par)				
Authorized: 50,000,000 shares as of June 30, 2012 and December 31, 2011				
Issued and outstanding: 16,442,119 shares as of June 30, 2012 and 16,442,119 shares as of December 31, 2011		20,552		20,552
Additional paid-in capital		61,557		61,557
Accumulated deficit		(40,349)		(38,217)
Accumulated other comprehensive loss				
Unrealized holding gain on available-for-sale securities, net of taxes		3,870		497
Unrealized non-credit holding loss on OTTI available-for-sale securities, net		(4,319)		(4,464)
Total accumulated other comprehensive loss, net of taxes		(449)		(3,967)
Total shareholders equity		41,311		39,925
Total Liabilities and Shareholders Equity	$	967,745	$	1,102,639

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

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FIRST NATIONAL COMMUNITY BANCORP, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF OPERATIONS

(unaudited)

(in thousands, except share data)	Three Months Ended June 30, 2012	Three Months Ended June 30, 2011	Six Months Ended June 30, 2012	Six Months Ended June 30, 2011
Interest income				
Interest and fees on loans	$ 7,529	$ 8,943	$ 15,318	$ 18,036
Interest and dividends on securities				
U.S. government agencies	476	827	1,231	1,749
State and political subdivisions, tax-free	1,007	1,406	1,963	2,816
State and political subdivisions, taxable	95	13	249	26
Other securities	273	58	307	102
Total interest and dividends on securities	1,851	2,304	3,750	4,693
Interest on interest-bearing deposits and federal funds sold	44	36	100	62
Total interest income	9,424	11,283	19,168	22,791
Interest expense				
Deposits				
Interest-bearing demand	157	539	340	1,151
Savings	44	87	90	182
Time ($100,000 and over)	385	664	800	1,362
Other time	791	1,167	1,679	2,408
Total interest on deposits	1,377	2,457	2,909	5,103
Interest on borrowed funds				
Interest on FHLB advances	340	797	754	1,666
Interest on subordinated debentures	569	569	1,138	1,131
Interest on junior subordinated debentures	57	51	115	102
Total interest on borrowed funds	966	1,417	2,007	2,899
Total interest expense	2,343	3,874	4,916	8,002
Net interest income before (credit) provision for loan and lease losses	7,081	7,409	14,252	14,789
(Credit) provision for loan and lease losses	(280)	765	(416)	2,509
Net interest income after (credit) provision for loan and lease losses	7,361	6,644	14,668	12,280
Non-interest income				
Deposit service charges	756	783	1,493	1,510
Net gain on the sale of securities		2,302	8	2,302
Gross other-than-temporary impairment (OTTI) gains (losses)	(117)	(479)	57	(209)
Portion of (gain) loss recognized in OCI (before taxes)	21	130	(153)	(140)
Other-than-temporary-impairment losses recognized in earnings	(96)	(349)	(96)	(349)
Net gain on the sale of loans held for sale	247	123	490	298
Net gain on the sale of other real estate owned	145	23	154	2,567
Net gain on the sale of other assets		19		20
Loan-related fees	125	182	249	359
Income on bank-owned life insurance	168	199	353	395
Other	199	175	343	337
Total non-interest income	1,544	3,457	2,994	7,439
Non-interest expense				

Salaries and employee benefits	3,621	3,459	7,259	6,855
Occupancy expense	501	821	1,099	1,498
Equipment expense	446	409	866	794
Advertising expense	140	182	288	343
Data processing expense	596	518	1,070	1,019
FDIC assessment	603	587	1,203	1,376
Bank shares tax	275	276	551	552
Expense of other real estate	226	121	404	688
Provision (credit) for off-balance sheet commitments	252	43	187	(191)
Legal expense	839	1,103	1,760	1,401
Professional fees	1,004	1,206	2,535	3,445
Insurance expenses	247	98	485	197
Other operating expenses	1,122	1,089	2,087	2,079
Total non-interest expense	9,872	9,912	19,794	20,056
Income (loss) before income taxes	(967)	189	(2,132)	(337)
Provision for income taxes				
Net Income (loss)	$ (967)	$ 189	$ (2,132)	$ (337)
Earnings (Loss) Per Share				
Basic	$ (0.06)	$ 0.01	$ (0.13)	$ (0.02)
Diluted	$ (0.06)	$ 0.01	$ (0.13)	$ (0.02)
Cash Dividends Declared Per Common Share	$	$	$	$
WEIGHTED AVERAGE NUMBER OF SHARES OUTSTANDING:				
Basic	16,442,119	16,440,190	16,442,119	16,437,491
Diluted	16,442,119	16,440,190	16,442,119	16,437,491

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 INCOME

(unaudited)

	Three months ended June 30, 2012	Three months ended June 30, 2011	Six months ended June 30, 2012	Six months ended June 30, 2011
	(In thousands)		(In thousands)	
Net income (loss)	$ (967)	$ 189	$ (2,132)	$ (337)
Other comprehensive income:				
Unrealized gains on securities available for sale	1,458	6,609	5,298	9,109
Tax expense	(496)	(2,247)	(1,800)	(3,097)
Net of tax amount	962	4,362	3,498	6,012
Non-credit related (gains) losses on OTTI securities not expected to be sold	117	479	(57)	209
Tax expense	(40)	(163)	19	(71)
Net of tax amount	77	316	(38)	138
Reclassification adjustment for losses included in net loss	96	(1,953)	88	(1,953)
Tax benefit	(33)	664	(30)	664
Net of tax amount	63	(1,289)	58	(1,289)
Total other comprehensive income	1,102	3,389	3,518	4,861
Total comprehensive income	$ 135	$ 3,578	$ 1,386	$ 4,524

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 Six Months Ended June 30, 2012 and 2011

(Unaudited)

(in thousands, except share data)	Number of Common Shares	Common Stock	Additional Paid-in Capital	Accumulated Deficit	Accumulated Comprehensive Loss	Total Shareholders Equity
BALANCES, DECEMBER 31, 2010	16,433,020	$ 20,541	$ 61,539	$ (37,882)	$ (12,143)	$ 32,055
Net loss for the period				(337)		(337)
Other comprehensive income, net of tax of $2,504					4,861	4,861
Proceeds from the issuance of common shares through dividend reinvestment plan	8,299	10	17			27
Balances, June 30, 2011	16,441,319	$ 20,551	$ 61,556	$ (38,219)	$ (7,282)	$ 36,606
BALANCES, DECEMBER 31, 2011	16,442,119	$ 20,552	$ 61,557	$ (38,217)	$ (3,967)	$ 39,925
Net loss for the period				(2,132)		(2,132)
Other comprehensive income, net of tax of $1,811					3,518	3,518
Balances, June 30, 2012	16,442,119	$ 20,552	$ 61,557	$ (40,349)	$ (449)	$ 41,311

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

FIRST NATIONAL COMMUNITY BANCORP, INC AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CASH FLOWS

(unaudited)

	Six months ended June 30,	
(in thousands)	**2012**	**2011**
Cash Flows from Operating Activities:		
Net loss	$ (2,132)	$ (337)
Adjustments to Reconcile Net loss to Net Cash (Used in) Provided by Operating Activities:		
Investment securities accretion, net	(830)	(754)
Equity in trust	(2)	(1)
Depreciation and amortization	619	750
(Credit) provision for loan and lease losses	(416)	2,509
Provision (credit) for off balance sheet commitments	187	(191)
Net gain on sale of investment securities	(8)	(2,302)
Other-than temporary impairment losses	96	349
Net gain on the sale of loans held for sale	(490)	(298)
Net gain on the sale of other real estate owned	(154)	(2,567)
(Recoveries) write-down of other real estate owned	(20)	266
Gain on the sale of other assets		(20)
Bank owned life insurance income	(353)	(395)
Proceeds from the sale of loans held for sale	17,117	15,512
Funds used to originate loans held for sale	(16,541)	(13,460)
Increase in interest payable	987	669
Increase in other liabilities	363	378
Decrease in interest receivable	244	319
Increase in refundable federal income taxes		(2)
Decrease in prepaid expenses and other assets	493	4,388
Net Cash (Used in) Provided by Operating Activities	(840)	4,813
Cash Flows from Investing Activities:		
Investment Securities:		
Proceeds from maturities, calls and principal payments	19,381	14,869
Proceeds from sales		16,103
Purchases	(19,811)	
Purchases of Federal Reserve Bank stock	(90)	
Redemption of FHLB stock	819	1,005
Net decrease in loans to customers	56,195	26,899
Proceeds from the sale of other real estate owned	2,336	6,101
Purchases of bank premises and equipment	(1,179)	(517)
Proceeds from the sale of bank premises and equipment		32
Net Cash Provided by Investing Activities	57,651	64,492
Cash Flows from Financing Activities:		
Net decrease in demand deposits, money market demand, interest-bearing demand accounts, and savings accounts	(59,430)	(19,346)
Net decrease in time deposits	(61,007)	(30,388)
Proceeds from FHLB advances	15,737	97,947
Repayment of FHLB advances	(27,997)	(134,006)
Repayment of other borrowed funds		(227)
Proceeds from issuance of common shares - dividend reinvestment plan		27

Net Cash Used in Financing Activities		(132,697)		(85,993)
Net Decrease in Cash and Cash Equivalents		(75,886)		(16,688)
Cash & Cash Equivalents at Beginning of Period		168,646		74,505
Cash & Cash Equivalents at End of Period	$	92,760	$	57,817
Supplemental Cash Flow Information				
Cash paid during the period for:				
Interest	$	3,929	$	7,333
Income Taxes		25		25
Other transactions:				
Principal balance of loans transferred to OREO		506		2,356
Transfer from loans held for sale to other assets				830
Transfer from loans held for sale to loans		94		1,803
Settlement of security settled on trade date		5,120		

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)

Notes to Consolidated Financial Statements

Note 1. Basis of Presentation

The consolidated financial statements are comprised 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). All inter-company transactions and balances have been eliminated. The accounting and reporting policies of the Company conform to U.S. Generally Accepted Accounting Principles (GAAP) and general practices within the financial services industry. In the opinion of management, all adjustments necessary to a fair presentation of the results for the quarterly period ended June 30, 2012 have been included.

In preparing these consolidated financial statements, management has made estimates and assumptions that affect the reported amounts of assets and liabilities as of the date of the consolidated statements of financial condition and results of operations for the periods indicated. 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), security valuations, the evaluation of deferred income taxes, and the impairment of securities and other real estate owned (OREO). The current economic environment has increased the degree of uncertainty inherent in these material estimates.

These financial statements should be read in conjunction with the consolidated financial statements and notes thereto included in the Company s December 31, 2011 audited financial statements filed on Form 10-K and the Company s March 31, 2012 unaudited financial statements filed on Form 10-Q.

Note 2. New Authoritative Accounting Guidance

Accounting Standards Update (ASU) No. 2011-04, Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRS , an update to ASC Topic 820 - Fair Value Measurement, results in common fair value measurement and disclosure requirements in U.S. GAAP and IFRS. The amendments in ASU No. 2011-04 include clarifications about the application of existing fair value measurement requirements and changes to principles for measuring fair value. ASU No. 2011-04 also requires additional disclosures about fair value measurements. ASU No. 2011-04 is required to be applied prospectively and is effective for interim and annual periods beginning after December 15, 2011. The Company adopted this new guidance for the quarter ended March 31, 2012. The adoption of this guidance did not have a material impact on the Company s consolidated financial statements; however, the adoption did have an impact on the Company s fair value disclosures. See Note 7 for the disclosures required by the adoption of this new guidance.

ASU No. 2011-05, Presentation of Comprehensive Income, an update to ASC Topic 220 - Comprehensive Income, was issued to improve the comparability, consistency and transparency of financial reporting. The amendment provides the entity an option to present the total of comprehensive income either in a single continuous statement of comprehensive income or in two separate but consecutive statements. The amendments do not change the items that must be reported in other comprehensive income. ASU No. 2011-05 is required to be applied retrospectively and is effective for interim and annual periods beginning after December 15, 2011. The Company adopted this new guidance for the quarter ended March 31, 2012. Upon adoption of this new guidance the Company presents comprehensive income in a separate Statement of Comprehensive Income.

ASU No. 2011-12 Comprehensive Income (Topic 220) - Deferral of the Effective Date for Amendments to the Presentation of Reclassifications of Items Out of Accumulated Other Comprehensive Income in Accounting Standards Update 2011-05 was issued in December 2011. This update defers only those changes in ASU No. 2011-05 that relate to the presentation of reclassification adjustments, the paragraphs in this update supersede certain pending paragraphs in ASU No. 2011-05. All other requirements in ASU No. 2011-05 are not affected by this update, including the requirement to report comprehensive income either in a single continuous financial statement or in two separate but consecutive financial statements and is effective for fiscal years, and interim periods within those years, beginning after December 15, 2011 and were adopted for the quarter ended March 31, 2012.

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Standards to be Adopted In Future Periods

ASU No. 2011-11, Balance Sheet (Topic 210) - Disclosures about Offsetting Assets and Liabilities was issued in December 2011. The objective of this update is to provide enhanced disclosures that will enable users of its financial statements to evaluate the effect or potential effect of netting arrangements on an entity s financial position. This includes the effect or potential effect of rights of setoff associated with an entity s recognized assets and recognized liabilities within the scope of this update. The amendments require enhanced disclosures by requiring improved information about financial instruments and derivative instruments that are either (1) offset in accordance with either ASC 210-20-45 or ASC 815-10-45 or (2) subject to an enforceable master netting arrangement or similar agreement, irrespective of whether they are offset in accordance with either ASC 210-20-45 or ASC 815-10-45. An entity is required to apply the amendments for annual reporting periods beginning on or after January 1, 2013, and interim periods within those annual periods. An entity should provide the disclosures required by those amendments retrospectively for all comparative periods presented. The adoption of ASU 2011-11 is not expected to have a material impact on the Company s consolidated financial statements.

Reclassification of Prior Year Financial Statements

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

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 to be monitored by a committee (the Committee) of at least three directors, none of whom is an employee or controlling shareholder of the Bank or its affiliates or a family member of any such person. The Committee is required to submit written progress reports on a monthly basis and the Agreement requires the Bank to make periodic reports and filings with the OCC. The members of the Committee are John P. Moses, Joseph Coccia, Joseph J. Gentile and Thomas J. Melone. The material provisions of the Order are as follows:

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

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

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

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

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

(vi) by October 31, 2010, the Board must adopt, implement and thereafter ensure compliance with a comprehensive conflict of interest policy applicable to the Bank s and the Company s directors, executive officers, principal shareholders and their affiliates and such

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person s immediate family members and their related interests, employees, and by November 30, 2010, conduct a review of existing relationships with such persons to identify those, if any, not in compliance with the policy; and review all subsequent proposed transactions with such persons or modifications of transactions;

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

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

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

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

(xi) by October 31, 2010, the Board is required to establish an effective, independent and ongoing loan review system to review, at least quarterly, the Bank s loan and lease portfolios to assure the timely identification and categorization of problem credits; by October 31, 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 must adopt and the Bank implement and adhere to a program to protect the Bank s interest in criticized assets; and the Bank may only extend additional credit (including renewals) to a borrower whose loans are criticized under specified circumstances;

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

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

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

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

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

Federal Reserve Agreement. On November 24, 2010, the Company entered into 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 must take appropriate steps to fully utilize the Company s financial and managerial resources to serve as a source of strength to the Bank, including taking steps to ensure that the Bank complies with its Consent Order entered into with the OCC;

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

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

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

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

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

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

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

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

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

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

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

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

During the six months ended June 30, 2012, and the year ended December 31, 2011, the Company incurred approximately $288 thousand and $1.0 million, respectively, of expenses related to entering into and complying with these regulatory agreements, consisting primarily of professional and consulting fees. In addition, the Order and the Agreement place restrictions on the Company s ability to borrow funds and to pay interest and dividends to its security holders. In the future, the Company expects to continue to experience increased costs related to compliance with these regulatory agreements, primarily as a result of increased head count and also expects to face certain restrictions on its operations for as long as it continues to operate under the Order and the Agreement. The Company expects, however, that future compliance expenses will decrease from the 2011 level, because the majority of the expenses incurred to date are related to development and implementation of processes and policies that, once those policies and processes are finalized and implemented, are not expected to recur.

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

Banking regulations also limit the amount of dividends that may be paid without prior approval of the Bank s regulatory agency. At August 24, 2012, 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).

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In accordance with the Order, the Bank is required to achieve and thereafter maintain a total risk-based capital equal to at least 13% of risk-weighted assets and a Tier 1 capital equal to at least 9% of adjusted total assets. At June 30, 2012, the Bank did not meet 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 June 30, 2012 and December 31, 2011 are presented in the following table:

CAPITAL ANALYSIS

(In thousands)	**June 30, 2012**	**December 31, 2011**
Company		
Tier I Capital:		
Total Tier I Capital	$ 51,028	$ 53,059
Tier II Capital:		
Subordinated notes	25,000	25,000
Allowable portion of allowance for loan losses	9,609	9,823
Total Tier II Capital	34,609	34,823
Total Risk-Based Capital	85,637	87,882
Total Risk Weighted Assets	$ 758,116	$ 774,452
Bank		
Tier I Capital:		
Total Tier I Capital	$ 80,194	$ 80,976
Tier II Capital:		
Allowable portion of allowance for loan losses	9,604	9,819
Total Tier II Capital	9,604	9,819
Total Risk-Based Capital	89,798	90,795
Total Risk Weighted Assets	$ 757,758	$ 774,097

	Actual		**For Capital Adequacy Purposes**		**To Be Well Capitalized Under Prompt Corrective Action Provision**	
At June 30, 2012	**Amount**	**Ratio**	**Amount**	**Ratio**	**Amount**	**Ratio**
Total Capital (to Risk Weighted Assets)						
Company	$ 85,637	11.30%	$ >60,649	>8.00%	N/A	N/A
Bank	$ 89,798	11.85%	$ >60,621	>8.00%	$ >75,776	>10.00%
Tier I Capital (to Risk Weighted Assets)						
Company	$ 51,028	6.73%	$ >30,325	>4.00%	N/A	N/A
Bank	$ 80,194	10.58%	$ >30,310	>4.00%	$ >45,465	>6.00%
Tier I Capital (to Average Assets)						
Company	$ 51,028	5.02%	$ >40,657	>4.00%	N/A	N/A
Bank	$ 80,194	7.89%	$ >40,643	>4.00%	$ >50,804	>5.00%

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At December 31, 2011	Actual Amount	Ratio	For Capital Adequacy Purposes Amount	Ratio	To Be Well Capitalized Under Prompt Corrective Action Provision Amount	Ratio
Total Capital (to Risk Weighted Assets)						
Company	$ 87,882	11.35%	$ >61,956	>8.00%	N/A	N/A
Bank	$ 90,795					