

FIRST NATIONAL COMMUNITY BANCORP INC  
Form 10-Q  
August 24, 2012  
Table of Contents

**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**

WASHINGTON, D.C. 20549

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**FORM 10-Q**

(Mark One)

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

For the quarterly period ended March 31, 2012

OR

**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  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  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

Accelerated Filer

Non-Accelerated Filer

Smaller reporting company

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

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

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**Common Stock, \$1.25 par value**  
(Title of Class)

**16,442,119 shares**  
(Outstanding at August 20, 2012)

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Table of Contents

|  |    |
|--|----|
| Contents   |    |
| PART I. Financial Information  | 3  |
| Item 1. Financial Statements   | 3  |
| <u>Consolidated Statements of Financial Condition</u>  | 3  |
| <u>Consolidated Statements of Operations</u>   | 4  |
| <u>Consolidated Statements of Comprehensive Income</u>   | 5  |
| <u>Consolidated Statements of Changes in Shareholders' Equity</u>                                    | 6  |
| <u>Consolidated Statements of Cash Flows</u>   | 7  |
| <u>Notes to Consolidated Financial Statements</u>  | 8  |
| <u>Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations</u> | 38 |
| <u>Item 3. Quantitative and Qualitative Disclosures about Market Risk</u>                            | 58 |
| <u>Item 4. Controls and Procedures</u>   | 59 |
| PART II. Other Information   | 59 |
| <u>Item 1. Legal Proceedings</u>   | 59 |
| <u>Item 1A. Risk Factors</u>   | 60 |
| <u>Item 2. Unregistered Sales of Equity Securities and Use of Proceeds</u>                           | 60 |
| <u>Item 3. Defaults upon Senior Securities</u>   | 60 |
| <u>Item 4. Mine Safety Disclosures</u>   | 60 |
| <u>Item 5. Other Information</u>   | 60 |
| <u>Item 6. Exhibits</u>  | 60 |

Table of Contents**FIRST NATIONAL COMMUNITY BANCORP, INC. AND SUBSIDIARIES****CONSOLIDATED STATEMENTS OF FINANCIAL CONDITION****(unaudited)**

| <b>(in thousands, except share data)</b>  | <b>March 31<br/>2012</b> | <b>December 31<br/>2011</b> |
|---|--------------------------|-----------------------------|
| <b>Assets</b>   |                          |                             |
| Cash and cash equivalents:  |                          |                             |
| Cash and due from banks   | \$ 16,953                | \$ 18,956                   |
| Interest-bearing deposits in other banks  | 58,771                   | 149,690                     |
| Total cash and cash equivalents   | 75,724                   | 168,646                     |
| Securities  |                          |                             |
| Available-for-sale at fair value  | 195,888                  | 185,475                     |
| Held-to-maturity at amortized cost (fair value \$2,326 and \$2,245)   | 2,119                    | 2,094                       |
| Stock in Federal Home Loan Bank of Pittsburgh, at cost  | 7,979                    | 8,399                       |
| Loans held for sale   | 1,735                    | 94                          |
| Loans, net of allowance for loan and lease losses of \$20,664 and \$20,834  | 667,814                  | 659,044                     |
| Bank premises and equipment, net  | 19,219                   | 18,846                      |
| Accrued interest receivable   | 2,661                    | 2,552                       |
| Refundable federal income taxes   | 11,612                   | 11,612                      |
| Intangible assets   | 756                      | 797                         |
| Bank-owned life insurance   | 26,953                   | 26,769                      |
| Other real estate owned   | 6,126                    | 6,958                       |
| Other assets  | 10,217                   | 11,353                      |
| <b>Total Assets</b>   | <b>\$ 1,028,803</b>      | <b>\$ 1,102,639</b>         |
| <b>Liabilities</b>  |                          |                             |
| Deposits  |                          |                             |
| Demand  | \$ 131,243               | \$ 134,016                  |
| Interest-bearing demand   | 272,026                  | 326,899                     |
| Savings   | 90,321                   | 87,712                      |
| Time (\$100,000 and over)   | 198,175                  | 199,790                     |
| Other time  | 198,473                  | 208,719                     |
| Total deposits  | 890,238                  | 957,136                     |
| Borrowed funds  |                          |                             |
| FHLB advances   | 44,586                   | 48,261                      |
| Subordinated debentures   | 25,000                   | 25,000                      |
| Junior subordinated debentures  | 10,310                   | 10,310                      |
| Total borrowed funds  | 79,896                   | 83,571                      |
| Accrued interest payable  | 4,892                    | 4,301                       |
| Other liabilities   | 12,601                   | 17,706                      |
| Total liabilities   | 987,627                  | 1,062,714                   |
| <b>Shareholders Equity</b>  |                          |                             |
| Common Shares (\$1.25 par)  |                          |                             |
| Authorized: 50,000,000 shares as of March 31, 2012 and December 31, 2011 Issued and outstanding: 16,442,119 shares as of March 31, 2012 and December 31, 2011 | 20,552                   | 20,552                      |
| Additional paid-in capital  | 61,557                   | 61,557                      |
| Accumulated Deficit   | (39,382)                 | (38,217)                    |
| Accumulated other comprehensive loss  |                          |                             |
| Unrealized holding gain on available-for-sale securities, net of taxes  | 2,780                    | 497                         |
| Unrealized non-credit holding loss on OTTI available-for-sale securities, net   | (4,331)                  | (4,464)                     |

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|  |                     |                     |
|--|---------------------|---------------------|
| Total accumulated other comprehensive loss, net of taxes | (1,551)             | (3,967)             |
| Total shareholders' equity                               | 41,176              | 39,925              |
| <b>Total Liabilities and Shareholders' Equity</b>        | <b>\$ 1,028,803</b> | <b>\$ 1,102,639</b> |

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

Table of Contents**FIRST NATIONAL COMMUNITY BANCORP, INC. AND SUBSIDIARIES****CONSOLIDATED STATEMENTS OF OPERATIONS****(unaudited)**

| <b>(in thousands, except share data)</b>  | <b>Three months ended March 31,</b> |              |
|---|-------------------------------------|--------------|
|   | <b>2012</b>                         | <b>2011</b>  |
| <b>Interest income</b>  |                                     |              |
| Interest and fees on loans  | \$ 7,789                            | \$ 9,093     |
| Interest and dividends on securities:   |                                     |              |
| U.S. government agencies  | 755                                 | 922          |
| State and political subdivisions, tax-free                                      | 956                                 | 1,410        |
| State and political subdivisions, taxable                                       | 154                                 | 13           |
| Other securities  | 34                                  | 44           |
| Total interest and dividends on securities                                      | 1,899                               | 2,389        |
| Interest on interest-bearing deposits and federal funds sold                    | 56                                  | 26           |
| Total interest income   | 9,744                               | 11,508       |
| <b>Interest expense</b>   |                                     |              |
| Deposits:   |                                     |              |
| Interest-bearing demand   | 183                                 | 612          |
| Savings   | 46                                  | 95           |
| Time (\$100,000 and over)   | 415                                 | 698          |
| Other time  | 888                                 | 1,241        |
| Total interest on deposits  | 1,532                               | 2,646        |
| <b>Interest on borrowed funds</b>   |                                     |              |
| Interest on FHLB advances   | 414                                 | 869          |
| Interest on subordinated debentures   | 569                                 | 562          |
| Interest on junior subordinated debentures                                      | 58                                  | 51           |
| Total interest on borrowed funds  | 1,041                               | 1,482        |
| Total interest expense  | 2,573                               | 4,128        |
| <b>Net interest income before (credit) provision for loan and lease losses</b>  | <b>7,171</b>                        | <b>7,380</b> |
| (Credit) provision for loan and lease losses                                    | (136)                               | 1,744        |
| <b>Net interest income after (credit) provision for loan and lease losses</b>   | <b>7,307</b>                        | <b>5,636</b> |
| <b>Non-interest income</b>  |                                     |              |
| Deposit service charges   | 737                                 | 727          |
| Net gain on the sale of securities  | 8                                   |              |
| Gross other-than-temporary impairment ( OTTI ) gains                            | 175                                 | 274          |
| Portion of gain recognized in other comprehensive income ( OCI ) (before taxes) | (175)                               | (274)        |
| Other-than-temporary-impairment losses recognized in earnings                   |                                     |              |
| Net gain on the sale of loans held for sale                                     | 243                                 | 175          |
| Net gain on the sale of other real estate                                       | 9                                   | 2,544        |
| Net gain on the sale of other assets  | 1                                   | 1            |
| Loan related fees   | 124                                 | 178          |
| Income on bank-owned life insurance   | 185                                 | 196          |
| Other   | 144                                 | 161          |
| Total non-interest income   | 1,450                               | 3,982        |
| <b>Non-interest expense</b>   |                                     |              |
| Salaries and employee benefits  | 3,638                               | 3,396        |
| Occupancy expense   | 598                                 | 677          |
| Equipment expense   | 420                                 | 385          |
| Advertising expense   | 148                                 | 161          |
| Data processing expense   | 474                                 | 501          |
| FDIC assessment   | 600                                 | 789          |

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|   |                   |                 |
|---|-------------------|-----------------|
| Bank shares tax                             | 276               | 276             |
| Expense of other real estate                | 178               | 567             |
| Provision for off-balance sheet commitments | (65)              | (234)           |
| Legal expense                               | 921               | 298             |
| Professional fees                           | 1,531             | 2,239           |
| Insurance expense                           | 238               | 99              |
| Other operating expenses                    | 965               | 990             |
| Total non-interest expense                  | 9,922             | 10,144          |
| <b>Loss before income taxes</b>             | <b>(1,165)</b>    | <b>(526)</b>    |
| Provision (credit) for income taxes         |                   |                 |
| <b>Net loss</b>                             | <b>\$ (1,165)</b> | <b>\$ (526)</b> |

**Loss Per Share**

|         |           |           |
|---------|-----------|-----------|
| Basic   | \$ (0.07) | \$ (0.03) |
| Diluted | \$ (0.07) | \$ (0.03) |

**Cash Dividends Declared Per Common Share**

**WEIGHTED AVERAGE NUMBER OF SHARES OUTSTANDING**

|         |            |            |
|---------|------------|------------|
| Basic   | 16,442,119 | 16,434,763 |
| Diluted | 16,442,119 | 16,434,763 |

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



Table of Contents**FIRST NATIONAL COMMUNITY BANCORP, INC. AND SUBSIDIARIES****CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME****(unaudited)**

| <b>(in thousands)</b>  | <b>Three months ended</b> |             |
|--|---------------------------|-------------|
|  | <b>March 31,</b>          |             |
|  | <b>2012</b>               | <b>2011</b> |
| Net loss   | \$ (1,165)                | \$ (526)    |
| Other comprehensive income:  |                           |             |
| Unrealized gains on securities available for sale                    | 3,494                     | 1,959       |
| Taxes  | (1,188)                   | (668)       |
| Net of tax amount  | 2,306                     | 1,291       |
| Non-credit related losses on OTTI securities not expected to be sold | 175                       | 274         |
| Taxes  | (60)                      | (93)        |
| Net of tax amount  | 115                       | 181         |
| Reclassification adjustment for gains included in net loss           | (8)                       |             |
| Taxes  | 3                         |             |
| Net of tax amount  | (5)                       |             |
| Total other comprehensive income                                     | 2,416                     | 1,472       |
| Total comprehensive income   | \$ 1,251                  | \$ 946      |

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

Table of Contents

**FIRST NATIONAL COMMUNITY BANCORP, INC. AND SUBSIDIARIES**  
**CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS EQUITY**

**For the Three Months Ended March 31, 2012 and 2011**

(unaudited)

| (in thousands, except per share data)  | Number<br>of Common<br>Shares | Common<br>Stock | Additional<br>Paid-in<br>Capital | Accumulated<br>Deficit | Accumulated<br>Other<br>Comprehensive<br>Loss | Total<br>Shareholders<br>Equity |
|--|-------------------------------|-----------------|----------------------------------|------------------------|---|---------------------------------|
| <b>BALANCES, DECEMBER 31,<br/>2010</b>   | 16,433,020                    | \$ 20,541       | \$ 61,539                        | \$ (37,882)            | \$ (12,143)                                   | \$ 32,055                       |
| Net loss for the period  |                               |                 |                                  | (526)                  |   | (526)                           |
| Other comprehensive income, net of<br>tax of \$761                               |                               |                 |                                  |                        | 1,472   | 1,472                           |
| Proceeds from issuance of common<br>shares through dividend reinvestment<br>plan | 5,771                         | 7               | 12                               |                        |   | 19                              |
| Balances, March 31, 2011   | 16,438,791                    | \$ 20,548       | \$ 61,551                        | \$ (38,408)            | \$ (10,671)                                   | \$ 33,020                       |
| <b>BALANCES, DECEMBER 31,<br/>2011</b>   | 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<br>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                       |

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

Table of Contents**FIRST NATIONAL COMMUNITY BANCORP, INC. AND SUBSIDIARIES****CONSOLIDATED STATEMENTS OF CASH FLOWS****(unaudited)**

| <b>(in thousands)</b>  | <b>Three months ended March 31,</b> |                 |
|--|-------------------------------------|-----------------|
|  | <b>2012</b>                         | <b>2011</b>     |
| <b>Cash Flows from Operating Activities:</b>   |                                     |                 |
| Net Loss   | \$ (1,165)                          | \$ (526)        |
| Reconciliation of Net Loss to Net Cash (Used in) Provided by Operating Activities:                           |                                     |                 |
| Investment securities accretion, net   | (400)                               | (330)           |
| Equity in trust  | (1)                                 | (1)             |
| Depreciation and amortization  | 274                                 | 380             |
| (Credit) provision loan and lease losses   | (136)                               | 1,744           |
| Provision for off balance sheet commitments  | (65)                                | (234)           |
| Gain on sale of investment securities  | (8)                                 |                 |
| Gain on the sale of loans held for sale  | (243)                               | (175)           |
| Gain on the sale of other real estate owned  | (9)                                 | (2,544)         |
| (Recovery) write-down of other real estate owned   | (26)                                | 158             |
| Gain on sale of other assets   |                                     | (1)             |
| Income from bank-owned life insurance  | (185)                               | (196)           |
| Proceeds from the sale of loans held for sale  | 8,739                               | 11,900          |
| Funds used to originate loans held for sale  | (10,188)                            | (9,415)         |
| (Decrease) increase in interest receivable   | (109)                               | 31              |
| Decrease in refundable federal income taxes  |                                     | (2)             |
| (Increase) decrease in prepaid expenses and other assets   | (240)                               | 2,461           |
| Increase in interest payable   | 591                                 | 282             |
| Increase in accrued expenses and other liabilities   | 80                                  | 98              |
| <b>Net Cash (Used in) Provided by Operating Activities</b>   | <b>(3,091)</b>                      | <b>3,630</b>    |
| <b>Cash Flows from Investing Activities:</b>   |                                     |                 |
| Investment Securities :  |                                     |                 |
| Proceeds from maturities, calls and principal payments   | 8,361                               | 6,614           |
| Purchases  | (19,850)                            |                 |
| Redemption of FHLB stock   | 420                                 | 515             |
| Net increase in loans to customers   | (8,583)                             | (1,384)         |
| Proceeds from the sale of other real estate owned  | 1,106                               | 5,513           |
| Purchases of bank premises and equipment   | (712)                               | (173)           |
| Proceeds from the sale of bank premises and equipment  |                                     | 8               |
| <b>Net Cash (Used in) Provided by Investing Activities</b>   | <b>(19,258)</b>                     | <b>11,093</b>   |
| <b>Cash Flows from Financing Activities:</b>   |                                     |                 |
| Net decrease in demand deposits, money market demand, interest-bearing demand accounts, and savings accounts | (55,037)                            | (14,429)        |
| Net decrease in time deposits  | (11,861)                            | (7,058)         |
| Proceeds from FHLB advances  | 5,313                               | 76,804          |
| Repayment of FHLB advances   | (8,988)                             | (72,620)        |
| Repayment of other borrowed funds  |                                     | (220)           |
| Proceeds from issuance of common shares - dividend reinvestment plan   |                                     | 19              |
| <b>Net Cash Used in Financing Activities</b>   | <b>(70,573)</b>                     | <b>(17,504)</b> |
| <b>Decrease in Cash and Cash Equivalents</b>   | <b>(92,922)</b>                     | <b>(2,781)</b>  |
| <b>Cash &amp; Cash Equivalents at Beginning of Period</b>  | <b>168,646</b>                      | <b>74,505</b>   |

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|   |    |        |    |        |
|---|----|--------|----|--------|
| <b>Cash &amp; Cash Equivalents at end of period</b> | \$ | 75,724 | \$ | 71,724 |
| <b>Supplemental Cash Flow Information</b>           |    |        |    |        |
| Cash paid during the period for:                    |    |        |    |        |
| Interest  | \$ | 1,982  | \$ | 2,364  |
| Income taxes  | \$ | 25     | \$ | 25     |
| Other transactions:                                 |    |        |    |        |
| Principal balance of loans transferred to OREO      |    | 239    |    | 2,104  |
| Transfer from loans held for sale to other assets   |    | 95     |    | 947    |
| Transfer from loans to other assets                 |    |        |    | 790    |
| Settlement of security recorded on trade date       |    | 5,120  |    |        |

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

Table of Contents

**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 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). 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 March 31, 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.

**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.

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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.

### **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

Table of Contents

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 person's immediate family members and their related interests, employees, and by November 30, 2010, conduct a review of existing



Table of Contents

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;

Table of Contents

(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 three months ended March 31, 2012, and the year ended December 31, 2011, the Company incurred approximately \$131 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. As of 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).

Table of Contents

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 March 31, 2012 and December 31, 2011, 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, 2012 and December 31, 2011 are presented in the following table:

CAPITAL ANALYSIS

| (In thousands)                                 | March 31,<br>2012 | December 31,<br>2011 |
|--|-------------------|----------------------|
| <b>Company</b>                                 |                   |                      |
| Tier I Capital:                                |                   |                      |
| Total Tier I Capital                           | \$ 51,949         | \$ 53,059            |
| Tier II Capital:                               |                   |                      |
| Subordinated notes                             | 25,000            | 25,000               |
| Allowable portion of allowance for loan losses | 9,878             | 9,823                |
| Total Tier II Capital                          | 34,878            | 34,823               |
| Total Risk-Based Capital                       | \$ 86,827         | \$ 87,882            |
| Total Risk Weighted Assets                     | \$ 779,084        | \$ 774,452           |

|  |            |            |
|--|------------|------------|
| <b>Bank</b>                                    |            |            |
| Tier I Capital:                                |            |            |
| Total Tier I Capital                           | \$ 80,491  | \$ 80,976  |
| Tier II Capital:                               |            |            |
| Allowable portion of allowance for loan losses | 9,873      | 9,819      |
| Total Tier II Capital                          | 9,873      | 9,819      |
| Total Risk-Based Capital                       | 90,364     | 90,795     |
| Total Risk Weighted Assets                     | \$ 778,724 | \$ 774,097 |

| At March 31, 2012         | Actual    |        | For Capital Adequacy Purposes |        | To Be Well Capitalized Under Prompt Corrective Action Provision |         |
|---------------------------|-----------|--------|-------------------------------|--------|---|---------|
|                           | Amount    | Ratio  | Amount                        | Ratio  | Amount  | Ratio   |
| <b>Total Capital</b>      |           |        |                               |        |   |         |
| (to Risk Weighted Assets) |           |        |                               |        |   |         |
| Company                   | \$ 86,827 | 11.14% | \$ >62,326                    | >8.00% | N/A   | N/A     |
| Bank                      | \$ 90,364 | 11.60% | \$ >62,298                    | >8.00% | \$ >77,872  | >10.00% |
| Tier I Capital            |           |        |                               |        |   |         |
| (to Risk Weighted Assets) |           |        |                               |        |   |         |
| Company                   | \$ 51,949 | 6.67%  | \$ >31,163                    | >4.00% | N/A   | N/A     |
| Bank                      | \$ 80,491 | 10.34% | \$ >31,149                    | >4.00% | \$ >46,723  | >6.00%  |
| Tier I Capital            |           |        |                               |        |   |         |
| (to Average Assets)       |           |        |                               |        |   |         |
| Company                   | \$ 51,949 | 4.86%  | \$ >42,791                    | >4.00% | N/A   | N/A     |
| Bank                      | \$ 80,491 | 7.53%  | \$ >42,777                    | >4.00% | \$ >53,471  | >5.00%  |



Table of Contents

| At December 31, 2011                     | Actual    |        | For Capital Adequacy Purposes |        | Capitalized Under Prompt Corrective Action Provision |         |
|--|-----------|--------|-------------------------------|--------|--|---------|
|  | Amount    | Ratio  | Amount                        | Ratio  | Amount   | Ratio   |
| Total Capital (to Risk Weighted Assets)  |           |        |                               |        |  |         |
| Company                                  | \$ 87,882 | 11.35% | \$ >61,956                    | >8.00% | N/A  | N/A     |
| Bank                                     | \$ 90,795 | 11.73% | \$ >61,928                    | >8.00% | \$ >77,410   | >10.00% |
| Tier I Capital (to Risk Weighted Assets) |           |        |                               |        |  |         |
| Company                                  | \$ 53,059 | 6.85%  | \$ >30,978                    | >4.00% | N/A  | N/A     |
| Bank                                     | \$ 80,976 | 10.46% | \$ >30,964                    | >4.00% | \$ >46,446   | >6.00%  |
| Tier I Capital (to Average Assets)       |           |        |                               |        |  |         |
| Company                                  | \$ 53,059 | 4.72%  | \$ >44,992                    | >4.00% | N/A  | N/A     |
| Bank                                     | \$ 80,976 | 7.20%  | \$ >44,978                    | >4.00% | \$ >56,227   | >5.00%  |

**Note 4. LOANS**

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

| (In thousands)                                 | March 31, 2012 | December 31, 2011 |
|--|----------------|-------------------|
| Residential real estate                        | \$ 78,690      | \$ 80,056         |
| Commercial real estate                         | 255,317        | 256,508           |
| Construction, land acquisition and development | 38,174         | 33,450            |
| Commercial and industrial loans                | 175,429        | 174,233           |
| Consumer loans                                 | 113,952        | 111,778           |
| State and political subdivisions               | 26,594         | 23,496            |
| Total loans, gross                             | 688,156        | 679,521           |
| Unearned discount                              | (145)          | (159)             |
| Net deferred loan fees and costs               | 467            | 516               |
| Allowance for loan and lease losses            | (20,664)       | (20,834)          |
| Loans, net                                     | \$ 667,814     | \$ 659,044        |

The Company has granted loans, letters of credit and lines of credit to certain executive officers and directors of the Company as well as to certain related parties of executive officers and directors. See Note 9 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, 2012, the Company sold \$8.5 million of one-to-four family mortgages. The Company retains servicing rights on these mortgages.

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The Company had \$1.7 million and \$94 thousand in loans held-for-sale at March 31, 2012 and December 31, 2011, 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 2011 Form 10-K for the risk characteristics related to the Company's loan segments.



Table of Contents

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-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 U.S. GAAP. The ALLL consists primarily of the following two components:

(1) Specific allowances are established for impaired loans (defined by the Company as all loans with an outstanding balance greater than \$100,000 rated doubtful or substandard and on non-accrual status and all 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. These segments are further disaggregated into classes. Loans rated special mention or substandard and accruing which are embedded in these loan segments are then separated from them. These separated 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 primarily based on the Company's own historical loss experience based on the loss rate for each group of loans with similar risk characteristics in its portfolio. In addition management evaluates and applies certain qualitative or environmental factors that are likely to cause estimated credit losses associated with the Company's existing portfolio that may differ from historical experience, which are discussed below. This evaluation is inherently subjective, as it requires material estimates that may be susceptible to significant revisions based upon changes in economic and real estate market conditions. Actual loan losses may be significantly more than the ALLL that is established, which could have a material negative effect on the Company's financial results.

In underwriting a loan secured by real property (unless exempt based on legal requirements), the Company requires an appraisal of the property by an independent licensed appraiser approved by the Company's board of directors. The appraisal is either reviewed internally or by an independent third party hired by the Company. Generally, management obtains updated appraisals when a loan is deemed impaired. These appraisals may be more limited than those prepared for the underwriting of a new loan. In addition, when the Company acquires other real estate owned, it generally obtains a current appraisal to substantiate the net carrying value of the asset.

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;

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- 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 its customers' credit quality.

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 Company's ALLL methodology results in a higher dollar amount of estimated probable losses. Conversely, when the loan portfolio decreases, absent other factors, the Company's ALLL methodology results in a lower dollar amount of estimated probable losses.

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Table of Contents

Each quarter, management evaluates the ALLL and adjusts the ALLL as appropriate through a provision for loan losses. While the Company uses the best information available to make evaluations, future adjustments to the ALLL may be necessary if conditions differ substantially from the information used in making the evaluations. In addition, as an integral part of its examination process, the Office of the Comptroller of the Currency 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.

The following tables set forth activity in the ALLL, by loan type, for the three months ended March 31, 2012 and 2011.

| (in thousands)                            | Real Estate             |                        | Commercial & Industrial                        |                       |          | Consumer      |                    | State and              |           | Total |
|---|-------------------------|------------------------|--|-----------------------|----------|---------------|--------------------|------------------------|-----------|-------|
|   | Residential Real Estate | Commercial Real Estate | Construction, Land Acquisition and Development | Solid Waste Landfills | Other    | Indirect Auto | Installment/ HELOC | Political Subdivisions |           |       |
| <b>Three Months Ended March 31, 2012:</b> |                         |                        |  |                       |          |               |                    |                        |           |       |
| <b>Allowance for loan losses:</b>         |                         |                        |  |                       |          |               |                    |                        |           |       |
| Beginning Balance, January 1, 2012        | \$ 1,823                | \$ 11,151              | \$ 2,590                                       | \$ 16                 | \$ 3,276 | \$ 802        | \$ 724             | \$ 452                 | \$ 20,834 |       |
| Charge-offs                               | (312)                   | (154)                  |  |                       | (49)     | (23)          | (56)               |                        | (594)     |       |
| Recoveries                                | 19                      | 317                    | 21   |                       | 125      | 68            | 10                 |                        | 560       |       |
| Provisions (credits)                      | 269                     | (573)                  | 234  |                       | 37       | (114)         | 46                 | (35)                   | (136)     |       |
| Ending Balance, March 31, 2012            | \$ 1,799                | \$ 10,741              | \$ 2,845                                       | \$ 16                 | \$ 3,389 | \$ 733        | \$ 724             | \$ 417                 | \$ 20,664 |       |
| <b>Three Months Ended March 31, 2011:</b> |                         |                        |  |                       |          |               |                    |                        |           |       |
| <b>Allowance for loan losses:</b>         |                         |                        |  |                       |          |               |                    |                        |           |       |
| Beginning Balance, January 1, 2011        | \$ 2,176                | \$ 9,640               | \$ 4,170                                       | \$ 11                 | \$ 4,839 | \$ 597        | \$ 576             | \$ 566                 | \$ 22,575 |       |
| Charge-offs                               | (136)                   | (457)                  | (6)  |                       | (109)    | (128)         | (92)               |                        | (928)     |       |
| Recoveries                                | 7                       | 13                     | 706  |                       | 74       | 38            | 1                  |                        | 839       |       |
| Provisions                                | 194                     | 1,664                  | (247)  | 5                     | (161)    | 74            | 91                 | 124                    | 1,744     |       |
| Ending Balance, March 31, 2011            | \$ 2,241                | \$ 10,860              | \$ 4,623                                       | \$ 16                 | \$ 4,643 | \$ 581        | \$ 576             | \$ 690                 | \$ 24,230 |       |

The following tables represent 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, 2012 and December 31, 2011:

| (in thousands)                        | Real Estate             |                        | Commercial & Industrial                        |                       |       | Consumer      |                    | State and              |        | Total |
|---------------------------------------|-------------------------|------------------------|--|-----------------------|-------|---------------|--------------------|------------------------|--------|-------|
|                                       | Residential Real Estate | Commercial Real Estate | Construction, Land Acquisition and Development | Solid Waste Landfills | Other | Indirect Auto | Installment/ HELOC | Political Subdivisions |        |       |
| <b>March 31, 2012</b>                 |                         |                        |  |                       |       |               |                    |                        |        |       |
| <b>Allowance for loan losses:</b>     |                         |                        |  |                       |       |               |                    |                        |        |       |
| Individually evaluated for impairment | \$ 73                   | \$ 530                 | \$ 71  | \$                    | \$    | \$            | \$                 | \$                     | \$ 674 |       |
| Collectively evaluated for impairment | 1,726                   | 10,211                 | 2,774  | 16                    | 3,389 | 733           | 724                | 417                    | 19,990 |       |

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|       |    |       |    |        |    |       |    |    |    |       |    |     |    |     |    |     |    |        |
|-------|----|-------|----|--------|----|-------|----|----|----|-------|----|-----|----|-----|----|-----|----|--------|
| Total | \$ | 1,799 | \$ | 10,741 | \$ | 2,845 | \$ | 16 | \$ | 3,389 | \$ | 733 | \$ | 724 | \$ | 417 | \$ | 20,664 |
|-------|----|-------|----|--------|----|-------|----|----|----|-------|----|-----|----|-----|----|-----|----|--------|

**Loans receivable:**

|                                       |    |        |    |         |    |        |    |        |    |         |    |        |    |        |    |        |    |         |
|---------------------------------------|----|--------|----|---------|----|--------|----|--------|----|---------|----|--------|----|--------|----|--------|----|---------|
| individually evaluated for impairment | \$ | 3,091  | \$ | 12,853  | \$ | 2,967  | \$ |        | \$ | 3,676   | \$ |        | \$ | 31     | \$ |        | \$ | 22,618  |
| collectively evaluated for impairment |    | 75,599 |    | 242,464 |    | 35,207 |    | 42,270 |    | 129,483 |    | 66,939 |    | 46,982 |    | 26,594 |    | 665,538 |
| Total                                 | \$ | 78,690 | \$ | 255,317 | \$ | 38,174 | \$ | 42,270 | \$ | 133,159 | \$ | 66,939 | \$ | 47,013 | \$ | 26,594 | \$ | 688,156 |

**December 31, 2011**

**Allowance for loan losses:**

|                                       |    |       |    |        |    |       |    |    |    |       |    |     |    |     |    |     |    |        |
|---------------------------------------|----|-------|----|--------|----|-------|----|----|----|-------|----|-----|----|-----|----|-----|----|--------|
| Individually evaluated for impairment | \$ | 65    | \$ | 545    | \$ | 91    | \$ |    | \$ |       | \$ |     | \$ |     | \$ |     | \$ | 701    |
| Collectively evaluated for impairment |    | 1,758 |    | 10,606 |    | 2,499 |    | 16 |    | 3,276 |    | 802 |    | 724 |    | 452 |    | 20,133 |
| Total                                 | \$ | 1,823 | \$ | 11,151 | \$ | 2,590 | \$ | 16 | \$ | 3,276 | \$ | 802 | \$ | 724 | \$ | 452 | \$ | 20,834 |

**Loans receivable:**

|                                       |    |        |    |         |    |        |    |        |    |         |    |        |    |        |    |        |    |         |
|---------------------------------------|----|--------|----|---------|----|--------|----|--------|----|---------|----|--------|----|--------|----|--------|----|---------|
| individually evaluated for impairment | \$ | 3,615  | \$ | 13,012  | \$ | 2,979  | \$ |        | \$ | 4,066   | \$ |        | \$ | 31     | \$ |        | \$ | 23,703  |
| collectively evaluated for impairment |    | 76,441 |    | 243,496 |    | 30,471 |    | 42,270 |    | 127,897 |    | 63,722 |    | 48,025 |    | 23,496 |    | 655,818 |
| Total                                 | \$ | 80,056 | \$ | 256,508 | \$ | 33,450 | \$ | 42,270 | \$ | 131,963 | \$ | 63,722 | \$ | 48,056 | \$ | 23,496 | \$ | 679,521 |

**Credit Quality Indicators Commercial Loans**

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

Table of Contents

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. The Company maintains a written description of the risk ratings 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 ALLL. After determining the historical loss factor which is adjusted for qualitative and environmental factors for each portfolio segment, segment balances collectively evaluated for impairment are multiplied by the general reserve loss factor for the respective portfolio segments in order to determine the general reserve. Loans that have an internal credit rating of special mention or substandard follow the same process however the qualitative and environmental factors are further adjusted for the increased risk.

The Company utilizes a loan rating system that assigns a degree of risk to commercial loans based on relevant information about the ability of borrowers to service their debt such as: current financial information, historical payment experience, credit documentation, public information and current economic trends, among other factors. Management analyzes these non-homogeneous loans individually based on credit risk and probability of collection for each type of class. Commercial loans include commercial indirect auto loans which are 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 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 - Loans rated 1 through 5 are considered pass ratings. These loans show no current or potential problems and are considered fully collectible. All such loans are considered collectively for ALLL calculation purposes.

Special Mention - Loans classified as special mention loans 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 loans have a potential weakness or pose an unwarranted financial risk which, if not corrected, could weaken the loan and increase risk in the future.

Substandard - Loans 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 - Loans 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 - Loans 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, 2012 and December 31, 2011.

Table of Contents**Commercial Credit Quality Indicators**

March 31, 2012

| (In thousands)                      | Real Estate             |                        | Commercial & Industrial                        |                       |            |                     |                                  | Total      |
|-------------------------------------|-------------------------|------------------------|--|-----------------------|------------|---------------------|----------------------------------|------------|
|                                     | Residential Real Estate | Commercial Real Estate | Construction, Land Acquisition and Development | Solid Waste Landfills | Other      | Installment / HELOC | State and Political Subdivisions |            |
| <b>Internal Risk Rating</b>         |                         |                        |  |                       |            |                     |                                  |            |
| Pass                                | \$ 18,881               | \$ 202,774             | \$ 21,687                                      | \$ 42,270             | \$ 119,262 | \$ 2,914            | \$ 26,561                        | \$ 434,349 |
| Special Mention                     | 579                     | 12,136                 | 219  |                       | 2,920      | 6                   |                                  | 15,860     |
| Substandard                         | 2,484                   | 40,407                 | 14,142   |                       | 5,109      | 145                 | 33                               | 62,320     |
| Doubtful                            |                         |                        |  |                       |            |                     |                                  |            |
| Loss                                |                         |                        |  |                       |            |                     |                                  |            |
| <b>Total Gross Loans Receivable</b> | \$ 21,944               | \$ 255,317             | \$ 36,048                                      | \$ 42,270             | \$ 127,291 | \$ 3,065            | \$ 26,594                        | \$ 512,529 |

**Commercial Credit Quality Indicators**

December 31, 2011

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

**Credit Quality Indicators - Other Loans**

Residential, consumer and commercial indirect auto loans are monitored on a pool basis due to their homogeneous nature. Loans that are delinquent 90 days or more are considered 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, 2012 and December 31, 2011.

| (in thousands) | March 31, 2012 |                    |       | December 31, 2011 |                    |       |
|----------------|----------------|--------------------|-------|-------------------|--------------------|-------|
|                | Accruing Loans | Non-accruing Loans | Total | Accruing Loans    | Non-accruing Loans | Total |
|                |                |                    |       |                   |                    |       |

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|  |    |         |    |       |    |         |    |         |    |       |        |         |
|--|----|---------|----|-------|----|---------|----|---------|----|-------|--------|---------|
| Construction, Land Acquisition and Development - Residential | \$ | 2,126   | \$ |       | \$ | 2,126   |    | 3,180   |    | \$    | 3,180  |         |
| Residential Real Estate                                      |    | 55,215  |    | 1,531 |    | 56,746  |    | 55,112  |    | 1,458 | 56,570 |         |
| Indirect Auto - Consumer                                     |    | 66,874  |    | 65    |    | 66,939  |    | 63,718  |    | 4     | 63,722 |         |
| Indirect Auto - Commercial                                   |    | 5,868   |    |       |    | 5,868   |    | 5,637   |    |       | 5,637  |         |
| Installment/HELOC  |    | 43,705  |    | 243   |    | 43,948  |    | 45,103  |    | 32    | 45,135 |         |
| Total  | \$ | 173,788 | \$ | 1,839 | \$ | 175,627 | \$ | 172,750 | \$ | 1,494 | \$     | 174,244 |

Included in loans receivable are loans for which the accrual of interest income has been discontinued due to deterioration in the financial condition of the borrowers. The recorded investment in these non-accrual loans was \$18.9 million and \$19.9 million at March 31, 2012 and December 31, 2011, respectively. Generally, loans are placed on non-accruing status when they become 90 days or more delinquent, and remain on non-accrual status until they are brought current, have six months of performance under the loan terms, and factors indicating reasonable doubt about the timely collection of payments no longer 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-accruing status. Loans past due 90 days or more and still accruing interest were \$142 thousand and \$5 thousand at March 31, 2012 and December 31, 2011, respectively, and consisted of loans that are well secured and are in the process of renewal.



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Table of Contents

The following table sets forth the detail, and delinquency status, of past due and non-accrual loans at March 31, 2012 and December 31, 2011:

| (in thousands)                                 | March 31, 2012              |                     |                     |                     |  | Total Performing Loans |
|--|-----------------------------|---------------------|---------------------|---------------------|--|------------------------|
|  | Performing (Accruing) Loans |                     |                     |                     |  |                        |
|  | 0-29 Days Past Due          | 30-59 Days Past Due | 60-89 Days Past Due | >= 90 Days Past Due |  |                        |
| <b>Real Estate</b>                             |                             |                     |                     |                     |  |                        |
| Residential Real Estate                        | \$ 74,197                   | \$ 557              | \$ 272              | \$ 27               |  | \$ 75,053              |
| Commercial Real Estate                         | 243,054                     | 2,154               | 1,281               |                     |  | 246,489                |
| Construction, Land Acquisition and Development | 35,877                      | 41                  |                     |                     |  | 35,918                 |
| <b>Total Real Estate</b>                       | <b>353,128</b>              | <b>2,752</b>        | <b>1,553</b>        | <b>27</b>           |  | <b>357,460</b>         |
| <b>Commercial and Industrial</b>               |                             |                     |                     |                     |  |                        |
| Solid Waste Landfills                          | 42,270                      |                     |                     |                     |  | 42,270                 |
| Other  | 128,340                     | 820                 | 120                 |                     |  | 129,280                |
| <b>Total Commercial and Industrial</b>         | <b>170,610</b>              | <b>820</b>          | <b>120</b>          |                     |  | <b>171,550</b>         |
| <b>Consumer</b>                                |                             |                     |                     |                     |  |                        |
| Indirect Auto                                  | 66,183                      | 569                 | 122                 |                     |  | 66,874                 |
| Installment/HELOC                              | 46,134                      | 520                 | 1                   | 115                 |  | 46,770                 |
| <b>Total Consumer</b>                          | <b>112,317</b>              | <b>1,089</b>        | <b>123</b>          | <b>115</b>          |  | <b>113,644</b>         |
| <b>State and Political Subdivisions</b>        |                             |                     |                     |                     |  |                        |
|  | 26,562                      |                     |                     |                     |  | 26,562                 |
| <b>Totals</b>                                  | <b>\$ 662,617</b>           | <b>\$ 4,661</b>     | <b>\$ 1,796</b>     | <b>\$ 142</b>       |  | <b>\$ 669,216</b>      |

|  | Non-Accruing Loans |                     |                     |                     | Total            |
|--|--------------------|---------------------|---------------------|---------------------|------------------|
|  | 0-29 Days Past Due | 30-59 Days Past Due | 60-89 Days Past Due | >= 90 Days Past Due |                  |
| <b>Real Estate</b>                             |                    |                     |                     |                     |                  |
| Residential Real Estate                        | \$ 504             | \$ 898              | \$ 327              | \$ 1,908            | \$ 3,637         |
| Commercial Real Estate                         | 567                |                     |                     | 8,261               | 8,828            |
| Construction, Land Acquisition and Development |                    |                     |                     | 2,256               | 2,256            |
| <b>Total Real Estate</b>                       | <b>1,071</b>       | <b>898</b>          | <b>327</b>          | <b>12,425</b>       | <b>14,721</b>    |
| <b>Commercial and Industrial</b>               |                    |                     |                     |                     |                  |
| Solid Waste Landfills                          |                    |                     |                     |                     |                  |
| Other  | 3,701              | 51                  |                     | 127                 | 3,879            |
| <b>Total Commercial and Industrial</b>         | <b>3,701</b>       | <b>51</b>           |                     | <b>127</b>          | <b>3,879</b>     |
| <b>Consumer</b>                                |                    |                     |                     |                     |                  |
| Indirect Auto                                  | 31                 | 3                   | 11                  | 20                  | 65               |
| Installment/HELOC                              |                    |                     |                     | 243                 | 243              |
| <b>Total Consumer</b>                          | <b>31</b>          | <b>3</b>            | <b>11</b>           | <b>263</b>          | <b>308</b>       |
| <b>State and Political Subdivisions</b>        |                    |                     |                     |                     |                  |
|  |                    |                     |                     | 32                  | 32               |
| <b>Totals</b>                                  | <b>\$ 4,803</b>    | <b>\$ 952</b>       | <b>\$ 338</b>       | <b>\$ 12,847</b>    | <b>\$ 18,940</b> |

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|   |    |         |    |       |    |       |    |        |    |         |
|---|----|---------|----|-------|----|-------|----|--------|----|---------|
| <b>Total gross loans<br/>receivable</b> | \$ | 667,420 | \$ | 5,613 | \$ | 2,134 | \$ | 12,989 | \$ | 688,156 |
|---|----|---------|----|-------|----|-------|----|--------|----|---------|

Table of Contents**Performing and Non-Performing Loan Delinquency Status**

December 31, 2011

| (in thousands)                                 | Performing (Accruing) Loans |                     |                     |                     | Total Performing Loans |
|--|-----------------------------|---------------------|---------------------|---------------------|------------------------|
|  | 0-29 Days Past Due          | 30-59 Days Past Due | 60-89 Days Past Due | >= 90 Days Past Due |                        |
| <b>Real Estate</b>                             |                             |                     |                     |                     |                        |
| Residential Real Estate                        | \$ 74,379                   | \$ 1,293            | \$ 248              | \$                  | \$ 75,920              |
| Commercial Real Estate                         | 243,873                     | 2,381               | 1,235               |                     | 247,489                |
| Construction, Land Acquisition and Development | 30,945                      | 241                 |                     |                     | 31,186                 |
| <b>Total Real Estate</b>                       | <b>349,197</b>              | <b>3,915</b>        | <b>1,483</b>        |                     | <b>354,595</b>         |
| <b>Commercial and Industrial</b>               |                             |                     |                     |                     |                        |
| Solid Waste Landfills                          | 42,270                      |                     |                     |                     | 42,270                 |
| Other  | 126,774                     | 667                 | 91                  | 5                   | 127,537                |
| <b>Total Commercial and Industrial</b>         | <b>169,044</b>              | <b>667</b>          | <b>91</b>           | <b>5</b>            | <b>169,807</b>         |
| <b>Consumer</b>                                |                             |                     |                     |                     |                        |
| Indirect Auto                                  | 62,753                      | 845                 | 120                 |                     | 63,718                 |
| Installment/HELOC                              | 47,617                      | 244                 | 163                 |                     | 48,024                 |
| <b>Total Consumer</b>                          | <b>110,370</b>              | <b>1,089</b>        | <b>283</b>          |                     | <b>111,742</b>         |
| <b>State and Political Subdivisions</b>        |                             |                     |                     |                     |                        |
|  | 23,464                      |                     |                     |                     | 23,464                 |
| <b>Totals</b>                                  | <b>\$ 652,075</b>           | <b>\$ 5,671</b>     | <b>\$ 1,857</b>     | <b>\$ 5</b>         | <b>\$ 659,608</b>      |

|  | Non-Performing Loans |                     |                     |                     | Total Non-accrual Loans |
|--|----------------------|---------------------|---------------------|---------------------|-------------------------|
|  | 0-29 Days Past Due   | 30-59 Days Past Due | 60-89 Days Past Due | >= 90 Days Past Due |                         |
| <b>Real Estate</b>                             |                      |                     |                     |                     |                         |
| Residential Real Estate                        | \$ 1,994             | \$ 964              | \$ 94               | \$ 1,084            | \$ 4,136                |
| Commercial Real Estate                         | 291                  | 220                 |                     | 8,508               | 9,019                   |
| Construction, Land Acquisition and Development | 426                  |                     |                     | 1,838               | 2,264                   |
| <b>Total Real Estate</b>                       | <b>2,711</b>         | <b>1,184</b>        | <b>94</b>           | <b>11,430</b>       | <b>15,419</b>           |
| <b>Commercial and Industrial</b>               |                      |                     |                     |                     |                         |
| Solid Waste Landfills                          |                      |                     |                     |                     |                         |
| Other  | 4,114                | 4                   | 126                 | 182                 | 4,426                   |
| <b>Total Commercial and Industrial</b>         | <b>4,114</b>         | <b>4</b>            | <b>126</b>          | <b>182</b>          | <b>4,426</b>            |
| <b>Consumer</b>                                |                      |                     |                     |                     |                         |
| Indirect Auto                                  |                      |                     |                     | 4                   | 4                       |
| Installment/HELOC                              |                      |                     |                     | 32                  | 32                      |
| <b>Total Consumer</b>                          |                      |                     |                     | <b>36</b>           | <b>36</b>               |
| <b>State and Political Subdivisions</b>        |                      |                     |                     |                     |                         |
|  |                      |                     |                     | 32                  | 32                      |
| <b>Total Non-accruing loans</b>                | <b>\$ 6,825</b>      | <b>\$ 1,188</b>     | <b>\$ 220</b>       | <b>\$ 11,680</b>    | <b>\$ 19,913</b>        |
| <b>Total loans receivable</b>                  | <b>\$ 658,900</b>    | <b>\$ 6,859</b>     | <b>\$ 2,077</b>     | <b>\$ 11,685</b>    | <b>\$ 679,521</b>       |

The total recorded investment in impaired loans, which consists of non-accrual loans greater than \$100,000 and performing TDRs, amounted to \$22.6 million and \$23.7 million at March 31, 2012 and December 31, 2011, respectively. The related allowance on impaired loans was \$0.7 million as of both March 31, 2012 and December 2011.

Table of Contents

The following tables provide an analysis of the Company's impaired loans as of March 31, 2012 and December 31, 2011:

Table of Contents**Impaired Loans**

March 31, 2012

| (In thousands)                                   | Recorded<br>Investment | Unpaid<br>Principal<br>Balance | Related<br>Allowance |
|--|------------------------|--------------------------------|----------------------|
| <b><u>With No Allowance Recorded:</u></b>        |                        |                                |                      |
| <b>Real Estate</b>                               |                        |                                |                      |
| Residential Real Estate                          | \$ 1,179               | \$ 1,264                       |                      |
| Commercial Real Estate                           | 788                    | 960                            |                      |
| Construction, Land Acquisition and Development   | 2,055                  | 5,384                          |                      |
| Total Real Estate                                | 4,022                  | 7,608                          |                      |
| <b>Commercial and Industrial</b>                 |                        |                                |                      |
| Solid Waste Landfills                            |                        |                                |                      |
| Other  | 3,676                  | 4,373                          |                      |
| Total Commercial and Industrial                  | 3,676                  | 4,373                          |                      |
| <b>Consumer</b>                                  |                        |                                |                      |
| Indirect Auto                                    |                        |                                |                      |
| Installment/HELOC                                | 31                     | 35                             |                      |
| Total Consumer                                   | 31                     | 35                             |                      |
| <b>State and Political Subdivisions</b>          |                        |                                |                      |
| <b>Total With No Allowance Recorded</b>          | <b>\$ 7,729</b>        | <b>\$ 12,016</b>               | <b>\$</b>            |
| <b><u>With a Related Allowance Recorded:</u></b> |                        |                                |                      |
| <b>Real Estate</b>                               |                        |                                |                      |
| Residential Real Estate                          | \$ 1,912               | \$ 2,618                       | \$ 73                |
| Commercial Real Estate                           | 12,065                 | 13,889                         | 530                  |
| Construction, Land Acquisition and Development   | 912                    | 978                            | 71                   |
| Total Real Estate                                | 14,889                 | 17,485                         | 674                  |
| <b>Commercial and Industrial</b>                 |                        |                                |                      |
| Solid Waste Landfills                            |                        |                                |                      |
| Other  |                        |                                |                      |
| Total Commercial and Industrial                  |                        |                                |                      |
| <b>Consumer</b>                                  |                        |                                |                      |
| Indirect Auto                                    |                        |                                |                      |
| Installment/HELOC                                |                        |                                |                      |
| Total Consumer                                   |                        |                                |                      |
| <b>State and Political Subdivisions</b>          |                        |                                |                      |
| <b>Total with Related Allowance</b>              | <b>\$ 14,889</b>       | <b>\$ 17,485</b>               | <b>\$ 674</b>        |
| <b><u>Total of impaired loans</u></b>            |                        |                                |                      |
| <b>Real Estate</b>                               |                        |                                |                      |
| Residential Real Estate                          | \$ 3,091               | \$ 3,882                       | \$ 73                |
| Commercial Real Estate                           | 12,853                 | 14,849                         | 530                  |
| Construction, Land Acquisition and Development   | 2,967                  | 6,362                          | 71                   |
| Total Real Estate                                | 18,911                 | 25,093                         | 674                  |

**Commercial and Industrial**

|  |              |              |
|--|--------------|--------------|
| Solid Waste Landfills                  |              |              |
| Other                                  | 3,676        | 4,373        |
| <b>Total Commercial and Industrial</b> | <b>3,676</b> | <b>4,373</b> |

**Consumer**

|                       |           |           |
|-----------------------|-----------|-----------|
| Indirect Auto         |           |           |
| Installment/HELOC     | 31        | 35        |
| <b>Total Consumer</b> | <b>31</b> | <b>35</b> |

**State and Political Subdivisions**

|                                 |           |               |           |               |           |            |
|---------------------------------|-----------|---------------|-----------|---------------|-----------|------------|
| <b>Total Impaired Loans (1)</b> | <b>\$</b> | <b>22,618</b> | <b>\$</b> | <b>29,501</b> | <b>\$</b> | <b>674</b> |
|---------------------------------|-----------|---------------|-----------|---------------|-----------|------------|

(1) Non-accrual loans with outstanding balances of less than \$100 thousand are not considered for individual impairment evaluation and are accordingly not included in the table above. However, these loans are evaluated collectively as homogenous pools in the general allowance calculation under ASC Topic 310. Total non-accrual loans with individual balances of less than \$100 thousand equaled \$2.0 million at March 31, 2012.

Table of Contents**Impaired Loans**

December 31, 2011

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



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| <b>Commercial and Industrial</b>        |  |       |        |       |
|---|--|-------|--------|-------|
| Solid Waste Landfills                   |  |       |        |       |
| Other                                   |  | 4,066 |        | 4,601 |
| Total Commercial and Industrial         |  | 4,066 |        | 4,601 |
| <b>Consumer</b>                         |  |       |        |       |
| Indirect Auto                           |  |       |        |       |
| Installment/HELOC                       |  | 31    |        | 35    |
| Total Consumer                          |  | 31    |        | 35    |
| <b>State and Political Subdivisions</b> |  |       |        |       |
| <b>Total Impaired Loans (1)</b>         |  | \$    | 23,703 | \$    |
|   |  |       |        | \$    |
|   |  |       |        | 701   |

(1) Non-accrual loans with outstanding balances of less than \$100 thousand are not considered for individual impairment evaluation and are accordingly not included in the table above. However, these loans are evaluated collectively as homogenous pools in the general allowance calculation under ASC Topic 310. Total non-accrual loans with individual balances of less than \$100 thousand equaled \$1.9 million at December 31, 2011.

Table of Contents

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, 2012 and 2011:

|  | Three Months Ended March 31, |                        |                    |                        |
|--|------------------------------|------------------------|--------------------|------------------------|
|  | 2012                         |                        |                    | 2011                   |
|  | Average<br>Balance           | Interest<br>Income (1) | Average<br>Balance | Interest<br>Income (1) |
|  | (in thousand)                |                        |                    |                        |
| Residential Real Estate                        | \$ 3,353                     | \$ 3                   | \$ 2,957           | \$ 2                   |
| Commercial Real Estate                         | 12,933                       | 70                     | 12,201             | 20                     |
| Construction, Land Acquisition and Development | 2,973                        | 12                     | 8,846              | 2                      |
| Total Real Estate                              | 19,259                       | 85                     | 24,004             | 24                     |
| Commercial and Industrial                      |                              |                        |                    |                        |
| Solid Waste Landfills                          |                              |                        |                    |                        |
| Other  | 3,871                        |                        | 5,605              | 5                      |
| Total Commercial and Industrial                | 3,871                        |                        | 5,605              | 5                      |
| Consumer                                       |                              |                        |                    |                        |
| Indirect Auto                                  |                              |                        |                    |                        |
| Installment/HELOC                              | 31                           |                        | 180                |                        |
| Total Consumer                                 | 31                           |                        | 180                |                        |
| State and Political Subdivisions               |                              |                        |                    |                        |
| Total Impaired Loans                           | \$ 23,161                    | \$ 85                  | \$ 29,789          | \$ 29                  |

(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, 2012 and 2011 in accordance with their original terms approximated \$405 thousand and \$726 thousand, respectively.

**Troubled Debt Restructured Loans**

The book balance of troubled debt restructured loans ( TDRs ) at March 31, 2012 and December 31, 2011 was \$10.1 million and \$10.8 million, respectively. The balances at March 31, 2012 included approximately \$4.6 million of TDRs on non-accrual status and \$5.5 million of TDRs on accrual status compared to \$5.1 million of TDRs on non-accrual status and \$5.7 million of TDRs in accrual status at December 31, 2011. Approximately \$134 thousand and \$185 thousand in specific reserves have been established for these loans as of March 31, 2012 and December 31, 2011, 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. Non-accruing restructured loans remain in non-accrual status until there has been a period of

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sustained repayment performance for a reasonable period, usually six months. In some instances, where the Company modifies a loan that is delinquent but not on non-accrual status, the restructured loan remains on accrual status provided the repayment performance remains in accordance to the modified terms.

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, 2012 and 2011:

Table of Contents

| (In thousands)   | For the three months ended March 31, 2012 |   |  | For the three months ended March 31, 2011 |   |  |
|--|---|---|--|---|---|--|
|  | Number of Contracts                       | Pre-Modification Outstanding Recorded Investments | Post-Modification Outstanding Recorded Investments | Number of Contracts                       | Pre-Modification Outstanding Recorded Investments | Post-Modification Outstanding Recorded Investments |
| <b>Troubled Debt Restructuring</b>                                     |   |   |  |   |   |  |
| Residential Real Estate Construction, Land Acquisition and Development |   | \$  | \$   | 1   | \$ 175  | \$ 55  |
| Total New Troubled Debt Restructuring                                  | 1   | \$ 39   | \$ 39  | 1   | \$ 83   | \$ 83  |
|  | 1   | \$ 39   | \$ 39  | 2   | \$ 258  | \$ 138   |

The TDRs described above did not have any impact on the allowance for loan losses.

The following table shows the types of modifications made during the three months ended March 31, 2012 and 2011:

| (In thousands)                              | Three months ended March 30, 2012 |                        |  |       | Three months ended March 30, 2011 |                        |  |        |
|---|-----------------------------------|------------------------|--|-------|-----------------------------------|------------------------|--|--------|
|   | Residential Real Estate           | Commercial Real Estate | Construction, Land Acquisition and Development | Total | Residential Real Estate           | Commercial Real Estate | Construction, Land Acquisition and Development | Total  |
| <i>Type of modification</i>                 |                                   |                        |  |       |                                   |                        |  |        |
| Extension of Term                           | \$                                | \$                     | \$ 39  | \$ 39 | \$                                | \$                     | \$ 83  | \$ 83  |
| Extension of Term and Principal Forgiveness |                                   |                        |  |       | 55                                |                        |  | 55     |
| Total TDRs                                  | \$                                | \$                     | \$ 39  | \$ 39 | \$ 55                             | \$                     | \$ 83  | \$ 138 |

There were no TDRs which re-defaulted (defined as past due 90 days) during the three months ended March 31, 2012 and for which the payment re-default occurred within one year of the modification. During the three months ended March 31, 2011 there was one Commercial Real Estate TDRs that re-defaulted in the amount of \$145 thousand.

**Note 5. Other Real Estate Owned**

The following schedule reflects a breakdown of OREO for the periods reviewed.

| (in thousands)         | March 31, 2012 | December 31, 2011 |
|------------------------|----------------|-------------------|
| Land/Lots              | \$ 3,572       | \$ 4,443          |
| Commercial Real Estate | 1,696          | 1,695             |

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|                         |    |       |    |       |
|-------------------------|----|-------|----|-------|
| Residential Real Estate |    | 858   |    | 820   |
| Total                   | \$ | 6,126 | \$ | 6,958 |

The following table reflects the activity in of OREO for the three months ended March 31, 2012 and 2011:

| (in thousands)               |    | 2012 | March 31, | 2011     |
|------------------------------|----|------|-----------|----------|
| Balance, beginning of period | \$ |      | 6,958     | \$ 9,633 |
| Additions                    |    |      | 239       | 2,104    |
| Recoveries / (write-downs)   |    |      | 26        | (158)    |
| Carrying value of OREO sold  |    |      | (1,097)   | (2,969)  |
| Balance, end of period       | \$ |      | 6,126     | \$ 8,610 |

Table of Contents

The following table details the components of net expense of OREO for the three months ended March 31, 2012 and 2011:

| (in thousands)                                     | Three Months Ended |      |      |     |
|--|--------------------|------|------|-----|
|  | March 31,          |      | 2011 |     |
|  | 2012               |      | 2011 |     |
| Insurance  | \$                 | 21   | \$   | 1   |
| Legal fees   |                    | 33   |      | 31  |
| Maintenance  |                    | 16   |      | 1   |
| Income from the operation of foreclosed properties |                    | (4)  |      | (6) |
| Professional Fees                                  |                    | 11   |      | 25  |
| Real estate taxes                                  |                    | 98   |      | 333 |
| Utilities  |                    | 4    |      | 11  |
| Other  |                    | 25   |      | 13  |
| Impairment charges (recoveries)                    |                    | (26) |      | 158 |
| Total  | \$                 | 178  | \$   | 567 |

**Note 6. Securities**

Securities have been classified in the consolidated financial statements according to management's intent. The amortized cost, gross unrealized gains and losses, and the fair value of the Company's securities available-for-sale at March 31, 2012 and December 31, 2011 are as follows:

| March 31, 2012 (in thousands)                   | Amortized Cost | Gross Unrealized Holding Gains | Gross Unrealized Holding Losses | Fair Value |
|---|----------------|--------------------------------|---------------------------------|------------|
| Obligations of U.S. government agencies         | \$ 5,851       | \$ 131                         | \$                              | \$ 5,982   |
| Obligations of state and political subdivisions | 96,071         | 5,272                          | 2,434                           | 98,909     |
| Collateralized mortgage obligations:            |                |                                |                                 |            |
| Government sponsored agency                     | 6,942          | 406                            | 3                               | 7,345      |
| Private Label                                   | 48,181         | 95                             | 366                             | 47,910     |
| Residential mortgage-backed securities:         |                |                                |                                 |            |
| Government sponsored agency                     | 29,145         | 1,238                          |                                 | 30,383     |
| Pooled Trust Preferred Senior Class             | 3,822          |                                | 2,133                           | 1,689      |
| Pooled Trust Preferred Mezzanine Class          | 6,716          |                                | 4,430                           | 2,286      |
| Corporate debt securities                       | 500            |                                | 121                             | 379        |
| Equity securities                               | 1,010          |                                | 5                               | 1,005      |
| Total available-for-sale securities             | \$ 198,238     | \$ 7,142                       | \$ 9,492                        | \$ 195,888 |

| December 31, 2011 (in thousands)                | Amortized cost | Gross unrealized holding gains | Gross unrealized holding losses | Fair value |
|---|----------------|--------------------------------|---------------------------------|------------|
| Obligations of U.S. government agencies         | \$ 7,893       | \$ 155                         | \$                              | \$ 8,048   |
| Obligations of state and political subdivisions | 96,392         | 3,767                          | 3,998                           | 96,161     |

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|   |        |         |     |       |       |        |            |
|---|--------|---------|-----|-------|-------|--------|------------|
| Collateralized mortgage obligations:    |        |         |     |       |       |        |            |
| Government sponsored agency             | 8,093  |         | 380 |       | 5     |        | 8,468      |
| Private Label                           | 36,607 |         | 13  |       | 364   |        | 36,256     |
| Residential mortgage-backed securities: |        |         |     |       |       |        |            |
| Government sponsored agency             | 30,426 |         | 967 |       |       |        | 31,393     |
| Pooled Trust Preferred Senior Class     | 3,833  |         |     |       | 2,229 |        | 1,604      |
| Pooled Trust Preferred Mezzanine Class  | 6,732  |         |     |       | 4,535 |        | 2,197      |
| Corporate debt securities               | 500    |         |     |       | 158   |        | 342        |
| Equity securities                       | 1,010  |         |     |       | 4     |        | 1,006      |
| Total securities available-for-sale     | \$     | 191,486 | \$  | 5,282 | \$    | 11,293 | \$ 185,475 |

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Table of Contents

The amortized cost, gross unrealized gains or losses and the fair value of the Company's securities held-to-maturity at March 31, 2012 and December 31, 2011 are as follows:

|   | Amortized<br>Cost | Gross<br>Unrealized<br>Holding<br>Gains | Gross<br>Unrealized<br>Holding<br>Losses | Fair Value |
|---|-------------------|---|--|------------|
| <b>March 31, 2012 (in thousands)</b>            |                   |   |  |            |
| Obligations of state and political subdivisions | \$ 2,119          | \$ 207                                  | \$                                       | \$ 2,326   |

|   | Amortized<br>Cost | Gross<br>Unrealized<br>Holding<br>Gains | Gross<br>Unrealized<br>Holding<br>Losses | Fair Value |
|---|-------------------|---|--|------------|
| <b>December 31, 2011 (in thousands)</b>         |                   |   |  |            |
| Obligations of state and political subdivisions | \$ 2,094          | \$ 151                                  | \$                                       | \$ 2,245   |

At March 31, 2012 and December 31, 2011, securities with a carrying amount of \$152.3 million and \$173.7 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, 2012 using contractual maturities. Expected maturities will differ from contractual maturity because issuers may have the right to call or prepay obligations with or without call or prepayment penalties. Because mortgage-backed securities are not due at a single maturity date, they are not included in the maturity categories in the following maturity summary.

| (In thousands)                      | Available-for-sale |               | Held-to-maturity  |               |
|-------------------------------------|--------------------|---------------|-------------------|---------------|
|                                     | Amortized<br>Cost  | Fair<br>Value | Amortized<br>Cost | Fair<br>Value |
| Amounts maturing in:                |                    |               |                   |               |
| One Year or Less                    | \$                 | \$            | \$                | \$            |
| One Year through Five Years         | 1,580              | 1,517         |                   |               |
| After Five Years through Ten Years  | 23,134             | 24,216        | 2,119             | 2,326         |
| After Ten Years                     | 88,246             | 83,512        |                   |               |
| Collateralized mortgage obligations | 55,123             | 55,255        |                   |               |
| Mortgage-backed securities          | 29,145             | 30,383        |                   |               |
| Total                               | \$ 197,228         | \$ 194,883    | \$ 2,119          | \$ 2,326      |

The Company did not sell any securities during the three months ended March 31, 2012 and 2011. The Company recognized gains of \$8 thousand and \$0 on securities called during the three months ended March 31, 2012 and 2011, respectively.

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





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Table of Contents

|   | Less than 12 Months |                         | 12 Months or Greater |                         | Total      |                         |
|---|---------------------|-------------------------|----------------------|-------------------------|------------|-------------------------|
|   | Fair Value          | Gross Unrealized Losses | Fair Value           | Gross Unrealized Losses | Fair Value | Gross Unrealized Losses |
| <b>March 31, 2012 (in thousands)</b>            |                     |                         |                      |                         |            |                         |
| Obligations of U.S. government agencies         | \$                  | \$                      | \$                   | \$                      | \$         | \$                      |
| Obligations of state and political subdivisions | 7,559               | 239                     | 16,461               | 2,195                   | 24,020     | 2,434                   |
| Collateralized mortgage obligations             |                     |                         |                      |                         |            |                         |
| Government sponsored agency                     | 747                 | 3                       |                      |                         | 747        | 3                       |
| Private label                                   | 34,944              | 366                     |                      |                         | 34,944     | 366                     |
| Residential mortgage-backed securities          |                     |                         |                      |                         |            |                         |
| Government sponsored agency                     |                     |                         |                      |                         |            |                         |
| Pooled Trust Preferred Senior Class             |                     |                         | 1,689                | 2,133                   | 1,689      | 2,133                   |
| Pooled Trust Preferred Mezzanine Class          |                     |                         | 2,286                | 4,430                   | 2,286      | 4,430                   |
| Corporate debt securities                       |                     |                         | 379                  | 121                     | 379        | 121                     |
| Equity securities                               | 995                 | 5                       |                      |                         | 995        | 5                       |
| Total   | \$ 44,245           | \$ 613                  | \$ 20,815            | \$ 8,879                | \$ 65,060  | \$ 9,492                |

|   | Less than 12 Months |                         | 12 Months or Greater |                         | Total      |                         |
|---|---------------------|-------------------------|----------------------|-------------------------|------------|-------------------------|
|   | Fair Value          | Gross Unrealized Losses | Fair Value           | Gross Unrealized Losses | Fair Value | Gross Unrealized Losses |
| <b>December 31, 2011 (in thousands)</b>         |                     |                         |                      |                         |            |                         |
| Obligations of U.S. government agencies         | \$                  | \$                      | \$                   | \$                      | \$         | \$                      |
| Obligations of state and political subdivisions | 11,129              | 241                     | 25,910               | 3,757                   | 37,039     | 3,998                   |
| Collateralized mortgage obligations             |                     |                         |                      |                         |            |                         |
| Government sponsored agency                     | 1,028               | 5                       |                      |                         | 1,028      | 5                       |
| Private label                                   | 30,459              | 364                     |                      |                         | 30,459     | 364                     |
| Residential mortgage-backed securities          |                     |                         |                      |                         |            |                         |
| Government sponsored agency                     |                     |                         |                      |                         |            |                         |
| Pooled Trust Preferred Senior Class             |                     |                         | 1,604                | 2,229                   | 1,604      | 2,229                   |
| Pooled Trust Preferred Mezzanine Class          |                     |                         | 2,197                | 4,535                   | 2,197      | 4,535                   |
| Corporate debt securities                       |                     |                         | 342                  | 158                     | 342        | 158                     |
| Equity securities                               | 996                 | 4                       |                      |                         | 996        | 4                       |
| Total   | \$ 43,612           | \$ 614                  | \$ 30,053            | \$ 10,679               | \$ 73,665  | \$ 11,293               |

At March 31, 2012, excluding pooled trust preferred securities ( PreTSLs ), 78 of the Company s debt securities holdings having unrealized losses have depreciated 4.6% from their amortized cost basis. These securities are guaranteed by either the U.S. Government, government sponsored agencies, other governments or corporations, and are considered investment grade. Seventy-four percent (74%) of the Company s investment in obligations of state and political subdivisions are also guaranteed by underlying insurance which further secures the safety of principal. These unrealized losses relate principally to current interest rates for similar types of securities. The Company does not intend to sell these securities and does not anticipate that it will be required to sell these securities before the full recovery of principal and interest due, which may be at maturity. Therefore, the Company did not consider the carrying value of these securities to be other-than-temporarily impaired at March 31, 2012.

At March 31, 2012, four of the Company s PreTSLs having realized cumulative credit-related OTTI losses of \$8.6 million and unrealized losses of \$6.6 million, have depreciated 62.27% and 80.92% from their current amortized cost and face values, respectively.

On a quarterly basis, management evaluates the Company s investment securities for OTTI. Unrealized losses on securities are considered to be other-than-temporarily-impaired when management believes the security s impairment is due to factors that could include the issuer s inability to

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

Table of Contents

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

To determine whether a security's impairment is other than temporary, the Company considers factors that include:

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

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

Based on the Company's evaluation at March 31, 2012, the Company has determined that the decreases in estimated fair value of the securities it holds in its portfolio are temporary.

*OTTI of Pooled Trust Preferred Collateralized Debt Obligations:*

At March 31, 2012, the amortized cost of our PreTSLs totaled \$10.5 million with an estimated fair value of \$4.0 million and is comprised of four securities, each of which is collateralized by debt issued by bank holding companies and insurance companies. The Company holds one senior tranche and three mezzanine tranches and all possess credit ratings below investment grade. At the time of initial issue, no more than 5% of any pooled security consisted of a security issued by any one institution. At March 31, 2012, three of these securities had no excess subordination and one had excess subordination, which was 14.24% of the current performing collateral. Excess subordination is the amount by which the underlying performing collateral exceeds the outstanding bonds in the current class plus all senior classes. It can also be referred to as credit enhancement. As deferrals and defaults of underlying issuers occur, the excess subordination is reduced or eliminated, increasing the risk of the security experiencing principal or interest shortfalls. Conversely, subordination can be increased as collateral transitions from non-performing to performing. The coverage ratio, or overcollateralization, of a specific security measures the rate of performing collateral to a given class of notes. It is calculated by dividing the performing collateral in a transaction by the current balance of the class of notes plus all classes senior to that class.

The following table presents information about the Company's collateral and subordination for its PreTSLs at March 31, 2012:

| Excess | Current<br>Number of | Actual<br>Deferrals /<br>Defaults as a<br>% | Expected |
|--------|----------------------|---|----------|
|--------|----------------------|---|----------|

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| Security    | Performing Collateral | Bonds Outstanding (in thousands) | (Insufficient) Collateral | Coverage Ratio | Excess Subordination | Performing Issuers | of Current Collateral | Future Default Rate |
|-------------|-----------------------|----------------------------------|---------------------------|----------------|----------------------|--------------------|-----------------------|---------------------|
| PreTSL IX   | \$ 299,520            | \$ 320,838                       | \$ (21,318)               | 93.36%         | N/A                  | 34                 | 31.90%                | 1.53%               |
| PreTSL XI   | 388,465               | 438,163                          | (49,698)                  | 88.66%         | N/A                  | 43                 | 32.30%                | 1.86%               |
| PreTSL XIX  | 470,831               | 534,746                          | (63,915)                  | 88.05%         | N/A                  | 47                 | 27.60%                | 1.38%               |
| PreTSL XXVI | 683,700               | 598,459                          | 85,241                    | 114.24%        | 14.24%               | 55                 | 28.00%                | 1.44%               |

The following list details information for each of the Company's PreTSLs at March 31, 2012 (in thousands):

| Security    | Class     | Amortized Cost | Fair Value | Unrealized Gain (Loss) | Moody's / Fitch Ratings | Credit Impairment Quarter to Date | Credit Impairment Year to Date | Credit Impairment Cumulative |
|-------------|-----------|----------------|------------|------------------------|-------------------------|-----------------------------------|--------------------------------|------------------------------|
| PreTSL IX   | Mezzanine | \$ 1,240       | \$ 541     | \$ (699)               | Ca / C                  | \$                                | \$                             | \$ 1,680                     |
| PreTSL XI   | Mezzanine | 1,563          | 632        | (931)                  | Ca / C                  |                                   |                                | 3,426                        |
| PreTSL XIX  | Mezzanine | 3,913          | 1,113      | (2,800)                | Ca / CC                 |                                   |                                | 3,262                        |
| PreTSL XXVI | Senior    | 3,822          | 1,689      | (2,133)                | B1 / CCC                |                                   |                                | 251                          |
| Total       |           | \$ 10,538      | \$ 3,975   | \$ (6,563)             |                         | \$                                | \$                             | \$ 8,619                     |

The Company's PreTSLs are measured for OTTI by determining whether an adverse change in estimated cash flows has occurred. The Company uses a third-party service provider to perform this analysis. Determining whether there has been an adverse change in estimated cash flows from the cash flows previously projected involves comparing the present value of remaining cash flows previously projected against the present value of the cash flows estimated at March 31, 2012. The Company considers the discounted cash flow analysis to be its primary evidence when determining whether credit related OTTI exists.

Table of Contents

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

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

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

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

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

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

- Prepayment Rate** Lack of liquidity in the market for PreTSL securities, credit rating downgrades and market uncertainties related to the financial industry are factors contributing to the impairment of these securities. During the early years of PreTSL securities, prepayments were common as issuers were able to refinance into lower cost borrowings. Since the middle of 2007, however, this option has all but disappeared and the Company is operating in an environment which makes early redemption of these instruments unlikely. Accordingly, the

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Company has assumed zero prepayments when modeling the cash flows of these securities. The Company performed a sensitivity analysis during the first quarter ended March 31, 2012 using 1% and 3% prepayment assumptions. As a result of this analysis, the Company determined that employing a 1% and a 3% prepayment assumption rather than assuming zero prepayments would not have resulted in a credit loss. Credit losses could increase as a result of an increase in the prepayment assumption because prepayments reduce the amount of excess subordination that would be available to absorb expected losses.

- **Credit Analysis** A quarterly credit evaluation is performed for each of the securities. While the underlying core component of these securities are the credit characteristics of the underlying issuers, typically banks, other characteristics of the securities and issuers are evaluated and stressed to determine cash flow. These include but are not limited to the interest rate payable by each issuer, certain derivative contracts, default timing, and interest rate volatility. Issuer level credit

Table of Contents

considers all evidence available to us and includes the nature of the issuer's business, its years of operating history, corporate structure, loan composition, loan concentrations, deposit mix, asset growth rates, geographic footprint and local environment. Depending upon the security, and its place in the capital structure, certain analytical assumptions are isolated with greater scrutiny. The core analysis for each specific issuer focuses on profitability, return on assets, shareholders' equity, net interest margin, credit quality ratios, operating efficiency, capital adequacy and liquidity.

The Company has evaluated its PreTSLs considering all available evidence, including information received after the statement of financial condition date but before the filing date, and determined that the estimated discounted cash flows are greater than the securities' carrying value, resulting in no impairment charges to earnings of accumulated other comprehensive income for the three months ended March 31, 2012.

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

| (In thousands)   | 2012     | 2011      |
|--|----------|-----------|
| Beginning Balance January 1  | \$ 8,619 | \$ 22,598 |
| Credit losses on debt securities for which OTTI was not previously recognized        |          |           |
| Additional credit losses on debt securities for which OTTI was previously recognized |          |           |
| Ending Balance, March 31   | \$ 8,619 | \$ 22,598 |

Investments in FHLB and FRB stock, which has limited marketability, are carried at cost totaled \$9.2 million and \$9.7 million at March 31, 2012 and December 31, 2011, respectively. FRB stock of \$1.3 million is included in Other Assets at March 31, 2012 and December 31, 2011. Management noted no indicators of impairment for the FHLB of Pittsburgh and FRB of Philadelphia at March 31, 2012.

**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). 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.

An 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.

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.

Table of Contents

**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 (PLCMOs) in the Company's securities portfolio are 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). The valuation of PreTSLs is further described below and in Note 6 of these financial statements.

At March 31, 2012, the Company owned PreTSLs having an amortized cost of \$10.5 million. The market for these securities at March 31, 2012 is not active and markets for similar securities are also not active. PreTSLs were historically priced using Level 2 inputs. However, the decline in the level of observable inputs and market activity in this class of investments by the measurement date has been significant and resulted in unreliable external pricing. Broker pricing and bid/ask spreads, when available, vary widely. The once active market has become comparatively inactive. As such, the valuation of these investments is now determined using Level 3 inputs. The Company obtained the valuations from a third-party service provider that prepared the valuations using a discounted cash flows approach. The Company takes measures to validate the service provider's analysis and is actively involved in the valuation process, including reviewing and verifying the assumptions used in the valuation calculations. The difference between the discounted cash flow calculations for the purpose of estimating OTTI credit losses, described in Note 6, and the calculations used for fair value relates only to the discount rate used.

Results of a discounted cash flow test are significantly affected by variables such as the estimate of the probability of default, estimates of future cash flows, discount rates, prepayment rates and the creditworthiness of the underlying issuers. Refer to the discussion of these variables in Note 6 including quantitative information about Level 3 inputs not described below. The Company considers these inputs to be unobservable Level 3 inputs because they are based on the Company's estimates about the assumptions market participants would use in pricing this type of asset and developed based on the best information available in the circumstances rather than on observable inputs. The Company continues to

monitor the market for PreTSLs to assess the market activity and the availability of observable inputs and will continue to apply these controls and procedures to the valuations received from its third party service provider for the period it continues to use an outside valuation service. As it relates to fair value measurements, once each issuer is categorized and the forecasted default rates have been applied, the expected cash flows are modeled using the methodologies described above. The Company then applies a 10% discount rate to PreTSL XXVI, a 12% discount rate to PreTSL XIX, and a 15% discount rate to PreTSL IX and PreTSL XI to the expected cash flows to estimate fair value.

Changes to prepayment, default and discount rate assumptions will result in changes to the forecast cash flows and therefore changes to the fair values of the PreTSLs. An increase in prepayment assumptions increases the valuation of PreTSL XXVI and decreases the valuation of the remaining PreTSLs. The Company expects that an increase in default rates will decrease the fair value of the Company's PreTSLs and a decrease in default rates will increase the fair value of these securities. The Company expects that an

Table of Contents

increase in discount rates will decrease the fair value of these securities and a decrease in discount rates will increase the fair value of these securities. The Company does not believe these unobservable inputs to be interrelated.

At March 31, 2012, the Company owned investment grade PLCMOs, having an amortized cost of \$48.2 million. PLCMOs are securitized products where payments from residential mortgage loans are pooled together and passed on to different classes of owners in various tranches. The markets for such securities are generally characterized by a limited number of new issuances, a significant reduction in trading volumes and wide bid-ask spreads, all driven by the lack of market participants. Although estimated prices can generally be obtained for such securities, the level of market observable assumptions used is severely limited in the valuation. Specifically, market assumptions regarding credit adjusted cash flows and liquidity influences on discount rates were difficult to observe at the individual security level. Because of the inactivity in the markets and the lack of observable valuation inputs, the PLCMOs were valued by a third party specialist using a discounted cash flow approach and proprietary pricing model. The model uses inputs such as estimated prepayment speeds, losses, recoveries, default rates that are implied by the underlying performance of collateral in the structure or similar structures, and discount rates that are implied by market prices for similar securities and collateral structure types. The following table presents quantitative information about Level 3 inputs used to measure the fair value of these securities at March 31, 2012:

| Security Type      | Valuation Technique  | Unobservable Input | Range           | Weighted Average |
|--------------------|----------------------|--------------------|-----------------|------------------|
| Private Label CMOs | Discounted cash flow | Prepayment rate    | 5.30% - 35.21%  | 10.93%           |
|                    |                      | Default rate       | 0.50% - 14.86%  | 7.11%            |
|                    |                      | Loss severity      | 23.61% - 75.17% | 54.45%           |
|                    |                      | Discount rate      | 3.50% - 5.50%   | 4.14%            |

Changes to prepayment, default, loss severity, and discount rate assumptions will result in changes to the forecast cash flows and therefore changes to their fair values. An increase in prepayment assumptions increases the valuation of those securities owned at a discount and decreases those owned at a premium. The Company expects that an increase in default rates will decrease the fair value of the Company's PLCMOs and a decrease in default rates will increase the fair value of the securities. The Company expects that an increase in loss severity will decrease the fair value of these securities and a decrease in loss severity will increase the fair value of the Company's PLCMOs. The Company expects that an increase in discount rates will decrease the fair value of these securities and a decrease in discount rates will increase the fair value of these securities. Generally, a change in the assumption used for the probability of default is accompanied by a directionally similar change in the assumption used for loss severity and a directionally opposite change in the assumption used for prepayment rates.

At March 31, 2012, the Company owned three securities issued by state and political subdivisions having an amortized cost of \$2.8 million that are valued using Level 3 inputs. Two of these securities, with an amortized cost of \$1.2 million, had their ratings withdrawn by nationally recognized credit rating agencies. The third security with an amortized cost of \$1.6 million was downgraded by several nationally recognized credit rating agencies during 2010. As a result of the ratings withdrawals and downgrade, the market for these securities at March 31, 2012 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. The first two securities were valued based on similar nonrated Pennsylvania Sewer bonds adjusted for coupon and maturity. For the third security, the Company obtained a bid indication from a third-party municipal trading desk to determine the fair value of this security.

**Loans**

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For non-impaired loans and non-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. See also Note 4 Loans.

Table of Contents

**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, 2012 and December 31, 2011, and indicate the fair value hierarchy of the valuation techniques utilized by the Company to determine the fair value:

**Fair Value Measurements at March 31, 2012**

| (in thousands)                                  | Fair value        | Quoted prices<br>in active markets<br>for identical<br>assets (Level 1) | Significant<br>other<br>observable<br>inputs<br>(Level 2) | Significant<br>other<br>unobservable<br>inputs<br>(Level 3) |
|---|-------------------|---|---|---|
| <b>Available-for-sale securities:</b>           |                   |   |   |   |
| Obligations of U.S. Government Agencies         | \$ 5,982          | \$  | \$ 5,982  | \$  |
| Obligations of political and state subdivisions | 98,909            |   | 96,186  | 2,723   |
| Government sponsored agency CMOs                | 7,345             |   | 7,345   |   |
| Private label CMO                               | 47,910            |   |   | 47,910  |
| Residential mortgage backed securities          | 30,383            |   | 30,383  |   |
| Pooled trust preferred senior class             | 1,689             |   |   | 1,689   |
| Pooled trust preferred mezzanine class          | 2,286             |   |   | 2,286   |
| Corporate debt securities                       | 379               |   | 379   |   |
| Equity securities                               | 1,005             | 1,005   |   |   |
| <b>Total securities available-for-sale</b>      | <b>\$ 195,888</b> | <b>\$</b>   | <b>\$ 140,275</b>   | <b>\$</b>   |
|   |                   | <b>\$</b>   |   | <b>\$ 54,608</b>  |

Table of Contents**Fair Value Measurements at December 31, 2011**

| (in thousands)                                  | Fair value        | Quoted prices<br>in active markets<br>for identical<br>assets (Level 1) | Significant<br>other<br>observable<br>inputs<br>(Level 2) | Significant<br>other<br>unobservable<br>inputs<br>(Level 3) |
|---|-------------------|---|---|---|
| Available-for-sale securities:                  |                   |   |   |   |
| Obligations of U.S. government agencies         | \$ 8,048          | \$  | \$ 8,048  | \$  |
| Obligations of state and political subdivisions | 96,161            |   | 93,350  | 2,811   |
| Government sponsored agency CMO                 | 8,468             |   | 8,468   |   |
| Private label CMO                               | 36,256            |   |   | 36,256  |
| Residential mortgage-backed securities          | 31,393            |   | 31,393  |   |
| Pooled trust preferred Senior Class             | 1,604             |   |   | 1,604   |
| Pooled trust preferred Mezzanine Class          | 2,197             |   |   | 2,197   |
| Corporate debt securities                       | 342               |   | 342   |   |
| Equity securities                               | 1,006             | 1,006   |   |   |
| <b>Total securities available-for-sale</b>      | <b>\$ 185,475</b> | <b>\$ 1,006</b>   | <b>\$ 141,601</b>   | <b>\$ 42,868</b>  |

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, 2012 and 2011:

**Fair Value Measurements Using Significant Unobservable Inputs (Level 3)**

| (in thousands)                               | PreTSLs         | State and<br>Political<br>Subdivisions | Private<br>Label<br>CMOs | Total            |
|--|-----------------|--|--------------------------|------------------|
| <b>Balance at December 31, 2011</b>          | 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              |
| <b>Balance at March 31, 2012</b>             | <b>\$ 3,975</b> | <b>\$ 2,723</b>                        | <b>\$ 47,910</b>         | <b>\$ 54,608</b> |

**Fair Value Measurements Using Significant Unobservable Inputs (Level 3)**

| (in thousands)                      | PreTSLs         | State and<br>Political<br>Subdivisions | Total           |
|-------------------------------------|-----------------|--|-----------------|
| <b>Balance at December 31, 2010</b> | <b>\$ 3,069</b> | <b>\$ 2,245</b>                        | <b>\$ 5,314</b> |
| Accretion of discount               | 3               | 3                                      | 3               |



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|  |    |       |       |       |          |
|--|----|-------|-------|-------|----------|
| Paydowns                                     |    |       | (130) |       | (130)    |
| Total gains or losses (realized/unrealized): |    |       |       |       |          |
| Included in earnings                         |    |       |       |       |          |
| Included in other comprehensive income       |    | 271   |       |       | 271      |
| <b>Balance at March 31, 2011</b>             | \$ | 3,343 | \$    | 2,115 | \$ 5,458 |

There were no transfers between levels within the fair value hierarchy during the periods ended March 31, 2012 and 2011.

**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:

Table of Contents

| (in thousands)                          | Fair Value Measurements at   |  |                                       |  |  |                                       |
|---|--|--|---------------------------------------|--|--|---------------------------------------|
|   | March 31, 2012   |  |                                       | December 31, 2011  |  |                                       |
|   | Quoted<br>Prices in<br>Active<br>Markets for<br>Identical<br>Assets<br>(Level I) | Significant<br>Other<br>Observable<br>Inputs<br>(Level II) | Unobservable<br>Inputs<br>(Level III) | Quoted<br>Prices in<br>Active<br>Markets for<br>Identical<br>Assets<br>(Level I) | Significant<br>Other<br>Observable<br>Inputs<br>(Level II) | Unobservable<br>Inputs<br>(Level III) |
| Collateral-dependent impaired loans (1) |  |  | \$ 16,481                             |  |  | \$ 12,555                             |
| Other real estate owned                 |  |  | 986                                   |  |  | 5,212                                 |

(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 identifiable. 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 identifiable, 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 amounts in the table above represent the value of OREO properties at March 31, 2012 and December 31, 2011 that 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<br>Measurement | March 31, 2012 |            | December 31, 2011 |            |
|---------------------------------|---------------------------|----------------|------------|-------------------|------------|
|                                 |                           | Carrying Value | Fair Value | Carrying Value    | Fair Value |
| Financial assets                |                           |                |            |                   |            |
| Cash and short term investments | Level 1                   | \$ 75,724      | \$ 75,724  | \$ 168,646        | \$ 168,646 |
| Securities                      | See previous table        | 198,007        | 198,214    | 187,569           | 187,720    |
| FHLB and FRB Stock              | Level 2                   | 9,239          | 9,239      | 9,659             | 9,659      |
| Loans, net                      | Level 3                   | 667,814        | 673,245    | 659,044           | 661,833    |
| Loans held for sale             | Level 2                   | 1,735          | 1,735      | 94                | 94         |

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|                             |         |         |         |         |         |
|-----------------------------|---------|---------|---------|---------|---------|
| Accrued interest receivable | Level 2 | 2,661   | 2,661   | 2,552   | 2,552   |
| Mortgage servicing rights   | Level 3 | 771     | 1,153   | 777     | 1,185   |
| Financial liabilities       |         |         |         |         |         |
| Deposits - other than time  | Level 1 | 493,590 | 493,590 | 548,627 | 548,627 |
| Deposits - time             | Level 2 | 396,648 | 403,435 | 408,509 | 415,611 |
| Borrowed funds              | Level 2 | 79,896  | 85,319  | 83,571  | 89,628  |
| Accrued interest payable    | Level 2 | 4,892   | 4,892   | 4,301   | 4,301   |

Table of Contents**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 shows the calculation of both basic and diluted earnings per common share for the three months ended March 31, 2012 and 2011:

| (in thousands, except share amounts)                         | Three months ended |            |
|--|--------------------|------------|
|  | March 31,          |            |
|  | 2012               | 2011       |
| Net loss   | \$ (1,165)         | \$ (526)   |
| Basic weighted-average number of common shares outstanding   | 16,442,119         | 16,434,763 |
| Plus: Common share equivalents                               |                    |            |
| Diluted weighted-average number of common shares outstanding | 16,442,119         | 16,434,763 |
| Loss per common share:                                       |                    |            |
| Basic  | \$ (0.07)          | \$ (0.03)  |
| Diluted  | \$ (0.07)          | \$ (0.03)  |

Common share equivalents, in the table above, exclude 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. 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, 2012 and 2011.

March 31,

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| (In thousands)                       | 2012 |          | 2011 |          |
|--------------------------------------|------|----------|------|----------|
| Outstanding at beginning of the year | \$   | 87,442   | \$   | 92,217   |
| New loans and advances               |      | 9,870    |      | 23,041   |
| Repayments / reductions              |      | (10,814) |      | (19,067) |
| Other*                               |      |          |      | (590)    |
| Outstanding at end of period         | \$   | 86,498   | \$   | 95,601   |

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\* Other represents loans to related parties that ceased being related parties during the period.

Table of Contents

At March 31, 2012, loans to directors, executive officers and their related parties which were not performing in accordance with the terms of the loan agreements totaled \$244 thousand. Also, at March 31, 2012, loans in the amount of \$677 thousand to directors, executive officers and their related parties were categorized as criticized loans within the Bank's risk rating system, meaning they are considered to present a higher risk of collection than other loans.

Included in related party loans is \$6.2 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 \$2.5 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, 2012 and December 31, 2011 amounted to \$129.4 million and \$146.8 million, respectively. Interest paid on the deposits amounted to \$81 thousand and \$153 thousand for the three months ended on March 31, 2012 and 2011, respectively.

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. The Company recorded payments for these services of \$217 thousand and \$76 thousand for the three months ended on March 31, 2012 and 2011, respectively.

Subordinated notes held by officers and directors and/or their related parties totaled \$10 million at both March 31, 2012 and December 31, 2011, respectively. There was no interest paid to directors on these notes for the three months ended on March 31, 2012 and 2011, respectively. Interest accrued and unpaid on loans to directors totaled \$1.4 million at March 31, 2012.

The Company leases its Honesdale branch from a related party. Total lease payments were \$2 thousand for both the three months ended on March 31, 2012 and 2011.

**Note 10. Stock Option 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.

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There was no compensation expense related to options under both the Stock Incentive Plan and the Directors' Stock Plan for the three months ended March 31, 2012 and 2011.

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, |  |         |  |
|--|------------------------------|--|---------|--|
|  | 2012                         |  | 2011    |  |
|  | Shares                       | Weighted<br>Average<br>Exercise<br>Price | Shares  | Weighted<br>Average<br>Exercise<br>Price |
| Outstanding at the beginning of the period | 188,193                      | \$ 12.62                                 | 222,616 | \$ 12.58                                 |
| Granted                                    |                              |  |         |  |
| Exercised                                  |                              |  |         |  |
| Forfeited                                  |                              |  |         |  |
| Outstanding at the end of the period       | 188,193                      | \$ 12.62                                 | 222,616 | \$ 12.58                                 |
| Options exercisable at March 31,           | 188,193                      | \$ 12.62                                 | 222,616 | \$ 12.58                                 |

Table of Contents

As of March 31, 2012, there was no unrecognized compensation expense.

Information pertaining to options outstanding at March 31, 2012 is as follows:

| Range of Exercise Price | Number Outstanding | Options Outstanding                         |                                 | Options Exercisable |                                 |
|-------------------------|--------------------|---|---------------------------------|---------------------|---------------------------------|
|                         |                    | Weighted Average Remaining Contractual Life | Weighted Average Exercise Price | Number Exercisable  | Weighted Average Exercise Price |
| \$5.81 - \$23.13        | 188,193            | 3.5   | \$ 12.62                        | 188,193             | \$ 12.62                        |

As of March 31, 2012, there was no aggregate intrinsic value of exercisable options.

**Item 2 Management's Discussion and Analysis of Financial Condition and Results of Operations**

This Quarterly Report should be read in conjunction with the more detailed and comprehensive disclosures included on our Form 10-K for the year ended December 31, 2011. 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 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, 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



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changes in trade, monetary and fiscal policies and laws, including interest rate policies of the Board of Governors of the Federal Reserve System; inflation, interest rate, market and monetary fluctuations; the timely development of and acceptance of new products and services; the impact of the Company's ability to comply with its regulatory agreements and orders; the effectiveness of the Company's revised system of internal controls; the ability of the Company to attract additional capital investment; the impact of changes in financial services laws and regulations (including laws concerning taxes, banking, securities and insurance); technological changes; changes in consumer spending and saving habits; the nature, extent, and timing of governmental actions and reforms, and the success of the Company at managing the risks involved in the foregoing.

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

Readers should carefully review the risk factors described in the Annual Report and other documents that we periodically file with the Securities and Exchange Commission, including our Form 10-K for the year ended December 31, 2011.

Table of Contents

**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, OREO, and the evaluation of deferred income tax and the impairment of securities to be critical as management is required to make subjective and/or complex judgments about matters that are inherently uncertain and could be most subject to revision as new information becomes available.

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

*Allowance for Loan and Lease Losses*

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

The ALLL represents management's estimate of probable loan losses inherent in the loan portfolio. Determining the amount of the ALLL is considered a critical accounting estimate because it requires significant judgment and the use of estimates related to the amount and timing of expected future cash flows on impaired loans, estimated losses on pools of homogeneous loans based on historical loss experience, qualitative factors, and consideration of current economic trends and conditions, all of which may be susceptible to significant change. Various banking regulators, as an integral part of their examination of the Company, also review the ALLL. Such regulators may require, based on their judgments about information available to them at the time of their examination, that certain loan 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 Company changed its policy for determining the ALLL effective for 2009. The general reserve component of the ALLL, previously based on one aggregated pool of unimpaired loans, was increased after assigning these loans to one of three pools of Pass, Special Mention or Substandard and Accruing and applying historical loss factors and varied qualitative factor basis point allocations based on the risk profile in each pool to determine the appropriate reserve related to those loans. The general reserve component of the ALLL also increased

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because of higher historical loss experience resulting from the increased loan charge-offs of impaired loans. Substandard loans on nonaccrual status are included in impaired loans.

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 would be used to determine fair value of any investments that require inputs that are both unobservable and significant to the fair value measurement (level 3). 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 consolidated financial condition or results of operations. See Notes 6 and 7 of the consolidated financial statements included in Item 1 hereof for more information about our securities valuation techniques.

Management must periodically evaluate if unrealized losses (as determined based on the securities valuation methodologies discussed above) on individual securities classified as held-to-maturity or available-for-sale in the investment portfolio are considered to be OTTI. The analysis of OTTI requires the use of various assumptions, including, but not limited to, the length of time an investment s

Table of Contents

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 securities for the three months ended March 31, 2012 and 2011 within the consolidated statements of operations. See - Securities section below and Note 6 Securities to the consolidated financial statements included in Item 1 hereof for information about our historical OTTI charges.

*Other Real Estate Owned*

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

*Income Taxes*

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

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

In connection with determining our income tax provision or benefit, the Company considers maintaining liabilities for uncertain tax positions and tax strategies that management believes contain an element of uncertainty. Periodically, the Company evaluates each of our tax positions and strategies to determine whether a liability for uncertain tax benefits is required. As of March 31, 2012 and December 31, 2011, 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. 2011-04, 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.

Table of Contents

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.

**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.

**Executive Summary**

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

The Company recorded a net loss of \$1.2 million, or \$(0.07) per diluted common share, an increase in net loss of \$0.7 million compared to a net loss of \$0.5 million or \$(0.03) per diluted common share for the three month period ended March 31, 2011. This increase in net loss was largely due to a \$1.8 million decrease in interest income, and a \$2.5 million decrease in total non-interest income, partially offset by a \$1.7 million decrease in total interest expense and a \$0.2 million decrease in non-interest expense. The return on average equity was (2.79) % for the three months ended March 31, 2012, compared to (1.61) % for the three months ended March 31, 2011. Return on average assets was (0.11) % for the three months ended March 31, 2012, compared to (0.05) % for three months ended March 31, 2011. Average equity to average assets was 3.91% and 2.84 % for the three months ended March 31, 2012 and 2011, respectively. The Company did not pay any dividends during the three months ended March 31, 2012 and 2011, respectively.

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Total assets decreased \$73.8 million, or 6.7% to \$1.03 billion, at March 31, 2012 as compared to \$1.10 billion at December 31, 2011 primarily due to a \$92.9 million decrease in cash and cash equivalents, and a \$1.2 million decrease in other assets, partially offset by a \$10.4 million increase in securities available-for-sale, a \$1.6 million increase in loans held for sale, and an \$8.8 million increase in net loans.

Total deposits decreased \$66.9 million, or 7.0%, to \$890.2 million at March 31, 2012 as compared to \$957.1 million at December 31, 2011. During the same period, demand deposits decreased by \$2.8 million, or 2.1%, interest-bearing demand deposits decreased \$54.9 million, or 16.8%, and total time deposits decreased by \$11.9 million, or 2.9%. These decreases were partially offset by a \$2.6 million, or 3.0%, increase in savings deposits, during the same period. Borrowed funds decreased by \$3.7 million, or 4.4%, during the first three months of 2012 to \$79.9 million from \$83.6 million at December 31, 2011. Other liabilities decreased by \$5.1 million, or 28.8%, mostly attributable to the settlement, in the quarter ended March 31, 2012, of the \$5.2 million security the Company recorded on a trade date basis at December 31, 2011.

Total shareholders' equity increased \$1.3 million, or 3.1%, to \$41.2 million at March 31, 2012 from \$39.9 million at December 31, 2011. The increase is primarily due to a \$2.4 million reduction in accumulated other comprehensive loss for the three months ended March 31, 2012 partly offset by the net loss of \$1.2 million for the same period.

Table of Contents

**Summary of Performance**

**Net Interest Income**

Net interest income consists of interest income and fees on interest-earning assets less interest expense on deposits and borrowed funds. It represents the largest component of the Company's operating income and as such is the primary determinant of profitability. The net interest margin on a fully tax equivalent basis is calculated by dividing tax equivalent net interest income by average interest earning assets and is a key measurement used in the banking industry to measure income from earning assets. The net interest margin was 3.20% for the three months ended March 31, 2012, an increase of 13 basis points compared to the same period in 2011. This increase in the net interest margin was due to a decrease of 46 basis points in the tax equivalent yield on interest bearing liabilities partially offset by a decrease of 40 basis points in the tax equivalent yield on earning assets. Rate spread, the difference between the average yield on interest earning assets and the average cost of interest bearing liabilities shown on a fully tax equivalent basis was 3.09% for the three months ended March 31, 2012, an increase of 14 basis points versus the same period in 2011.

Net interest income on a tax equivalent basis was \$7.9 million for the first quarter of 2012, a \$0.4 million, or 5.4%, decrease from \$8.3 million for the first quarter of 2011. The decrease was due to lower yields earned on loans partially offset by a decrease in yields on interest-bearing liabilities and an increase in yield on investment securities.

Interest income on loans on a tax equivalent basis decreased \$1.3 million for the three month period ended March 31, 2012 compared to the same period in 2011 primarily due to a 21 basis point decline in the tax equivalent yield on loans and a \$78.5 million, or 10.3%, decrease in average loan balances. The yield on loans was negatively affected by the payoffs of higher yielding loans which cannot be replaced in this low interest rate environment and lower loan demand caused by the continuing economic slowdown. The decrease in average loans to \$684.4 million at March 31, 2012 was primarily due to pay downs and transfers of foreclosed loans into other real estate owned (OREO).

Interest and dividend income on investment securities on a tax equivalent basis decreased by \$711 thousand during the quarter ended March 31, 2012 as compared to the quarter ended March 31, 2011 primarily due to lower average balances partially offset by higher investment yields. The \$64.5 million, or 24.5%, decrease in average investments to \$199.0 million at March 31, 2012 from \$263.5 million at March 31, 2011 was primarily due to significant security sales during 2011.

Average interest-bearing deposits in other banks and federal funds sold increased by \$57.1 million during the quarter ended March 31, 2012 as compared to the same quarter in 2011. The increase in the average balance of interest-bearing deposits in other banks and federal funds sold was attributable to the Company increasing its holdings of liquid assets.

Average interest bearing liabilities totaled \$887.1 million for the quarter ended March 31, 2012, a decrease of \$129.6 million, or 12.7%, compared to the same period in 2011 primarily due to decreases in average borrowings and deposits. Average interest-bearing demand deposits, savings deposits, time deposits over \$100 thousand, and other time deposits decreased \$24.5 million, \$1.1 million, \$3.6 million and \$41.7 million, respectively. The Company continued to pursue the pricing strategy it implemented in 2011 to reduce its cost of funds and to concentrate deposit growth on short-term maturities. The Company continued to reposition maturing longer term time deposits into short-term products, whenever possible, and allowed the residual to run-off. The cost of interest-bearing demand deposits, savings deposits, time deposits



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over \$100 thousand, and other time deposits decreased 49, 21, 57, and 28 basis points respectively, from the same period in 2011. The average cost of interest-bearing deposits decreased by 46 basis points to 1.16% in the quarter ended March 31, 2012 from 1.62% for the same period in 2011. The decrease in the rate on interest-bearing deposits was driven primarily by the pricing decreases that resulted from the Company's pricing strategy and an overall decrease in market rates.

Average borrowings decreased \$58.5 million, or 41.6%, as compared to the comparable quarter in the prior year. The cost of borrowed funds increased by 86 basis points to 5.08% for the quarter ended March 31, 2012 as compared 4.22% for the same period in 2011. The 86 basis point increase in the cost of borrowed funds for the quarter ended March 31, 2012 is primarily attributable to the repayment of maturing FHLB advances that were at lower rates, resulting in higher-rate borrowings becoming a larger percentage of total borrowings and an increase in the cost of borrowed funds.

Net interest income represents the difference between income on interest-earning assets and expense on interest-bearing liabilities. 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, 2012 and 2011, 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.

Table of Contents

| ASSETS  |    |           |       |       |    |           |                |
|---|----|-----------|-------|-------|----|-----------|----------------|
| Loans-taxable (4)   | \$ | 649,062   | 7,381 | 4.55% | \$ | 723,968   | \$ 8,648 4.78% |
| Total Loans (1)(2)  |    | 684,390   | 7,999 | 4.68% |    | 762,899   | \$ 9,322 4.89% |
| Securities-tax free   |    | 80,356    | 1,485 | 7.39% |    | 122,372   | 2,136 6.98%    |
| Interest-bearing deposits in other banks and federal funds sold |    | 102,114   | 56    | 0.22% |    | 45,034    | 26 0.23%       |
| Non-earning assets  |    | 103,273   |       |       |    | 105,736   |                |
| Total Assets  | \$ | 1,067,670 |       |       | \$ | 1,154,255 |                |
| LIABILITIES AND SHAREHOLDERS EQUITY                             |    |           |       |       |    |           |                |
| Interest-bearing demand deposits                                |    | 316,234   | 183   | 0.23% |    | 340,697   | \$ 612 0.72%   |
| Time deposits over \$100,000                                    |    | 189,065   | 415   | 0.88% |    | 192,736   | 698 1.45%      |
| Total Interest-bearing Deposits                                 |    | 805,084   | 1,532 | 0.76% |    | 876,156   | 2,646 1.21%    |
| Total Interest-Bearing Liabilities                              |    | 887,092   | 2,573 | 1.16% |    | 1,016,686 | 4,128 1.62%    |
| Other liabilities   |    | 17,885    |       |       |    | 15,846    |                |
| Total Liabilities and Shareholders Equity                       | \$ | 1,067,670 |       |       | \$ | 1,154,255 |                |
| Tax equivalent adjustment                                       |    |           | (715) |       |    |           | (955)          |

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- (1) Interest income is presented on a tax equivalent basis using a 34% rate.
  - (2) Loans are stated net of unearned income.
  - (3) Nonaccrual loans are included in loans within earning assets.
  - (4) Loan fees included in interest income are not significant.
  - (5) The yields for securities that are classified as available for sale are based on the average historical amortized cost.

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- (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.

Table of Contents

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.

| (in thousands)   | March 31,<br>2012 vs. 2011 |                             |                 |
|--|----------------------------|-----------------------------|-----------------|
|  | Increase (Decrease)        |                             |                 |
|  | Due to<br>Volume           | Due to<br>Change in<br>Rate | Total<br>Change |
| <b>Interest Income:</b>  |                            |                             |                 |
| Loans - taxable  | \$ (865)                   | \$ (402)                    | \$ (1,267)      |
| Loans - tax free   | (63)                       | 7                           | (56)            |
| Total loans  | (928)                      | (395)                       | (1,323)         |
| Securities - taxable   | (167)                      | 107                         | (60)            |
| Securities - tax free  | (770)                      | 119                         | (651)           |
| Total securities   | (937)                      | 226                         | (711)           |
| Interest-bearing deposits in other banks<br>and federal funds sold | 31                         | (1)                         | 30              |
| Total interest income  | (1,834)                    | (170)                       | (2,004)         |
| <b>Interest Expense:</b>   |                            |                             |                 |
| Interest-bearing demand deposits                                   | (41)                       | (388)                       | (429)           |
| Savings deposits   | (1)                        | (48)                        | (49)            |
| Time deposits over \$100,000                                       | (13)                       | (270)                       | (283)           |
| Other time deposits  | (189)                      | (164)                       | (353)           |
| Total interest-bearing deposits                                    | (244)                      | (870)                       | (1,114)         |
| Borrowed funds and other<br>interest-bearing liabilities           | (702)                      | 261                         | (441)           |
| Total interest expense   | (946)                      | (609)                       | (1,555)         |
| Net Interest Income  | \$ (888)                   | \$ 439                      | \$ (449)        |

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

**Provision for Loan and Lease Losses**

Management closely monitors the loan portfolio and the adequacy of the Allowance for Loan and Lease Losses ( ALLL ) considering underlying borrower financial performance and collateral values and increasing credit risks. Future material adjustments may be necessary to the provision for loan and lease losses and the ALLL if economic conditions or loan performance differ substantially from the assumptions management used in making its evaluation of the ALLL.

The Company recorded a \$136 thousand credit for loan and lease losses for the three month period ended March 31, 2012, compared to a \$1.7 million provision for the three months ended March 31, 2011. The \$1.8 million reduction in the provision is attributable to the reduction in the number and volume of adversely classified loans, an improvement in the Company's historical loss factors, a \$68.8 million or 9.1% reduction in total loans outstanding and a \$32.8 million or 46.2% reduction in construction, land acquisition and development loans at March 31, 2012 compared to March 31, 2011, respectively. Construction, land acquisition and development loans have had a higher impact on the Company's

historical loss factors.

**Non-interest Income**

The Company recorded total non-interest income of \$1.5 million for the three months ended March 31, 2012, a decrease of \$2.5 million from the \$4.0 million earned during the comparable period in 2011. The decrease was due to a \$2.5 million decrease in the gain on the sale of other real estate owned.

**Non-interest Expense**

Non-interest expense was \$9.9 million for the three month period ended March 31, 2012, compared to \$10.1 million for the same period in 2011. The \$0.2 million decrease for the three months ended March 31, 2012 was primarily due to a \$708 thousand decrease

Table of Contents

in professional fees attributable to reduced regulatory compliance expenses, a \$389 thousand decrease in other real estate expense, and a \$189 thousand decrease in FDIC assessment. These decreases were partially offset by a \$623 increase in legal expenses, a \$242 thousand increase in salary and employee benefits, a \$169 increase in the provision for off-balance sheet commitments, and a \$139 thousand increase in insurance expense.

**Provision for Income Taxes**

The Company did not record a provision or benefit for income taxes for the quarters ended March 31, 2012 and 2011. In future periods, the Company anticipates that it will have a minimal tax provision or benefit until such time as it is able to reverse the deferred tax asset valuation allowance that it recorded in 2009.

**FINANCIAL CONDITION**

**Assets**

Total assets were \$1.03 billion at March 31, 2012, a decrease of \$73.8 million, or 6.7%, from \$1.10 billion at December 31, 2011.

**Cash and Cash Equivalents**

Cash and cash equivalents decreased \$92.9 million, or 55.1% during the three months ended March 31, 2012 to \$75.7 million. The decrease is primarily the result of a \$66.9 million decrease in total deposits which was the result of the Company repositioning maturing longer term time deposits into short-term products, whenever possible, and allowing the residual to run-off. The Company also purchased \$19.9 million of securities during the three months ended March 31, 2012. The Company did not pay any dividends during the quarter ended March 31, 2012 as it suspended paying dividends to conserve capital and comply with regulatory requirements.

**Securities**

The Company holds debt securities primarily for liquidity, interest rate risk management needs and to provide a source of interest income. Securities are classified as held-to-maturity and carried at amortized cost when the Company has the positive intent and ability to hold them to maturity. Securities not classified as held-to-maturity are classified as available-for-sale and are carried at fair value, with unrealized holding gains and losses reported in other comprehensive income, net of tax. The Company determines the appropriate classification of securities at the time of purchase. The decision to purchase or sell securities is based upon the current assessment of long and short-term economic and financial conditions, including the interest rate environment and other statement of financial condition components. Securities with limited marketability and/or restrictions, such as Federal Home Loan Bank and Federal Reserve Bank stocks, are carried at cost. Federal Reserve Bank stock is carried

in other assets.

At March 31, 2012, the Company's investment portfolio was comprised of U.S Government agency securities, taxable and tax-exempt obligations of states and political subdivisions, government sponsored agency and private label collateralized mortgage obligations ( CMOs ), pooled trust preferred securities ( PreTSLs ) principally collateralized by bank holding companies ( bank issuers ), and insurance companies, corporate debt, and equity securities.

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

Table of Contents

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,<br>2012 |         | December 31,<br>2011 |         |
|--|-------------------|---------|----------------------|---------|
| Obligations of U.S. government agencies        | \$                | 5,982   | \$                   | 8,048   |
| Obligation of state and political subdivisions |                   | 101,028 |                      | 98,255  |
| Collateralized mortgage obligations            |                   |         |                      |         |
| Government sponsored agency                    |                   | 7,345   |                      | 8,468   |
| Private label                                  |                   | 47,910  |                      | 36,256  |
| Residential mortgage-backed securities         |                   |         |                      |         |
| Government sponsored agency                    |                   | 30,383  |                      | 31,393  |
| Pooled trust preferred senior class            |                   | 1,689   |                      | 1,604   |
| Pooled trust preferred mezzanine class         |                   | 2,286   |                      | 2,197   |
| Corporate debt securities                      |                   | 379     |                      | 342     |
| Equity securities                              |                   | 1,005   |                      | 1,006   |
| Total  | \$                | 198,007 | \$                   | 187,569 |

There were no single issuers with an aggregate book value which exceeded ten percent (10%) of total shareholders' equity.

The following table sets forth the maturities of available-for-sale and held-to-maturity securities, based on book value, at March 31, 2012 and the weighted average yields of such securities calculated on the basis of the cost and effective yields weighted for the scheduled maturity of each security.



Table of Contents

|   | Within<br>One Year | > 1<br>5<br>Years | 6 - 10<br>Years | Over<br>10 Years | Mortgage-<br>Backed<br>Securities and<br>Collateralized<br>Mortgage<br>Obligations | No Fixed<br>Maturity | Total  |       |        |    |       |    |         |
|---|--------------------|-------------------|-----------------|------------------|--|----------------------|--------|-------|--------|----|-------|----|---------|
| <b>Available-for-sale securities</b>                |                    |                   |                 |                  |  |                      |        |       |        |    |       |    |         |
| U.S. Treasury securities                            | \$                 | \$                | \$              | \$               | \$   | \$                   | \$     |       |        |    |       |    |         |
| Yield   |                    |                   |                 |                  |  |                      |        |       |        |    |       |    |         |
| Obligations of U.S. government agencies             |                    |                   |                 | 5,982            |  |                      | 5,982  |       |        |    |       |    |         |
| Yield   |                    |                   |                 | 3.35%            |  |                      | 3.35%  |       |        |    |       |    |         |
| Obligations of state and political subdivisions (1) |                    | 1,517             | 24,217          | 73,175           |  |                      | 98,909 |       |        |    |       |    |         |
| Yield   |                    | 6.15%             | 4.77%           | 6.11%            |  |                      | 6.28%  |       |        |    |       |    |         |
| Corporate debt securities                           |                    |                   |                 | 379              |  |                      | 379    |       |        |    |       |    |         |
| Yield   |                    |                   |                 | 1.19%            |  |                      | 1.19%  |       |        |    |       |    |         |
| CMOs:   |                    |                   |                 |                  |  |                      |        |       |        |    |       |    |         |
| Government sponsored agencies                       |                    |                   |                 |                  | 7,345  |                      | 7,345  |       |        |    |       |    |         |
| Yield   |                    |                   |                 |                  | 4.20%  |                      | 4.20%  |       |        |    |       |    |         |
| Private label                                       |                    |                   |                 |                  | 47,910   |                      | 47,910 |       |        |    |       |    |         |
| Yield   |                    |                   |                 |                  | 3.96%  |                      | 3.96%  |       |        |    |       |    |         |
| Residential mortgage-backed securities:             |                    |                   |                 |                  |  |                      |        |       |        |    |       |    |         |
| Government sponsored agencies                       |                    |                   |                 |                  | 30,383   |                      | 30,383 |       |        |    |       |    |         |
| Yield   |                    |                   |                 |                  | 3.20%  |                      | 3.20%  |       |        |    |       |    |         |
| Pooled Trust Preferred Senior Class                 |                    |                   |                 | 1,689            |  |                      | 1,689  |       |        |    |       |    |         |
| Yield   |                    |                   |                 | 0.00%            |  |                      | 0.00%  |       |        |    |       |    |         |
| Pooled Trust Preferred Mezzanine Class              |                    |                   |                 | 2,286            |  |                      | 2,286  |       |        |    |       |    |         |
| Yield   |                    |                   |                 | 0.00%            |  |                      | 0.00%  |       |        |    |       |    |         |
| Equity securities (2)                               |                    |                   |                 |                  |  | 1,005                | 1,005  |       |        |    |       |    |         |
| Yield   |                    |                   |                 |                  |  | 4.37%                | 4.37%  |       |        |    |       |    |         |
| Total available-for-sale maturities                 | \$                 | \$                | 1,517           | \$               | 24,217   | \$                   | 83,511 | \$    | 85,638 | \$ | 1,005 | \$ | 195,888 |
| Weighted yield                                      |                    | 0.00%             | 6.15%           | 4.77%            | 6.36%  | 3.72%                | 4.37%  | 5.00% |        |    |       |    |         |
| <b>Held-to-maturity securities</b>                  |                    |                   |                 |                  |  |                      |        |       |        |    |       |    |         |
| Obligations of state and political subdivisions     |                    |                   | 2,119           |                  |  |                      | 2,119  |       |        |    |       |    |         |
| Yield   |                    |                   | 7.24%           |                  |  |                      | 7.24%  |       |        |    |       |    |         |
| Total held-to-maturity securities                   | \$                 | \$                | \$              | 2,119            | \$   | \$                   | \$     | 2,119 |        |    |       |    |         |
| Weighted yield                                      |                    | 0.00%             | 0.00%           | 7.24%            | 0.00%  | 0.00%                | 0.00%  | 7.24% |        |    |       |    |         |

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

(2) Yield represents actual return for the three months ended March 31, 2012.

*Other-Than-Temporary Impairment ( OTTI )*

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

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

Table of Contents

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

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

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

Based on the Company's evaluation at March 31, 2012, the Company has determined that the decreases in estimated fair value of the securities it holds in its portfolio are temporary. The Company's estimate of discounted cash flows it expects to receive are greater than the securities carrying value, resulting in no impairment charges to earnings for the three months ended March 31, 2012.

*OTTI of Pooled Trust Preferred Collateralized Debt Obligations:*

At March 31, 2012, the amortized cost of our PreTSLs totaled \$10.5 million with an estimated fair value of \$4.0 million and is comprised of four securities each of which is collateralized by debt issued by bank holding companies and insurance companies. The Company holds one senior tranche and three mezzanine tranches. All of the securities have been downgraded below investment grade. At the time of initial issue, no more than 5% of any pooled security consisted of a security issued by any one institution. At March 31, 2012, three of these securities had no excess subordination and one had excess subordination of 14.24% of the current performing collateral. Excess subordination is the amount by which the underlying performing collateral exceeds the outstanding bonds in the current class plus all senior classes. It can also be referred to as credit enhancement. As deferrals and defaults of underlying issuers occur, the excess subordination is reduced or eliminated, increasing the risk of the security experiencing principal or interest shortfalls. Conversely, subordination can be increased as collateral transitions from non-performing to performing. The coverage ratio, or overcollateralization, of a specific security measures the rate of performing collateral to a given class of notes. It is calculated by dividing the performing collateral in a transaction by the current balance of the class of notes plus all classes senior to that class.

The following table presents information about the Company's collateral and subordination for its PreTSLs at March 31, 2012:

| Excess | Current<br>Number of | Actual<br>Deferrals /<br>Defaults as a % | Expected |
|--------|----------------------|--|----------|
|--------|----------------------|--|----------|

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| Security    | Performing Collateral | Bonds Outstanding (in thousands) | (Insufficient) Collateral | Coverage Ratio | Excess Subordination | Performing Issuers | of Current Collateral | Future Default Rate |
|-------------|-----------------------|----------------------------------|---------------------------|----------------|----------------------|--------------------|-----------------------|---------------------|
| PreTSL IX   | \$ 299,520            | \$ 320,838                       | \$ (21,318)               | 93.36%         | N/A                  | 34                 | 31.90%                | 1.53%               |
| PreTSL XI   | 388,465               | 438,163                          | (49,698)                  | 88.66%         | N/A                  | 43                 | 32.30%                | 1.86%               |
| PreTSL XIX  | 470,831               | 534,746                          | (63,915)                  | 88.05%         | N/A                  | 47                 | 27.60%                | 1.38%               |
| PreTSL XXVI | 683,700               | 598,459                          | 85,241                    | 114.24%        | 14.24%               | 55                 | 28.00%                | 1.44%               |

The following list details information for each of the Company's PreTSLs at March 31, 2011:

| Security    | Class     | Amortized Cost (in thousands) | Fair Value | Unrealized Gain (Loss) | Moody's / Fitch Ratings | Credit Impairment Quarter to Date | Credit Impairment Year to Date | Credit Impairment Cumulative |
|-------------|-----------|-------------------------------|------------|------------------------|-------------------------|-----------------------------------|--------------------------------|------------------------------|
| PreTSL IX   | Mezzanine | \$ 1,240                      | \$ 541     | \$ (699)               | Ca / C                  | \$                                | \$                             | \$ 1,680                     |
| PreTSL XI   | Mezzanine | 1,563                         | 632        | (931)                  | Ca / C                  |                                   |                                | 3,426                        |
| PreTSL XIX  | Mezzanine | 3,913                         | 1,113      | (2,800)                | Ca / CC                 |                                   |                                | 3,262                        |
| PreTSL XXVI | Senior    | 3,822                         | 1,689      | (2,133)                | B1 / CCC                |                                   |                                | 251                          |
| Total       |           | \$ 10,538                     | \$ 3,975   | \$ (6,563)             |                         | \$                                | \$                             | \$ 8,619                     |

The Company's PreTSLs are evaluated for OTTI by determining whether an adverse change in estimated cash flows has occurred. The Company uses a third-party service provider to perform this analysis. Determining whether there has been an adverse change in estimated cash flows from the cash flows previously projected involves comparing the present value of remaining cash flows

Table of Contents

previously projected against the present value of the cash flows estimated at March 31, 2012. The Company considers the discounted cash flow analysis to be its primary evidence when determining whether credit related OTTI exists.

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

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

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

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

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

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

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- **Prepayment Rate** Lack of liquidity in the market for PreTSL securities, credit rating downgrades and market uncertainties related to the financial industry are factors contributing to the impairment of these securities. During the early years of PreTSL securities, prepayments were common as issuers were able to refinance into lower cost borrowings. Since the middle of 2007, however, this option has all but disappeared and the Company is operating in an environment which makes early redemption of these instruments unlikely. Accordingly, the Company has assumed zero prepayments when modeling the cash flows of these securities. The Company will reevaluate its prepayment assumptions from time to time as appropriate. The Company performed a sensitivity analysis during the first quarter ended March 31, 2012 using 1% and 3% prepayment assumptions. As a result of this analysis, the Company determined that employing a 1% and a 3% prepayment assumption rather than assuming zero prepayments would not have resulted in a credit loss. Credit losses could increase as a result of an increase in the prepayment assumption because prepayments reduce the amount of excess subordination that would be available to absorb expected losses.

- **Credit Analysis** A quarterly credit evaluation is performed for each of the securities. While the underlying core component of these securities are the credit characteristics of the underlying issuers, typically banks, other characteristics of

Table of Contents

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

The Company has evaluated its PreTSLs considering all available evidence, including information received after the statement of financial condition date but before the filing date, and determined that the estimated discounted cash flows are greater than the securities' carrying value, resulting in no impairment charges to earnings or other comprehensive income for the three months ended March 31, 2012.

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

| (In thousands)   | 2012     | 2011      |
|--|----------|-----------|
| Beginning Balance January 1  | \$ 8,619 | \$ 22,598 |
| Credit losses on debt securities for which OTTI was not previously recognized        |          |           |
| Additional credit losses on debt securities for which OTTI was previously recognized |          |           |
| Ending Balance, March 31,  | \$ 8,619 | \$ 22,598 |

Investments in FHLB and FRB stock, which has limited marketability, are carried at cost \$9.2 million and \$9.7 million at March 31, 2012 and December 31, 2011, respectively. FRB stock of \$1.3 million is included in Other Assets at March 31, 2012 and December 31, 2011. Management noted no indicators of impairment for the FHLB of Pittsburgh and FRB of Philadelphia at March 31, 2012.

**Loans**

Net loans increased \$8.8 million, or 1.3%, to \$667.8 million at March 31, 2012 from \$659.0 million as of December 31, 2011. Net loans represented 64.9% of total assets at March 31, 2012, compared to 59.8% at December 31, 2011. Historically, commercial lending activities have represented a significant portion of the Company's loan activities. This includes commercial and industrial loans, commercial real estate loans and construction, land acquisition and development loans. Furthermore, from a collateral standpoint, a majority of the Company's loan portfolio consisted of loans secured by real estate. Real estate secured loans, which includes commercial real estate, construction, land acquisition and development, residential real estate and home equity loans, increased by \$711 thousand, or 0.2% to \$417.4 million at March 31, 2012, from \$416.7 million at December 31, 2011. Real estate secured loans as a percentage of total gross loans have decreased from 61.3% at December 31, 2011 to 60.7% of the loan portfolio at March 31, 2012.

Commercial and industrial loans increased \$1.2 million, or 0.7%, during the quarter from \$174.2 million at December 31, 2011 to \$175.4 million at March 31, 2012. Commercial and industrial loans consist primarily of equipment loans, working capital financing, revolving lines of credit and loans secured by cash and marketable securities. The increase was primarily due to loan originations. Loans secured by commercial real estate decreased \$1.2 million, or 0.5%, from \$256.5 million at December 31, 2011 to \$255.3 million at March 31, 2012. Commercial real estate loans include long-term commercial mortgage financing and are primarily secured by first or second lien mortgages. The decrease in commercial real estate loans was primarily attributable to loan pay downs. Construction, land acquisition and development loans increased \$4.7 million, or

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14.1%, during the quarter from \$33.5 million at December 31, 2011 to \$38.2 million at March 31, 2012. The increase in construction land acquisition and development loans was primarily attributable to originations and an increase in lending in this segment related to commercial real estate construction versus land developments.

Residential real estate loans totaled \$78.7 million at March 31, 2012. This represents a decrease of \$1.4 million, or 1.7%, from \$80.1 million at December 31, 2011. The components of residential real estate loans include fixed and variable rate mortgage loans. The decrease was primarily attributable to loan pay downs. The Company continues to adhere to a philosophy of underwriting fixed rate purchase and refinance residential mortgage loans that are generally then sold in the secondary market to reduce interest rate risk and provide funding for additional loans.

Consumer loans increased \$2.2 million during the quarter, or 1.9%, from \$111.8 million at December 31, 2011 to \$114.0 million at March 31, 2012. The increase was attributable to new loan originations.

Loans to states and political subdivisions totaled \$26.6 million at March 31, 2012, an increase of \$3.1 million, or 13.2%, from \$23.5 million at December 31, 2011. The increase was attributable to new loan originations.



Table of Contents

Details regarding the loan portfolio are as follows:

| (in thousands)                                 | March 31,<br>2012 | December 31,<br>2011 |
|--|-------------------|----------------------|
| Residential real estate                        | \$ 78,690         | \$ 80,056            |
| Commercial real estate                         | 255,317           | 256,508              |
| Construction, land acquisition and development | 38,174            | 33,450               |
| Commercial and industrial                      | 175,429           | 174,233              |
| Consumer                                       | 113,952           | 111,778              |
| State and political subdivisions               | 26,594            | 23,496               |
| Total loans, gross                             | 688,156           | 679,521              |
| Unearned discount                              | (145)             | (159)                |
| Net deferred loan fees and costs               | 467               | 516                  |
| Allowance for loan and lease losses            | (20,664)          | (20,834)             |
| Loans, net                                     | \$ 667,814        | \$ 659,044           |

Loan Concentrations: At March 31, 2012 and December 31, 2011, the Company's loan portfolio was concentrated in the following industries. All loans included in the Solid Waste Landfills are fully secured by cash collateral on deposit at the Bank.

| (In thousands)             | March 31, 2012 |                     | December 31, 2011 |                     |
|----------------------------|----------------|---------------------|-------------------|---------------------|
|                            | Amount         | % of Gross<br>Loans | Amount            | % of Gross<br>Loans |
| Land subdivision           | \$ 19,934      | 2.90%               | \$ 19,626         | 2.89%               |
| Shopping centers/complexes | 18,490         | 2.69%               | 18,722            | 2.76%               |
| Gas stations               | 15,376         | 2.23%               | 17,118            | 2.52%               |
| Office complexes/units     | 15,977         | 2.32%               | 16,091            | 2.37%               |
| Solid waste landfills      | 42,270         | 6.14%               | 42,270            | 6.22%               |

**Asset Quality**

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

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

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

A loan is considered impaired when it is probable that the Bank will be unable to collect all amounts due (including principal and interest) according to the contractual terms of the note and loan agreement. For purposes of the Company's analysis, loans which are identified as troubled debt restructures ( TDRs ) or are non-accrual and rated substandard or doubtful with an outstanding balance greater than \$100,000 are considered impaired. Impaired loans are analyzed individually for the amount of impairment. The

Table of Contents

Company generally utilizes the fair value of collateral method for collateral dependent loans, which make up the majority of the Company's impaired loans. A loan is considered to be collateral dependent when repayment of the loan is anticipated to come from the liquidation of the collateral held. For loans that are secured by real estate, external appraisals are obtained annually, or more frequently as warranted, to ascertain a fair value so that the impairment analysis can be updated. Should a current appraisal not be available at the time of impairment analysis, other sources of valuation such as current letters of intent, broker price opinions or executed agreements of sale may be used. For non-collateral dependent loans, the Company measures impairment based on the present value of expected future cash flows, net of disposal costs, discounted at the loan's original effective interest rate.

Loans to borrowers that are experiencing financial difficulty that are modified and result in the Company granting concessions to the borrower are classified as TDRs and are considered to be impaired. Concessions granted under a troubled debt restructuring generally involve a reduction of the rate or an extension of a loan's stated maturity date. Nonaccrual troubled debt restructurings are restored to accrual status if principal and interest payments, under the modified terms, are current for six consecutive months after modification.

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

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

Management actively manages impaired loans in an effort to reduce loan balances by working with customers to develop strategies to resolve borrower difficulties, through sale or liquidation of collateral, foreclosure, and other appropriate means. If real estate values continue to decline, it is more likely that we would be required to further increase our provision for loan and lease losses, which in turn, could result in reduced earnings.

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

The following table reflects non-performing loans (including non-performing TDRs) OREO and performing TDRs at the dates noted:

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| (in thousands)                                      | March 31,<br>2012 | December 31,<br>2011 |
|---|-------------------|----------------------|
| Non-accrual loans                                   | \$ 18,940         | \$ 19,913            |
| Loans past due 90 days or more and still accruing   | 142               | 5                    |
| Total Non-Performing Loans                          | 19,082            | 19,918               |
| Other Real Estate Owned                             | 6,162             | 6,958                |
| Total Non-Performing Loans and OREO                 | 25,244            | 26,876               |
| Performing TDRs                                     | 5,471             | 5,680                |
| Non-performing loans as a percentage of gross loans | 2.77%             | 2.93%                |

Table of Contents

The average balance of impaired loans was \$23.2 million and \$29.8 million for the three months ended March 31, 2012 and 2011, respectively. The Company recorded \$85 thousand and \$29 thousand of interest income on impaired loans for the three months ended March 31, 2012 and 2011, respectively.

In the first three months of 2012, total non-performing assets decreased \$1.7 million, or 6.1%, from \$26.9 million at December 31, 2011 to \$25.2 million at March 31, 2012 equally attributed to the decline in the OREO inventory and non-accrual loans. Non-performing assets represented 62.7% of shareholders' equity at March 31, 2012, as compared to 65.3% of shareholders' equity at December 31, 2011. The decrease in non-performing assets as a percentage of shareholders' equity is driven by the reduction of both the Company's total non-performing assets and its accumulated other comprehensive loss.

Changes in non-performing loans for the period indicated is as follows:

| (in thousands)                                    | 2012 | March 31, |    | 2011    |
|---|------|-----------|----|---------|
| Balance at January 1,                             | \$   | 19,913    | \$ | 28,366  |
| Newly placed on non-accrual                       |      | 941       |    | 7,568   |
| Loans past due 90 days or more and still accruing |      | 142       |    | 225     |
| Transferred to OREO                               |      | (239)     |    | (2,104) |
| Additional charge-offs                            |      | (188)     |    | (861)   |
| Loan payments                                     |      | (1,487)   |    |         |
| Loans sold  |      |           |    | (4,727) |
| Balance at March 31,                              | \$   | 19,082    | \$ | 28,467  |

During the three months ended March 31, 2011, a \$7.0 million credit was placed on non-accrual status. This credit represents a commercial loan secured by both commercial real estate and a partial guarantee from a government agency. Due to the collateral value, no allocation is provided for this credit in the allowance for loan and lease losses.

During the three months ended March 31, 2011, a term loan and line of credit secured by commercial real estate in the amount of \$1.8 million was transferred to OREO.

During the three months ended March 31, 2011, a land development loan secured by a residential subdivision in the amount of \$2.2 million and a participation in an out of area real estate bridge loan which was secured by real estate in the amount of \$2.5 million were sold.

The additional interest income that would have been earned on non-accrual and restructured loans for the quarter ended on March 31, 2012 and 2011 in accordance with their original terms approximated \$405 thousand and \$726 thousand, respectively.

The following table outlines delinquency within the Company's loan portfolio.

|                     | March 31,<br>2012 | December 31,<br>2011 |
|---------------------|-------------------|----------------------|
| Accruing:           |                   |                      |
| 30-59 days          | 0.68%             | 0.83%                |
| 60-89 days          | 0.26%             | 0.27%                |
| 90 + days           | 0.02%             | 0.00%                |
| Non-Accrual         | 2.75%             | 2.93%                |
| Total Delinquencies | 3.71%             | 4.03%                |

The decrease in total delinquencies as a percentage of gross loans at March 31, 2012 was primarily due to the more rigorous collections of non-performing loans. Delinquencies for accruing loans decreased from \$7.5 million at December 31, 2011 to \$6.6 million at March 31, 2012, primarily due to a decrease in residential real estate loans that were 30 - 89 days past due. In its evaluation for the ALLL, management considers a variety of qualitative factors including changes in the volume and severity of delinquencies.

Table of Contents

At March 31, 2012, the Company's ratio of non-performing loans to total gross loans remained relatively constant at 2.8% compared to 2.9% reported as of December 31, 2011.

**Allowance for Loan and Lease Losses**

The ALLL represents management's estimate of probable loan losses inherent in the loan portfolio. The ALLL is analyzed in accordance with GAAP and varies from year to year based on management's evaluation of the adequacy of the ALLL in relation to the risks inherent in the loan portfolio.

In its evaluation, management considers qualitative and environmental factors, including, but not limited to:

- Changes in national, local, and business economic conditions and developments, including the condition of various market segments;
- Changes in the nature and volume of the Company's loan portfolio;
- Changes in the Company's lending policies and procedures, including underwriting standards, collection, charge-off and recovery practices and results;
- Changes in the experience, ability and depth of the Company's 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 its customers' credit quality.

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

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Doubtful loans, non-accrual and substandard loans and troubled debt restructurings are considered to be impaired and are analyzed individually to determine the amount of impairment. Circumstances such as construction delays, declining real estate values, and the inability of the borrowers to make scheduled payments have resulted in these loan relationships being classified as impaired. The fair value of collateral method is generally used for this measurement unless the loan is non-collateral dependent in which case, a discounted cash flow analysis is performed. Appraisals are received at least annually to ensure that impairment measurements reflect current market conditions. Should a current appraisal not be available at the time of impairment analysis, other valuation sources including current letters of intent, broker price opinions or executed agreements of sale may be used. Only downward adjustments are made based on these supporting values. Included in all impairment calculations is a cost to sell adjustment of approximately 10%, which is based on typical cost factors, including a 6% broker commission, 1% transfer taxes and 3% various other miscellaneous costs associated with the sales process. Sales costs are periodically revised based on actual experience. The ALLL analysis is adjusted for subsequent events that may arise after the end of the reporting period but before the financial reports are filed.

The Company's ALLL consists of both specific and general components. At March 31, 2012, the ALLL that related to impaired loans was \$0.7 million, or 3.3% of the total ALLL. The ALLL also included a general allocation of \$20.0 million, which represented 96.7% of the total ALLL of \$20.7 million. The ratio of the ALLL to total gross loans at March 31, 2012 and December 31, 2011 was 3.00% and 3.07%, respectively, based on total loans of \$688.1 million and \$679.5 million, respectively.



Table of Contents

The following table presents an allocation of the ALLL and percent of loans in each category at March 31, 2012 and December 31, 2011:

**Allocation of the Allowance for Loan Losses**

(in thousands)

|  | March 31, 2012 |   | December 31, 2011 |   |
|--|----------------|---|-------------------|---|
|  | Amount         | Percentage of Loans in Each Category to Total Loans | Amount            | Percentage of Loans in Each Category to Total Loans |
| Residential real estate                        | \$ 1,799       | 11.44%  | \$ 1,823          | 7.81%   |
| Commercial real estate                         | 10,741         | 37.13%  | 11,151            | 37.64%  |
| Construction, land acquisition and development | 2,845          | 5.55%   | 2,590             | 4.45%   |
| Commercial and industrial                      | 3,405          | 25.32%  | 3,292             | 24.80%  |
| Consumer                                       | 1,457          | 16.70%  | 1,526             | 21.84%  |
| State and political subdivision                | 417            | 3.86%   | 452               | 3.46%   |
| Total  | \$ 20,664      | 100.00%   | \$ 20,834         | 100.00%   |

Table of Contents

The following table presents an analysis of ALLL for the three months ended March 31, 2012 and 2011.

| (in thousands)   | For the three months |           |
|--|----------------------|-----------|
|  | 2012                 | 2011      |
| Balance at beginning of period   | 20,834               | 22,575    |
| (Credit) provision for loan losses   | (136)                | 1,744     |
| Charge-offs:   |                      |           |
| Residential real estate  | (312)                | (136)     |
| Commercial real estate   | (154)                | (457)     |
| Construction land acquisition and development  |                      | (6)       |
| Commercial and industrial  | (49)                 | (109)     |
| Consumer   | (79)                 | (220)     |
| State and political subdivisions   |                      |           |
| Total charge-offs  | (594)                | (928)     |
| Recoveries:  |                      |           |
| Residential real estate  | 19                   | 7         |
| Commercial real estate   | 317                  | 13        |
| Construction land acquisition and development  | 21                   | 706       |
| Commercial & industrial  | 125                  | 74        |
| Consumer   | 78                   | 39        |
| State and political subdivisions   |                      |           |
| Total recoveries   | 560                  | 839       |
| Net charge-offs  | (34)                 | (89)      |
| Balance at end of period   | \$ 20,664            | \$ 24,230 |
| Net charge-offs during the period as a percentage of average loans outstanding during the period | 0.00%                | 0.01%     |
| Allowance for loan and lease losses as a percentage of gross loans at March 31                   | 3.00%                | 3.20%     |

**Other Real Estate Owned**

OREO totaled \$6.1 million at March 31, 2012, which is a decrease of \$0.8 million, from \$6.9 million at December 31, 2011. At March 31, 2012, OREO consisted of twenty-nine properties as compared to twenty-eight properties at December 31, 2011. Eight of the properties held in OREO at March 31, 2012 totaled \$4.7 million and represented 70.4% of the total. Included in OREO are six properties totaling \$880 thousand, or 13.1%, of OREO, located outside of the Company's general market area. Additionally, \$5.2 million, or 77.2%, of OREO is in the Pocono region located within the Company's primary market area that has been hit particularly hard during the recent economic downturn.

The Company is actively marketing these properties for sale through a variety of channels including internal marketing and the use of outside brokers/realtors. The carrying value of OREO is generally calculated at an amount not greater than 90% of the most recent fair market appraised value. A 10% factor is generally used to estimate costs to sell, which is based on typical cost factors, such as 6% broker commission, 1%

transfer taxes, and 3% various other miscellaneous costs associated with the sales process. This market value is updated on an annual basis or more frequently if new valuation information is available. Further deterioration in the real estate market could result in additional losses on these properties.

Table of Contents

The following schedule reflects the roll forward of OREO:

| (in thousands)               | March 31,<br>2012 | March 31,<br>2011 |
|------------------------------|-------------------|-------------------|
| Balance, beginning of period | \$ 6,958          | \$ 9,633          |
| Additions                    | 239               | 2,104             |
| Recoveries / (write-downs)   | 26                | (158)             |
| Carrying value of OREO sold  | (1,097)           | (2,969)           |
| Balance, end of period       | \$ 6,126          | \$ 8,610          |

The following schedule reflects a breakdown of OREO for the periods reviewed:

| (in thousands)                | March 31,<br>2012 | December 31,<br>2011 |
|-------------------------------|-------------------|----------------------|
| Land / Lots                   | \$ 3,572          | \$ 4,443             |
| Commercial Real Estate        | 1,696             | 1,695                |
| Residential Real Estate       | 858               | 820                  |
| Total Other Real Estate Owned | \$ 6,126          | \$ 6,958             |

The Company foreclosed on one property during the three months ended March 31, 2012. The expenses related to maintaining OREO and the subsequent write down of the values related to declines in value since foreclosure amounted to \$178 thousand for the three months ended March 31, 2012, compared to \$567 thousand for the same period in 2011.

**Liabilities**

Total liabilities were \$987.6 million at March 31, 2012, a decrease of \$75.1 million, or 7.1%, from \$1.06 billion at December 31, 2011. Deposit liabilities decreased \$66.9 million, or 7.0%, to \$890.2 million at March 31, 2012 as compared to \$957.1 million at December 31, 2011. During the same period demand deposits decreased by \$2.8 million, or 2.1%, interest-bearing demand deposits decreased \$54.9 million, or 16.8%, and total time deposits decreased by \$11.9 million, or 3.0%. These decreases were partially offset by a \$2.6 million, or 3.0%, increase in savings deposits, during the same period. The Company continued to pursue the pricing strategy it implemented in 2011 to reduce its cost of funds and to concentrate deposit growth on short-term maturities. The Company continued to reposition maturing longer term time deposits into short-term products, whenever possible, and allowed the residual to run-off. Borrowed funds decreased by \$3.7 million, or 4.4%, during the first three months of 2012 to \$79.9 million from \$83.6 million at December 31, 2011.

**Equity**

Total shareholders' equity increased \$1.3 million, or 3.1%, to \$41.2 million at March 31, 2012 from \$39.9 million at December 31, 2011. The increase is primarily due to a \$2.4 million reduction in accumulated other comprehensive loss for the three months ended March 31, 2012, partly offset by the net loss of \$1.2 million for the same period. The decrease in accumulated other comprehensive loss was primarily attributed to the stabilization in the fair value of securities held in the available-for-sale portfolio. Book value per common share was \$2.50 at March 31, 2012.

compared to \$2.43 at December 31, 2011.

### **Liquidity**

The term liquidity refers to the ability of the Company to generate sufficient amounts of cash to meet its cash flow needs. Liquidity is required to fulfill the borrowing needs of the Company's credit customers and the withdrawal and maturity requirements of its deposit customers, as well as to meet other financial commitments. Cash and cash equivalents (cash and due from banks and federal funds sold) are the Company's most liquid assets. At March 31, 2012, cash and cash equivalents totaled \$75.7 million, a decrease of \$92.9

Table of Contents

million from \$168.6 million at December 31, 2011. Investing activities utilized \$19.3 million, operating activities utilized \$3.1 million and financing activities utilized \$70.6 million of cash and cash equivalents during the quarter. The cash flows used by investing activities were largely attributable to purchases of investment securities totaling \$19.9 million. The \$70.6 million used by financing activities was primarily attributed to a \$55.0 million decreases in demand deposits and savings accounts, and a \$11.9 million decrease in time deposits, and \$3.7 million of net repayments of FHLB borrowings. The funds used by operating activities pertain to a decrease in accrued expenses and interest in loans held for sale.

**Interest Rate Risk**

Our consolidated statements of financial position have been prepared in accordance with U.S. GAAP, which requires the measurement of financial position and operating results in terms of historical dollars without considering the changes in fair value of certain investments due to changes in interest rates. Generally, the fair value of financial investments such as loans and securities fluctuates inversely with changes in interest rates. As a result, increases in interest rates could result in decreases in the fair value of our interest-earning assets and could adversely affect our results of operation if such assets were sold, or, in the case of securities classified as available-for-sale, could lead to decreases in our shareholders' equity, if such securities were retained.

We manage the mix of interest-earning assets and interest-bearing liabilities on a continuous basis to maximize return and adjust our exposure to interest rate risk. This report quantifies the potential changes in net interest income and net portfolio value should interest rates go up or down (shocked) 200 basis points, assuming the yield curves of the rate shocks will be parallel to each other. Net portfolio value is defined as the market value of assets net of the market value of liabilities. The fair value of assets and liabilities is determined using a discounted cash flow calculation. The net portfolio value ratio is the ratio of the net portfolio value to the market value of assets. All changes in income and value are measured as percentage changes from the projected net interest income and net portfolio value at the base interest rate scenario. The base interest rate scenario assumes interest rates at March 31, 2012. Various estimates regarding prepayment assumptions are made at each level of rate shock. However, prepayment penalty income is excluded from this analysis. Actual results could differ significantly from these estimates.

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

|  | RATES + 200 | RATES - 200 |
|--|-------------|-------------|
| <b>Earnings at risk:</b>                   |             |             |
| Percent change in net interest income      | 4.50%       | (8.21)%     |
| <b>Economic value at risk:</b>             |             |             |
| Percent change in economic value of equity | (2.45)%     | 9.45%       |

**Off-Balance Sheet Arrangements**

In the normal course of operations, the Company engages in a variety of financial transactions that, in accordance with U.S. GAAP, are not recorded in our consolidated financial statements or are recorded in amounts that differ from the notional amounts. These transactions involve,

to varying degrees, elements of credit, interest rate, and liquidity risk. Such transactions are used for general corporate purposes and for customer needs. Corporate purpose transactions are used to help manage credit, interest rate, and liquidity risk or to optimize capital. Customer transactions are used to manage customers' requests for funding.

For the three months ended March 31, 2012, the Company did not engage in any off-balance sheet transactions that would have or would be reasonably likely to have a material effect on its consolidated financial condition.

**Item 3 Quantitative and Qualitative Disclosures about Market Risk**

There have been no material changes in the company's exposure to market risk during the first three months of 2012. For discussion of the Company's exposure to market risk, refer to Item 7A, Quantitative and Qualitative Disclosure about Market Risk, contained in the Company's Form 10-K for the year ended December 31, 2011.

Table of Contents

**Item 4 Controls and Procedures**

As of March 31, 2012, the Company carried out an evaluation, under the supervision and with the participation of the Company's management, including the Company's Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of the Company's disclosure controls and procedures pursuant to Rule 13a-15(b), as adopted by the Securities and Exchange Commission (SEC) under the Securities Exchange Act of 1934 (Exchange Act). The Company had previously reported that, as of December 31, 2011, it had identified a material weakness in its internal control over the financial close process as described in the Company's Annual Report on Form 10-K for the year ended December 31, 2011. While the Company made progress in remediating the deficiencies in its internal controls over financial reporting relating to the weaknesses noted in its 2011 Annual Report, all actions were not fully implemented and there was an insufficient period of time to determine whether those processes that were implemented were operating effectively as of March 31, 2012. Based upon that evaluation, the Company's Chief Executive Officer and Chief Financial Officer concluded that the Company's disclosure controls and procedures were not effective as of the end of the period covered by this report.

The Company's weaknesses will not be considered remediated until new internal controls are operational for a sufficient period of time and are tested, and management concludes that these controls are operating effectively. The Company is not aware of any transactions that were improperly undertaken as a result of the material weaknesses described in its Annual Report and therefore does not believe that the material weaknesses had any material impact on the Company's financial statements.

Disclosure controls and procedures are the controls and other procedures that are designed to ensure that information required to be disclosed in the reports that the Company files or submits under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms. Disclosure controls and procedures include, without limitation, controls and procedures designed to ensure that information required to be disclosed in the reports that the Company files or submits to the SEC under the Exchange Act is accumulated and communicated to management, including the Chief Executive Officer and Chief Financial Officer, as appropriate, to allow timely decisions regarding required disclosure.

Internal control over financial reporting includes those policies and procedures that pertain to the maintenance of records that in reasonable detail accurately and fairly reflect the transactions and dispositions of the assets of the Company; provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the Company are only being made in accordance with authorizations of management and directors of the Company; and provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the Company's assets that could have a material effect on the financial statements. Due to inherent limitations, internal control over financial reporting is not intended to provide absolute assurance that a misstatement of our financial statements would be prevented or detected.

The Company continually seeks to improve the effectiveness and efficiency of its internal control over financial reporting, resulting in frequent process refinements. Except for refinements necessary to correct the deficiencies identified in the Company's Annual Report on Form 10-K for the year ended December 31, 2011, there have been no changes to the Company's internal control over financial reporting during the quarter ended March 31, 2012 that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

**PART II Other Information**



**Item 1 Legal Proceedings.**

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

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

Table of Contents

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

**Item 1A Risk Factors.**

Management of the Company does not believe there have been any material changes in the risk factors that were previously disclosed in the Company's Form 10-K for the year ending December 31, 2011.

**Item 2 Unregistered Sales of Equity Securities and Use of Proceeds.**

None.

**Item 3 Defaults upon Senior Securities.**

None.

**Item 4 Mine Safety Disclosures.**

Not applicable.

**Item 5 Other Information.**

None.

**Item 6 Exhibits.**

The following exhibits are filed herewith or incorporated by reference.

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|                 |  |
|-----------------|--|
| EXHIBIT 3.1     | Amended and Restated Articles of Incorporation dated May 19, 2010 filed as Exhibit 3.1 to the Company's Current Report on Form 8-K on May 19, 2010, is hereby incorporated by reference. |
| EXHIBIT 3.2     | Amended and Restated Bylaws filed as Exhibit 3.2 to the Company's quarterly report on Form 10-Q as filed on April 6, 2012 is hereby incorporated by reference.                           |
| EXHIBIT 4.1     | Form of Common Stock Certificate filed as Exhibit 4.1 to the Company's Form 10-K for the year ended December 31, 2009, as filed on March 16, 2010, is hereby incorporated by reference.  |
| EXHIBIT 4.2     | Form of Subordinated Note filed as Exhibit 4.1 to the Company's Current Report on Form 8-K dated August 28, 2009, is hereby incorporated by reference.                                   |
| EXHIBIT 31.1*   | Certification of Chief Executive Officer   |
| EXHIBIT 31.2*   | Certification of Chief Financial Officer   |
| EXHIBIT 32.1**  | Section 1350 Certification Chief Executive Officer and Chief Financial Officer   |
| EXHIBIT 101.INS | XBRL INSTANCE DOCUMENT   |
| EXHIBIT 101.SCH | XBRL TAXONOMY EXTENSION SCHEMA   |
| EXHIBIT 101.CAL | XBRL TAXONOMY EXTENSION CALCULATION LINKBASE   |
| EXHIBIT 101.DEF | XBRL TAXONOMY EXTENSION DEFINITION LINKBASE  |
| EXHIBIT 101.LAB | XBRL TAXONOMY EXTENSION LABEL LINKBASE   |
| EXHIBIT 101.PRE | XBRL TAXONOMY EXTENSION PRESENTATION LINKBASE  |

Table of Contents

**SIGNATURES**

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

Registrant: FIRST NATIONAL COMMUNITY BANCORP, INC.

Date: August 24, 2012

By: /s/ Steven R. Tokach  
Steven R. Tokach  
President and Chief Executive Officer

Date: August 24, 2012

By: /s/ Edward J. Lipkus  
Edward J. Lipkus  
Chief Financial Officer  
Principal Accounting Officer