

FIRST NATIONAL COMMUNITY BANCORP INC
Form 10-K
March 13, 2009
UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-K

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

For the fiscal year ended December 31, 2008

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. 333-24121

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)

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

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

Securities registered pursuant to Section 12(g) of the Act:
Common Stock, \$1.25 par value

(Title of Class)

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

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or section 15(d) of the Act. Yes No

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

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Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K.

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

Large Accelerated Filer Accelerated Filer

Non-Accelerated Filer Smaller reporting company

(Do not check if a 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

The aggregate market value of the voting and non-voting common stock of the registrant, held by non-affiliates was approximately \$246,044,877 at June 30, 2008.

APPLICABLE ONLY TO CORPORATE REGISTRANTS

State the number of shares outstanding of each of the registrant's classes of common stock, as of the latest practicable date: 16,047,928 shares of common stock as of March 11, 2009.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the Registrant's Proxy Statement for the Annual Meeting of Shareholders to be held May 20, 2009 are incorporated by reference into Part III of this report.

FIRST NATIONAL COMMUNITY BANCORP, INC.

PART I

Item 1. Business.

CORPORATE PROFILE

The Business of First National Community Bancorp, Inc.

THE COMPANY

First National Community Bancorp, Inc. (the "company") is a Pennsylvania business, incorporated in 1997 and is registered as a financial holding company under the Bank Holding Company Act of 1956, as amended. The company became an active bank holding company on July 1, 1998 when it acquired ownership of First National Community Bank (the "bank"). On November 2, 2000, the Federal Reserve Bank of Philadelphia approved the company's application to change its status to a financial holding company as a complement to the company's strategic objective. The bank is a wholly-owned subsidiary of the company.

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

THE BANK

The bank was established as a national banking association in 1910 as "The First National Bank of Dunmore." Based upon shareholder approval received at a Special Shareholders' Meeting held October 27, 1987, the bank changed its name to "First National Community Bank" effective March 1, 1988. The bank's operations are conducted from offices located in Lackawanna, Luzerne, Wayne and Monroe Counties, Pennsylvania:

| <u>Office</u> | <u>Date Opened</u> |
|--|--------------------|
| Main | October 1910 |
| Scranton | September 1980 |
| Dickson City | December 1984 |
| Keyser Village (formerly Fashion Mall) | April 2008 |
| Wilkes-Barre | July 1993 |
| Pittston Plaza | April 1995 |
| Kingston | August 1996 |
| Exeter | November 1998 |
| Daleville | April 2000 |
| Plains | June 2000 |
| Back Mountain | October 2000 |
| Clarks Green | October 2001 |
| Hanover Township | January 2002 |
| Nanticoke | April 2002 |
| Hazleton | October 2003 |
| Route 315 | February 2004 |

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Honesdale
Stroudsburg
Honesdale Route 6
Marshalls Creek

November 2006
May 2007
October 2007
May 2008

The bank provides many commercial banking services to individuals and businesses including Image Checking and E-Statement. Deposit products include standard checking, savings and certificate of deposit products, as well as a variety of preferred products for higher balance customers. The bank also participates in the Certificate of Deposit Account Registry program which allows customers to secure FDIC insurance on balances in excess of the standard limitations. Consumer loans include both secured and unsecured installment loans, fixed and variable rate mortgages, jumbo mortgages, home equity term loans and lines of credit and "Instant Money" overdraft protection loans. Additionally, the bank is also in the business of underwriting indirect auto loans which are originated through various auto dealers in northeastern Pennsylvania and dealer floor plan loans. VISA personal credit cards are available through the bank, as well as the FNCB Check Card which allows customers to access their checking account at any retail location that accepts VISA and serves the dual purpose of an ATM card. In the commercial lending field, the bank offers demand

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and term loans, either secured or unsecured, letters of credit, working capital loans, accounts receivable, inventory or equipment financing loans, and commercial mortgages. In addition, the bank offers MasterCard, VISA processing services and Remote Deposit Capture to its commercial customers, as well as our Cash Management service which can be accessed through FNCBusiness Online, which is Internet based. FNCBusiness Online is a menu driven product that allows our business customers to have direct access to their account information and the ability to perform internal and external transfers and process Direct Deposit payroll transactions for employees, 24 hours a day, 7 days a week, from their place of business. Asset management services are conveniently available at FNCB through FNCB Investment Services. As a result of the bank's partnership with FNCB Investment Services, our customers are able to access alternative products such as mutual funds, annuities, stock and bond purchases, etc. directly from our FNCB Investment Services representatives. The bank also offers customers the convenience of 24-hour banking, seven days a week, through FNCB Online and its Bill Payment service via the Internet and its ATM network. Automated teller machines are available at the following locations:

Community Offices

Dunmore
 Scranton
 Dickson City
 Keyser Village
 Wilkes-Barre
 Pittston
 Kingston
 Exeter
 Daleville
 Plains
 Back Mountain
 Clarks Green
 Hanover Township
 Nanticoke
 Hazleton
 Route 315
 Honesdale
 Stroudsburg
 Honesdale Route 6
 Marshalls Creek

Remote Locations

Petro Truck Stop, 98 Grove St., Dupont
 Bill's Shoprite Supermarket, Rt. 502, Daleville
 Joe's Kwik Mart, 620 N. Blakely St., Dunmore
 Joe's Kwik Mart, Rts 940 and I-380, Pocono Summit
 Joe's Kwik Mart, 303 Route 315, Dupont
 107 Woodland Road, Mt. Pocono
 Pocono Village Mall, Mt. Pocono
 Cooper's Seafood, 701 N. Washington Ave., Scranton

Additionally, to further enhance 24-hour banking services, Telephone Banking (Account Link), Loan by Phone, and Mortgage Link are available to customers. These services provide consumers the ability to access account information, perform related account transfers, and apply for a loan through the use of a touch tone telephone. Also, in our efforts to continually provide consumers the best possible service, the bank implemented in 2004 a Bounce Protection service which provides consumers with an added level of protection against unanticipated cash flow emergencies and account reconciliation errors.

As of December 31, 2008 industry concentrations exist within the following four industries. Loans and lines of credit to each of these industries were as follows:

| | | % of |
|--------------------------------|--------------|------------|
| | | Regulatory |
| | Amount | Capital |
| Land Subdivision | \$89,040,000 | 70% |
| Shopping Centers/Complexes | \$41,404,000 | 33% |
| Hotels | \$36,260,000 | 29% |
| Solid Waste Landfills Industry | \$35,132,000 | 28% |

First lien mortgages on the real estate and a diverse group of borrowers provide security against undue risks in the portfolio.

COMPETITION

The bank is one of two financial institutions with principal offices in Dunmore. Primary competition in the Lackawanna County market comes from numerous commercial banks and savings and loan associations operating in the area. Our Luzerne County offices share many of the same competitors we face in Lackawanna County as well as several

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banks and savings and loans that are not in our Lackawanna County market. In 2006, the bank entered the Wayne County market. Competition for loan and deposit relationships is primarily with three banks headquartered in Wayne County as well as other institutions located within the market. In 2007, the bank ventured into Monroe County with its first office in Stroudsburg and added a second office in Marshalls Creek in 2008. Competition in Monroe County comes from many of the same competitors we face in the other markets as well as other institutions headquartered in that area. Deposit deregulation has intensified the competition for deposits among banks in recent years. Additional competition is derived from credit unions, finance companies, brokerage firms, insurance companies and retailers.

SUPERVISION AND REGULATION

The company is subject to the Securities Exchange Act of 1934 ("1934 Act") and must file quarterly and annual reports with the U.S. Securities and Exchange Commission regarding its business operations. As a registered financial holding company under the Bank Holding Company Act of 1956, as amended, the company is subject to the supervision and examination by the Federal Reserve Board.

The bank is subject to regulation and supervision by the Office of the Comptroller of the Currency, which includes regular examinations of the bank's records and operations. With the passage of legislation to foster economic recovery and ease consumer concerns, as a member of the Federal Deposit Insurance Corporation (FDIC), the bank's depositors' accounts are insured up to \$250,000 per ownership category until December 31, 2009. Individual Retirement Accounts (IRA's) are insured up to \$250,000 permanently. This substantive change is designed to bolster consumer confidence in the safety of their money in banks and in the strength of the banking system. To obtain this protection for its depositors, the bank pays an assessment and is subject to the regulations of the FDIC. The bank is also a member of the Federal Reserve System and as such is subject to the rules promulgated by the Federal Reserve Board.

During 2008, the United States government responded to the financial crisis with programs designed to strengthen the financial system and provide the liquidity necessary to allow banks to continue to serve their customers. The Troubled Asset Relief Program (TARP) was designed to inject capital into banks who would then have liquidity to better manage their business. Inclusion in the program carried restrictions on the participating financial institution. The bank reviewed the merits of the program, but ultimately decided not to participate in TARP. The Temporary Liquidity Guarantee Program (TLGP) was designed to provide unlimited FDIC insurance coverage on certain categories of deposits until December 31, 2009. In order to provide the coverage for its customers, the bank agreed to pay increased insurance premiums. For the benefit of our customers, First National Community Bank elected to participate in the TLGP.

Financial Services Modernization Legislation. - In November 1999, the Gramm-Leach-Bliley Act of 1999, or the GLB, was enacted. The GLB repeals provisions of the Glass-Steagall Act which restricted the affiliation of Federal Reserve member banks with firms "engaged principally" in specified securities activities, and which restricted officer, director or employee interlocks between a member bank and any company or person "primarily engaged" in specified securities activities.

In addition, the GLB also contains provisions that expressly preempt any state law restricting the establishment of financial affiliations, primarily related to insurance. The general effect of the law is to establish a comprehensive framework to permit affiliations among commercial banks, insurance companies, securities firms and other financial service providers by revising and expanding the Bank Holding Company Act framework to permit a holding company to engage in a full range of financial activities through a new entity known as a "financial holding company." "Financial activities" is broadly defined to include not only banking, insurance and securities activities, but also merchant banking and additional activities that the Federal Reserve Board, in consultation with the Secretary of the Treasury, determines to be financial in nature, incidental to such financial activities or complementary activities that do not pose a substantial risk to the safety and soundness of depository institutions or the financial system generally.

The GLB also permits national banks to engage in expanded activities through the formation of financial subsidiaries. A national bank may have a subsidiary engaged in any activity authorized for national banks directly or any financial activity, except for insurance underwriting, insurance investments, real estate investment or development, or merchant banking, which may only be conducted through a subsidiary of a financial holding company. Financial activities include all activities permitted under new sections of the Bank Holding Company Act or permitted by regulation.

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To the extent that the GLB permits banks, securities firms and insurance companies to affiliate, the financial services industry may experience further consolidation. The GLB is intended to grant to community banks certain powers as a matter of right that larger institutions have accumulated on an ad hoc basis and which unitary savings and loan holding companies already possess. Nevertheless, the GLB may have the result of

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increasing the amount of competition that First National Community Bancorp, Inc. faces from larger institutions and other types of companies offering financial products, many of which may have substantially more financial resources than First National Community Bancorp, Inc. has.

USA Patriot Act of 2001- In October 2001, the USA Patriot Act of 2001 was enacted in response to the terrorist attacks in New York, Pennsylvania and Washington D.C. which occurred on September 11, 2001. The Patriot Act is intended to strengthen U.S. law enforcement's and the intelligence communities' abilities to work cohesively to combat terrorism on a variety of fronts. The potential impact of the Patriot Act on financial institutions of all kinds is significant and wide ranging. The Patriot Act contains sweeping anti-money laundering and financial transparency laws and imposes various regulations, including standards for verifying client identification at account opening, and rules to promote cooperation among financial institutions, regulators and law enforcement entities in identifying parties that may be involved in terrorism or money laundering.

IMLAFATA - As part of the USA Patriot Act, Congress adopted the International Money Laundering Abatement and Financial Anti-Terrorism Act of 2001 (IMLAFATA). IMLAFATA amended the Bank Secrecy Act and adopted certain additional measures that increase the obligation of financial institutions, including First National Community Bancorp, Inc., to identify their customers, watch for and report upon suspicious transactions, respond to requests for information by federal banking regulatory authorities and law enforcement agencies, and share information with other financial institutions. The Secretary of the Treasury has adopted several regulations to implement these provisions. First National Community Bancorp, Inc. is also barred from dealing with foreign "shell" banks. In addition, IMLAFATA expands the circumstances under which funds in a bank account may be forfeited. IMLAFATA also amended the BHC Act and the Bank Merger Act to require the federal banking regulatory authorities to consider the effectiveness of a financial institution's anti-money laundering activities when reviewing an application to expand operations. First National Community Bancorp, Inc. has in place a Bank Secrecy Act compliance program.

Sarbanes-Oxley Act of 2002 - In 2002, the Sarbanes-Oxley Act (the "Act") became law. The stated goals of the Act are to increase corporate responsibility, to provide for enhanced penalties for accounting and auditing improprieties at publicly traded companies and to protect investors by improving the accuracy and reliability of corporate disclosures pursuant to the securities laws.

The Act is the most far-reaching U.S. securities legislation enacted in decades. The Act generally applies to all companies, both U.S. and non-U.S., that file or are required to file periodic reports with the Securities and Exchange Commission (the "SEC") under the Securities Exchange Act of 1934. Due to the SEC's extensive role in implementing rules relating to many of the Act's new requirements, the final scope of these requirements remains to be determined.

The Act includes very specific additional disclosure requirements and new corporate governance rules, requires the SEC and securities exchanges to adopt extensive additional disclosure, corporate governance and other related rules and mandates further studies of certain issues by the SEC. The Act represents significant federal involvement in matters traditionally left to state regulatory systems, such as the regulation of the accounting profession, and to state corporate law, such as the relationship between a board of directors and management and between a board of directors and its committees.

The Act addresses, among other matters:

- audit committees for all reporting companies;
- certification of financial statements by the chief executive officer and the chief financial officer;
- the forfeiture of bonuses or other incentive-based compensation and profits from the sale of an issuer's securities by directors and senior officers in the twelve month period following initial publication of any financial statements that later require restatement;
- a prohibition on insider trading during pension plan black out periods;
- disclosure of off-balance sheet transactions;

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- a prohibition on personal loans to directors and officers; expedited filing requirements for Form 4's;
- disclosure of a code of ethics and filing a Form 8-K for a change or waiver of such code;
- "real time" filing of periodic reports;
- the formation of a public accounting oversight board;
- auditor independence; and
- various increased criminal penalties for violations of securities laws.

The SEC was delegated the task of enacting rules to implement various provisions with respect to, among other matters, disclosure in periodic filings pursuant to the Exchange Act.

Regulation W - Transactions between a bank and its "affiliates" are quantitatively and qualitatively restricted under the Federal Reserve Act. The Federal Deposit Insurance Act applies Sections 23A and 23B to insured nonmember banks in the same manner and to the same extent as if they were members of the Federal Reserve System. The Federal Reserve Board has also issued Regulation W, which codifies prior regulations under Sections 23A and 23B of the Federal Reserve Act and interpretative guidance with respect to affiliate transactions. Regulation W incorporates the exemption from the affiliate transaction rules but expands the exemption to cover the purchase of any type of loan or extension of credit from an affiliate. Affiliates of a bank include, among other entities, the bank's holding company and companies that are under common control with the bank. First National Community Bancorp, Inc. is considered to be an affiliate of First National Community Bank. In general, subject to certain specified exemptions, a bank or its subsidiaries are limited in their ability to engage in "covered transactions" with affiliates:

- to an amount equal to 10% of the bank's capital and surplus, in the case of covered transactions with any one affiliate; and
- to an amount equal to 20% of the bank's capital and surplus, in the case of covered transactions with all affiliates.

In addition, a bank and its subsidiaries may engage in covered transactions and other specified transactions only on terms and under circumstances that are substantially the same, or at least as favorable to the bank or its subsidiary, as those prevailing at the time for comparable transactions with nonaffiliated companies. A "covered transaction" includes:

- a loan or extension of credit to an affiliate;
- a purchase of, or an investment in, securities issued by an affiliate;
- a purchase of assets from an affiliate, with some exceptions;
- the acceptance of securities issued by an affiliate as collateral for a loan or extension of credit to any party; and
- the issuance of a guarantee, acceptance or letter of credit on behalf of an affiliate.

In addition, under Regulation W:

- a bank and its subsidiaries may not purchase a low-quality asset from an affiliate;
- covered transactions and other specified transactions between a bank or its subsidiaries and an affiliate must be on terms and conditions that are consistent with safe and sound banking practices; and
- with some exceptions, each loan or extension of credit by a bank to an affiliate must be secured by collateral with a market value ranging from 100% to 130%, depending on the type of collateral, of the amount of the loan or extension of credit.

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Regulation W generally excludes all non-bank and non-savings association subsidiaries of banks from treatment as affiliates, except to the extent that the Federal Reserve Board decides to treat these subsidiaries as affiliates.

Concurrently with the adoption of Regulation W, the Federal Reserve Board has proposed a regulation which would further limit the amount of loans that could be purchased by a bank from an affiliate to not more than 100% of the bank's capital and surplus.

The global and U.S. economies are experiencing significantly reduced business activity as a result of, among other factors, disruptions in the financial system during the past year. Dramatic declines in the housing market during the past year, with falling home prices and increasing foreclosures and unemployment, have resulted in significant write-downs of asset values by financial institutions, including government-sponsored entities and major commercial and investment banks. These write-downs, initially of mortgage-backed securities but spreading to credit default swaps and other derivative securities have caused many financial institutions to seek additional capital, to merge with larger and stronger institutions and, in some cases, to fail.

Reflecting concern about the stability of the financial markets generally and the strength of counterparties, many lenders and institutional investors have reduced, and in some cases, ceased to provide funding to borrowers, including other financial institutions. The availability of credit, confidence in the financial sector, and level of volatility in the financial markets have been significantly adversely affected as a result. In recent weeks, volatility and disruption in the capital and credit markets has reached unprecedented levels. In some cases, the markets have produced downward pressure on stock prices and credit capacity for certain issuers without regard to those issuers' underlying financial strength.

In response to the financial crises affecting the banking system and financial markets and going concern threats to investment banks and other financial institutions, on October 3, 2008, the Emergency Economic Stabilization Act of 2008 (the "EESA") was signed into law. Pursuant to the EESA, the U.S. Treasury will have the authority to, among other things, purchase up to \$700 billion of mortgages, mortgage-backed securities and certain other financial instruments from financial institutions for the purpose of stabilizing and providing liquidity to the U.S. financial markets. The EESA included a provision for a temporary increase in FDIC insurance from \$100,000 to \$250,000 per depositor through December 31, 2009.

On October 14, 2008, Secretary Paulson, after consulting with the Federal Reserve and the FDIC, announced that the Department of the Treasury will purchase equity stakes in a wide variety of banks and thrifts. Under this program, known as the Troubled Asset Relief Program ("TARP") Capital Purchase Program, from the \$700 billion authorized by the EESA, the Treasury will make \$250 billion of capital available to U.S. financial institutions in the form of preferred stock. In conjunction with the purchase of preferred stock, the Treasury will receive warrants to purchase common stock with an aggregate market price equal to 15% of the preferred investment. Participating financial institutions will be required to adopt the Treasury's standards for executive compensation and corporate governance for the period during which the Treasury holds equity issued under TARP Capital Purchase Program.

Also on October 14, 2008, after receiving a recommendation from the boards of the FDIC and the Federal Reserve, and consulting with the President, Secretary Paulson signed the systemic risk exception to the FDIC Act, enabling the FDIC to temporarily provide a 100% guarantee of the senior debt of all FDIC-insured institutions and their holding companies, as well as deposits in non-interest bearing transaction deposit accounts under a Temporary Liquidity Guarantee Program. Coverage under the Temporary Liquidity Guarantee Program is available until November 12, 2008 without charge and thereafter at a cost of 75 basis points per annum for senior unsecured debt and 10 basis points per annum for non-interest bearing transaction deposits. Under the Capital Purchase Program, the Corporation sold \$10,000,000 in Series A Fixed Rate Cumulative Perpetual Preferred Stock to the United States Department of the Treasury.

It is not clear at this time what impact the EESA, TARP Capital Purchase Program, the Temporary Liquidity Guarantee Program, other liquidity and funding initiatives of the Federal Reserve and other agencies that have been previously announced, and any additional programs that may be initiated in the future will have on the financial markets and the other difficulties described above, including the extreme levels of volatility and limited credit availability currently being experienced, or on the U.S. banking and financial industries and the broader U.S. and global

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economies. Further adverse effects could have an adverse effect on the Corporation and its business.

EMPLOYEES

As of December 31, 2008 the bank employed 310 persons, including 60 part-time employees.

AVAILABLE INFORMATION

The company files reports, proxy and information statements and other information electronically with the Securities and Exchange Commission. You may read and copy any materials that the company files with the SEC at the SEC's Public Reference Room at 450 Fifth Street, NW, Washington, DC 20549. You can obtain information on the operation of the Public Reference Room by calling the SEC at 1-800-SEC-0330. The SEC maintains an Internet site that contains reports, proxy and information statements, and other information regarding issuers that file electronically with the SEC. The SEC's website site address is <http://www.sec.gov>. The company's web site address is <http://www.fncb.com>. The company makes available free of charge through our website, our annual report on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K, and amendments to those reports filed or furnished pursuant to Section 13(a) or 15(d) of the Exchange Act as soon as reasonably practicable after we electronically file such material with, or furnish it to, the SEC. Further, we will provide electronic or paper copies of the company's filings free of charge upon request. A copy of the company's Annual Report on Form 10-K for the year ended December 31, 2008 may be obtained without charge from our website at www.fncb.com or via email at fncb@fncb.com. Information may also be obtained via written request to First National Community Bancorp, Inc. Attention: Treasurer, 102 East Drinker Street, Dunmore, PA 18512.

Item 1A. Risk Factors.

The soundness of other financial institutions may adversely affect us.

Financial services institutions are interrelated as a result of trading, clearing, counterparty, or other relationships. The Corporation has exposure to many different industries and counterparties, and routinely executes transactions with counterparties in the financial services industry, including commercial banks, brokers and dealers, investment banks, and other institutional clients. Many of these transactions expose the Corporation to credit risk in the event of a default by a counterparty or client. In addition, the Corporation's credit risk may be exacerbated when the collateral held by the Corporation cannot be realized upon or is liquidated at prices not sufficient to recover the full amount of the credit or derivative exposure due to the Corporation. Any such losses could have a material adverse affect on the Corporation's financial condition and results of operations.

Current levels of market volatility are unprecedented and may have materially adverse effects on our liquidity and financial condition.

The capital and credit markets have been experiencing extreme volatility and disruption for more than 12 months. In recent weeks, the volatility and disruption have reached unprecedented levels. In some cases, the markets have exerted downward pressure on stock prices, security prices and credit capacity for certain issuers without regard to those issuers' underlying financial strength. If the current levels of market disruption and volatility continue or worsen, there can be no assurance that we will not experience adverse effects, which may be material, on our liquidity, financial condition and profitability.

The Company Is Subject To Interest Rate Risk

The Company's earnings and cash flows are largely dependent upon its net interest income. Net interest income is the difference between interest income earned on interest-earning assets such as loans and securities and interest expense paid on interest-bearing liabilities such as deposits and borrowed funds. Interest rates are highly sensitive to many factors that are beyond the Company's control, including general economic conditions and policies of various governmental and regulatory agencies and, in particular, the Board of Governors of the Federal Reserve System. Changes in monetary policy, including changes in interest rates, could influence not only the interest the Company receives on loans and securities and the amount of interest it pays on deposits and borrowings, but such changes could also affect (i) the Company's ability to originate loans and obtain deposits, (ii) the fair value of the Company's financial assets and liabilities, and (iii) the average duration of the Company's mortgage-backed securities portfolio. If the interest rates paid on deposits and other borrowings increase at a faster rate than the interest rates received on loans and other investments, the Company's net interest income, and therefore earnings, could be adversely affected. Earnings could also be adversely affected if the interest rates received on loans and other investments fall more quickly than the interest rates paid on deposits and other borrowings.

Although management believes it has implemented effective asset and liability management strategies, to reduce the potential effects of changes in interest rates on the Company's results of operations, any substantial, unexpected, prolonged change in market interest rates could have a material adverse effect on the Company's financial condition and results of operations.

The Company Is Subject To Lending Risk

As of December 31, 2008, approximately 44% of the Company's loan portfolio consisted of commercial real estate loans. These types of loans are generally viewed as having more risk of default than residential real estate loans or consumer loans. These types of loans are also typically larger than residential real estate loans and consumer loans. Because the Company's loan portfolio contains a significant number of commercial real estate loans with relatively large balances, the deterioration of one or a few of these loans could cause a significant increase in non-performing loans. An increase in non-performing loans could result in a net loss of earnings from

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these loans, an increase in the provision for possible loan losses and an increase in loan charge-offs, all of which could have a material adverse effect on the Company's financial condition and results of operations.

If the Company's allowance for loan losses is not sufficient to cover actual loan losses, its earnings could decrease.

The Company's loan customers may not repay their loans according to the terms of their loans, and the collateral securing the payment of their loans may be insufficient to assure repayment. The Company may experience significant credit losses, which could have a material adverse effect on its operating results. The Company makes various assumptions and judgments about the collectability of its loan portfolio, including the creditworthiness of its borrowers and the value of the real estate and other assets serving as collateral for the repayment of many of its loans. In determining the amount of the allowance for loan losses, the Company reviews its loans and its loss and delinquency experience, and the Company evaluates economic conditions. If its assumptions prove to be incorrect, its allowance for loan losses may not cover inherent losses in its loan portfolio at the date of its financial statements. Material additions to the Company's allowance would materially decrease its net income. At December 31, 2008, its allowance for loan losses totaled \$8.3 million, representing .86% of its total loans.

Although the Company believes it has underwriting standards to manage normal lending risks, it is difficult to assess the future performance of its loan portfolio due to the relatively recent origination of many of these loans. The Company can give you no assurance that its non-performing loans will not increase or that its non-performing or delinquent loans will not adversely affect its future performance.

In addition, federal and state regulators periodically review the Company's allowance for loan losses and may require it to increase its allowance for loan losses or recognize further loan charge-offs. Any increase in its allowance for loan losses or loan charge-offs as required by these regulatory agencies could have a material adverse effect on its results of operations and financial condition.

The Company's Profitability Depends Significantly On Economic Conditions In The Commonwealth of Pennsylvania specifically in Lackawanna and Luzerne County

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

There is no assurance that the Company will be able to successfully compete with others for business.

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

affect its overall financial condition and earnings.

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The Company's Controls and Procedures May Fail or Be Circumvented

Management regularly reviews and updates the Company's internal controls, disclosure controls and procedures, and corporate governance policies and procedures. Any system of controls, however well designed and operated, is based in part on certain assumptions and can provide only reasonable, not absolute, assurances that the objectives of the system are met. Any failure or circumvention of the Company's controls and procedures or failure to comply with regulations related to controls and procedures could have a material adverse effect on the Company's business, results of operations and financial condition.

The Company Relies On Dividends From Its Subsidiaries For Most Of Its Revenue

The Company is a separate and distinct legal entity from its subsidiaries. It receives substantially all of its revenue from dividends from its subsidiaries. These dividends are the principal source of funds to pay dividends on the Company's common stock, interest and principal on debt when applicable, and normal operating expenditures. Various federal and/or state laws and regulations limit the amount of dividends that the Bank and certain non-bank subsidiaries may pay to the Company. Also, its right to participate in a distribution of assets upon a subsidiary's liquidation or reorganization is subject to the prior claims of the subsidiary's creditors. In the event the Bank is unable to pay dividends to the Company, it may not be able to service debt, pay obligations or pay dividends on the Company's common stock. The inability to receive dividends from the Bank could have a material adverse effect on the Company's business, financial condition and results of operations.

The Company May Not Be Able To Attract and Retain Skilled People

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

The Company Is Subject To Claims and Litigation Pertaining To Fiduciary Responsibility

From time to time, customers make claims and take legal action pertaining to the Company's performance of its fiduciary responsibilities. Whether customer claims and legal action related to the Company's performance of its fiduciary responsibilities are founded or unfounded, if such claims and legal actions are not resolved in a manner favorable to the Company they may result in significant financial liability and/or adversely affect the market perception of the Company and its products and services as well as impact customer demand for those products and services. Any financial liability or reputation damage could have a material adverse effect on the Company's business, which, in turn, could have a material adverse effect on the Company's financial condition and results of operations.

The Trading Volume In The Company's Common Stock Is Less Than That Of Other Larger Financial Services Companies

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The Company's common stock is traded on the Over-the-Counter (OTC) Bulletin Board; the trading volume in its common stock is less than that of other larger financial services companies. A public trading market having the desired characteristics of depth, liquidity and orderliness depends on the presence in the marketplace of willing buyers and sellers of the Company's common stock at any given time. This presence depends on the individual decisions of investors and general economic and market conditions over which the Company has no control. Given the lower trading volume of the Company's common stock, significant sales of the Company's common stock, or the expectation of these sales, could cause the Company's stock price to fall.

Item 1B. Unresolved Staff Comments.

Not Applicable

Item 2. Properties.

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| <u>Property</u> | <u>Location</u> | <u>Ownership</u> | <u>Type of Use</u> |
|-----------------|--|------------------|-------------------------|
| 1 | 102 East Drinker Street Dunmore, PA | Own | Main Office |
| 2 | 419-421 Spruce Street Scranton, PA | Own | Scranton Branch |
| 3 | 934 Main Street Dickson City, PA | Own | Dickson City Branch |
| 4 | 1743 North Keyser Avenue Scranton, PA | Lease | Keyser Village Branch |
| 5 | 23 West Market Street Wilkes-Barre, PA | Lease | Wilkes-Barre Branch |
| 6 | 1700 North Township Blvd. Pittston, PA | Lease | Pittston Plaza Branch |
| 7 | 754 Wyoming Avenue Kingston, PA | Lease | Kingston Branch |
| 8 | 1625 Wyoming Avenue Exeter, PA | Lease | Exeter Branch |
| 9 | Route 502 & 435 Daleville, PA | Lease | Daleville Branch |
| 10 | 27 North River Road Plains, PA | Lease | Plains Branch |
| 11 | 169 North Memorial Highway Shavertown, PA | Lease | Back Mountain Branch |
| 12 | 269 East Grove Street Clarks Green, PA | Own | Clarks Green Branch |
| 13 | 734 Sans Souci Parkway Hanover Township, PA | Lease | Hanover Township Branch |
| 14 | 194 South Market Street Nanticoke, PA | Own | Nanticoke Branch |
| 15 | 330-352 West Broad Street Hazleton, PA | Own | Hazleton Branch |
| 16 | 3 Old Boston Road Pittston, PA | Lease | Route 315 Branch |

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| | | | |
|----|---|-------|--------------------------|
| 17 | 1001 Main Street Honesdale, PA | Own | Honesdale Branch |
| 18 | 301 McConnell Street Stroudsburg, PA | Own | Stroudsburg Branch |
| 19 | 1127 Texas Palmyra Highway Honesdale, PA | Lease | Honesdale Route 6 Branch |
| 20 | 5120 Milford Road East Stroudsburg, PA | Own | Marshalls Creek Branch |
| 21 | 200 South Blakely Street Dunmore, PA | Lease | Administrative Center |
| 22 | 107-109 South Blakely Street Dunmore, PA | Own | Parking Lot |
| 23 | 114-116 South Blakely Street Dunmore, PA | Own | Parking Lot |

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| | | | |
|----|---|-----|-------------|
| 24 | 1708 Tripp Avenue Dunmore, PA | Own | Parking Lot |
| 25 | 119-123 South Blakely Street Dunmore, PA | Own | Parking Lot |
| 26 | Rt. 940 Blakeslee, PA | Own | Land |
| 27 | Route 611 Paradise Township, PA | Own | Land |
| 28 | Main Street Taylor, PA | Own | Land |

Item 3. Legal Proceedings.

Neither the company nor its subsidiaries are involved in any material pending legal proceedings, other than routine litigation incidental to the business nor does the company know of any proceedings contemplated by governmental authorities.

Item 4. Submission of Matters to a Vote of Security Holders.

Not Applicable

PART II

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

INVESTOR INFORMATION

MARKET PRICES OF STOCK AND DIVIDENDS PAID

The company’s common stock is not actively traded. The principal market area for the company’s stock is northeastern Pennsylvania, although shares are held by residents of other states across the country. First National Community Bancorp, Inc. is listed in the Over-The-Counter Bulletin Board (OTCBB) Stocks under the symbol “FNCB”. Quarterly market highs and lows and dividends paid for each of the past two years are presented below. These prices represent actual transactions. The company expects that comparable cash dividends will be paid in the future.

| QUARTER | MARKET PRICE | | DIVIDENDS PAID PER SHARE |
|---------|--------------|---------|-----------------------------|
| | HIGH | LOW | |
| | 2008 | | |
| First | \$18.96 | \$12.98 | \$.11 |
| Second | 16.47 | 13.48 | .11 |
| Third | 15.27 | 11.87 | .11 |
| Fourth | 13.48 | 9.56 | .13 |
| | | | \$ 0.46 |
| | 2007 | | |
| First | \$23.76 | \$20.00 | \$.10 |
| Second | 22.48 | 19.20 | .10 |
| Third | 20.00 | 16.25 | .10 |
| Fourth | 18.99 | 16.00 | .12 |
| | | | \$ 0.42 |

* Share and per share information includes the retroactive effect of the 25% stock dividend paid December 27, 2007.

MARKET MAKERS

The following firms are known to make a market in the company's stock:

| | | | |
|---|--|---|--|
| Boening & Scattergood, Inc. 4 Tower Bridge 200 Barr Harbor Drive, Suite 300 W. Conshohocken, PA 19428-2979 (610) 832-1212 | Ferris, Baker Watts, Incorporated 100 Light Street Baltimore, MD 21202 (800) 638-7411 | Monroe Securities 47 State Street Rochester, NY 14614 (800) 766-5560 | Stifel Nicolaus & Co. One Financial Plaza 501 North Broadway St. Louis, MO 63102-2102 (800) 776-6821 |
|---|--|---|--|

TRANSFER AGENT

Registrar and Transfer Company

10 Commerce Drive

Cranford, NJ 07016-9982

Shareholder questions regarding stock ownership should be directed to the Investor Relations Department at Registrar and Transfer Company at 1-800-368-5948.

HOLDERS

As of March 11, 2009, there were approximately 1,650 holders of the company's common stock.

DIVIDEND CALENDAR

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Dividends on the company's common stock, if approved by the Board of Directors, are customarily paid on or about March 15, June 15, September 15 and December 15. Record dates for dividends are customarily on or about March 1, June 1, September 1, and December 1.

EQUITY COMPENSATION PLAN

Information regarding the company's compensation plans under which equity securities of the registrant are authorized for issuance as of December 31, 2008 is set forth under the caption "Equity Compensation Plan Information" in the Proxy Statement filed for the annual meeting of shareholders to be held on May 20, 2009 and is incorporated by reference.

PERFORMANCE GRAPH

Information regarding the company's stock performance graph is set forth under the caption "Stock Performance Graph and Table" in the Proxy Statement filed for the annual meeting of shareholders to be held on May 20, 2009 and is incorporated by reference.

PURCHASE OF EQUITY SECURITIES BY THE ISSUER OR AFFILIATED PURCHASERS

None.

Item 6. Selected Financial Data.FIRST NATIONAL COMMUNITY BANCORP, INC. AND SUBSIDIARIES
SELECTED FINANCIAL DATA

(In thousands, except per share data)

| | For the Years Ended December 31, | | | | |
|--|----------------------------------|-------------|-------------|-------------|------------|
| | 2008 | 2007 | 2006 | 2005 | 2004 |
| Total assets | \$1,313,759 | \$1,297,553 | \$1,186,327 | \$1,009,254 | \$908,498 |
| Interest-bearing balances with financial institutions | 0 | 0 | 0 | 2,178 | 1,980 |
| Securities | 258,795 | 306,530 | 270,433 | 238,223 | 231,831 |
| Net loans | 956,674 | 899,015 | 830,665 | 708,413 | 626,799 |
| Total deposits | 952,892 | 945,517 | 920,973 | 750,666 | 671,713 |
| Long-Term Debt | 202,243 | 135,942 | 147,489 | 126,942 | 138,449 |
| Stockholders' equity | 100,342 | 107,142 | 96,862 | 84,419 | 75,723 |
| Net interest income before provision for credit losses | 40,209 | 39,314 | 35,482 | 30,950 | 25,269 |
| Provision for credit losses | 2,700 | 2,200 | 2,080 | 1,860 | 1,400 |
| Other income | 7,812 | 6,345 | 4,897 | 3,904 | 4,789 |
| Other expenses | 25,634 | 23,797 | 20,773 | 18,943 | 17,399 |
| Income before income taxes | 19,687 | 19,662 | 17,526 | 14,051 | 11,259 |
| Provision for income taxes | 4,604 | 4,966 | 4,017 | 2,826 | 1,996 |
| Net income | 15,083 | 14,696 | 13,509 | 11,225 | 9,263 |
| Cash dividends paid | 7,294 | 6,614 | 5,776 | 4,513 | 3,885 |
| Per share data: | | | | | |
| Net income - basic ⁽¹⁾ | \$0.95 | \$0.94 | \$0.88 | \$0.74 | \$0.62 |
| Net income - diluted ⁽¹⁾ | \$0.93 | \$0.92 | \$0.86 | \$0.72 | \$0.60 |
| Cash dividends ⁽²⁾ | \$0.46 | \$0.42 | \$0.38 | \$0.30 | \$0.26 |
| Book value ⁽¹⁾⁽³⁾ | \$6.33 | \$6.87 | \$6.31 | \$5.58 | \$5.11 |
| Weighted average number of shares outstanding—basic ⁽¹⁾ | 15,862,335 | 15,601,377 | 15,352,406 | 15,125,382 | 14,823,060 |
| Weighted average number of shares outstanding—diluted ⁽¹⁾ | 16,200,098 | 15,931,260 | 15,721,491 | 15,537,485 | 15,362,307 |

⁽¹⁾ Earnings per share and book value per share are calculated based on the weighted average number of shares outstanding during each year, after giving retroactive effect to the 25% stock dividend paid December 27, 2007, the 10% stock dividend paid March 31, 2006 and the 100% stock dividend paid September 30, 2004. Basic earnings per common share is computed by dividing net income available to common shareholders by the weighted average number of common shares outstanding for the period. Diluted earnings per common share is computed by dividing net income available to common shareholders, adjusted for any changes in income that would result from the assumed conversion of all potential dilutive common shares, by the sum of the weighted average number of common shares outstanding and the effect of all dilutive potential common shares outstanding for the period.

⁽²⁾ Cash dividends per share have been restated to reflect to retroactive effect of the 25% stock dividend paid December 27, 2007, the 10% stock dividend paid March 31, 2006 and the 100% stock dividend paid September 30, 2004.

⁽³⁾ Reflects the effect of SFAS No. 115 in the amount of \$(20,201,000) IN 2008, \$(2,190,000) in 2007, \$(70,000) in 2006, \$(524,000) in 2005, and \$1,030,000 in 2004.

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

Certain of the matters discussed in this document and in documents incorporated by reference herein, including matters discussed under the caption "Management's Discussion and Analysis of Financial Condition and Results of Operation," may constitute forward-looking statements for purposes of the Securities Act of 1933, as amended, and the Securities Exchange Act of 1934, as amended, and as such may involve known and unknown risks, uncertainties and other factors which may cause the actual results, performance, or achievements of the Company to be materially different from future results, performance, or achievements expressed or implied by such forward-looking statements. The words "expect," "anticipate," "intend," "plan," "believe," "seek," "estimate," and similar expressions are intended to identify such forward-looking statements.

The Company's actual results may differ materially from the results anticipated in these forward-looking statements due to a variety of factors, including, without limitation (a) the effects of future economic conditions on the Company and its customers; (b) the costs and effects of litigation and of unexpected or adverse outcomes in such litigation; (c) governmental monetary and fiscal policies, as well as legislative and regulatory changes; (d) the effect of changes in accounting policies and practices, as may be adopted by the regulatory agencies, as well as the Financial Accounting Standards Board and other accounting standard setters; (e) the risks of changes in interest rates on the level and composition of deposits, loan demand, and the values of loan collateral, securities and interest rate protection agreements, as well as interest rate risks; (f) the effects of competition from other commercial banks, thrifts, mortgage banking firms, consumer finance companies, credit unions, securities brokerage firms, insurance companies, money market and other mutual funds and other financial institutions operating in the Company's market area and elsewhere, including institutions operating locally, regionally, nationally, and internationally, together with such competitors offering banking products and services by mail, telephone, computer, and the Internet; (g) technological changes; (h) acquisitions and integration of acquired businesses; (i) the failure of assumptions underlying the establishment of reserves for loan losses and estimations of values of collateral and various financial assets and liabilities; (j) acts of war or terrorism and (k) volatilities in the securities markets and in deteriorating economic conditions. All written or oral forward-looking statements attributable to the Company are expressly qualified in their entirety by these cautionary statements. The company undertakes no obligation to publicly revise or update these forward-looking statements to reflect events or circumstances that arise after the date of this report. Readers should carefully review the risk factors described in other documents that are filed periodically with the SEC.

The following financial review of First National Community Bancorp, Inc. is presented on a consolidated basis and is intended to provide a comparison of the financial performance of the company, including its wholly-owned subsidiary, First National Community Bank for the years ended December 31, 2008, 2007 and 2006. The information presented below should be read in conjunction with the company's consolidated financial statements and accompanying notes appearing elsewhere in this report. All share and per share information reflects the retroactive effect of the 25% stock dividend paid December 27, 2007 and the 10% stock dividend paid March 31, 2006.

SUMMARY

Net Income totaled \$15,083,000 in 2008 which was \$387,000, or 3%, higher than the \$14,696,000 earned last year. The 2007 earnings were \$1.2 million, or 9%, higher than the \$13,509,000 reported for 2006. Basic earnings per share increased from the \$0.94 per share reported in 2007 to \$0.95 in 2008. In 2007, basic earnings per share improved 7% from \$0.88 in 2006 to \$0.94. The weighted average number of shares outstanding used to calculate basic earnings per share was 15,862,335 in 2008, 15,601,377 in 2007, and 15,352,406 in 2006.

The earnings improvement recorded in 2008 included an \$895,000, or 2%, increase in net interest income before providing for credit losses due to the growth of the balance sheet. Other income increased \$1.5 million over 2007 which includes a \$430,000 increase from service charges and fees and a \$1,037,000 increase in net gains from the sale of assets. Operating expenses increased \$1.8 million in comparison to 2007 which includes the costs associated with the addition of a new community office and additional growth. The annual provision for credit losses was \$500,000 higher than in the prior period, and federal income tax expense decreased \$362,000 due to a higher level of tax free income on loans and securities.

The earnings improvement recorded in 2007 included a \$3.8 million, or 11%, increase in net interest income before providing for credit losses due to the growth of the balance sheet. Other income increased \$1.5 million over 2006 which includes a \$724,000 increase from service charges and fees and a \$724,000 increase in net gains from the sale of assets. Operating expenses increased \$3.0 million in comparison to 2006 which includes the expansion of the branch network by two offices and costs associated with additional growth. The annual provision for credit losses was \$120,000

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higher than the prior period, and federal income taxes increased \$949,000 due to the overall improvement in earnings.

The company's return on assets for the years ended December 31, 2008, 2007, and 2006 was 1.17%, 1.18%, and 1.26%, respectively while the return on average equity was 14.35%, 14.32%, and 15.30%.

NET INTEREST INCOME

Net interest income, the difference between interest income and fees on earning assets and interest expense on deposits and borrowed funds, is the largest component of the company's operating income and as such is the primary determinant of profitability. Changes in net interest income occur due to fluctuations in the balances and/or mixes of interest-earning assets and interest-bearing liabilities, and changes in their corresponding interest yields and costs. Before providing for future credit losses, net interest income increased \$895,000 in 2008 due to growth in loans and the positive impact of downward pricing on interest bearing assets and liabilities. Changes in non-performing assets, together with interest lost and recovered on those assets, also impacted comparisons of net interest income. In the following schedules, net interest income is analyzed on a tax-equivalent basis, thereby increasing interest income on certain tax-exempt loans and investments by the amount of federal income tax savings realized. In this manner, the true economic impact on earnings from various assets and liabilities can be more accurately compared.

In 2008, tax-equivalent net interest income improved \$1.3 million, or 3%, when compared to the prior year. Growth of the balance sheet, effective asset-liability management strategies and the positive impact due to repricing all contributed to earnings improvement.

Average loans outstanding increased \$39 million, or 4% in 2008. The average yield earned on the loan portfolio decreased one hundred twenty one basis points as a result of the Federal Reserve monetary policy which reduced the prime interest rate by 4.00% to help a struggling economy. This strategy had a significant impact on our variable rate loans, resulting in an \$8.2 million decrease in income earned on total loans. Commercial loans were most severely impacted by the lower interest rate environment due to the high volume of variable rate credits. Interest income decreased \$9.1 million on this group of loans in spite of a \$24 million increase in average loans outstanding. Included in this total is over \$16 million of commercial loan balances which were transferred to nonaccrual status during 2008, and this transfer combined with balances previously placed in this non-earning category, resulted in a \$1.2 million loss of earnings on those assets. Retail loans outstanding grew \$15.7 million on average due primarily to a \$9.8 million increase in average indirect auto loans. Earnings on those loans improved \$946,000 when compared to last year.

Average securities decreased \$3 million in 2008 as liquidity was utilized to fund loan growth. Investment in higher yielding mortgage-back securities and tax-free municipal bonds led to a fourteen basis point improvement in the yield earned which resulted in an additional \$206,000 of interest income over the prior year. Money market balances were limited to \$717,000 on average as funds were utilized in higher earning assets. Earnings on this category of assets decreased \$16,000 in 2008 due to the lower interest rate environment.

Average interest-bearing deposit balances decreased \$18 million in 2008 as many time deposits matured and migrated to competitors paying above market rates due to their inability to access other sources of funds. Interest-bearing demand deposits decreased \$4 million during the year due to activity in large commercial accounts and municipal relationships while average savings deposits increased \$3 million. Average time deposits decreased \$17 million as many customers withdrew funds as interest rates paid on certificates of deposit decreased. The average cost of interest-bearing deposits decreased 1.10% from the 2007 rate which helped to offset the earnings lost on assets. Average borrowed funds outstanding increased \$60 million in 2008 to offset the deposits lost, and the average rate paid on these borrowings was ninety eight basis points lower than the rate paid in 2007.

Overall, growth of the balance sheet combined with a fourteen basis point increase in the spread earned resulted in the \$1.3 million increase in tax-equivalent net interest income. The net interest margin remained stable at 3.59%. Investment leveraging transactions continued to add to the profitability of the company in 2008, contributing almost \$1.4 million to pre-tax earnings, but the average spread earned on the transactions was 1.69% which negatively impacted the net interest margin. Exclusive of these transactions, the company's 2008 net interest margin would have been 3.73% which equals the comparable 3.73% recorded last year.

During 2007, tax-equivalent net interest income improved \$4,172,000, or 11%, compared to the 2006 total. Significant loan growth once again had a major impact on the company's improved earnings. Higher yields earned on loans and securities also contributed to the increased income. Effective asset-liability management strategies allowed the

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company to avoid significant margin compression while positioning for the next cycle of interest rates. The net interest margin decreased fourteen basis points from the 3.73% reported in 2006 to 3.59% in 2007.

Average loans outstanding increased \$119 million, or 15%, over the 2006 level and the average yield earned on total loans improved .17% in 2007, resulting in a \$10.4 million increase in earnings from the portfolio. Commercial lending provided the majority of the growth, adding almost \$82 million of balances on average and \$7.4 million of the earnings improvement. Average consumer loans outstanding increased \$37 million in 2007 primarily due to growth in indirect auto loans and home equity lending, providing an additional \$3.0 million improvement.

Average investment securities were \$39 million higher than the prior year, and the higher yields recorded on new purchases contributed to a .39% increase in the average yield earned, resulting in \$3.3 million of additional interest income. Money market balances decreased \$2.1 million on average, resulting in a \$100,000 reduction in earnings from these low yielding assets.

Average deposit growth was also significant in 2007, due primarily to increased municipal relationships and the full year's impact from the deposits acquired in 2006. Average interest-bearing deposit balances grew \$135 million in 2007. Municipal growth contributed to a \$38 million increase in interest-bearing demand balances and also factored into the .22% increase in the cost of these funds. Time deposits greater than \$100,000 increased \$31 million on average as commercial customers took advantage of rising interest rates and moved monies into these higher earning deposits. Overall, the company's cost of deposits increased .40% in 2007. Borrowed funds and other interest-bearing liabilities increased \$18 million on average, and this growth combined with a .24% increase in the cost of these borrowings added \$1.3 million of interest expense in 2007.

As a result, the positive growth of the balance sheet offset the impact of rising liability costs, but the net interest margin decreased from the 3.73% reported in 2006 to 3.59% in 2007. Another factor affecting the company's net interest margin was investment leveraging transactions which match assets with liabilities at various points in the interest rate cycles. These transactions provided over \$800,000 of net interest income in 2007, but the interest spread of 1.24% had a negative impact on the company's overall net interest margin. Exclusive of these transactions, the 2007 margin would have been 3.73% which is .15% lower than the comparable 3.88% recorded in 2006.

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Yield Analysis

(dollars in thousands-taxable equivalent basis)(1)

| | 2008 | | | 2007 | | | 2006 | | |
|--|-----------------|-------------------------|-----------------------|-----------------|-------------------------|-----------------------|-----------------|-------------------------|-----------------------|
| | Average Balance | Interest Income/Expense | Average Interest Rate | Average Balance | Interest Income/Expense | Average Interest Rate | Average Balance | Interest Income/Expense | Average Interest Rate |
| ASSETS: | | | | | | | | | |
| Earning Assets:(2) | | | | | | | | | |
| Commercial loans-taxable | \$664,333 | \$42,523 | 6.40% | \$650,679 | \$52,276 | 8.03% | \$576,002 | \$45,461 | 7.89% |
| Commercial loans-tax free | 48,325 | 3,494 | 7.23% | 38,229 | 2,874 | 7.52% | 31,085 | 2,256 | 7.26% |
| Mortgage loans | 36,890 | 2,619 | 7.10% | 34,695 | 2,352 | 6.78% | 29,642 | 1,961 | 6.62% |
| Installment loans | 177,228 | 11,253 | 6.35% | 163,729 | 10,574 | 6.46% | 131,767 | 7,994 | 6.07% |
| Total Loans | 926,776 | 59,889 | 6.46% | 887,332 | 68,076 | 7.67% | 768,496 | 57,672 | 7.50% |
| Securities-taxable | 194,162 | 11,020 | 5.68% | 211,139 | 11,446 | 5.42% | 177,315 | 8,338 | 4.70% |
| Securities-tax free | 88,376 | 5,774 | 6.53% | 74,817 | 5,142 | 6.87% | 69,313 | 4,996 | 7.21% |
| Total Securities | 282,538 | 16,794 | 5.94% | 285,956 | 16,588 | 5.80% | 246,628 | 13,334 | 5.41% |
| Interest-bearing deposits with banks | 0 | 0 | 0.00% | 0 | 0 | 0.00% | 1,279 | 55 | 4.30% |
| Federal funds sold | 717 | 12 | 1.67% | 544 | 28 | 5.15% | 1,406 | 73 | 5.19% |
| Total Money Market Assets | 717 | 12 | 1.67% | 544 | 28 | 5.15% | 2,685 | 128 | 4.77% |
| Total Earning Assets | 1,210,031 | 76,695 | 6.34% | 1,173,832 | 84,692 | 7.22% | 1,017,809 | 71,134 | 6.99% |
| Non-earning assets | 90,921 | | | 81,529 | | | 59,947 | | |
| Allowance for credit losses | (6,861) | | | (8,357) | | | (7,873) | | |
| Total Assets | \$1,294,091 | | | \$1,247,004 | | | \$1,069,883 | | |
| LIABILITIES AND STOCKHOLDERS' EQUITY: | | | | | | | | | |
| Interest-Bearing Liabilities: | | | | | | | | | |
| Interest-bearing demand deposits | \$288,226 | \$4,025 | 1.40% | \$292,134 | \$8,064 | 2.76% | \$254,065 | \$6,453 | 2.54% |
| Savings deposits | 74,349 | 692 | 0.93% | 71,444 | 868 | 1.21% | 72,889 | 960 | 1.32% |
| Time deposits over \$100,000 | 182,205 | 6,633 | 3.64% | 193,834 | 9,271 | 4.78% | 162,559 | 7,143 | 4.39% |
| Other time deposits | 309,585 | 12,239 | 3.95% | 314,469 | 15,413 | 4.90% | 246,993 | 10,959 | 4.44% |
| Total Interest-Bearing Deposits | 854,365 | 23,589 | 2.76% | 871,881 | 33,616 | 3.86% | 736,506 | 25,515 | 3.46% |
| Borrowed funds and other | | | | | | | | | |
| Interest-bearing liabilities | 237,631 | 9,653 | 4.06% | 177,537 | 8,956 | 5.04% | 159,714 | 7,671 | 4.80% |
| Total Interest-Bearing Liabilities | 1,091,996 | 33,242 | 3.04% | 1,049,418 | 42,572 | 4.06% | 896,220 | 33,186 | 3.70% |
| Demand deposits | 81,772 | | | 80,515 | | | 73,637 | | |
| Other liabilities | 15,194 | | | 14,429 | | | 11,746 | | |
| Stockholders' equity | 105,129 | | | 102,642 | | | 88,280 | | |
| Total Liabilities and Stockholders' Equity | \$1,294,091 | | | \$1,247,004 | | | \$1,069,883 | | |
| Net Interest Income Spread | | \$43,453 | 3.30% | | \$42,120 | 3.16% | | \$37,948 | 3.29% |
| Net Interest Margin | | | 3.59% | | | 3.59% | | | 3.73% |

(1) In this schedule and other schedules presented on a tax-equivalent basis, income that is exempt from federal income taxes, i.e. interest on state and municipal securities, has been adjusted to a tax-equivalent basis using a 35% federal income tax rate.

(2) Excludes non-performing loans.

RATE VOLUME ANALYSIS

The most significant impact on net income between periods is derived from the interaction of changes in the volume and rates earned or paid on interest-earning assets and interest-bearing liabilities. The volume of earning dollars in loans and investments, compared to the volume of interest-bearing liabilities represented by deposits and borrowings, combined with the spread, produces the changes in net interest income between periods. Components of interest income and interest expense are presented on a tax-equivalent basis using the statutory federal income tax rate of 35%.

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.

Rate/Volume Variance Report(1)
(in thousands-taxable equivalent basis)

| | 2008 vs 2007 | | | 2007 vs 2006 | | |
|---|-----------------|--------------------|----------------|-----------------|--------------------|----------------|
| | Total Change | Increase(Decrease) | | Total Change | Increase(Decrease) | |
| | | Due to Volume | Due to Rate | | Due to Volume | Due to Rate |
| Interest Income: | | | | | | |
| Commercial loans-taxable | \$(9,753) | \$1,807 | \$(11,560) | \$6,815 | \$6,032 | \$783 |
| Commercial loans-tax free | 620 | 771 | (151) | 618 | 518 | 100 |
| Mortgage loans | 267 | 147 | 120 | 391 | 334 | 57 |
| Installment loans | 679 | 847 | (168) | 2,580 | 1,939 | 641 |
| Total Loans | (8,187) | 3,572 | (11,759) | 10,404 | 8,823 | 1,581 |
| Securities-taxable | (426) | (1,245) | 819 | 3,108 | 1,591 | 1,517 |
| Securities-tax free | 632 | 932 | (300) | 146 | 396 | (250) |
| Total Securities | 206 | (313) | 519 | 3,254 | 1,987 | 1,267 |
| Interest-bearing deposits with banks | 0 | 0 | 0 | (55) | (55) | 0 |
| Federal funds sold | (16) | 9 | (25) | (45) | (45) | 0 |
| Total Money Market Assets | (16) | 9 | (25) | (100) | (100) | 0 |
| Total Interest Income | (7,997) | 3,268 | (11,265) | 13,558 | 10,710 | 2,848 |
| Interest Expense: | | | | | | |
| Interest-bearing demand deposits | (4,039) | (130) | (3,909) | 1,611 | 967 | 644 |
| Savings deposits | (176) | 29 | (205) | (92) | (19) | (73) |
| Time deposits over \$100,000 | (2,638) | (600) | (2,038) | 2,128 | 1,374 | 754 |
| Other time deposits | (3,174) | (192) | (2,982) | 4,454 | 2,995 | 1,459 |
| Total Interest-Bearing Deposits | (10,027) | (893) | (9,134) | 8,101 | 5,317 | 2,784 |
| Borrowed funds and other interest-bearing liabilities | 697 | 3,002 | (2,305) | 1,285 | 437 | 848 |
| Total Interest Expense | (9,330) | 2,109 | (11,439) | 9,386 | 5,754 | 3,632 |
| Net Interest Income | \$1,333 | \$1,159 | \$174 | \$4,172 | \$4,956 | \$(784) |

(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.

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CURRENT YEAR

During 2008, tax-equivalent net interest income increased \$1.3 million over the prior year total. Balance sheet growth was profitable as evidenced by the \$1.1 million of improvement related to volume. The repricing of interest sensitive assets and liabilities combined with growth at current market levels contributed to a positive variance due to rate in the amount of \$174,000.

Interest income recognized on loans decreased \$8.2 million in 2008. The \$39 million increase in average loans outstanding led to a \$3.6 million increase in interest income, but repricing resulting from Federal Reserve interest rate cuts contributed to the \$11.8 million decrease due to rate. Included in the negative variance due to rate is the \$1.2 million of lost earnings on nonaccrual loans. Investment securities added \$200,000 more interest income in 2008 in spite of lower balances due to the repositioning of the securities portfolio into higher earning assets. Earnings from money market assets were \$16,000 less than the prior year as funds were utilized in higher earning asset categories.

Deposits runoff resulted in an \$893,000 decrease in interest expense in 2008, while declining interest rates led to an additional \$9.1 million reduction of interest expense. The \$10 million decrease in the cost of deposits combined with a \$700,000 increase in the cost of borrowings due to increased balances resulted in a \$9.3 million reduction in total interest expense which more than offset the \$8.0 million decrease in interest income, resulting in the \$1.3 million improvement in net interest income recorded for the year.

PRIOR YEAR

In 2007, tax-equivalent net interest income was \$4.2 million higher than the 2006 total. Growth of the balance sheet added \$5.0 million to earnings in 2007 as the \$10.7 million of interest income earned on new loans and securities exceeded the \$5.8 million of additional cost from growth in deposits and borrowed funds. Loan growth added \$8.8 million of income while new security purchases provided an increase of \$2.0 million. A decrease in the average balances of money market assets resulted in a \$100,000 reduction in earnings in this category. Total interest expense increased \$5.8 million due to volume primarily from growth in interest-bearing deposits, but also due to higher levels of borrowed funds to meet liquidity needs. Interest rate targets set by the Federal Reserve remained stable throughout much of 2007, but a 100% reduction in key rates during the last four months of the year and growth in higher costing funding sources led to a negative variance due to rates. Higher yields on loans provided a \$1.6 million increase in earnings, while new security purchases at the top of the interest rate cycle contributed to the \$1.3 million of additional income. Interest expense was impacted by the type of growth recorded in 2007, as 84% of the increase was generated in higher costing certificates of deposit and borrowed funds. The \$3.6 million increase in the cost of liabilities due to pricing led to a \$784,000 reduction in net interest income due to rates.

PROVISION FOR CREDIT LOSSES

The provision for credit losses varies from year to year based on management's evaluation of the adequacy of the allowance for credit losses in relation to the risks inherent in the loan portfolio. In its evaluation, management considers credit quality, changes in loan volume, composition of the loan portfolio, past experience, delinquency trends, and the economic conditions. Consideration is also given to examinations performed by regulatory authorities and the company's independent auditors. The provision for credit losses was \$2,700,000 in 2008, \$2,200,000 in 2007, and \$2,080,000 in 2006. The ratio of the loan loss reserve to total loans was .86% at December 31, 2008, .69% at December 31, 2007 and .72% at December 31, 2006.

OTHER INCOME

| <u>Other Income</u> | 2008 | 2007 | 2006 |
|---|----------------|---------|---------|
| | (in thousands) | | |
| Service charges | \$3,118 | \$2,840 | \$2,645 |
| Net gain/loss on the sale of securities | 1,156 | 721 | (201) |
| Net gain/loss on the sale of loans | 414 | 310 | 240 |
| Net gain on the sale of other real estate | 520 | 0 | 297 |
| Net gain on the sale of other assets | 3 | 26 | (3) |
| Other | 2,601 | 2,448 | 1,919 |
| Total Other Income | \$7,812 | \$6,345 | \$4,897 |

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The company's other income category can be separated into three distinct sub-categories; service charges make up the core component of this area of earnings while net gains (losses) from the sale of assets and other fee income comprise the balance.

During 2008, total other income increased \$1.5 million, or 23%, over the 2007 total due to improvement in all three components. Service charges improved \$278,000, or 10%, due to a \$293,000 increase in overdraft privilege fees. Income generated from the sale of assets increased \$1.0 million compared to 2007. Securities were sold to reposition the portfolio for future benefits and residential mortgages were sold to reduce the company's exposure to interest rate risk. Additionally, a \$520,000 gain was recognized from the sale of several properties which were previously classified as Other Real Estate Owned. Other fee income also increased \$153,000, or 6%, due to increased fees recognized on financial services and Bank Owned Life Insurance.

In 2007, other income increased \$1,448,000 compared to the prior year due to improvement in each category. Service charges improved \$195,000, or 7%, due primarily to fees generated on accounts acquired with a branch office in November, 2006. Gains from the sale of assets increased \$724,000 over 2006 as securities were sold during the year to reposition the portfolio for improved performance in future periods and residential mortgages were sold to reduce the company's exposure to interest rate risk. Other income increased \$529,000 over 2006 due to a significant increase in letter of credit fees.

OTHER EXPENSES

| <u>Other Expenses</u> | 2008 | 2007 | 2006 |
|--------------------------|----------------|----------|----------|
| | (in thousands) | | |
| Salary expense | \$10,469 | \$ 9,628 | \$ 8,494 |
| Employee benefit expense | 2,276 | 2,289 | 2,090 |
| Occupancy expense | 2,349 | 2,116 | 1,626 |
| Equipment expense | 1,811 | 1,577 | 1,388 |
| Advertising expense | 988 | 890 | 705 |
| Data processing expense | 1,610 | 1,682 | 1,560 |
| Other operating expenses | 6,131 | 5,615 | 4,910 |
| Total Other Expenses | \$25,634 | \$23,797 | \$20,773 |

In 2008, total other expenses increased \$1.8 million, or 8%, from the prior year total. Employee costs rose \$828,000, which accounted for 45% of the increase, while occupancy and equipment costs increased approximately \$467,000. All other expenses increased \$542,000, or 7%. The company's overhead ratio was 1.98% in 2008 compared to 1.91% in 2007.

Salary and benefit costs accounted for 50% of total operating expenses in 2008. The increase in employee costs includes an \$841,000 increase in salaries which reflects the cost of the new Stroudsburg and Honesdale Route 6 offices that opened in 2007 and the new Marshalls Creek office which opened in May, 2008. Employee benefit costs decreased \$13,000 in 2008 as earnings generated from Bank Owned Life Insurance policies associated with the company's deferred compensation plan offset increases in other categories. As of December 31, 2008, the company had 280 full-time equivalent employees on staff compared to the 276 reported on December 31, 2007.

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Occupancy and equipment costs rose \$467,000 due to the addition of branch offices. The increase in all other operating expenses includes a \$346,000 increase in FDIC insurance due to deposit growth and an increase in insurance premiums.

In 2007, total other expenses increased \$3.0 million, or 15%, from the 2006 level. Employee costs increased \$1.3 million or 43% of the total while occupancy and equipment costs rose \$679,000. All other expenses increased \$1.0 million, or 33% of the total increase. The company's overhead ratio, which measures non-interest expense as a percentage of average assets, was 1.91% in 2007 compared to 1.94% in 2006, reflecting the stringent controls over expenses in spite of the significant growth recorded during the year.

Salaries increased \$1,134,000 in 2007, which includes \$364,000 from new offices that opened during 2006 and 2007. The balance of the increase, \$770,000 or 9% was due to merit increases and staff additions necessitated by the growth of the company. Employee benefit costs increased \$199,000 over the 2006 level and includes a \$68,000 increase in health benefits, a \$70,000 increase in the company's contribution to the Employees' Profit Sharing Plan, and a

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\$61,000 increase in other payroll related benefits. At December 31, 2007, the company had 276 full-time equivalent employees on staff compared to the 257 reported on December 31, 2006.

Occupancy costs increased \$490,000, or 30%, in 2007 due to the new offices opened during the past two years in addition to general maintenance.

Equipment costs increased \$189,000, or 14%, due to growth and increased maintenance expenses. All other operating expenses increased \$1,012,000, or 14%, including a 26% increase in advertising costs, rising data processing costs and the increased cost of goods and services.

PROVISION FOR INCOME TAXES

Federal income tax expense decreased \$362,000 in 2008 due primarily to the benefits derived from tax-exempt income. The company's effective tax rate was 23.4% in 2008 and 25.3% in 2007.

In 2007, federal income tax expense increased \$949,000 compared to 2006. The \$2.1 million increase in income before taxes added \$904,000 to the book provision while benefits received from tax-exempt income and other permanent differences were \$45,000 less than 2006. The company's effective tax rate was 25.3% in 2007 and 22.9% in 2006.

FINANCIAL CONDITION

Total assets increased \$16 million during 2008, but growth was limited due to the deposit runoff experienced during the year end, and the \$20 million decrease related to unrealized losses on investment securities. Loan growth of \$60 million was funded with securities sales, a \$7 million increase in total deposits and a \$17 million increase in borrowed funds.

SECURITIES

The primary objectives in managing the company's securities portfolio are to maintain the necessary flexibility to meet liquidity and asset and liability management needs and to provide a stable source of interest income.

Total securities decreased \$48 million in 2008 as the company sold securities to generate liquidity for loan growth. During the year, \$66 million of securities were sold and \$41 million of securities were called prior to maturity. In many cases, proceeds from the sales or calls were reinvested in higher earning assets which will provide an improved net interest income stream during the current low interest rate cycle. Also contributing to the decrease was a \$28 million reduction in the fair value of available for sale securities. As management has the ability to hold debt securities until maturity, or for the foreseeable future of classified as available-for-sale, no declines are deemed to be other-than-temporary.

During 2008, the company also added \$24 million of investment leveraging transactions which are projected to add over \$300,000 of net income annually, but will negatively impact the company's net interest margin due to the spreads earned. As of December 31, 2008, the company had \$89 million of these leveraged transactions outstanding. Management remains committed to strategies which present minimal risk and will help to meet the objectives of the company's investment and asset/liability management policies. Investment sales were executed to shed the portfolio of low earning bonds, bonds which were projected to be called prior to maturity in the near future, and bonds which had been reduced in size by principal prepayments to below portfolio parameters.

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The following table sets forth the carrying value of securities at the dates indicated:

| | December 31, 2008 (in thousands) | 2007 | 2006 |
|--|--|-----------|-----------|
| U.S. Treasury securities and obligations of U.S. government agencies | \$32,233 | \$52,504 | \$59,347 |
| Obligations of state and political subdivisions | 101,451 | 74,627 | 77,128 |
| Collateralized mortgage obligations | 61,063 | 78,871 | 63,288 |
| Mortgage-backed securities | 30,061 | 62,143 | 42,501 |
| Corporate debt securities | 21,926 | 28,308 | 20,006 |
| Equity securities | 12,061 | 10,077 | 8,163 |
| Total | \$258,795 | \$306,530 | \$270,433 |

The following table sets forth the maturities of securities at December 31, 2008 (in thousands) 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. Tax-equivalent adjustments, using a 35% rate, have been made in calculating yields on obligations of state and political subdivisions.

| | Within One Year | 2 - 5 Years | 6 - 10 Years | Over 10 Years | Mortgage- Backed Securities | No Fixed Maturity | Total |
|---|--------------------|----------------|-----------------|------------------|-----------------------------------|----------------------|---------|
| U.S. Treasury securities | \$ 1,011 | \$ 0 | \$ 0 | \$ 0 | \$ 0 | \$ 0 | \$1,011 |
| Yield | 2.74% | | | | | | 2.74% |
| Obligations of U.S. government agencies | | 999 | 999 | 29,417 | | | 31,415 |
| Yield | | 5.45% | 5.82% | 6.11% | | | 6.08% |
| Obligations of state and political subdivisions (1) | | 1,328 | 6,181 | 100,309 | | | 107,818 |
| Yield | | 5.18% | 6.05% | 6.65% | | | 6.60% |
| Corporate debt securities | | 1,566 | | 38,109 | | | 39,675 |
| Yield | | 4.84% | | 4.59% | | | 4.60% |
| CMOs | | | | | 69,031 | | 69,031 |
| Yield | | | | | 5.73% | | 5.73% |
| Mortgage-backed securities | | | | | 28,827 | | 28,827 |
| Yield | | | | | 5.68% | | 5.68% |

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| | | | | | | | |
|-----------------------|----------|----------|----------|------------|-----------|-----------|-----------|
| Equity securities (2) | | | | | | 12,097 | 12,097 |
| Yield | | | | | | 3.68% | 3.68% |
| Total maturities | \$ 1,011 | \$ 3,893 | \$ 7,180 | \$ 167,835 | \$ 97,858 | \$ 12,097 | \$289,874 |
| Weighted yield | 2.74% | 5.11% | 6.02% | 6.09% | 5.71% | 3.68% | 5.84% |

(1) Yields on state and municipal securities have been adjusted to a tax-equivalent basis using a 35% federal income tax rate.

(2) Yield presented represents 2008 actual return.

LOANS

Net loans increased \$58 million, or 6%, in 2008. Commercial loans increased \$18 million during the year as significant payoffs limited growth in this area of lending. Loans secured by real estate increased \$10 million in 2008, while installment loans increased \$28 million during the year due primarily to growth in the company's indirect auto loan portfolio which reflects a changing environment in this category of lending. All other loans increased \$2 million in 2008.

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

Loans Outstanding

(in thousands)

| | December 31 | | | | |
|-----------------------------|-------------|-----------|-----------|-----------|-----------|
| | 2008 | 2007 | 2006 | 2005 | 2004 |
| Commercial and Financial | \$221,026 | \$202,665 | \$157,837 | \$132,838 | \$130,937 |
| Real Estate | 590,341 | 579,851 | 567,030 | 478,582 | 402,792 |
| Installment | 119,501 | 91,052 | 80,770 | 73,217 | 69,027 |
| Other | 34,440 | 32,136 | 31,591 | 30,139 | 30,136 |
| Total Loans Gross | 965,308 | 905,704 | 837,228 | 714,776 | 632,892 |
| Unearned Discount | (380) | (470) | (569) | 0 | 0 |
| Allowance for Credit Losses | (8,254) | (6,219) | (5,994) | (6,363) | (6,093) |
| Net Loans | \$956,674 | \$899,015 | \$830,665 | \$708,413 | \$626,799 |

The following schedule shows the repricing distribution of loans outstanding as of December 31, 2008. Also provided are these amounts classified according to sensitivity to changes in interest rates.

Loans Outstanding – Repricing Distribution

(in thousands)

| | December 31 | | | |
|---|-------------|------------|-----------|-----------|
| | Within | One to | Over Five | Total |
| | One Year | Five Years | Years | |
| Commercial and Financial | \$145,862 | \$61,385 | \$13,779 | \$221,026 |
| Real Estate | 360,888 | 155,862 | 73,591 | 590,341 |
| Installment | 2,564 | 94,593 | 22,344 | 119,501 |
| Other | 5,253 | 4,537 | 24,650 | 34,440 |
| Total | \$514,567 | \$316,377 | \$134,364 | \$965,308 |
| Loans with predetermined interest rates | \$ 22,337 | \$163,432 | \$117,541 | \$303,310 |
| Loans with floating rates | 492,230 | 152,945 | 16,823 | 661,998 |
| Total | \$514,567 | \$316,377 | \$134,364 | \$965,308 |

ASSET QUALITY

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The company manages credit risk through the application of policies and procedures designed to foster sound underwriting and credit monitoring practices, 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.

The company's risk management committee meets quarterly or more often as required and makes recommendations to the board of directors regarding provisions for credit losses. The committee reviews individual problem credits and ensures that ample reserves are established considering both general allowances and specific allocations.

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The following schedule reflects various non-performing categories as of December 31 for each of the last five years:

| | December 31 | | | | |
|---|----------------|---------|---------|-------|-------|
| | 2008 | 2007 | 2006 | 2005 | 2004 |
| | (in thousands) | | | | |
| Nonaccrual and impaired loans: | | | | | |
| Impaired loans | \$22,087 | \$ 0 | \$ 0 | \$ 0 | \$ 0 |
| Other nonaccrual loans | 176 | 3,106 | 2,299 | 70 | 303 |
| Loans past due 90 days or more and still accruing | | | | | |
| | 1,151 | 904 | 412 | 721 | 539 |
| Other Real Estate Owned | 2,308 | 2,588 | 2,188 | 0 | 0 |
| Total Non-Performing Assets | \$25,722 | \$6,598 | \$4,899 | \$791 | \$842 |

In 2008, total non-performing assets increased \$19.1 million as the effects of the economic crisis impacted borrowers' ability to make scheduled payments and reduced the value of real estate collateral securing many loans. Nonaccrual loans (including impaired loans) increased \$19.2 million during the year due primarily to the addition of four credits which represent construction projects in which the bank is a participant. 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. Workout efforts continue on each of these credits, but declining real estate values will hamper the bank's ability to receive full recovery on these credits. As of December 31, 2008, the bank has evaluated the recovery of its recorded investment in these impaired loans and has established a FAS 114 Valuation Allowance totaling \$900,000 for potential losses on these loans. This valuation allowance results from current market declines in the underlying value of the collateral securing these loans.

Other Real Estate Owned decreased \$280,000 in 2008. The year end balance includes one property on which the bank had assumed title during 2008. During 2008, the bargain lease obligation associated with the property was fulfilled. The future use or disposition of the property is being assessed. Current expenses associated with the property are being recovered through a short-term occupancy arrangement at the present time. During 2008, three properties which were carried as Other Real Estate Owned on December 31, 2007 were sold. A gain of \$520,000 was recognized on the sales in 2008.

During 2007, total non-performing assets increased \$1.7 million including an \$807,000 increase in nonaccrual loans, a \$492,000 increase in loans past due ninety days or more, and a \$400,000 increase in other real estate owned. The increase in nonaccrual loans was due primarily to the addition of one large credit caused by the borrowers' inability to make scheduled payments. The company has not experienced any principal loss on this credit and based on the collateral valuation, no future loss is expected. During 2007, losses totaling \$387,000 were recognized on loans carried as non-accrual on December 31, 2006, although the majority of the loss is projected to be recovered through the sale of property. Any future losses from other loans carried in nonaccrual status at December 31, 2007 is expected to be minimal after accounting for the sale of collateral.

Other Real Estate Owned increased \$400,000 in 2007 due to the addition of one property. The company recovered the entire balance during 2008 from the sale of property. The remaining \$2.1 million outstanding balance carried in Other Real Estate Owned consisted of one property which was transferred in 2006 in lieu of foreclosure. In 2008, the bank assumed ownership of this property through the exercise of a lease obligation.

On December 31, 2008, the company's ratio of nonaccrual and impaired loans to total loans was 2.31% compared to the .35% reported in 2007. The company continues to acknowledge the weakness in local real estate markets, emphasizing strict underwriting standards to minimize the negative impact of the current environment.

ALLOWANCE FOR CREDIT LOSSES

The following table presents an allocation of the allowance for credit losses as of the end of each of the last five years (in thousands):

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| Loan Loss Reserve Allocation | | | | | | | | | | |
|---|---|------|---|------|---|------|---|------|---|------|
| | 12/31/08 | | 12/31/07 | | 12/31/06 | | 12/31/05 | | 12/31/04 | |
| | Percentage of Loans in Each Category to Total Loans | | Percentage of Loans in Each Category to Total Loans | | Percentage of Loans in Each Category to Total Loans | | Percentage of Loans in Each Category to Total Loans | | Percentage of Loans in Each Category to Total Loans | |
| | Amount | | Amount | | Amount | | Amount | | Amount | |
| Commercial and Financial | \$7,462 | 91% | \$5,730 | 77% | \$5,511 | 77% | \$5,804 | 79% | \$3,041 | 79% |
| Real Estate | 259 | 3% | 91 | 4% | 114 | 4% | 55 | 4% | 44 | 3% |
| Installment | 481 | 6% | 344 | 19% | 317 | 19% | 391 | 17% | 272 | 18% |
| Unallocated | 52 | - | 54 | - | 52 | - | 113 | - | 2,736 | - |
| Allowance for credit losses | \$8,254 | 100% | \$6,219 | 100% | \$5,994 | 100% | \$6,363 | 100% | \$6,093 | 100% |
| Allowance for off-balance sheet commitments | 896 | | 1,350 | | 1,544 | | 1,165 | | 1,007 | |
| | \$9,150 | | \$7,569 | | \$7,538 | | \$7,528 | | \$7,100 | |

The following schedule presents an analysis of the allowance for credit losses for each of the last five years (in thousands):

| | Years Ended December 31 | | | | |
|----------------------------------|-------------------------|---------|---------|---------|---------|
| | 2008 | 2007 | 2006 | 2005 | 2004 |
| Balance, January 1 | \$7,569 | \$7,538 | \$7,528 | \$7,100 | \$6,578 |
| Charge-Offs: | | | | | |
| Commercial and Financial | 466 | 329 | 83 | 64 | 293 |
| Real Estate | 313 | 2,615 | 1,802 | 1,523 | 412 |
| Installment | 499 | 452 | 535 | 435 | 423 |
| Other Loans | 49 | 0 | 0 | 0 | 0 |
| Total Charge-Offs | 1,327 | 3,396 | 2,420 | 2,022 | 1,128 |
| Recoveries on Charged-Off Loans: | | | | | |
| Commercial and Financial | 6 | 6 | 8 | 257 | 51 |

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| | | | | | |
|-----------------------------|---------|---------|---------|---------|---------|
| Real Estate | 17 | 1,023 | 110 | 108 | 66 |
| Installment | 177 | 198 | 232 | 225 | 133 |
| Other Loans | 8 | 0 | 0 | 0 | 0 |
| Total Recoveries | 208 | 1,227 | 350 | 590 | 250 |
| Net Charge-Offs | 1,119 | 2,169 | 2,070 | 1,432 | 878 |
| Provision for Credit Losses | 2,700 | 2,200 | 2,080 | 1,860 | 1,400 |
| Balance, December 31 | \$9,150 | \$7,569 | \$7,538 | \$7,528 | \$7,100 |

Allocated as:

Allowance for off-balance sheet commitments

| | | | | | |
|-----------------------------|---------|---------|---------|---------|---------|
| | \$ 896 | \$1,350 | \$1,544 | \$1,165 | \$1,007 |
| Allowance for credit losses | 8,254 | 6,219 | 5,994 | 6,363 | 6,093 |
| Balance, December 31 | \$9,150 | \$7,569 | \$7,538 | \$7,528 | \$7,100 |

Net Charge-Offs during the period as a percentage of average loans outstanding during the period

| | | | | | |
|--|------|------|------|------|------|
| | .12% | .24% | .27% | .21% | .15% |
|--|------|------|------|------|------|

Allowance for credit losses as a percentage of loans outstanding at end of period

| | | | | | |
|--|------|------|------|------|------|
| | .86% | .69% | .72% | .89% | .97% |
|--|------|------|------|------|------|

Net charge-offs total \$1.1 million in 2008. As a result of these charge-offs, an increase in nonaccrual loans and the growth of the loan portfolio, the company determined that additional provisions were necessary to maintain the strength of the reserve and provided \$2.7 million in 2008. Charge-off and recovery activity is consistent with prior periods and includes writedowns on credits incurred in the normal course of business. The installment loan charge-offs include \$345,000 of indirect auto loans, of which \$151,000 was recovered in 2008 through sales of the vehicles. During 2008, there were \$0 losses recognized on loans carried as nonaccrual on December 31, 2007. The company's ratio of net charge-offs to average loans is comparable to its national peer groups while the ratio of the allowance for credit losses to total loans is adequate considering current delinquency levels.

DEPOSITS

The primary source of funds to support the company's growth is its deposit base, and emphasis has been placed on accumulating new deposits while making every effort to retain current relationships. Competition from other banks and non-bank institutions has made deposit growth extremely challenging, in recent years, and the economic crisis of 2008 led several competitors with limited access to other liquidity sources to pay extremely high rates to retain deposits, thereby limiting our growth opportunities. Total deposits increased \$7 million in 2008 comprised of a \$13 million increase in interest-bearing demand deposit balances and a \$9 million increase in savings and accounts which was partially offset by a \$15 million decrease in time deposits.

The average daily amount of deposits and rates paid on such deposits is summarized for the periods indicated in the following table (in thousands):

| | Year Ended December 31, | | | | | |
|-------------------------------------|-------------------------|-------|-----------|-------|-----------|-------|
| | 2008 | | 2007 | | 2006 | |
| | Amount | Rate | Amount | Rate | Amount | Rate |
| Noninterest bearing demand deposits | \$81,772 | | \$80,515 | | \$73,637 | |
| Interest-bearing demand deposits | 288,226 | 1.40% | 292,134 | 2.76% | 254,065 | 2.54% |
| Savings deposits | 74,349 | 0.93% | 71,444 | 1.21% | 72,889 | 1.32% |
| Time deposits | 491,790 | 3.84% | 508,303 | 4.86% | 409,552 | 4.42% |
| Total | \$936,137 | | \$952,396 | | \$810,143 | |

Maturities of time deposits of \$100,000 or more outstanding at December 31, 2008, are summarized as follows (in thousands):

| | |
|--------------------------|-----------|
| 3 months or less | \$100,824 |
| Over 3 through 6 months | 23,589 |
| Over 6 through 12 months | 42,300 |
| Over 12 months | 24,339 |
| Total | \$191,052 |

On February 27, 2009, the FDIC announced that it was increasing federal deposit insurance premiums, beginning the second quarter of 2009, for well managed, well capitalized banks to a range between 12 and 16 cents per \$100 of insured deposits on an annual basis. Currently, we have approximately \$938,000,000 in FDIC-insured deposits and anticipate our insurance premiums for 2009, which will be paid from our earnings, to increase by 100% or approximately \$700,000.

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The FDIC also voted to impose a special assessment of 20 basis points on all FDIC-insured banks to be collected on September 30, 2009. The FDIC chairman has stated that this special assessment would be cut in half if Congress approves certain pending litigation. At the full assessment of 20 basis points, this special assessment would adversely affect earnings by \$1,876,000 based on our current federally-insured deposit amounts. Furthermore, the FDIC has the authority, after June 30, 2009, to impose an additional 10 basis point emergency special assessment on all FDIC-insured banks if it estimates the reserve ratio of the Deposit Insurance Fund will fall to a level that it believes would adversely affect public confidence or to a level which would be close to zero or negative at the end of a calendar quarter. At this time we cannot estimate the probability of this event; however, any additional FDIC assessment and/or premium would be adverse to our 2009 earnings.

CAPITAL

A strong capital base is essential to the continued growth and profitability of the company and is therefore a management priority. The company's principal capital planning goals are to provide an adequate return to shareholders while retaining a sufficient base from which to provide for future growth, while at the same time complying with all regulatory standards. As more fully described in Note 15 to the financial statements, regulatory authorities have prescribed specified minimum capital ratios as guidelines for determining capital adequacy to help insure the safety and soundness of financial institutions.

The following schedules present information regarding the company's risk-based capital at December 31, 2008, 2007 and 2006 and selected other capital ratios.

CAPITAL ANALYSIS

(in thousands)

| | December 31 | | |
|--|-------------|-------------|-----------|
| | 2008 | 2007 | 2006 |
| Tier I Capital: | | | |
| Total Tier I Capital | \$117,285 | \$109,732 | \$97,048 |
| Tier II Capital: | | | |
| Allowable portion of allowance for credit losses | \$ 9,150 | \$ 7,569 | \$ 7,538 |
| Total Risk-Based Capital | \$126,435 | \$117,301 | \$104,586 |
| Total Risk-Weighted Assets | \$1,130,824 | \$1,045,008 | \$980,201 |

CAPITAL RATIOS

| | | December 31 | | |
|---------------------------|------------|-------------|--------|--------|
| | Regulatory | | | |
| | Minimum | 2008 | 2007 | 2006 |
| Total Risk-Based Capital | 8.00% | 11.18% | 11.22% | 10.67% |
| Tier I Risk-Based Capital | 4.00% | 10.37% | 10.50% | 9.90% |
| Tier I Leverage Ratio | 4.00% | 8.99% | 8.87% | 9.16% |
| Return on Assets | N/A | 1.17% | 1.18% | 1.26% |
| Return on Equity* | N/A | 14.35% | 14.32% | 15.30% |
| Equity to Assets Ratio* | N/A | 9.18% | 8.43% | 8.18% |
| Dividend Payout Ratio | N/A | 48.36% | 45.01% | 42.75% |

* Includes the effect of SFAS 115 in the amount of \$(20,201,000) in 2008, \$(2,190,000) in 2007 and \$(70,000) in 2006.

During 1999, the company implemented a Dividend Reinvestment Plan which has resulted in an influx to capital of \$20.4 million to date. The company also adopted stock option plans for directors and senior officers. New capital generated from the exercise of stock options is \$4.2 million at December 31, 2008. In November 2007, the company declared a 5-for-4 stock split effected in the form of a 25% stock dividend, payable December 27, 2007 resulting in the issuance of 3,149,133 new shares. In February 2006, the company declared a 10% stock dividend payable March 31, 2006, resulting in the issuance of 1,391,085 new shares. The company has also paid 100% stock dividends on September 30, 2004 and January 31, 2003 which resulted in 5,423,425 and 2,603,838 new shares, respectively. At the 2005 Annual Meeting, shareholders approved management's proposal to increase the number of authorized shares of common stock from 20,000,000 to 50,000,000 shares.

In 2008, regulatory capital increased \$11.2 million comprised of a \$7.7 million increase in retained earnings after paying cash dividends of \$7.3 million and recognizing a \$56,000 charge for a cumulative-effect adjustment for the initial application of a new accounting principle, a \$3.3 million increase due to the company's dividend reinvestment plan and a \$2 million increase due to the issuance of shares from the company's stock option plans. As of December 31, 2008, there were 32,195,389 shares of stock available for future sale or stock dividends. The number of shareholders of record at December 31, 2008 was 1,644. Quarterly market highs and lows, dividends paid and known market makers are highlighted in the Investor Information section of this Annual Report. Refer to Note 15 to the financial statements for further discussion of capital requirements and dividend limitations.

ECONOMIC CONDITIONS AND FORWARD OUTLOOK

Economic conditions affect financial institutions, as they do other businesses, in a number of ways. Rising inflation affects all businesses through increased operating costs but affects banks primarily through the manner in which they manage their interest sensitive assets and liabilities in a rising rate environment. Economic recession can also have a material effect on financial institutions as the assets and liabilities affected by a decrease in interest rates must be managed in a way that will maximize the largest component of a bank's income, that being net interest income. Recessionary periods may also tend to decrease borrowing needs and increase the uncertainty inherent in the borrowers' ability to pay previously advanced loans. Additionally, reinvestment of investment portfolio maturities can pose a

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problem as attractive rates are not as available. Management closely monitors the interest rate risk of the balance sheet and the credit risk inherent in the loan portfolio in order to minimize the effects of fluctuations caused by changes in general economic conditions.

While we are cautiously optimistic about the prospect of continued growth and earnings improvement, any forward-looking statements by their nature are subject to assumptions, risks and uncertainties. Actual results could vary from those implied for a variety of reasons including:

- A change in interest rates which is more immediate or more significant than anticipated.
- The demand for new loans and the ability of borrowers to repay outstanding debt.
- The timing of expansion plans could be altered by forces beyond our control such as weather or regulatory approvals.
- Our ability to continue to attract new deposits from our marketplace to meet the daily liquidity needs of the company.

Other than as disclosed herein, as of March 11, 2009, the company was not aware of any pronouncements or legislation that would have a material impact on the results of operations.

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

ASSET AND LIABILITY MANAGEMENT

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

- (1) manage exposure to changes in the interest rate environment to achieve a neutral interest sensitivity position within reasonable ranges,
- (2) ensure adequate liquidity and funding,
- (3) maintain a strong capital base, and
- (4) maximize net interest income opportunities.

The company manages these objectives through its Senior Management and Asset and Liability Management Committees (ALCO). Members of the committees meet regularly to develop balance sheet strategies affecting the future level of net interest income, liquidity and capital. Items that are considered in asset and liability management include balance sheet forecasts, the economic environment, the anticipated direction of interest rates and the company's earnings sensitivity to changes in these rates.

INTEREST RATE SENSITIVITY

The company analyzes its interest sensitivity position to manage the risk associated with interest rate movements through the use of gap analysis and simulation modeling. Interest rate risk arises from mismatches in the repricing of assets and liabilities within a given time period. Gap analysis is an approach used to quantify these differences. A positive gap results when the amount of interest-sensitive assets exceeds that of interest-sensitive liabilities within a given time period. A negative gap results when the amount of interest-sensitive liabilities exceeds that of interest-sensitive assets.

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

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

INTEREST RATE GAP

The following schedule illustrates the company's interest rate gap position as of December 31, 2008 which measures sensitivity to interest rate fluctuations for certain interest sensitivity periods.

Interest Rate Sensitivity Analysis
as of December 31, 2008
(in thousands)

| | Rate Sensitive | | | | | Not Rate Sensitive | Total |
|--|-----------------|-------------------|--------------------|-----------------|-------------------|--------------------------|-------------|
| | 1 to 90 Days | 91 to 180 Days | 181 to 365 Days | 1 to 5 Years | Beyond 5 Years | | |
| Commercial loans | \$360,432 | \$17,038 | \$38,153 | \$222,190 | \$87,655 | \$ 0 | \$725,468 |
| Mortgage loans | 2,194 | 3,289 | 5,309 | 21,812 | 3,506 | 0 | 36,110 |
| Installment loans | 37,295 | 10,419 | 23,667 | 104,644 | 27,325 | 0 | 203,350 |
| Total Loans | 399,921 | 30,746 | 67,129 | 348,646 | 118,486 | 0 | 964,928 |
| Securities-taxable | 44,707 | 7,820 | 13,377 | 67,279 | 8,026 | 12,096 | 153,305 |
| Securities-tax free | 830 | 1,360 | 1,190 | 15,630 | 86,480 | 0 | 105,490 |
| Total Securities | 45,537 | 9,180 | 14,567 | 82,909 | 94,506 | 12,096 | 258,795 |
| Interest-bearing deposits with banks | 0 | 0 | 0 | 0 | 0 | 0 | 0 |
| Federal funds sold | 0 | 0 | 0 | 0 | 0 | 0 | 0 |
| Total Money Market Assets | 0 | 0 | 0 | 0 | 0 | 0 | 0 |
| Total Earning Assets | 445,458 | 39,926 | 81,696 | 431,555 | 212,992 | 12,096 | 1,223,723 |
| Non-earning assets | 0 | 0 | 0 | 0 | 0 | 98,290 | 98,290 |
| Allowance for credit losses | 0 | 0 | 0 | 0 | 0 | (8,254) | (8,254) |
| Total Assets | \$445,458 | \$39,926 | \$81,696 | \$431,555 | \$212,992 | \$102,132 | \$1,313,759 |
| Interest-bearing demand deposits | \$302,058 | \$ 0 | \$ 0 | \$ 0 | \$ 0 | \$ 0 | \$302,058 |
| Savings deposits | 78,180 | 0 | 1,346 | 0 | 0 | 0 | 79,526 |
| Time deposits \$100,000 and over | 111,946 | 22,119 | 38,909 | 17,604 | 474 | 0 | 191,052 |
| Other time deposits | 126,272 | 45,810 | 55,410 | 71,050 | 1,954 | 0 | 300,496 |
| Total Interest-Bearing Deposits | 618,456 | 67,929 | 95,665 | 88,654 | 2,428 | 0 | 873,132 |
| Borrowed funds and other interest-bearing liabilities | 70,088 | 3,164 | 26,419 | 126,056 | 19,470 | 0 | 245,197 |
| Total Interest-Bearing Liabilities | 688,544 | 71,093 | 122,084 | 214,710 | 21,898 | 0 | 1,118,329 |
| Demand deposits | 0 | 0 | 0 | 0 | 0 | 79,760 | 79,760 |
| Other liabilities | 0 | 0 | 0 | 0 | 0 | 15,328 | 15,328 |
| Stockholders' equity | 0 | 0 | 0 | 0 | 0 | 100,342 | 100,342 |

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Total Liabilities and Stockholders'
Equity

| | | | | | | | |
|-------------------------------|-------------|-------------|-------------|------------|-----------|------------|-------------|
| | \$688,544 | \$71,093 | \$122,084 | \$214,710 | \$21,898 | \$195,430 | \$1,313,759 |
| Interest Rate Sensitivity gap | \$(243,086) | \$(31,167) | \$(40,388) | \$216,845 | \$191,094 | \$(93,298) | |
| Cumulative gap | \$(243,086) | \$(274,253) | \$(314,641) | \$(97,796) | \$93,298 | | |

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EARNINGS AT RISK AND ECONOMIC VALUE AT RISK SIMULATIONS

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

EARNINGS AT RISK

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

ECONOMIC VALUE AT RISK

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

The following table illustrates the simulated impact of a 200 basis point upward or downward movement in interest rates on net interest income, and the change in economic value. This analysis assumed that interest-earning asset and interest-bearing liability levels at December 31, 2008 remained constant. The impact of the rate movements were developed by simulating the effect of rates changing over a twelve-month period from the December 31, 2008 levels.

| | RATES + 200 | RATES – 200 |
|--|-------------|-------------|
| Earnings at risk: | | |
| Percent change in net interest income | (6.33)% | (.45)% |
| Economic value at risk: | | |
| Percent change in economic value of equity | (40.25)% | 4.82% |

Economic value has the most meaning when viewed within the context of risk-based capital. Therefore, the economic value may change beyond the company’s policy guideline for a short period of time as long as the risk-based capital ratio is greater than 10%.

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 December 31, 2008 cash and cash equivalents totaled \$18.2 million, compared to the December 31, 2007 level of \$24.7 million. Financing activities provided \$20.9 million and operating activities provided \$11.2 million of cash and cash equivalents during the year while investing activities utilized \$38.7 million. The cash flows provided by financing activities is due primarily to an increase in interest-bearing demand deposits and borrowed funds to meet short-term liquidity needs, while the funds provided by operating activities pertains to interest payments received on loans and investments. The cash used in investing activities consists of loan proceeds and security purchases.

Core deposits, which represent the company's primary source of liquidity, averaged \$754 million in 2008, a decrease of \$5 million from the \$759 million average in 2007.

The company has other potential sources of liquidity, including repurchase agreements. Additionally, the company can borrow on credit lines established at several correspondent banks, the Federal Home Loan Bank of

Pittsburgh and the Federal Reserve Discount Window.

Item 8. Financial Statements and Supplementary Data.

The information required by this item is set forth on pages 26-45 of the Company's 2008 Annual Report to Shareholders, which pages are included as Exhibit 13 hereto, and incorporated herein by reference.

Item 9. Changes in and Disagreements with Accountants on Accounting and Financial Disclosure.

Not Applicable

Item 9A. Controls and Procedures.

Conclusion Regarding the Effectiveness of Disclosure Controls and Procedures - 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 along with the company's Chief Financial Officer, of the effectiveness of the design and operation of the Company's disclosure controls and procedures, as such term is defined under Rule 13a - 15(e) promulgated under the Securities Exchange Act of 1934, as amended (the Exchange Act). Based upon that evaluation, the company's Chief Executive Officer along with the company's Chief Financial Officer concluded that as of December 31, 2008 the company's disclosure controls and procedures are effective in timely alerting them to material information relating to the company (including its consolidated subsidiaries) required to be included in the company's periodic SEC filings.

Changes in Internal Controls over Financial Reporting - There were no changes in our internal control over financial reporting that occurred during the period covered by this annual report that have materially affected, or are, reasonably likely to materially affect, the company's internal controls over financial reporting.

Management's Report on Internal Control Over Financial Reporting

Management is responsible for establishing and maintaining adequate internal control over financial reporting for First National Community Bancorp, Inc. (the "Company"). Internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles.

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.

Any control system, no matter how well conceived and operated, can provide only reasonable, not absolute, assurance that the objectives of the control system are met. The design of a control system inherently has limitations, and the benefits of controls must be weighed against their costs. Additionally, controls can be circumvented by the individual acts of some persons, by collusion of two or more people, or by management override of the controls. Therefore, no assessment of a cost-effective system of internal controls can provide absolute assurance that all control issues and instances of fraud, if any, will be detected.

As of December 31, 2008, management of the company conducted an assessment of the effectiveness of the company's internal control over financial reporting based on criteria established in *Internal Control – Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). Based on this assessment, management has concluded that the company's internal control over financial reporting was effective as of December 31, 2008.

Management's assessment of the effectiveness of the company's internal control over financial reporting as of December 31, 2008, has been audited by Demetrius and Company, L.L.C., the independent registered public accounting firm that audited the company's financial statements for the period covered. A copy of the Demetrius and Company, L.L.C. report is included in this annual report.

/s/ J. David Lombardi
J. David Lombardi
President and Chief Executive Officer

/s/ William Lance
William S. Lance
Principal Financial Officer

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REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors and

Stockholders of First National Community Bancorp, Inc.

We have audited First National Community Bancorp, Inc.'s ("Company") internal control over financial reporting as of December 31, 2008, based on criteria established in *Internal Control—Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). First National Community Bancorp, Inc.'s management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting included in the accompanying Management's Report on Internal Control over Financial Reporting. Our responsibility is to express an opinion on the Company's internal control over financial reporting based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit of internal control over financial reporting included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, and testing and evaluating the design and operating effectiveness of internal control based on the assessed risk. Our audit also included performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the Company; (2) 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 being made only in accordance with authorizations of management and directors of the Company; and (3) 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.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, First National Community Bancorp, Inc. maintained, in all material respects, effective internal control over financial reporting as of December 31, 2008, based on criteria established in *Internal Control—Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO).

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheets as of December 31, 2008 and 2007 and the related consolidated statements of income, stockholders' equity and comprehensive income, and cash flows for each of the three years in the period ended December 31, 2008 of First National Community Bancorp, Inc., and subsidiaries, and our report dated March 11, 2009 expressed an unqualified opinion on those consolidated financial statements.

DEMETRIUS & COMPANY, L.L.C.

Wayne, New Jersey

March 11, 2009

Item 9B. Other Information.

None

FIRST NATIONAL COMMUNITY BANCORP, INC.

PART III

Item 10. Directors, Executive Officers and Corporate Governance.

Information regarding directors, nominees, principal officers, audit committees and audit committee financial experts required by this item is set forth under the captions "Information as to Nominees and Directors", "Principal Officers of the Company", "Principal Officers of the Bank", "Information about the Company's Audit Committee and its Charter", "Report of the Audit Committee", and "Section 16(a) Beneficial Ownership Reporting Compliance" in the Proxy Statement filed for the annual meeting of shareholders to be held on May 20, 2009 and is incorporated herein by reference.

The company has adopted a Code of Ethics that applies to directors, officers and employees of the company and the bank. A copy of the Code of Ethics was included as an exhibit to the company's Form 10-K for the year ended December 31, 2005 and filed with the Securities and Exchange Commission. A request for the Company's Code of Ethics can be made either in writing to William Lance, First National Community Bancorp, Inc., 102 East Drinker Street, Dunmore, Pennsylvania, 18512 or by email at fncb@fncb.com.

Item 11. Executive Compensation.

The information required by this item is set forth under the captions "Executive Compensation", "Compensation Discussion and Analysis", "Option Grants in 2008", "Equity Compensation Plan Information", "Deferred Compensation Plan Information", "Compensation of Directors", "Potential Payments Upon Termination or Change-in-Control", "Compensation Committee Report", and "Board of Directors Interlocks and Insider Participation" in the Proxy Statement filed for the annual meeting of shareholders to be held on May 20, 2009 and is incorporated herein by reference.

Item 12. Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters.

The information required by this item regarding security ownership of certain beneficial owners and management is set forth under the caption "Principal Beneficial Owners of the Company's Common Stock" in the Proxy Statement filed for the annual meeting of shareholders to be held on May 20, 2009 and is incorporated herein by reference.

Information regarding the Company's compensation plans under which equity securities of the registrant are authorized for issuance as of December 31, 2008 is set forth under the caption "Equity Compensation Plan Information" in the Proxy Statement filed for the annual meeting of shareholders to be held on May 20, 2009 and is incorporated herein by reference.

Item 13. Certain Relationships and Related Transactions, and Director Independence.

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The information required by this item is set forth under the captions "Certain Relationships and Related Transactions" and "Governance of the Company" in the Proxy Statement filed for the annual meeting of shareholders to be held on May 20, 2009 and is incorporated herein by reference.

Item 14. Principal Accountant Fees and Services.

The information required by this item is set forth under the caption "Independent Auditors" in the Proxy Statement filed for the annual meeting of shareholders to be held on May 20, 2009 and is incorporated herein by reference.

PART IV

Item 15. Exhibits and Financial Statement Schedules.

1. Financial Statements

The following financial statements are included by reference in Part II, Item 8 hereof:

Report of Independent Registered Public Accounting Firm

Consolidated Balance Sheet

Consolidated Statement of Income

Consolidated Statement of Stockholders' Equity

Consolidated Statement of Cash Flows

Notes to Consolidated Financial Statements

2. Financial Statement Schedules

Financial Statement Schedules are omitted because the required information is either not applicable, not required or is shown in the respective financial statements or in the notes thereto.

3. The following Exhibits are filed herewith or incorporated by reference:

- EXHIBIT 3.1 Articles of Incorporation – filed as Exhibit 3.1 to the Company's Form 10-K for the year ended December 31, 2005 is hereby incorporated by reference
- EXHIBIT 3.2 By –laws - filed as Exhibit 3.2 to the Company's Form 10-K for the year ended December 31, 2005 is hereby incorporated by reference
- EXHIBIT 10.1 Dividend Reinvestment Plan – filed as Exhibit 99.1 to the Company's Registration Statement on Form S-3 as filed on August 1, 2007 is hereby incorporated by reference
- EXHIBIT 10.2 Stock Incentive Plan - filed as Exhibit 10.2 to the Company's Form 10-K for the year ended December 31, 2004 is hereby incorporated by reference
- EXHIBIT 10.3 Stock Option Plan - filed as Exhibit 10.3 to the Company's Form 10-K for the year ended December 31, 2004 is hereby incorporated by reference
- EXHIBIT 10.4 Deferred Compensation Plan - filed as Exhibit 10.4 to the Company's Form 10-K for the year ended December 31, 2004 is hereby incorporated by reference
- EXHIBIT 13 Annual Report
- EXHIBIT 14 Code of Ethics - filed as Exhibit 14 to the Company's Form 10-K for the year ended December 31, 2005 is hereby incorporated by reference
- EXHIBIT 21 Subsidiaries

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- 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
- EXHIBIT 32.2 Section 1350 Certification – Chief Financial Officer

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Pursuant to the requirements of Section 13 or 15(d) 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.

/s/ J. David Lombardi

J. David Lombardi

President/Chief Executive Officer

/s/ William Lance

William Lance, Treasurer

Principal Financial Officer and Principal
Accounting Officer

/s/ Linda D'Amario

Linda D'Amario

Comptroller

Date: March 11, 2009

Pursuant to the requirements of the Securities Act of 1934, this report has been signed below by the following persons on behalf of the registrant and in the capacities and on the dates indicated:

Directors:

| | | | |
|---|-----------------|---|-----------------|
| <u>/s/ Michael G. Cestone</u> Michael G. Cestone | 3/11/09 Date | <u>/s/ Louis A. DeNaples, Jr.</u> Louis A. DeNaples, Jr. | 3/11/09 Date |
| Michael J. Cestone, Jr. | Date | <u>/s/ Joseph J. Gentile</u> Joseph J. Gentile | 3/11/09 Date |
| <u>/s/ Joseph Coccia</u> Joseph Coccia | 3/11/09 Date | Joseph O. Haggerty | Date |

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/s/ William P. Conaboy
William P. Conaboy

3/11/09
Date

/s/ J. David Lombardi
J. David Lombardi

3/11/09
Date

/s/ Dominick L. DeNaples
Dominick L. DeNaples

3/11/09
Date

/s/ John P. Moses
John P. Moses

3/11/09
Date

Louis A. DeNaples

Date