EMCLAIRE FINANCIAL CORP
Form 10-K
March 27, 2009

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-K

(Mark One):

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

For the fiscal year ended: December 31, 2008

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

For the transition period from: to

Commission File Number: 000-18464

EMCLAIRE FINANCIAL CORP.

(Exact name of registrant as specified in its charter)

Pennsylvania	**25-1606091**
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)
612 Main Street, Emlenton, PA	**16373**
(Address of principal executive office)	(Zip Code)

Registrant s telephone number: **(724) 867-2311**

Securities registered pursuant to Section 12(b) of the Act: **None.** **OTC Electronic Bulletin Board (OTCBB)**
Name of exchange on which registered

Securities registered pursuant to Section 12(g) of the Act:

Common Stock, par value $1.25 per share

(Title of Class)

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act.

YES o NO x.

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act.

YES o NO x.

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

Indicate by check mark 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. x

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer or a smaller reporting company.

Large accelerated filer o Accelerated filer o Non-accelerated filer o Smaller reporting company x

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Act). YES o NO x.

As of June 30, 2008, the aggregate value of the 1,267,835 shares of Common Stock of the Registrant issued and outstanding on such date, which excludes 152,410 shares held by the directors and officers of the Registrant as a group, was approximately $28.7 million. This figure is based on the last sales price of $25.75 per share of the Registrant s Common Stock on June 30, 2008.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the Proxy Statement for the 2009 Annual Meeting of Stockholders are incorporated by reference in Part III of this Form 10-K.

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Discussions of certain matters in this Form 10-K and other related year end documents may constitute forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended (the Exchange Act), and as such, may involve risks and uncertainties. Forward-looking statements, which are based on certain assumptions and describe future plans, strategies, and expectations, are generally identifiable by the use of words or phrases such as believe , plan , expect , intend anticipate , estimate , project , forecast , may increase , may fluctuate , may improve and similar expressions of future or conditional verb will , should , would , and could . These forward-looking statements relate to, among other things, expectations of the business environment in which the Corporation operates, projections of future performance, potential future credit experience, perceived opportunities in the market and statements regarding the Corporation s mission and vision. The Corporation s actual results, performance and achievements may differ materially from the results, performance, and achievements expressed or implied in such forward-looking statements due to a wide range of factors. These factors include, but are not limited to, changes in interest rates, general economic conditions, the local economy, the demand for the Corporation s products and services, accounting principles or guidelines, legislative and regulatory changes, monetary and fiscal policies of the U.S. Government, U.S. Treasury, and Federal Reserve, real estate markets, competition in the financial services industry, attracting and retaining key personnel, performance of new employees, regulatory actions, changes in and utilization of new technologies and other risks detailed in the Corporation s reports filed with the Securities and Exchange Commission (SEC) from time to time. These factors should be considered in evaluating the forward-looking statements, and undue reliance should not be placed on such statements. The Corporation does not undertake, and specifically disclaims any obligation, to update any forward-looking statements to reflect occurrences or unanticipated events or circumstances after the date of such statements.

PART I

Item 1. Business

General

Emclaire Financial Corp. (the Corporation) is a Pennsylvania corporation and financial holding company that provides a full range of retail and commercial financial products and services to customers in western Pennsylvania through its wholly owned subsidiary bank, the Farmers National Bank of Emlenton (the Bank). The Corporation also provides real estate settlement services to Bank and other customers through its subsidiary, Emclaire Settlement Services, LLC (the Title Company). In addition, the Bank provides investment advisory services through its Farmers National Financial Services division.

The Bank was organized in 1900 as a national banking association and is a financial intermediary whose principal business consists of attracting deposits from the general public and investing such funds in real estate loans secured by liens on residential and commercial property, consumer loans, commercial business loans, marketable securities and interest-earning deposits. The Bank operates through a network of twelve retail branch offices in Venango, Butler, Clarion, Clearfield, Elk, Jefferson and Mercer counties, Pennsylvania. The Corporation and the Bank are headquartered in Emlenton, Pennsylvania.

The Bank is subject to examination and comprehensive regulation by the Office of the Comptroller of the Currency (OCC), which is the Bank s chartering authority, and the Federal Deposit Insurance Corporation (FDIC), which insures customer deposits held by the Bank to the full extent provided by law. The Bank is a member of the Federal Reserve Bank of Cleveland (FRB) and the Federal Home Loan Bank of Pittsburgh (FHLB). The Corporation is a registered financial holding company pursuant to the Bank Holding Company Act of 1956 (BHCA), as amended.

The Corporation completed the acquisition of Elk County Savings and Loan Association (ECSLA) and the merger conversion of ECSLA with and into the Bank as of October 17, 2008. Associated with the merger conversion, the Corporation also conducted a common stock offering to eligible depositors and borrowers of ECSLA and the general public. The merger conversion and the offering generated $4.5 million in additional equity for the Corporation.

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On December 23, 2008 the Corporation issued to the U.S. Department of the Treasury (U.S. Treasury), in exchange for aggregate consideration of $7.5 million, 7,500 shares of Fixed Rate Cumulative Perpetual Preferred Stock, Series A, with a liquidation preference of $1,000, and a ten year warrant to purchase up to 50,836 shares of the Corporation s common stock at an exercise price of $22.13 per share. The preferred securities pay cumulative dividends of 5% a year for the first five years and 9% a year thereafter.

At December 31, 2008, the Corporation had $375.7 million in total assets, $36.1 million in stockholders equity, $264.8 million in loans and $286.6 million in deposits.

Lending Activities

General. The principal lending activities of the Bank are the origination of residential mortgage, commercial mortgage, commercial business and consumer loans. Significantly all of the Bank s loans are secured by property in the Bank s primary market area.

One-to-Four Family Mortgage Loans. The Bank offers first mortgage loans secured by one-to-four family residences located in the Bank s primary lending area. Typically such residences are single-family owner occupied units. The Bank is an approved, qualified lender for the Federal Home Loan Mortgage Corporation (FHLMC). As a result, the Bank may sell loans to and service loans for the FHLMC in market conditions and circumstances where this is advantageous in managing interest rate risk.

Home Equity Loans. The Bank originates home equity loans secured by single-family residences. These loans may be either a single advance fixed-rate loan with a term of up to 20 years, or a variable rate revolving line of credit. These loans are made only on owner-occupied single-family residences.

Commercial Business and Commercial Real Estate Loans. Commercial lending constitutes a significant portion of the Bank s lending activities. Commercial business and commercial real estate loans amounted to 47.3% of the total loan portfolio at December 31, 2008. Commercial real estate loans generally consist of loans granted for commercial purposes secured by commercial or other nonresidential real estate. Commercial loans consist of secured and unsecured loans for such items as capital assets, inventory, operations and other commercial purposes.

Consumer Loans. Consumer loans generally consist of fixed-rate term loans for automobile purchases, home improvements not secured by real estate, capital and other personal expenditures. The Bank also offers unsecured revolving personal lines of credit and overdraft protection.

Loans to One Borrower. National banks are subject to limits on the amount of credit that they can extend to one borrower. Under current law, loans to one borrower are limited to an amount equal to 15% of unimpaired capital and surplus on an unsecured basis, and an additional amount equal to 10% of unimpaired capital and surplus if the loan is secured by readily marketable collateral. At December 31, 2008, the Bank s loans to one borrower limit based upon 15% of unimpaired capital was $5.4 million. At December 31, 2008, the Bank had no single lending relationship exceeding this limit.

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Loan Portfolio. The following table sets forth the composition and percentage of the Corporation s loans receivable in dollar amounts and in percentages of the portfolio as of December 31:

(Dollar amounts in thousands)	2008 Dollar Amount	%	2007 Dollar Amount	%	2006 Dollar Amount	%	2005 Dollar Amount	%	2004 Dollar Amount	%
Mortgage loans on real estate:										
Residential first mortgages	$ 74,130	27.7%	$ 65,706	28.3%	$ 64,662	30.0%	$ 66,011	34.0%	$ 69,310	38.2%
Home equity loans and lines of credit	57,454	21.5%	49,426	21.3%	47,330	22.0%	39,933	20.5%	31,548	17.4%
Commercial	85,689	32.1%	71,599	30.9%	61,128	28.4%	52,990	27.3%	48,539	26.8%
Total real estate loans	217,273	81.3%	186,731	80.5%	173,120	80.4%	158,934	81.8%	149,397	82.4%
Other loans:										
Commercial business	40,787	15.2%	35,566	15.3%	34,588	16.0%	27,732	14.2%	23,898	13.2%
Consumer	9,429	3.5%	9,679	4.2%	7,671	3.6%	7,729	4.0%	8,090	4.4%
Total other loans	50,216	18.7%	45,245	19.5%	42,259	19.6%	35,461	18.2%	31,988	17.6%
Total loans receivable	267,489	100.0%	231,976	100.0%	215,379	100.0%	194,395	100.0%	181,385	100.0%
Less:										
Allowance for loan losses	2,651		2,157		2,035		1,869		1,810	
Net loans receivable	$ 264,838		$ 229,819		$ 213,344		$ 192,526		$ 179,575	

The following table sets forth the scheduled contractual principal repayments or interest repricing of loans in the Corporation s portfolio as of December 31, 2008. Demand loans having no stated schedule of repayment and no stated maturity are reported as due within one year.

(Dollar amounts in thousands)	Due in one year or less	Due from one to five years	Due from five to ten years	Due after ten years	Total
Residential mortgages	$ 1,518	$ 4,938	$ 14,162	$ 53,512	$ 74,130
Home equity loans and lines of credit	130	6,040	22,446	28,838	57,454
Commercial mortgages	3,821	3,599	13,664	64,605	85,689
Commercial business	4,085	11,438	6,552	18,712	40,787
Consumer	362	7,759	913	395	9,429
	$ 9,916	$ 33,774	$ 57,737	$ 166,062	$ 267,489

The following table sets forth the dollar amount of the Corporation s fixed and adjustable rate loans with maturities greater than one year as of December 31, 2008:

(Dollar amounts in thousands)	Fixed rates	Adjustable rates
Residential mortgage	$ 51,745	$ 20,867
Home equity loans and lines of credit	53,358	3,966
Commercial mortgage	35,117	46,751
Commercial business	33,250	3,452
Consumer	9,067	

$	182,537	$	75,036

Contractual maturities of loans do not reflect the actual term of the Corporation s loan portfolio. The average life of mortgage loans is substantially less than their contractual terms because of loan prepayments and enforcement of due-on-sale clauses, which give the Corporation the right to declare a loan immediately payable in the event, among other things, that the borrower sells the real property subject to the mortgage. Scheduled principal amortization also reduces the average life of the loan portfolio. The average life of mortgage loans tends to increase when current market mortgage rates substantially exceed rates on existing mortgages and conversely, decrease when rates on existing mortgages substantially exceed current market interest rates.

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Delinquencies and Classified Assets

Delinquent Loans and Real Estate Acquired Through Foreclosure (REO). Typically, a loan is considered past due and a late charge is assessed when the borrower has not made a payment within fifteen days from the payment due date. When a borrower fails to make a required payment on a loan, the Corporation attempts to cure the deficiency by contacting the borrower. The initial contact with the borrower is made shortly after the seventeenth day following the due date for which a payment was not received. In most cases, delinquencies are cured promptly.

If the delinquency exceeds 60 days, the Corporation works with the borrower to set up a satisfactory repayment schedule. Typically loans are considered non-accruing upon reaching 90 days delinquent, although the Corporation may be receiving partial payments of interest and partial repayments of principal on such loans. When a loan is placed in non-accrual status, previously accrued but unpaid interest is deducted from interest income. The Corporation institutes foreclosure action on secured loans only if all other remedies have been exhausted. If an action to foreclose is instituted and the loan is not reinstated or paid in full, the property is sold at a judicial or trustee s sale at which the Corporation may be the buyer.

Real estate properties acquired through, or in lieu of, foreclosure are to be sold and are initially recorded at fair value at the date of foreclosure establishing a new cost basis. After foreclosure, management periodically performs valuations and the real estate is carried at the lower of carrying amount or fair value less cost to sell. Revenue and expenses from operations and changes in the valuation allowance are included in loss on foreclosed real estate. The Corporation generally attempts to sell its REO properties as soon as practical upon receipt of clear title. The original lender typically handles disposition of those REO properties resulting from loans purchased in the secondary market.

As of December 31, 2008, the Corporation s non-performing assets, which include non-accrual loans, loans delinquent due to maturity, troubled debt restructuring, repossessions and REO, amounted to $1.1 million or 0.28% of the Corporation s total assets. Interest income of $78,000 would have been recorded in 2008 if these loans had been current and were outstanding during the entire period. Interest of $43,000 on these loans was included in income during 2008.

Classified Assets. Regulations applicable to insured institutions require the classification of problem assets as substandard, doubtful, or loss depending upon the existence of certain characteristics as discussed below. A category designated special mention must also be maintained for assets currently not requiring the above classifications but having potential weakness or risk characteristics that could result in future problems. An asset is classified as substandard if not adequately protected by the current net worth and paying capacity of the obligor or of the collateral pledged, if any. A substandard asset is characterized by the distinct possibility that the Corporation will sustain some loss if the deficiencies are not corrected. Assets classified as doubtful have all the weaknesses inherent in those classified as substandard. In addition, these weaknesses make collection or liquidation in full, on the basis of currently existing facts, conditions and values, highly questionable or improbable. Assets classified as loss are considered uncollectible and of such little value that their continuance as assets is not warranted.

The Corporation s classification of assets policy requires the establishment of valuation allowances for loan losses in an amount deemed prudent by management. Valuation allowances represent loss allowances that have been established to recognize the inherent risk associated with lending activities. When the Corporation classifies a problem asset as a loss, the portion of the asset deemed uncollectible is charged off immediately.

The Corporation regularly reviews the problem loans and other assets in its portfolio to determine whether any require classification in accordance with the Corporation s policy and applicable regulations. As of December 31, 2008, the Corporation s classified and criticized assets amounted to $9.6 million, with $6.5 million classified as substandard and $3.1 million identified as special mention.

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The following table sets forth information regarding the Corporation s non-performing assets as of December 31:

(Dollar amounts in thousands)	2008	2007	2006	2005	2004
Non-performing loans	$ 1,011	$ 952	$ 1,841	$ 1,452	$ 840
Total as a percentage of gross loans	0.38%	0.41%	0.85%	0.74%	0.46%
Repossessions					2
Real estate acquired through foreclosure	50	129	98	106	69
Total as a percentage of total assets	0.01%	0.04%	0.03%	0.04%	0.03%
Total non-performing assets	$ 1,061	$ 1,081	$ 1,939	$ 1,558	$ 911
Total non-performing assets as a percentage of total assets	0.28%	0.35%	0.65%	0.57%	0.33%
Allowance for loan losses as a percentage of non-performing loans	262.22%	226.58%	110.54%	128.72%	215.48%

Allowance for Loan Losses. Management establishes allowances for estimated losses on loans based upon its evaluation of the pertinent factors underlying the types and quality of loans; historical loss experience based on volume and types of loans; trend in portfolio volume and composition; level and trend on non-performing assets; detailed analysis of individual loans for which full collectibility may not be assured; determination of the existence and realizable value of the collateral and guarantees securing such loans and the current economic conditions affecting the collectibility of loans in the portfolio. The Corporation analyzes its loan portfolio at least quarterly for valuation purposes and to determine the adequacy of its allowance for losses. Based upon the factors discussed above, management believes that the Corporation s allowance for losses as of December 31, 2008 of $2.7 million was adequate to cover probable losses inherent in the portfolio.

The following table sets forth an analysis of the allowance for losses on loans receivable for the years ended December 31:

(Dollar amounts in thousands)	2008	2007	2006	2005	2004
Balance at beginning of period	$ 2,157	$ 2,035	$ 1,869	$ 1,810	$ 1,777
Provision for loan losses	500	256	358	205	290
Allowance for loan losses of ECSLA	206				
Charge-offs:					
Mortgage loans	(92)	(82)	(154)	(46)	(165)
Commercial business loans		(22)	(18)	(60)	(36)
Consumer loans	(160)	(60)	(49)	(91)	(117)
	(252)	(164)	(221)	(197)	(318)

Recoveries:					
Mortgage loans		1			17
Commercial business loans	15	16	19	18	19
Consumer loans	25	13	10	33	25
	40	30	29	51	61
Net charge-offs	(212)	(134)	(192)	(146)	(257)
Balance at end of period	$ 2,651	$ 2,157	$ 2,035	$ 1,869	$ 1,810
Ratio of net charge-offs to average loans outstanding	0.08%	0.06%	0.09%	0.08%	0.14%
Ratio of allowance to total loans at end of period	0.99%	0.93%	0.94%	0.96%	1.00%

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The following table provides a breakdown of the allowance for loan losses by major loan category for the years ended December 31:

(Dollar amounts in thousands)

	2008		2007		2006		2005		2004	
Loan Categories:	**Dollar Amount**	**Percent of loans in each category to total loans**	**Dollar Amount**	**Percent of loans in each category to total loans**	**Dollar Amount**	**Percent of loans in each category to total loans**	**Dollar Amount**	**Percent of loans in each category to total loans**	**Dollar Amount**	**Percent of loans in each category to total loans**
Commercial, financial and agricultural	$ 431	16.3%	$ 387	17.9%	$ 532	26.1%	$ 554	29.6%	$ 503	27.8%
Commercial mortgages	1,369	51.6%	1,068	49.5%	820	40.3%	841	45.0%	1,137	62.8%
Residential mortgages	363	13.7%	309	14.3%	239	11.7%	211	11.3%	10	0.6%
Home equity loans	467	17.6%	368	17.1%	339	16.7%	150	8.0%	39	2.2%
Consumer loans	73	2.8%	79	3.7%	83	4.1%	106	5.7%	121	6.7%
Unallocated	(52)	-2.0%	(54)	-2.5%	22	1.1%	7	0.4%		0.0%
	$ 2,651	100%	$ 2,157	100%	$ 2,035	100%	$ 1,869	100%	$ 1,810	100%

Investment Activities

General. The Corporation maintains an investment portfolio of securities such as U.S. government agencies, mortgage-backed securities, municipal and corporate securities and equity securities.

Investment decisions are made within policy guidelines established by the Board of Directors. This policy is aimed at maintaining a diversified investment portfolio, which complements the overall asset/liability and liquidity objectives of the Bank, while limiting the related credit risk to an acceptable level.

The following table sets forth certain information regarding the fair value, weighted average yields and contractual maturities of the Corporation s securities as of December 31, 2008:

(Dollar amounts in thousands)	**Due in 1 year or less**	**Due from 1 to 3 years**	**Due from 3 to 5 years**	**Due from 5 to 10 years**	**Due after 10 years**	**No scheduled maturity**	**Total**
U.S. Government securities	$ 1,027	$ 2,506	$ 4,012	$ 8,549	$ 3,983	$	$ 20,077
Mortgage-backed securities		247	408	2,721	27,004		30,380
Municipal securities			100	4,097	9,611		13,808
Corporate securities	3,984						3,984
Equity securities						3,194	3,194

Estimated fair value	$	5,011	$	2,753	$	4,520	$	15,367	$	40,598	$	3,194	$ 71,443
Weighted average yield (1)		5.49%		4.09%		4.68%		5.05%		4.35%		4.29%	4.59%

(1) Weighted average yield is calculated based upon amortized cost.

The following table sets forth the fair value of the Corporation s investment securities as of December 31:

(Dollar amounts in thousands)		**2008**		**2007**		**2006**
U.S. Government agencies	$	20,077	$	29,334	$	30,748
Mortgage-backed securities		30,380		1,884		2,339
Municipal securities		13,808		14,251		15,262
Corporate securities		3,984		2,939		
Equity securities		3,194		3,511		3,425
	$	71,443	$	51,919	$	51,774

For additional information regarding the Corporation s investment portfolio see Management s Discussion and Analysis of Financial Condition and Results of Operations in item 7 and Notes to Consolidated Financial Statements beginning on page F-7.

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Sources of Funds

General. Deposits are the primary source of the Bank s funds for lending and investing activities. Secondary sources of funds are derived from loan repayments, investment maturities and borrowed funds. Loan repayments can be considered a relatively stable funding source, while deposit activity is greatly influenced by interest rates and general market conditions. The Bank also has access to funds through other various sources. For a description of the Bank s sources of funds, see Management s Discussion and Analysis of Financial Condition and Results of Operations in item 7.

Deposits. The Bank offers a wide variety of retail deposit account products to both consumer and commercial deposit customers, including time deposits, non-interest bearing and interest bearing demand deposit accounts, savings deposits and money market accounts.

Deposit products are promoted in periodic newspaper and radio advertisements, along with notices provided in customer account statements. The Bank s marketing strategy is based on its reputation as a community bank that provides quality products and personal customer service.

The Bank pays interest rates on its interest bearing deposit products that are competitive with rates offered by other financial institutions in its market area. Management reviews interest rates on deposits weekly and considers a number of factors, including: (1) the Bank s internal cost of funds; (2) rates offered by competing financial institutions; (3) investing and lending opportunities; and (4) the Bank s liquidity position.

The following table sets forth maturities of the Corporation s certificates of deposit of $100,000 or more at December 31, 2008 by time remaining to maturity:

(Dollar amounts in thousands)		**Amount**
Less than three months	$	2,663
Over three months to six months		11,480
Over six months to twelve months		4,681
Over twelve months		19,945
	$	38,769

Borrowings. Borrowings may be used to compensate for reductions in deposit inflows or net deposit outflows, or to support lending and investment activities. These borrowings include FHLB advances, federal funds, repurchase agreements, advances from the Federal Reserve Discount Window and lines of credit at the bank and holding company with other correspondent banks.

(Dollar amounts in thousands)	December 31, 2008	2007
Ending balance	$ 48,188	$ 40,400
Average balance	45,096	32,441
Maximum balance	54,683	40,400
Weighted average rate	3.89%	4.46%

For additional information regarding the Corporation s deposit base and borrowed funds, see Management s Discussion and Analysis of Financial Condition and Results of Operations in item 7 and Notes to Consolidated Financial Statements beginning on page F-7.

Subsidiary Activity

The Corporation has two wholly owned subsidiaries, the Bank, a national association and the Title Company. As of December 31, 2008, the Bank and the Title Company had no subsidiaries.

Personnel

At December 31, 2008, the Bank had 104 full time equivalent employees. There is no collective bargaining agreement between the Bank and its employees, and the Bank believes its relationship with its employees to be satisfactory.

Competition

The Bank competes for loans, deposits and customers with other commercial banks, savings and loan associations, securities and brokerage companies, mortgage companies, insurance companies, finance companies, money market funds, credit unions and other nonbank financial service providers.

Supervision and Regulation

General. Bank holding companies and banks are extensively regulated under both federal and state law. Set forth below is a summary description of certain provisions of certain laws that relate to the regulation of the Corporation and the Bank. The description does not purport to be complete and is qualified in its entirety by reference to the applicable laws and regulations.

The Corporation. The Corporation is a registered bank holding company, and subject to regulation and examination by the FRB under the BHCA of 1956, as amended. The Corporation is required to file with the FRB periodic reports and such additional information as the FRB may require. Recent changes to the Bank Holding Company rating system emphasizes risk management and evaluation of the potential impact of non-depository entities on safety and soundness.

The FRB may require the Corporation to terminate an activity or terminate control of or liquidate or divest certain subsidiaries, affiliates or investments when the FRB believes the activity or the control of the subsidiary or affiliate constitutes a significant risk to the financial safety, soundness or stability of any of its banking subsidiaries. The FRB also has the authority to regulate provisions of certain bank holding company debt, including the authority to impose interest ceilings and reserve requirements on such debt. Under certain circumstances, the Corporation must file written notice and obtain FRB approval prior to purchasing or redeeming its equity securities.

Further, the Corporation is required by the FRB to maintain certain levels of capital. See Capital Standards.

The Corporation is required to obtain prior FRB approval for the acquisition of more than 5% of the outstanding shares of any class of voting securities or substantially all of the assets of any bank or bank holding company. Prior FRB approval is also required for the merger or consolidation of the Corporation and another bank holding company.

The Corporation is prohibited by the BHCA, except in certain statutorily prescribed instances, from acquiring direct or indirect ownership or control of more than 5% of the outstanding voting shares of any company that is not a bank or bank holding company and from engaging directly or indirectly in activities other than those of banking, managing or controlling banks, or furnishing services to its subsidiaries. However, subject to the prior FRB approval, the Corporation may engage in any, or acquire shares of companies engaged in, activities that the FRB deems to be so closely related to banking or managing or controlling banks as to be a proper incident thereto.

Under FRB regulations, the Corporation is required to serve as a source of financial and managerial strength to the Corporation s subsidiary bank and may not conduct operations in an unsafe or unsound manner. In addition, it is the FRB s policy that a bank holding company should stand ready to use available resources to provide adequate capital funds to its subsidiary banks during periods of financial stress or adversity and should maintain the financial flexibility and capital-raising capacity to obtain additional resources for assisting its subsidiary banks. A bank holding company s failure to meet its obligations to serve as a source of strength to its subsidiary banks will generally be considered by the FRB to be an unsafe and unsound banking practice or a violation of FRB regulations or both.

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The Corporation is also a bank holding company within the meaning of the Pennsylvania Banking Code. As such, the Corporation and its subsidiaries are subject to examination by, and may be required to file reports with, the Pennsylvania Department of Banking.

The Corporation s securities are registered with the SEC under the Exchange Act. As such, the Corporation is subject to the information, proxy solicitation, insider trading, corporate governance, and other requirements and restrictions of the Exchange Act. The public may obtain all forms and information filed with the SEC through their website http://www.sec.gov.

The Bank. As a national banking association, the Bank is subject to primary supervision, examination and regulation by the OCC. The Corporation is also subject to regulations of the FDIC as administrator of the Deposit Insurance Fund (DIF) and the FRB. If, as a result of an examination of the Bank, the OCC should determine that the financial condition, capital resources, asset quality, earnings prospects, management, liquidity or other aspects of the Corporation s operations are unsatisfactory or that the Bank is violating or has violated any law or regulation, various remedies are available to the OCC. Such remedies include the power to enjoin unsafe or unsound practices, to require affirmative action to correct any conditions resulting from any violation or practice, to issue an administrative order that can be judicially enforced, to direct an increase in capital, to restrict the Bank s growth, to assess civil monetary penalties, and to remove officers and directors. The FDIC has similar enforcement authority, in addition to its authority to terminate the Bank s deposit insurance in the absence of action by the OCC and upon a finding that the Bank is operating in an unsafe or unsound condition, is engaging in unsafe or unsound activities, or that the Corporation s conduct poses a risk to the deposit insurance fund or may prejudice the interest of its depositors.

A national bank may have a financial subsidiary engaged in any activity authorized for national banks directly or certain permissible activities. Generally, a financial subsidiary is permitted to engage in activities that are financial in nature or incidental thereto, even though they are not permissible for the national bank itself. The definition of financial in nature includes, among other items, underwriting, dealing in or making a market in securities, including, for example, distributing shares of mutual funds. The subsidiary may not, however, engage as principal in underwriting insurance, issue annuities or engage in real estate development or investment or merchant banking.

The Sarbanes-Oxley Act of 2002. The Sarbanes-Oxley Act of 2002 addresses accounting oversight and corporate governance matters, including:

- The prohibition of accounting firms from providing various types of consulting services to public clients and requiring accounting firms to rotate partners among public client assignments every five years;
- Increased penalties for financial crimes and forfeiture of executive bonuses in certain circumstances;
- Required executive certification of financial presentations;
- Increased requirements for board audit committees and their members;
- Enhanced disclosure of controls and procedures and internal control over financial reporting;
- Enhanced controls on, and reporting of, insider trading; and
- Statutory separations between investment bankers and analysts.

The new legislation and its implementing regulations have resulted in increased costs of compliance, including certain outside professional costs. To date these costs have not had a material impact on the Corporation s operations.

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USA PATRIOT Act of 2001. The USA PATRIOT Act of 2001 and its implementing regulations significantly expanded the anti-money laundering and financial transparency laws. Under the USA PATRIOT Act, financial institutions are subject to prohibitions regarding specified financial transactions and account relationships, as well as enhanced due diligence and know your customer standards in their dealings with foreign financial institutions and foreign customers. For example, the enhanced due diligence policies, procedures and controls generally require financial institutions to take reasonable steps:

- To conduct enhanced scrutiny of account relationships to guard against money laundering and report any suspicious transaction,
- To ascertain the identity of the nominal and beneficial owners of, and the source of funds deposited into, each account as needed to guard against money laundering and report any suspicious transactions,
- To ascertain for any foreign bank, the shares of which are not publicly traded, the identity of the owners of the foreign bank, and the nature and extent of the ownership interest of each such owner, and
- To ascertain whether any foreign bank provides correspondent accounts to other foreign banks and, if so, the identity of those foreign banks and related due diligence information.

Under the USA PATRIOT Act, financial institutions are required to establish and maintain anti-money laundering programs which include:

- The establishment of a customer identification program,
- The development of internal policies, procedures, and controls,
- The designation of a compliance officer,
- An ongoing employee training program, and
- An independent audit function to test the programs.

The Bank has implemented comprehensive policies and procedures to address the requirements of the USA PATRIOT Act.

Privacy. Federal banking rules limit the ability of banks and other financial institutions to disclose non-public information about consumers to nonaffiliated third parties. Pursuant to these rules, financial institutions must provide:

- Initial notices to customers about their privacy policies, describing the conditions under which they may disclose nonpublic personal information to nonaffiliated third parties and affiliates;
- Annual notices of their privacy policies to current customers; and
- A reasonable method for customers to opt out of disclosures to nonaffiliated third parties.

These privacy provisions affect how consumer information is transmitted through diversified financial companies and conveyed to outside vendors. The Corporation s privacy policies have been implemented in accordance with the law.

Dividends and Other Transfers of Funds. Dividends from the Bank constitute the principal source of income to the Corporation. The Corporation is a legal entity separate and distinct from the Bank. The Bank is subject to various statutory and regulatory restrictions on its ability to pay dividends to the Corporation. In addition, the Bank s regulators have the authority to prohibit the Bank from paying dividends, depending upon the Bank s financial condition, if such payment is deemed to constitute an unsafe or unsound practice.

The Corporation entered into a Securities Purchase Agreement (the Agreement) on December 23, 2008 with the U.S. Treasury in association with its participation in the Capital Purchase Program (CPP) of the Emergency Economic Stabilization Act of 2008 (EESA). Under the Agreement, the Corporation may not increase its dividend for three years unless the preferred shares purchase by the U.S. Treasury have been redeemed in whole or transferred to a third party which is not an affiliate of the Corporation. For additional information regarding the CPP see Notes to Consolidated Financial Statements beginning on page F-7.

Transactions with Affiliates. The Bank is subject to certain restrictions imposed by federal law on any extensions of credit to, or the issuance of a guarantee or letter of credit on behalf of, any affiliates, the purchase of, or investments in, stock or other securities thereof, the taking of such securities as collateral for loans, and the purchase of assets of any affiliates. Such restrictions prevent any affiliates from borrowing from the Bank unless the loans are secured by marketable obligations of designated amounts. Further, such secured loans and investments by the Bank to or in any affiliate are limited, individually, to 10% of the Bank s capital and surplus (as defined by federal regulations), and such secured loans and investments are limited, in the aggregate, to 20% of the Bank s capital and surplus. Some of the entities included in the definition of an affiliate are parent companies, sister banks, sponsored and advised companies, investment companies whereby the Bank or its affiliate serves as investment advisor, and financial subsidiaries of the bank. Additional restrictions on transactions with affiliates may be imposed on the Bank under the prompt corrective action provisions of federal law. See Prompt Corrective Action and Other Enforcement Mechanisms.

Loans to One Borrower Limitations. With certain limited exceptions, the maximum amount that a national bank may lend to any borrower (including certain related entities of the borrower) at one time may not exceed 15% of the unimpaired capital and surplus of the institution, plus an additional 10% of unimpaired capital and surplus for loans fully secured by readily marketable collateral. At December 31, 2008, the Bank s loans-to-one-borrower limit was $5.4 million based upon the 15% of unimpaired capital and surplus measurement. At December 31, 2008, the bank had no single lending relationship exceeding this limit.

Capital Standards. The federal banking agencies have adopted risk-based minimum capital guidelines intended to provide a measure of capital that reflects the degree of risk associated with a banking organization s operations for both transactions reported on the balance sheet as assets and transactions which are recorded as off-balance sheet items. Under these guidelines, nominal dollar amounts of assets and credit equivalent amounts of off-balance sheet items are multiplied by one of several risk adjustment percentages, which range from 0% for assets with low credit risk, such as federal banking agencies, to 100% for assets with relatively high credit risk.

The risk-based capital ratio is determined by classifying assets and certain off-balance sheet financial instruments into weighted categories, with higher levels of capital being required for those categories perceived as representing greater risk. Under the capital guidelines, a banking organization s total capital is divided into tiers. Tier I capital consists of (1) common equity, (2) qualifying noncumulative perpetual preferred stock, (3) a limited amount of qualifying cumulative perpetual preferred stock and (4) minority interests in the equity accounts of consolidated subsidiaries (including trust-preferred securities), less goodwill and certain other intangible assets. Not more than 25% of qualifying Tier I capital may consist of trust-preferred securities. Tier II capital consists of hybrid capital instruments, perpetual debt, mandatory convertible debt securities, a limited amount of subordinated debt, preferred stock that does not qualify as Tier I capital, a limited amount of the allowance for loan and lease losses and a limited amount of unrealized holding gains on equity securities. Tier III capital consists of qualifying unsecured subordinated debt. The sum of Tier II and Tier III capital may not exceed the amount of Tier I capital.

The guidelines require a minimum ratio of qualifying total capital to risk-adjusted assets of 8% and a minimum ratio of Tier 1 capital to risk-adjusted assets of 4%. In addition to the risk-based guidelines, federal banking regulators require banking organizations to maintain a minimum amount of Tier 1 capital to total assets, referred to as the leverage ratio. For a banking organization rated in the highest of the five categories used by regulators to rate banking organizations, the minimum leverage ratio of Tier 1 capital to total assets must be 3%. In addition to these uniform risk-based capital guidelines and leverage ratios that apply across the industry, the regulators have the discretion to set individual minimum capital requirements for specific institutions at rates significantly above the minimum guidelines and ratios.

In addition, federal banking regulators may set capital requirements higher than the minimums described above for financial institutions whose circumstances warrant it. For example, a financial institution experiencing or anticipating significant growth may be expected to maintain capital positions substantially above the minimum supervisory levels without significant reliance on intangible assets.

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Prompt Corrective Action and Other Enforcement Mechanisms. Federal banking agencies possess broad powers to take corrective and other supervisory action to resolve the problems of insured depository institutions, including but not limited to those institutions that fall below one or more prescribed minimum capital ratios. Each federal banking agency has promulgated regulations defining the following five categories in which an insured depository institution will be placed, based on its capital ratios: well capitalized, adequately capitalized, undercapitalized, significantly undercapitalized, and critically undercapitalized. At December 31, 2008, the Bank exceeded the required ratios for classification as well capitalized.

An institution that, based upon its capital levels, is classified as well capitalized, adequately capitalized, or undercapitalized may be treated as though it were in the next lower capital category if the appropriate federal banking agency, after notice and opportunity for hearing, determines that an unsafe or unsound condition or an unsafe or unsound practice warrants such treatment. At each successive lower capital category, an insured depository institution is subject to more restrictions. The federal banking agencies, however, may not treat a significantly undercapitalized institution as critically undercapitalized unless its capital ratio actually warrants such treatment.

In addition to measures taken under the prompt corrective action provisions, commercial banking organizations may be subject to potential enforcement actions by the federal regulators for unsafe or unsound practices in conducting their businesses or for violations of any law, rule, regulation, or any condition imposed in writing by the agency or any written agreement with the agency. Finally, pursuant to an interagency agreement, the FDIC can examine any institution that has a substandard regulatory examination score or is considered undercapitalized without the express permission of the institution s primary regulator.

Safety and Soundness Standards. The federal banking agencies have adopted guidelines designed to assist the federal banking agencies in identifying and addressing potential safety and soundness concerns before capital becomes impaired. The guidelines set forth operational and managerial standards relating to: (i) internal controls, information systems and internal audit systems, (ii) loan documentation, (iii) credit underwriting, (iv) asset growth, (v) earnings, and (vi) compensation, fees and benefits. In addition, the federal banking agencies have also adopted safety and soundness guidelines with respect to asset quality and earnings standards. These guidelines provide six standards for establishing and maintaining a system to identify problem assets and prevent those assets from deteriorating. Under these standards, an insured depository institution should: (i) conduct periodic asset quality reviews to identify problem assets, (ii) estimate the inherent losses in problem assets and establish reserves that are sufficient to absorb estimated losses, (iii) compare problem asset totals to capital, (iv) take appropriate corrective action to resolve problem assets, (v) consider the size and potential risks of material asset concentrations, and (vi) provide periodic asset quality reports with adequate information for management and the board of directors to assess the level of asset risk. These guidelines also set forth standards for evaluating and monitoring earnings and for ensuring that earnings are sufficient for the maintenance of adequate capital and reserves.

Insurance of Accounts. The deposits of the Bank are insured to the maximum extent permitted by the DIF and are backed by the full faith and credit of the U.S. Government. As insurer, the FDIC is authorized to conduct examinations of, and to require reporting by, insured institutions. It also may prohibit any insured institution from engaging in any activity determined by regulation or order to pose a serious threat to the FDIC.

The deposits of the Bank have historically been insured by the FDIC up to $100,000 per insured depositor, except certain types of retirement accounts, which are insured up to $250,000 per insured depositor. On October 3, 2008, the maximum amount insured under FDIC deposit insurance was temporarily increased from $100,000 to $250,000 per insured depositor through December 31, 2009. This increase was part of the EESA of 2008. Additionally, the Bank has elected to participate in the FDIC s Temporary Liquidity Guarantee Program (TLGP). Under the TLGP, all noninterest bearing deposit transaction accounts, lawyers trust accounts and NOW accounts that pay interest rates equal to or less than 50 basis points and public funds held in noninterest bearing accounts with balances over $250,000 will also be fully insured through

December 31, 2009 at an additional cost to the Bank of 10 basis points per dollar over $250,000 on a per account basis. After December 31, 2009, the standard insurance limit will return to $100,000 for all deposit categories except retirement accounts, which will continue to be insured up to $250,000 per insured depositor.

Each FDIC insured institution is assigned to one of three capital groups which are based solely on the level of an institution s capital well capitalized, adequately capitalized, and undercapitalized. These capital levels are defined in the same manner as under the prompt corrective action system discussed above. These three groups are then divided into three subgroups which reflect varying levels of supervisory concern, from those which are considered to be healthy to those which are considered to be of substantial supervisory concern. In 2007 and 2008, the annual insurance premiums on bank deposits insured by the DIF varied between $.05 and $.43 per $100 of deposits.

In addition, all institutions with deposits insured by the FDIC are required to pay assessments to fund interest payments on bonds issued by the Financing Corporation, a mixed-ownership government corporation established to recapitalize the predecessor to the DIF. The annual assessment rate set for the fourth quarter of 2008 was 27.5 basis points of insured deposits and is adjusted quarterly. These assessments will continue until the Financing Corporation bonds mature in 2019.

The FDIC may terminate the deposit insurance of any insured depository institution, including the Bank, if it determines after a hearing that the institution has engaged or is engaging in unsafe or unsound practices, is in an unsafe or unsound condition to continue operations, or has violated any applicable law, regulation, order or any condition imposed by an agreement with the FDIC. It also may suspend deposit insurance temporarily during the hearing process for the permanent termination of insurance, if the institution has no tangible capital. If insurance of accounts is terminated, the accounts at the institution at the time of the termination, less subsequent withdrawals, shall continue to be insured for a period of six months to two years, as determined by the FDIC. Management is aware of no existing circumstances which would result in termination of the Bank s deposit insurance.

On December 16, 2008, the FDIC approved the final rule to raise the risk-based deposit insurance assessment rates uniformly by seven basis points for the first quarter of 2009 assessment period beginning on January 1, 2009. On February 26, 2009, the FDIC approved the final rule to raise the assessment rates for the assessment period beginning on April 1, 2009, and subsequent assessment periods. The new assessment scheme will differentiate between risk profiles and will require riskier institutions to pay higher assessment rates based on classification into one of four risk categories. Institutions that are rated in the category with the lowest risk will see their initial base rates increase to between 12 and 16 basis points.

On February 26, 2009, the FDIC adopted an interim rule, with request for comment, to impose a one-time 20 basis point emergency assessment effective on June 30, 2009 and to be collected on September 30, 2009. Based on our most recent FDIC deposit insurance assessment base, the emergency special assessment of 20 basis points, if implemented, would increase our FDIC deposit insurance premiums by approximately $565,000 in 2009. The FDIC has indicated in recent press reports that it may consider reducing the emergency special assessment by half to 10 basis points if, among other factors, Congress enacts legislation to expand the FDIC s line of credit with the Department of Treasury to $100 billion.

On February 26, 2009, the FDIC adopted another interim rule, with request for comment, to have the option to impose a further special assessment of up to 10 basis points on an institution s assessment base on the last day of any calendar quarter after June 30, 2009 to be collected at the same time the risk-based assessment are collected. The assessment will be imposed if the FDIC determines the DIF reserve ratio will fall to a level that would adversely affect public confidence or to a level close to zero or negative, among other factors. The ultimate goal of the increase in assessment rates and the proposed special assessments is to restore the DIF ratio to a minimum of 1.15% within the next seven years. However, the interim rules are subject to change and may or may not be enacted.

Given the enacted and proposed increases in assessments for insured financial institutions in 2009, the Corporation anticipated that FDIC assessments on deposits will have a significantly greater impact on operating expenses in 2009 compared to 2008 and could materially affect our reported earnings, liquidity and capital.

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Interstate Banking and Branching. Banks have the ability, subject to certain State restrictions, to acquire, by acquisition or merger, branches outside its home state. The establishment of new interstate branches is also possible in those states with laws that expressly permit it. Interstate branches are subject to certain laws of the states in which they are located. Competition may increase further as banks branch across state lines and enter new markets.

Consumer Protection Laws and Regulations. The bank regulatory agencies are focusing greater attention on compliance with consumer protection laws and their implementing regulations. Examination and enforcement have become more intense in nature, and insured institutions have been advised to monitor carefully compliance with such laws and regulations. The Bank is subject to many federal consumer protection statutes and regulations, some of which are discussed below.

The Community Reinvestment Act (CRA) is intended to encourage insured depository institutions, while operating safely and soundly, to help meet the credit needs of their communities. The CRA specifically directs the federal regulatory agencies, in examining insured depository institutions, to assess a bank s record of helping meet the credit needs of its entire community, including low- and moderate-income neighborhoods, consistent with safe and sound banking practices. The CRA further requires the agencies to take a financial institution s record of meeting its community credit needs into account when evaluating applications for, among other things, domestic branches, mergers or acquisitions, or holding company formations. The agencies use the CRA assessment factors in order to provide a rating to the financial institution. The ratings range from a high of outstanding to a low of substantial noncompliance. In its last examination for CRA compliance, as of April 21, 2008, the Bank was rated satisfactory.

On September 1, 2005, the federal banking agencies amended the CRA regulations to:

- Establish the definition of Intermediate Small Bank as an institution with total assets of $250 million to $1 billion, without regard to any holding company; and
- Take into account abusive lending practices by a bank or its affiliates in determining a bank s CRA rating.

The Fair Credit Reporting Act (FCRA), as amended by the Fair and Accurate Credit Transactions Act of 2003 (FACTA), requires financial firms to help deter identity theft, including developing appropriate fraud response programs, and give consumers more control of their credit data. It also reauthorizes a federal ban on state laws that interfere with corporate credit granting and marketing practices. In connection with the FACTA, financial institution regulatory agencies proposed rules that would prohibit an institution from using certain information about a consumer it received from an affiliate to make a solicitation to the consumer, unless the consumer has been notified and given a chance to opt out of such solicitations. A consumer s election to opt out would be applicable for at least five years.

The Federal Trade Commission (FTC), the federal bank regulatory agencies and the National Credit Union Administration (NCUA) have issued regulations (the Red Flag Rules) requiring financial institutions and creditors to develop and implement written identity theft prevention programs as part of the FACTA. The programs must be in place by May 1, 2009 and must provide for the identification, detection and response to patterns, practices or specific activities known as red flags that could indicate identity theft. These red flags may include unusual account activity, fraud alerts on a consumer report or attempted use of suspicious account application documents. The program must also describe appropriate responses that would prevent and mitigate the crime and detail a plan to update the program. The program must be managed by the Board of Directors or senior employees of the institution or creditor, include appropriate staff training and provide oversight of any service providers.

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The Check Clearing for the 21st Century Act (Check 21) facilitates check truncation and electronic check exchange by authorizing a new negotiable instrument called a substitute check, which is the legal equivalent of an original check. Check 21, effective October 28, 2004, does not require banks to create substitute checks or accept checks electronically; however, it does require banks to accept a legally equivalent substitute check in place of an original.

The Equal Credit Opportunity Act (ECOA) generally prohibits discrimination in any credit transaction, whether for consumer or business purposes, on the basis of race, color, religion, national origin, sex, marital status, age (except in limited circumstances), receipt of income from public assistance programs, or good faith exercise of any rights under the Consumer Credit Protection Act.

The Truth in Lending Act (TILA) is designed to ensure that credit terms are disclosed in a meaningful way so that consumers may compare credit terms more readily and knowledgeably. As a result of the TILA, all creditors must use the same credit terminology to express rates and payments, including the annual percentage rate, the finance charge, the amount financed, the total of payments and the payment schedule, among other things.

The Fair Housing Act (FHA) regulates many practices, including making it unlawful for any lender to discriminate in its housing-related lending activities against any person because of race, color, religion, national origin, sex, handicap or familial status. A number of lending practices have been found by the courts to be, or may be considered, illegal under the FHA, including some that are not specifically mentioned in the FHA itself.

The Home Mortgage Disclosure Act (HMDA) grew out of public concern over credit shortages in certain urban neighborhoods and provides public information that will help show whether financial institutions are serving the housing credit needs of the neighborhoods and communities in which they are located. The HMDA also includes a fair lending aspect that requires the collection and disclosure of data about applicant and borrower characteristics as a way of identifying possible discriminatory lending patterns and enforcing anti-discrimination statutes.

The term predatory lending, much like the terms safety and soundness and unfair and deceptive practices, is far-reaching and covers a potentially broad range of behavior. As such, it does not lend itself to a concise or a comprehensive definition. But typically predatory lending involves at least one, and perhaps all three, of the following elements:

- Making unaffordable loans based on the assets of the borrower rather than on the borrower s ability to repay an obligation (asset-based lending)
- Inducing a borrower to refinance a loan repeatedly in order to charge high points and fees each time the loan is refinanced (loan flipping)
- Engaging in fraud or deception to conceal the true nature of the loan obligation from an unsuspecting or unsophisticated borrower.

FRB regulations aimed at curbing such lending significantly widen the pool of high-cost home-secured loans covered by the Home Ownership and Equity Protection Act of 1994, a federal law that requires extra disclosures and consumer protections to borrowers. Lenders that violate the rules face cancellation of loans and penalties equal to the finance charges paid.

Effective April 8, 2005, OCC guidelines require national banks and their operating subsidiaries to comply with certain standards when making or purchasing loans to avoid predatory or abusive residential mortgage lending practices. Failure to comply with the guidelines could be deemed an unsafe and unsound or unfair or deceptive practice, subjecting the bank to supervisory enforcement actions.

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Finally, the Real Estate Settlement Procedures Act (RESPA) requires lenders to provide borrowers with disclosures regarding the nature and cost of real estate settlements. Also, RESPA prohibits certain abusive practices, such as kickbacks, and places limitations on the amount of escrow accounts. Penalties under the above laws may include fines, reimbursements and other penalties. Due to heightened regulatory concern related to compliance with the CRA, FACTA, TILA, FHA, ECOA, HMDA and RESPA generally, the Bank may incur additional compliance costs or be required to expend additional funds for investments in its local community.

Federal Home Loan Bank System. The Bank is a member of the FHLB. Among other benefits, each FHLB serves as a reserve or central bank for its members within its assigned region. Each FHLB is financed primarily from the sale of consolidated obligations of the FHLB system. Each FHLB makes available loans or advances to its members in compliance with the policies and procedures established by the Board of Directors of the individual FHLB. As an FHLB member, the Bank is required to own a certain amount of capital stock in the FHLB. At December 31, 2008, the Bank was in compliance with the stock requirements.

Federal Reserve System. The FRB requires all depository institutions to maintain noninterest bearing reserves at specified levels against their transaction accounts (primarily checking) and non-personal time deposits. At December 31, 2008, the Bank was in compliance with these requirements.

Item 1A. Risk Factors

In analyzing whether to make or to continue an investment in our securities, investors should consider, among other factors, the following risk factors.

The current economic environment poses significant challenges for the Corporation and could adversely affect its financial condition and results of operations.

The Corporation is operating in a challenging and uncertain economic environment, including generally uncertain national and local conditions. Financial institutions continue to be affected by sharp declines in the real estate market and constrained financial markets. Dramatic declines in the housing market over the past year, with falling home prices and increasing foreclosures and unemployment, have resulted in significant write-downs of asset values by financial institutions. Continued declines in real estate values, home sales volumes, and financial stress on borrowers as a result of the uncertain economic environment could have an adverse effect on the Bank s borrowers or their customers, which could adversely affect the Corporation s financial condition and results of operations. A worsening of these conditions would likely exacerbate the adverse effects on the Corporation and others in the financial services industry. For example, further deterioration in local economic conditions in the Corporation s markets could drive losses beyond that which is provided for in its allowance for loan losses. The Corporation may also face the following risks in connection with these events:

- Economic conditions that negatively affect housing prices and the job market have resulted, and may continue to result, in a deterioration in credit quality of the Bank s loan portfolio, and such deterioration in credit quality has had, and could continue to have, a negative impact on the Corporation s business.

- Market developments may affect consumer confidence levels and may cause adverse changes in payment patterns, causing increases in delinquencies and default rates on loans and other credit facilities.

- The processes the Corporation uses to estimate the allowance for loan losses may no longer be reliable because they rely on complex judgments, including forecasts of economic conditions, which may no longer be capable of accurate estimation.

- The Bank s ability to assess the creditworthiness of its customers may be impaired if the processes and approaches it uses to select, manage, and underwrite its customers become less predictive of future charge-offs.

- The Corporation expects to face increased regulation of its industry, and compliance with such regulation may increase its costs, limit its ability to pursue business opportunities, and increase compliance challenges.

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As these conditions or similar ones continue to exist or worsen, the Corporation could experience continuing or increased adverse effects on its financial condition and results of operations.

The Corporation s business is subject to various lending and other economic risks that could adversely impact the Corporation s financial condition and results of operations.

Change in economic conditions, particularly an economic slowdown, could hurt the Corporation s business. The Corporation s business is directly affected by political and market conditions, broad trends in industry and finance, legislative and regulatory changes, and changes in governmental monetary and fiscal policies and inflation, all of which are beyond the Corporation s control. A deterioration in economic conditions, in particular an economic slowdown within the Corporation s geographic region, could result in the following consequences, any of which could have a material adverse effect on the Corporation s business:

- loan delinquencies may increase;
- problem assets and foreclosures may increase;
- demand for the Corporation s products and services may decline; and
- collateral for loans made by the Bank many decline in value, in turn reducing a client s borrowing power, and reducing the value of assets and collateral associated with the Corporation s loans held for investment.

The declining real estate market could impact the Corporation s business.

The Bank s business activities and credit exposures are concentrated in Western Pennsylvania and the surrounding region. A continued downturn in this regional real estate market could hurt the Corporation s business because of the geographic concentration within this regional area. If there is a significant decline in real estate values, the collateral for the Bank s loans will provide less security. As a result, the Bank s ability to recover on defaulted loans by selling the underlying real estate would be diminished, and we would be more likely to suffer losses on defaulted loans.

The building of market share through our branching strategy could cause our expenses to increase faster than revenues.

We opened one new branch office during calendar year 2008. There are considerable costs involved in opening offices and new offices generally require a period of time to generate sufficient revenues to offset their costs, especially in areas in which we do not have an established presence. Accordingly, any new office can be expected to negatively impact our earnings for some period of time until the office reaches certain economies of scale. We have no assurance our new office will be successful even after it has been established.

If external funds are not available, this could adversely impact our growth and future prospects.

We primarily rely on deposits and FHLB advances to fund our operations. Although we have historically been able to replace maturing deposits if desired, no assurance can be given that we will be able to replace such funds in the future if our financial condition or market conditions were to change. Although we consider the sources of existing funds adequate for our current liquidity needs, we may seek brokered deposits or debt in the future to achieve our long-term business objectives. There can be no assurance additional funds, if sought, would be available to us or, if available, would be on favorable terms. If additional financing sources are unavailable or are not available on reasonable terms, our growth and future prospects could be adversely affected.

Item 1B. Unresolved Staff Comments

None.

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Item 2. Properties

The Corporation owns no real property but utilizes the main office of the Bank. The Corporation s and the Bank s executive offices are located at 612 Main Street, Emlenton, Pennsylvania. The Corporation pays no rent or other form of consideration for the use of this facility.

The Corporation owns and leases numerous other premises for use in conducting business activities. The Corporation considers these facilities owned or occupied under lease to be adequate. For additional information regarding the Corporation s properties, see Notes to Consolidated Financial Statements , Note 7, Premises and Equipment.

Item 3. Legal Proceedings

Neither the Bank nor the Corporation is involved in any material legal proceedings. The Bank, from time to time, is party to litigation that arises in the ordinary course of business, such as claims to enforce liens, claims involving the origination and servicing of loans, and other issues related to the business of the Bank. In the opinion of management, the resolution of any such issues would not have a material adverse impact on the financial position, results of operation, or liquidity of the Bank or the Corporation.

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

No matters were submitted to stockholders for a vote during the quarter ended December 31, 2008.

PART II

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

Market, Holder and Dividend Information

Emclaire Financial Corp. common stock is traded on the Over the Counter Bulletin Board (OTCBB) under the symbol EMCF . The listed market makers for the Corporation s common stock include:

Ferris, Baker Watts, Inc.	Boenning and Scattergood	Parker/Hunter
100 Light Street, 8th Floor	4 Tower Bridge, Suite 300	600 Grant Street - Suite 3100
Baltimore, MD 21202	200 Bar Harbor Drive	Pittsburgh, PA 15219
Telephone: (800) 436-2000	West Conshonhocken, PA 19428	Telephone: (800) 441-1514
	Telephone: (800) 883-1212	

The bid and ask price of the Corporation s common stock were $22.10 and $23.50, respectively, as of February 9, 2009. The Corporation traditionally has paid regular quarterly cash dividends. As a result of the Corporation s participation in the U.S. Treasury s CPP, the Corporation may not pay a dividend in excess of $0.32 per share until the earlier of December 23, 2011 and the date the preferred shares have been redeemed in whole or transferred to a non-affiliated third party.

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The following table sets forth the high and low sale market prices of the Corporation s common stock as well as cash dividends paid for the quarterly periods presented:

	Market Price High	Market Price Low	Market Price Close	Cash Dividend
2008:				
Fourth quarter	$ 24.50	$ 20.05	$ 23.50	$ 0.34
Third quarter	26.50	21.00	24.00	0.32
Second quarter	28.00	24.60	25.75	0.32
First quarter	28.35	24.55	26.50	0.32
2007:				
Fourth quarter	$ 28.25	$ 25.20	$ 25.75	$ 0.67
Third quarter	27.75	25.00	25.60	0.29
Second quarter	27.00	23.50	25.25	0.29
First quarter	31.00	26.75	27.25	0.29

In light of current and projected economic conditions, the Board of Directors has determined to reduce the Corporation s quarterly cash dividend from the current rate of $0.32 per share to $0.14 per share effective for the second quarter of 2009. Future dividends will be determined by the Board of Directors after giving consideration to the Corporation s financial condition, results of operations, tax status, industry standards, economic conditions, regulatory requirements and other factors.

As of December 31, 2008, there were approximately 730 stockholders of record and 1,431,404 shares of common stock entitled to vote, receive dividends and considered outstanding for financial reporting purposes. The number of stockholders of record does not include the number of persons or entities who hold their stock in nominee or street name.

Common stockholders may have Corporation dividends reinvested to purchase additional shares. Participants may also make optional cash purchases of common stock through this plan and pay no brokerage commissions or fees. To obtain a plan document and authorization card call 800-757-5755.

Purchases of Equity Securities

The Corporation did not repurchase any of its equity securities in the year ended December 31, 2008.

Item 6. Selected Financial Data

Not applicable as the Corporation is a smaller reporting company.

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

The following discussion and analysis represents a review of Emclaire Financial Corp. s consolidated financial condition and results of operations. This review should be read in conjunction with the consolidated financial statements beginning on page F-3.

Overview

The Corporation reported a decrease in net income of $267,000 or 9.9% for 2008 as consolidated net income amounted to $2.4 million or $1.87 per common share for 2008, compared to net income of $2.7 million or $2.13 per common share for 2007. The decrease resulted from the following:

- Net interest income increased primarily due to an increase in interest earned on loans resulting from the Bank s loan growth during the year.

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- The provision for loan losses increased related to the aforementioned loan growth experienced during the year.

- Noninterest income decreased primarily due to other than temporary impairment charges recorded during 2008 on two marketable equity investment securities. Conversely, during 2007, the Corporation realized security gains primarily from the sale of a community bank stock investment as a result of that bank s merger with a larger financial institution.

- Noninterest expense increased due to severance charges recorded related to the retirement of the Corporation s former Chairman, President and Chief Executive Officer, contract termination fees recorded in connection with an automated teller machine (ATM) processing conversion planned for 2009 and costs related to the additional of a branch banking office in Grove City, Pennsylvania.

- The provision for income taxes decreased as a result of decreased pre-tax income.

- The Corporation realized extraordinary income related to the completion of a merger conversion with ECSLA in Ridgway, Pennsylvania.

During the year ended December 31, 2008, the Corporation experienced asset growth of 20.5% as total assets increased $63.9 million to $375.7 million at year end from $311.7 million at December 31, 2007. This asset growth was driven by total loan portfolio growth of $35.0 million or 15.2%, security portfolio growth of $19.5 million or 37.6% and an increase in cash and equivalents of $6.1 million or 58.1%. This asset growth was funded by an increase in customer deposits of $42.4 million or 17.4% and an increase in borrowed funds of $7.8 million or 19.3%.

Changes in Financial Condition

Total assets increased $63.9 million or 20.5% to $375.7 million at December 31, 2008 from $311.7 million at December 31, 2007. This increase was due to increases in loans receivable, securities available for sale and cash and equivalents of $35.0 million, $19.5 million and $6.1 million, respectively.

The increase in the Corporation s total assets was primarily funded by increases in total liabilities of $52.5 million or 18.3% and total stockholders equity of $11.4 million or 46.2%. The increase in total liabilities was primarily due to an increase in total deposits of $42.4 million or 17.4% and an increase in borrowed funds of $7.8 million or 19.3%. The increase in stockholders equity was primarily due to a purchase of preferred stock by the U.S. Treasury in connection with the CPP and the issuance of common stock related to the Corporation s public stock offering in connection with the ECSLA merger conversion.

Cash and cash equivalents. These accounts increased a combined $6.1 million or 58.1% to $16.6 million at December 31, 2008 from $10.5 million at December 31, 2007. These accounts are typically increased by net operating results, deposits by customers into savings and checking accounts, loan and security repayments and proceeds from borrowed funds. Decreases result from customer deposit withdrawals, new loan originations or other loan fundings, security purchases, repayments of borrowed funds and cash dividends to stockholders. The increased balance is primarily due to the Bank s investment in certificates of deposits with other financial institutions.

Securities. Securities increased $19.5 million or 37.6% to $71.4 million at December 31, 2008 from $51.9 million at December 31, 2007. This increase was primarily related to the purchase of mortgage-backed securities, partially offset by a decrease in U.S. Government agency securities as a result of such securities being called throughout the year. The mortgage-backed securities were funded with short-term borrowings to obtain a favorable interest rate spread.

Loans receivable. Net loans receivable increased $35.0 million or 15.2% to $264.8 million at December 31, 2008 from $229.8 million at December 31, 2007, as a result of loan production of $75.1 million during 2008 partially offset by normal amortization and payoffs. This increase was primarily attributed to growth in the Corporation s commercial and residential mortgage loan portfolios. Commercial real estate loans increased $14.1 million or 19.7% and residential first mortgage loans increased $8.4 million or 12.8% as $7.0 million was added in association with the ECSLA acquisition. Also contributing to loan portfolio growth were increases in home equity and commercial business loans of $8.0 million and $5.2 million, respectively.

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Non-performing assets. Non-performing assets include non-accrual loans, loans 90 days past due and still accruing, REO. Non-performing assets were $1.1 million or 0.28% of total assets at December 31, 2008 compared to $1.1 million or 0.35% of total assets at December 31, 2007. Non-performing assets consisted of non-performing loans and REO of $1.0 million and $50,000, respectively, at December 31, 2008 and $1.0 million and $129,000, respectively, at December 31, 2007. At December 31, 2008, non-performing assets consisted primarily of commercial and residential mortgage loans.

Federal bank stocks. Federal bank stocks were comprised of FHLB stock and FRB stock of $3.5 million and $333,000, respectively, at December 31, 2008. These stocks are purchased and redeemed at par as directed by the federal banks and levels maintained are based primarily on borrowing and other correspondent relationships between the Corporation and the banks. The increase in federal bank stocks can be attributed to increased short-term borrowings with the FHLB. In December 2008, the FHLB notified member banks that it was suspending dividend payments and the repurchase of capital stock. Management evaluated the FHLB stock for impairment and determined that no impairment charge was necessary as of December 31, 2008.

Bank-owned life insurance (BOLI). The Corporation maintains single premium life insurance policies on twenty current and former officers and employees of the Bank. In addition to providing life insurance coverage, whereby the Bank as well as the officers and employees receive life insurance benefits, the appreciation of the cash surrender value of the BOLI will serve to offset and finance existing and future employee benefit costs. Increases in this account during 2008 were associated with an increase in the cash surrender value of the policies, partially offset by certain administrative expenses.

Premises and equipment. Premises and equipment increased $705,000 or 8.9% to $8.6 million at December 31, 2008 from $7.9 million at December 31, 2007. The overall increase in premises and equipment during the year was due to capital expenditures of $1.4 million, partially offset by normal depreciation and amortization of $737,000. Major capital expenditures during the year consisted of improvements made at the full service banking office in Grove City, Pennsylvania that was purchased in December of 2006 and opened during 2008. In addition, construction began on a new facility to replace the current office in East Brady, Pennsylvania. This facility is expected to open during the first quarter of 2009. Also, the Corporation made a significant investment in technology with an upgrade to its mainframe equipment and related system software.

Deposits. Total deposits increased $42.4 million or 17.4% to $286.6 million at December 31, 2008 from $244.3 million at December 31, 2007. Noninterest bearing deposits increased $9.2 million or 19.6% during the year and interest bearing deposits increased by $33.1 million or 16.8%. Contributing to this increase was $6.5 million in deposits obtained at the new Grove City, Pennsylvania office and $6.2 million of deposits added in connection with the ECSLA acquisition. Deposit growth in the remaining eleven offices totaled $29.7 million.

Borrowed funds. Borrowed funds increased $7.8 million or 19.3% to $48.2 million at December 31, 2008 from $40.4 million at December 31, 2007. This increase was related to the funding of certain mortgage-backed investment securities.

Stockholders equity. Stockholders equity increased $11.4 million or 46.2% to $36.1 million at December 31, 2008 from $24.7 million at December 31, 2007. This increase was primarily the result of the U.S. Treasury s purchase of $7.5

million of preferred stock related to the CPP. Also during the year, the Corporation completed a public stock offering related to the ECSLA merger in which 163,569 shares of Emclaire common stock were issued at a price of $21.15, resulting in proceeds of $3.5 million, net of discount on common stock of $293,000.

Changes in Results of Operations

The Corporation reported net income of $2.4 million and $2.7 million in 2008 and 2007, respectively. The following Average Balance Sheet and Yield/Rate Analysis and Analysis of Changes in Net Interest Income tables should be utilized in conjunction with the discussion of the net interest income and interest expense components of net income.

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Average Balance Sheet and Yield/Rate Analysis. The following table sets forth, for the periods indicated, information concerning the total dollar amounts of interest income from interest-earning assets and the resulting average yields, the total dollar amounts of interest expense on interest-bearing liabilities and the resulting average costs, net interest income, interest rate spread and the net interest margin earned on average interest-earning assets. For purposes of this table, average loan balances include non-accrual loans and exclude the allowance for loan losses and interest income includes accretion of net deferred loan fees. Interest and yields on tax-exempt loans and securities (tax-exempt for federal income tax purposes) are shown on a fully tax equivalent basis. The information is based on average daily balances during the periods presented.

	Year ended December 31,					
	2008			2007		
(Dollar amounts in thousands)	**Average Balance**	**Interest**	**Yield / Rate**	**Average Balance**	**Interest**	**Yield / Rate**
Interest-earning assets:						
Loans, taxable	$ 240,714	$ 15,906	6.61%	$ 215,771	$ 15,006	6.95%
Loans, tax-exempt	5,954	370	6.21%	6,286	407	6.47%
Total loans receivable	246,668	16,276	6.60%	222,057	15,413	6.94%
Securities, taxable	44,447	1,992	4.48%	36,882	1,571	4.26%
Securities, tax-exempt	14,031	921	6.56%	14,750	996	6.75%
Total securities	58,478	2,913	4.98%	51,632	2,567	4.97%
Interest-earning deposits with banks	7,515	201	2.67%	3,209	166	5.17%
Federal bank stocks	2,868	102	3.56%	2,315	144	6.22%
Total interest-earning cash equivalents	10,383	303	2.92%	5,524	310	5.61%
Total interest-earning assets	**315,529**	**19,492**	**6.18%**	**279,213**	**18,290**	**6.55%**
Cash and due from banks	5,512			5,952		
Other noninterest-earning assets	14,928			14,649		
Total Assets	$ 335,969			$ 299,814		
Interest-bearing liabilities:						
Interest-bearing demand deposits	$ 92,208	1,332	1.44%	$ 73,364	956	1.30%
Time deposits	121,275	5,083	4.19%	121,889	5,484	4.50%
Total interest-bearing deposits	213,483	6,415	3.00%	195,253	6,440	3.30%
Borrowed funds, short-term	10,096	182	1.80%	1,208	33	2.73%
Borrowed funds, long-term	35,000	1,571	4.49%	31,233	1,413	4.52%
Total borrowed funds	45,096	1,753	3.89%	32,441	1,446	4.46%
Total interest-bearing liabilities	**258,579**	**8,168**	**3.16%**	**227,694**	**7,886**	**3.46%**
Noninterest-bearing demand deposits	48,696			45,086		
Funding and cost of funds	**307,275**	**8,168**	**2.66%**	**272,780**	**7,886**	**2.89%**
Other noninterest-bearing liabilities	2,762			2,810		
Total Liabilities	310,037			275,590		

Stockholders Equity		25,932					24,224			
Total Liabilities and Stockholders Equity	$	335,969				$	299,814			
Net interest income			**$**	**11,324**				**$**	**10,404**	
Interest rate spread (difference between weighted average rate on interest-earning assets and interest-bearing liabilities)					**3.02%**					**3.09%**
Net interest margin (net interest income as a percentage of average interest-earning assets)					**3.59%**					**3.73%**

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Analysis of Changes in Net Interest Income. The following table analyzes the changes in interest income and interest expense in terms of: (1) changes in volume of interest-earning assets and interest-bearing liabilities and (2) changes in yields and rates. The table reflects the extent to which changes in the Corporation s interest income and interest expense are attributable to changes in rate (change in rate multiplied by prior year volume), changes in volume (changes in volume multiplied by prior year rate) and changes attributable to the combined impact of volume/rate (change in rate multiplied by change in volume). The changes attributable to the combined impact of volume/rate are allocated on a consistent basis between the volume and rate variances. Changes in interest income on loans and securities reflect the changes in interest income on a fully tax equivalent basis.

	2008 versus 2007 Increase (decrease) due to		
(Dollar amounts in thousands)	**Volume**	**Rate**	**Total**
Interest income:			
Loans	$ 1,650	$ (787)	$ 863
Securities	341	5	346
Interest-earning deposits with banks	144	(109)	35
Federal bank stocks	29	(71)	(42)
Total interest-earning assets	2,164	(962)	1,202
Interest expense:			
Deposits	574	(599)	(25)
Borrowed funds	510	(203)	307
Total interest-bearing liabilities	1,084	(802)	282
Net interest income	$ 1,080	$ (160)	$ 920

2008 Results Compared to 2007 Results

The Corporation reported net income of $2.4 million and $2.7 million for 2008 and 2007, respectively. The $267,000 or 9.9% decrease in net income was attributed to increases in noninterest expense and the provision for loan losses of $1.9 million and $244,000, respectively, and a decrease in noninterest income of $456,000, partially offset by an increase in net interest income of $956,000 and a decrease in the provision for income taxes of $439,000. In addition, extraordinary income of $906,000 was recorded in 2008 associated with the ECSLA acquisition.

Net interest income. The primary source of the Corporation s revenue is net interest income. Net interest income is the difference between interest income on earning assets such as loans and securities, and interest expense on liabilities, such as deposits and borrowed funds, used to fund the earning assets. Net interest income is impacted by the volume and composition of interest-earning assets and interest-bearing liabilities, and changes in the level of interest rates. Tax equivalent net interest income increased $920,000 to $11.3 million for 2008, compared to $10.4 million for 2007. This increase in net interest income can be attributed to an increase in tax equivalent interest income of $1.2 million partially offset by an increase in interest expense of $282,000.

Interest income. Tax equivalent interest income increased $1.2 million or 6.6% to $19.5 million for 2008, compared to $18.3 million for 2007. This increase can be attributed to increases in interest earned on loans, securities and interest-earning deposits of $863,000, $346,000, and $35,000, partially offset by a decrease in dividends on federal bank stocks of $42,000.

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Tax equivalent interest earned on loans receivable increased $863,000 or 5.6% to $16.3 million for 2008, compared to $15.4 million for 2007. During that time, average loans increased $24.6 million or 11.1%, generating $1.7 million of additional loan interest income. The increase in average loans outstanding can be attributed to $75.1 million of loan production in 2008, the addition of loans from the ECSLA acquisition, and the impact in 2008 of loan growth in late 2007. Offsetting this favorable asset growth, the yield on loans decreased 34 basis points to 6.60% for 2008, versus 6.94% for 2007 as a result of declines in market interest rates throughout 2008 causing a $787,000 decrease in interest income.

Tax equivalent interest earned on securities increased $346,000 or 13.5% to $2.9 million for 2008, compared to $2.6 million for 2007. During this time, average securities increased $6.8 million or 13.3% accounting for $341,000 in additional security interest income. This increase was primarily related to the purchase of mortgage-backed securities during the year. The average yield on securities remained stable at 4.98% for 2008 versus 4.97% for 2007.

Interest earned on interest-earning deposit accounts increased $35,000 to $201,000 for 2008, compared to $166,000 for 2007. Average interest-earning deposits increased $4.3 million or 134.2% primarily related to certificates of deposits held with other financial institutions. This increase generated $144,000 of additional interest income. Partially offsetting the favorable volume variance, the average yield decreased 250 basis points due to declining market interest rates resulting in a $109,000 decrease in interest income. Interest earned on federal bank stocks decreased $42,000 to $102,000 for 2008, compared to $144,000 for 2007 as a result of lower yields despite higher volume.

Interest expense. Interest expense increased $282,000 or 3.6% to $8.2 million for 2008, compared to $7.9 million for 2007. This increase can be attributed to an increase in interest incurred on borrowed funds of $307,000, partially offset by a decrease in interest incurred on interest-bearing deposits of $25,000.

Interest expense on borrowed funds increased $307,000 to $1.8 million for 2008, compared to $1.5 million for 2007 as a result of the addition of $5.0 million of FHLB long-term borrowings placed in the fourth quarter of 2007 to fund loan growth and an increase in average FHLB short-term borrowings to $10.1 million during 2008 from $1.2 million in 2007. The increase in average short-term borrowed funds was due to borrowings utilized primarily to fund the purchase of certain mortgage-backed investment securities.

Deposit interest expense decreased $25,000 and totaled $6.4 million for 2008 and 2007. This decrease was primarily due to a decrease in the cost of interest-bearing deposits of 30 basis points to 3.00% for 2008 compared to 3.30% for 2007 decreasing interest expense by $599,000. Partially offsetting the favorable yield variance, the average volume of deposits increased by $18.2 million or 9.3% contributing an additional $574,000 in interest expense.

Provision for loan losses. The Corporation records provisions for loan losses to maintain a level of total allowance for loan losses that management believes, to the best of its knowledge, covers all known and inherent losses that are both probable and reasonably estimable at each reporting date. Management considers historical loss experience, the present and prospective financial condition of borrowers, current conditions (particularly as they relate to markets where the Corporation originates loans), the status of non-performing assets, the estimated underlying value of the collateral and other factors related to the collectability of the loan portfolio.

The provision for loan losses increased $244,000 or 95.3% to $500,000 for 2008, compared to $256,000 for 2007. The Corporation s allowance for loan losses amounted to $2.7 million or 0.99% of the Corporation s total loan portfolio at December 31, 2008, compared to $2.2 million or 0.93% at December 31, 2007. The allowance for loan losses as a percentage of non-performing loans at December 31, 2008 and 2007 was 262.2% and 226.6%, respectively. The increase in the provision for loan losses was primarily due to the aforementioned growth in the Corporation s loan portfolio.

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Noninterest income. Noninterest income includes revenue that is not related to interest rates, but rather to services rendered and activities conducted in the financial services industry, including fees on depository accounts, general transaction and service fees, commissions on financial services, security and loan gains and losses, and earnings on BOLI. Noninterest income decreased $456,000 or 15.5% to $2.5 million for 2008 compared to $2.9 million for 2007. This decrease was primarily related to impairment charges recorded on two marketable equity securities during 2008 totaling $391,000. The impairment of these financial industry securities were considered to be other than temporary due to developments in the financial conditions and near-term prospects of the issuers, a downturn in economic conditions of the industry and deteriorating book values of the securities. Conversely, during 2007, the Corporation realized $166,000 in gains primarily from the sale of a community bank stock investment as a result of that bank s merger with a larger financial institution.

Partially offsetting this decrease in noninterest income, fee and service charges and other noninterest income increased $89,000 and $71,000, respectively. Theses increases were the result of increased overdraft fee income and gains realized during 2008 associated with the sale of foreclosed properties.

Noninterest expense. Noninterest expense increased $1.9 million or 20.4% to $11.0 million for 2008, compared to $9.2 million for 2007. This increase in noninterest expense was comprised of increases in compensation and employee benefits, premises and equipment and other expenses of $1.3 million, $125,000 and $486,000, respectively.

The largest component of noninterest expense, compensation and employee benefits, increased $1.3 million or 24.7%. This increase was primarily the result of severance charges totaling $590,000 recorded in 2008, principally associated with the retirement of the Corporation s former Chairman of the Board, President and Chief Executive Officer in December 2008. Also contributing to the increase in compensation and benefits expense were customary salary and wage increases and the addition of staff related to the new Grove City, Pennsylvania office which opened in April 2008.

Premises and equipment expense increased $125,000 or 7.9%, related to operating costs associated with the new Grove City office and a write-down of the Bank s East Brady, Pennsylvania building as the current office has not been sold and the new facility will be ready for occupancy in early 2009.

Other expense increased $486,000 or 19.6% primarily due to an increase in other operating expenses of $361,000. The increase in other operating expenses was primarily the result of contract termination fees of $360,000 recognized in connection with an ATM processing conversion planned for 2009. Management s strategic decision to change the Bank s ATM processor was made in an effort to improve customer service, increase operational efficiency and provide future cost savings.

Other expense includes FDIC insurance expense, which totaled $82,000 and $28,000 for the years ended December 31, 2008 and 2007, respectively. Due to the assessment credits that partially offset FDIC premium expense in 2008 and 2007 as well as deposit insurance premium increases projected for 2009 and possible emergency assessments, FDIC insurance expense will be significantly higher in 2009.

The provision for income taxes decreased $439,000 or 55.2% to $356,000 for 2008, compared to $795,000 for 2007 due to a decrease in pre-tax earnings of $1.6 million and a decrease in the Corporation s effective tax rate to 18.9 % for 2008 from 22.8% for 2007.

Extraordinary item. The Corporation recognized $906,000 of extraordinary income during 2008 related to the acquisition of ECSLA. The extraordinary income, also defined as negative goodwill, was the result of the sum of the fair values of the assets acquired less the liabilities assumed exceeding the acquisition cost.

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Market Risk Management

Market risk for the Corporation consists primarily of interest rate risk exposure and liquidity risk. The Corporation is not subject to currency exchange risk or commodity price risk, and has no trading portfolio, and therefore, is not subject to any trading risk. In addition, the Corporation does not participate in hedging transactions such as interest rate swaps and caps. Changes in interest rates will impact both income and expense recorded and also the market value of long-term interest-earning assets.

The primary objective of the Corporation s asset liability management function is to maximize the Corporation s net interest income while simultaneously maintaining an acceptable level of interest rate risk given the Corporation s operating environment, capital and liquidity requirements, balance sheet mix, performance objectives and overall business focus. One of the primary measures of the exposure of the Corporation s earnings to interest rate risk is the timing difference between the repricing or maturity of interest-earning assets and the repricing or maturity of its interest-bearing liabilities.

The Corporation s Board of Directors has established a Finance Committee, consisting of four outside directors, the President and Chief Executive Officer (CEO) and the Principal Accounting Officer (PAO), to monitor market risk, including primarily interest rate risk. This committee, which meets at least quarterly, generally establishes and monitors the investment, interest rate risk and asset liability management policies established by the Corporation.

In order to minimize the potential for adverse affects of material and prolonged changes in interest rates on the Corporation s results of operations, the Corporation s management has implemented and continues to monitor asset liability management policies to better match the maturities and repricing terms of the Corporation s interest-earning assets and interest-bearing liabilities. Such policies have consisted primarily of (i) originating adjustable-rate mortgage loans; (ii) originating short-term secured commercial loans with the rate on the loan tied to the prime rate or reset features in which the rate changes at determined intervals; (iii) emphasizing investment in shorter-term (15 years or less) investment securities; (iv) selling longer-term (30-year) fixed-rate residential mortgage loans in the secondary market; (v) maintaining a high level of liquid assets (including securities classified as available for sale) that can be readily reinvested in higher yielding investments should interest rates rise; (vi) emphasizing the retention of lower-costing savings accounts and other core deposits; and (vii) lengthening liabilities and locking in lower borrowing rates with longer terms whenever possible.

Interest Rate Sensitivity Gap Analysis

The implementation of asset and liability initiatives and strategies and compliance with related policies, combined with other external factors such as demand for the Corporation s products and economic and interest rate environments in general, has resulted in the Corporation maintaining a one-year cumulative interest rate sensitivity gap ranging between a positive and negative 20% of total assets. The one-year interest rate sensitivity gap is identified as the difference between the Corporation s interest-earning assets that are scheduled to mature or reprice within one year and its interest-bearing liabilities that are scheduled to mature or reprice within one year.

The interest rate sensitivity gap is defined as the difference between the amount of interest-earning assets maturing or repricing within a specific time period and the amount of interest-bearing liabilities maturing or repricing within that time period. A gap is considered positive when the amount of interest rate-sensitive assets exceeds the amount of interest rate-sensitive liabilities, and is considered negative when the amount of interest rate-sensitive liabilities exceeds the amount of interest rate-sensitive assets. Generally, during a period of rising interest rates, a negative gap would adversely affect net interest income while a positive gap would result in an increase in net interest income. Conversely, during a period of falling interest rates, a negative gap would result in an increase in net interest income and a positive gap would adversely affect net interest income. The closer to zero, or more neutral, that gap is maintained, generally, the lesser the impact of market interest rate changes on net interest income.

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Based on certain assumptions provided by a federal regulatory agency, which management believes most accurately represents the sensitivity of the Corporation s assets and liabilities to interest rate changes, at December 31, 2008, the Corporation s interest-earning assets maturing or repricing within one year totaled $140.3 million while the Corporation s interest-bearing liabilities maturing or repricing within one-year totaled $114.1 million, providing an excess of interest-bearing assets over interest-earning liabilities of $26.1 million or 7.0% of total assets. At December 31, 2008, the percentage of the Corporation s assets to liabilities maturing or repricing within one year was 122.9%.

The following table presents the amounts of interest-earning assets and interest-bearing liabilities outstanding as of December 31, 2008 which are expected to mature, prepay or reprice in each of the future time periods presented:

(Dollar amounts in thousands)	**Due in six months or less**	**Due within six months to one year**	**Due within one to three years**	**Due within three to five years**	**Due in over five years**	**Total**
Total interest-earning assets	$ 96,261	$ 44,015	$ 95,673	$ 51,658	$ 59,922	$ 347,529
Total interest-bearing liabilities	81,498	32,634	67,848	51,581	101,280	334,841
Maturity or repricing gap during the period	$ 14,763	$ 11,381	$ 27,825	$ 77	$ (41,358)	$ 12,688
Cumulative gap	$ 14,763	$ 26,144	$ 53,969	$ 54,046	$ 12,688	
Ratio of gap during the period to total assets	3.93%	3.03%	7.41%	0.02%	(11.01)%	
Ratio of cumulative gap to total assets	3.93%	6.96%	14.37%	14.39%	3.38%	
Total assets						$ 375,664

Although certain assets and liabilities may have similar maturities or periods of repricing, they may react in different degrees to changes in market interest rates. The interest rates on certain types of assets and liabilities may fluctuate in advance of changes in market interest rates, while interest rates on other types of assets and liabilities may lag behind changes in market interest rates. In the event of a change in interest rates, prepayment and early withdrawal levels would likely deviate significantly from those assumed in calculating the table. The ability of many borrowers to service their debt may decrease in the event of an interest rate increase.

The one-year interest rate sensitivity gap has been the most common industry standard used to measure an institution s interest rate risk position regarding maturities, repricing and prepayments. In recent years, in addition to utilizing interest rate sensitivity gap analysis, the Corporation has increased its emphasis on the utilization of interest rate sensitivity simulation analysis to evaluate and manage interest rate risk.

Interest Rate Sensitivity Simulation Analysis

The Corporation also utilizes income simulation modeling in measuring its interest rate risk and managing its interest rate sensitivity. The Finance Committee of the Corporation believes that simulation modeling enables the Corporation to more accurately evaluate and manage the possible effects on net interest income due to the exposure to changing market interest rates, the slope of the yield curve and different loan and security prepayment and deposit decay assumptions under various interest rate scenarios.

As with gap analysis and earnings simulation modeling, assumptions about the timing and variability of cash flows are critical in net portfolio equity