

SHORE BANCSHARES INC  
Form 10-Q  
November 09, 2010

UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
Washington, D.C. 20549

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FORM 10-Q

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

For the Quarterly Period Ended September 30, 2010

OR

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

For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission file number 0-22345

SHORE BANCSHARES, INC.  
(Exact name of registrant as specified in its charter)

Maryland  
(State or Other Jurisdiction of  
Incorporation or Organization)

52-1974638  
(I.R.S. Employer  
Identification No.)

18 East Dover Street, Easton, Maryland  
(Address of Principal Executive Offices)

21601  
(Zip Code)

(410) 822-1400  
Registrant's Telephone Number, Including Area Code

N/A

Former name, former address and former fiscal year, if changed since last report.

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

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes £ No £ (Not Applicable)

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

|                         |                          |                           |                                     |
|-------------------------|--------------------------|---------------------------|-------------------------------------|
| Large accelerated filer | <input type="checkbox"/> | Accelerated filer         | <input checked="" type="checkbox"/> |
| Non-accelerated filer   | <input type="checkbox"/> | Smaller reporting company | <input type="checkbox"/>            |

(Do not check if a smaller reporting company)

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

APPLICABLE ONLY TO CORPORATE ISSUERS

Indicate the number of shares outstanding of each of the issuer’s classes of common stock, as of the latest practicable date: 8,443,436 shares of common stock outstanding as of October 29, 2010.

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## PART I – FINANCIAL INFORMATION

## Item 1. Financial Statements.

SHORE BANCSHARES, INC.  
 CONSOLIDATED BALANCE SHEETS  
 (Dollars in thousands, except per share amounts)

|  | September 30,<br>2010<br>(Unaudited) | December 31,<br>2009 |
|--|--------------------------------------|----------------------|
| <b>ASSETS</b>  |                                      |                      |
| Cash and due from banks  | \$ 21,764                            | \$ 14,411            |
| Interest-bearing deposits with other banks   | 18,014                               | 598                  |
| Federal funds sold   | 35,161                               | 60,637               |
| Investment securities:   |                                      |                      |
| Available for sale, at fair value  | 96,219                               | 97,595               |
| Held to maturity, at amortized cost – fair value of \$8,125 (2010) and \$9,012 (2009)  | 7,856                                | 8,940                |
| Loans  | 906,490                              | 916,557              |
| Less: allowance for credit losses  | (13,153)                             | (10,876)             |
| Loans, net   | 893,337                              | 905,681              |
| Premises and equipment, net  | 14,714                               | 14,307               |
| Goodwill   | 12,954                               | 15,954               |
| Other intangible assets, net   | 4,969                                | 5,406                |
| Other real estate and other assets owned, net  | 1,517                                | 2,572                |
| Other assets   | 27,998                               | 30,415               |
| <b>TOTAL ASSETS</b>  | <b>\$ 1,134,503</b>                  | <b>\$ 1,156,516</b>  |
| <b>LIABILITIES</b>   |                                      |                      |
| Deposits:  |                                      |                      |
| Noninterest-bearing demand   | \$ 121,480                           | \$ 122,492           |
| Interest-bearing demand  | 122,774                              | 133,946              |
| Money market and savings   | 261,500                              | 249,793              |
| Certificates of deposit \$100,000 or more  | 266,082                              | 262,663              |
| Other time   | 210,592                              | 222,043              |
| Total deposits   | 982,428                              | 990,937              |
| Short-term borrowings  | 17,782                               | 20,404               |
| Accrued expenses and other liabilities   | 10,509                               | 15,936               |
| Long-term debt   | 1,429                                | 1,429                |
| <b>TOTAL LIABILITIES</b>   | <b>1,012,148</b>                     | <b>1,028,706</b>     |
| <b>STOCKHOLDERS' EQUITY</b>  |                                      |                      |
| Common stock, par value \$.01 per share; shares authorized – 35,000,000; shares issued and outstanding – 8,443,436 (2010) and 8,418,963 (2009) | 84                                   | 84                   |
| Warrant  | 1,543                                | 1,543                |
| Additional paid in capital   | 30,173                               | 29,872               |
| Retained earnings  | 92,115                               | 96,151               |
| Accumulated other comprehensive (loss) income  | (1,560)                              | 160                  |

|  |              |              |
|--|--------------|--------------|
| TOTAL STOCKHOLDERS' EQUITY                 | 122,355      | 127,810      |
| TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY | \$ 1,134,503 | \$ 1,156,516 |

See accompanying notes to Consolidated Financial Statements.

SHORE BANCSHARES, INC.  
CONSOLIDATED STATEMENTS OF INCOME (LOSS) (Unaudited)  
(Dollars in thousands, except per share amounts)

|   | For the Three Months Ended |           | For the Nine Months Ended |           |
|---|----------------------------|-----------|---------------------------|-----------|
|   | September 30,              |           | September 30,             |           |
|   | 2010                       | 2009      | 2010                      | 2009      |
| <b>INTEREST INCOME</b>                                |                            |           |                           |           |
| Interest and fees on loans                            | \$ 13,083                  | \$ 14,001 | \$ 39,004                 | \$ 41,372 |
| Interest and dividends on investment securities:      |                            |           |                           |           |
| Taxable   | 677                        | 800       | 2,405                     | 2,324     |
| Tax-exempt  | 50                         | 77        | 165                       | 241       |
| Interest on federal funds sold                        | 21                         | 31        | 47                        | 61        |
| Interest on deposits with other banks                 | 6                          | 4         | 11                        | 11        |
| Total interest income                                 | 13,837                     | 14,913    | 41,632                    | 44,009    |
| <b>INTEREST EXPENSE</b>                               |                            |           |                           |           |
| Interest on deposits                                  | 3,117                      | 4,368     | 9,744                     | 13,094    |
| Interest on short-term borrowings                     | 17                         | 19        | 68                        | 96        |
| Interest on long-term debt                            | 16                         | 98        | 47                        | 247       |
| Total interest expense                                | 3,150                      | 4,485     | 9,859                     | 13,437    |
| NET INTEREST INCOME                                   | 10,687                     | 10,428    | 31,773                    | 30,572    |
| Provision for credit losses                           | 4,193                      | 1,702     | 16,727                    | 5,318     |
| NET INTEREST INCOME AFTER PROVISION FOR CREDIT LOSSES | 6,494                      | 8,726     | 15,046                    | 25,254    |
| <b>NONINTEREST INCOME</b>                             |                            |           |                           |           |
| Service charges on deposit accounts                   | 841                        | 861       | 2,458                     | 2,558     |
| Trust and investment fee income                       | 357                        | 274       | 1,145                     | 750       |
| Investment securities gains                           | -                          | -         | -                         | 49        |
| Insurance agency commissions                          | 2,513                      | 2,744     | 7,997                     | 8,972     |
| Other noninterest income                              | 932                        | 840       | 2,493                     | 3,087     |
| Total noninterest income                              | 4,643                      | 4,719     | 14,093                    | 15,416    |
| <b>NONINTEREST EXPENSE</b>                            |                            |           |                           |           |
| Salaries and wages                                    | 4,404                      | 4,765     | 13,257                    | 14,064    |
| Employee benefits                                     | 897                        | 1,211     | 2,936                     | 3,791     |
| Occupancy expense                                     | 547                        | 616       | 1,766                     | 1,752     |
| Furniture and equipment expense                       | 325                        | 299       | 938                       | 915       |
| Data processing                                       | 696                        | 675       | 1,987                     | 1,865     |
| Directors' fees                                       | 118                        | 109       | 344                       | 394       |
| Goodwill and other intangible assets impairment       | 3,051                      | -         | 3,051                     | -         |
| Amortization of other intangible assets               | 128                        | 128       | 386                       | 386       |
| Insurance agency commissions expense                  | 338                        | 428       | 1,230                     | 1,515     |
| FDIC insurance premium expense                        | 448                        | 458       | 1,389                     | 1,621     |
| Other noninterest expenses                            | 1,677                      | 1,608     | 5,354                     | 4,570     |

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|  |            |          |            |          |
|--|------------|----------|------------|----------|
| Total noninterest expense                          | 12,629     | 10,297   | 32,638     | 30,873   |
| (LOSS) INCOME BEFORE INCOME TAXES                  | (1,492)    | 3,148    | (3,499)    | 9,797    |
| Income tax (benefit) expense                       | (92)       | 1,197    | (982)      | 3,740    |
| NET (LOSS) INCOME                                  | (1,400)    | 1,951    | (2,517)    | 6,057    |
| Preferred stock dividends and discount accretion   | -          | -        | -          | 1,876    |
| Net (loss) income available to common shareholders | \$ (1,400) | \$ 1,951 | \$ (2,517) | \$ 4,181 |
| Basic net (loss) earnings per common share         | \$ (0.17)  | \$ 0.23  | \$ (0.30)  | \$ 0.50  |
| Diluted net (loss) earnings per common share       | \$ (0.17)  | \$ 0.23  | \$ (0.30)  | \$ 0.50  |
| Dividends paid per common share                    | \$ 0.06    | \$ 0.16  | \$ 0.18    | \$ 0.48  |

See accompanying notes to Consolidated Financial Statements.

SHORE BANCSHARES, INC.  
CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY (Unaudited)  
For the Nine Months Ended September 30, 2010 and 2009  
(Dollars in thousands, except per share amounts)

|  | Preferred | Common |          | Additional | Retained  | Accumulated   | Total         |
|--|-----------|--------|----------|------------|-----------|---------------|---------------|
|  | Stock     | Stock  | Warrant  | Paid in    | Earnings  | Other         | Stockholders' |
|  |           |        |          | Capital    |           | Comprehensive | Equity        |
|  |           |        |          |            |           | Income        |               |
|  |           |        |          |            |           | (Loss)        |               |
| Balances, January 1, 2010  | \$ -      | \$ 84  | \$ 1,543 | \$ 29,872  | \$ 96,151 | \$ 160        | \$ 127,810    |
| Comprehensive income:  |           |        |          |            |           |               |               |
| Net loss   | -         | -      | -        | -          | (2,517)   | -             | (2,517)       |
| Unrealized gains on available-for-sale securities, net of taxes  | -         | -      | -        | -          | -         | 989           | 989           |
| Unrealized losses on cash flow hedging activities, net of taxes  | -         | -      | -        | -          | -         | (2,709)       | (2,709)       |
| Total comprehensive income                                       |           |        |          |            |           |               | (4,237)       |
| Stock-based compensation expense                                 |           |        |          |            |           |               |               |
|  | -         | -      | -        | 301        | -         | -             | 301           |
| Cash dividends paid (\$0.18 per share)                           |           |        |          |            |           |               |               |
|  | -         | -      | -        | -          | (1,519)   | -             | (1,519)       |
| Balances, September 30, 2010                                     | \$ -      | \$ 84  | \$ 1,543 | \$ 30,173  | \$ 92,115 | \$ (1,560)    | \$ 122,355    |
| Balances, January 1, 2009  | \$ -      | \$ 84  | \$ -     | \$ 29,768  | \$ 96,140 | \$ 1,393      | \$ 127,385    |
| Comprehensive income:  |           |        |          |            |           |               |               |
| Net income   | -         | -      | -        | -          | 6,057     | -             | 6,057         |
| Unrealized losses on available-for-sale securities, net of taxes | -         | -      | -        | -          | -         | (276)         | (276)         |
| Unrealized losses on cash flow hedging activities, net of taxes  | -         | -      | -        | -          | -         | (652)         | (652)         |
| Total comprehensive income                                       |           |        |          |            |           |               | 5,129         |
| Warrant issued   |           |        |          |            |           |               |               |
|  | -         | -      | 1,543    | -          | -         | -             | 1,543         |
| Preferred shares issued pursuant to TARP                         |           |        |          |            |           |               |               |
|  | 25,000    | -      | -        | -          | -         | -             | 25,000        |
| Discount from issuance of preferred stock                        |           |        |          |            |           |               |               |
|  | (1,543)   | -      | -        | -          | -         | -             | (1,543)       |
| Discount accretion   |           |        |          |            |           |               |               |
|  | 68        | -      | -        | -          | (68)      | -             | -             |



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|  |          |       |          |           |           |        |            |
|--|----------|-------|----------|-----------|-----------|--------|------------|
| Repurchase of preferred stock                        | (23,525) | -     | -        | -         | -         | -      | (23,525)   |
| Common shares issued for employee stock-based awards | -        | -     | -        | 2         | -         | -      | 2          |
| Stock-based compensation expense                     | -        | -     | -        | 74        | -         | -      | 74         |
| Preferred stock dividends                            | -        | -     | -        | -         | (1,808)   | -      | (1,808)    |
| Cash dividends paid (\$0.48 per share)               | -        | -     | -        | -         | (4,038)   | -      | (4,038)    |
| Balances, September 30, 2009                         | \$ -     | \$ 84 | \$ 1,543 | \$ 29,844 | \$ 96,283 | \$ 465 | \$ 128,219 |

See accompanying notes to Consolidated Financial Statements.

SHORE BANCSHARES, INC.  
 CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (LOSS) (Unaudited)  
 (Dollars in thousands)

|  | For the Three Months Ended |          | For the Nine Months Ended |          |
|--|----------------------------|----------|---------------------------|----------|
|  | September 30,              |          | September 30,             |          |
|  | 2010                       | 2009     | 2010                      | 2009     |
| Net (loss) income  | \$ (1,400)                 | \$ 1,951 | \$ (2,517)                | \$ 6,057 |
| Other comprehensive (loss) income:                                 |                            |          |                           |          |
| Securities available for sale:                                     |                            |          |                           |          |
| Unrealized holding gains (losses) on available-for-sale securities | 242                        | 604      | 1,654                     | (410)    |
| Tax effect   | (97)                       | (241)    | (665)                     | 163      |
| Reclassification of gains recognized in net income                 | -                          | -        | -                         | (49)     |
| Tax effect   | -                          | -        | -                         | 20       |
| Net of tax amount  | 145                        | 363      | 989                       | (276)    |
| Cash flow hedging activities:                                      |                            |          |                           |          |
| Unrealized holding losses on cash flow hedging activities          | (1,077)                    | (1,093)  | (4,543)                   | (1,093)  |
| Tax effect   | 435                        | 441      | 1,834                     | 441      |
| Net of tax amount  | (642)                      | (652)    | (2,709)                   | (652)    |
| Total other comprehensive loss                                     | (497)                      | (289)    | (1,720)                   | (928)    |
| Comprehensive (loss) income  | \$ (1,897)                 | \$ 1,662 | \$ (4,237)                | \$ 5,129 |

See accompanying notes to Consolidated Financial Statements.

SHORE BANCSHARES, INC.  
CONSOLIDATED STATEMENTS OF CASH FLOWS (Unaudited)  
(Dollars in thousands)

|   | For the Nine Months Ended<br>September 30, |          |
|---|--|----------|
|   | 2010                                       | 2009     |
| <b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>                                      |  |          |
| Net (loss) income   | \$ (2,517)                                 | \$ 6,057 |
| Adjustments to reconcile net income to net cash provided by operating activities: |  |          |
| Provision for credit losses   | 16,727                                     | 5,318    |
| Goodwill and other intangible assets impairment                                   | 3,051                                      | -        |
| Depreciation and amortization   | 1,835                                      | 1,370    |
| Discount accretion on debt securities   | (91)                                       | (191)    |
| Stock-based compensation expense  | 301  | 74       |
| Gains on sales of securities  | -  | (49)     |
| Losses on sales of other real estate owned  | 56   | -        |
| Write-downs of other real estate owned  | 657  | 159      |
| Gains on interest rate swaps  | -  | (420)    |
| Net changes in:   |  |          |
| Insurance premiums receivable   | 565  | 155      |
| Accrued interest receivable   | 90   | (163)    |
| Other assets  | (1,589)                                    | (1,704)  |
| Accrued interest payable  | (855)                                      | (132)    |
| Other liabilities   | (4,572)                                    | 285      |
| Net cash provided by operating activities   | 13,658                                     | 10,759   |
| <b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>                                      |  |          |
| Proceeds from maturities and principal payments of securities available for sale  | 44,113                                     | 36,686   |
| Proceeds from sales of securities available for sale                              | -  | 2,048    |
| Purchases of securities available for sale  | (41,580)                                   | (54,851) |
| Proceeds from maturities and principal payments of securities held to maturity    | 1,070                                      | 2,815    |
| Purchases of securities held to maturity  | -  | (1,563)  |
| Net increase in loans   | (5,030)                                    | (36,059) |
| Purchases of premises and equipment   | (1,253)                                    | (982)    |
| Proceeds from sales of other real estate owned                                    | 990  | -        |
| Purchases of interest rate caps   | -  | (6,475)  |
| Investment in unconsolidated subsidiary   | (25)                                       | -        |
| Net cash used in investing activities   | (1,715)                                    | (58,381) |
| <b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>                                      |  |          |
| Net (decrease) increase in demand, money market and savings deposits              | (477)                                      | 102,839  |
| Net (decrease) increase in certificates of deposit                                | (8,032)                                    | 43,987   |
| Net decrease in short-term borrowings   | (2,622)                                    | (35,296) |
| Repayment of long-term debt   | -  | (6,000)  |
| Net receipt of counterparty collateral – interest rate caps                       | -  | 6,528    |
| Proceeds from issuance of preferred stock and warrant                             | -  | 25,000   |
| Repurchase of preferred stock   | -  | (23,525) |
| Proceeds from issuance of common stock  | -  | 2        |

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|  |           |           |
|--|-----------|-----------|
| Preferred stock dividends paid                       | -         | (1,808)   |
| Common stock dividends paid                          | (1,519)   | (4,038)   |
| Net cash (used in) provided by financing activities  | (12,650)  | 107,689   |
| Net (decrease) increase in cash and cash equivalents | (707)     | 60,067    |
| Cash and cash equivalents at beginning of period     | 75,646    | 27,294    |
| Cash and cash equivalents at end of period           | \$ 74,939 | \$ 87,361 |
| Supplemental cash flows information:                 |           |           |
| Interest paid  | \$ 10,715 | \$ 13,569 |
| Income taxes paid                                    | \$ 988    | \$ 3,678  |
| Transfers from loans to other real estate owned      | \$ 668    | \$ 2,072  |

See accompanying notes to Consolidated Financial Statements.

Shore Bancshares, Inc.  
Notes to Consolidated Financial Statements  
For the Three and Nine Months Ended September 30, 2010 and 2009  
(Unaudited)

Note 1 - Basis of Presentation

The consolidated financial statements include the accounts of Shore Bancshares, Inc. and its subsidiaries with all significant intercompany transactions eliminated. The consolidated financial statements conform to accounting principles generally accepted in the United States of America (“GAAP”) and to prevailing practices within the banking industry. The accompanying interim financial statements are unaudited; however, in the opinion of management all adjustments necessary to present fairly the consolidated financial position at September 30, 2010, the consolidated results of operations and comprehensive income for the three and nine months ended September 30, 2010 and 2009, and changes in stockholders’ equity and cash flows for the nine months ended September 30, 2010 and 2009, have been included. All such adjustments are of a normal recurring nature. The amounts as of December 31, 2009 were derived from the 2009 audited financial statements. The results of operations for the three and nine months ended September 30, 2010 are not necessarily indicative of the results to be expected for any other interim period or for the full year. This Quarterly Report on Form 10-Q should be read in conjunction with the Annual Report of Shore Bancshares, Inc. on Form 10-K for the year ended December 31, 2009. For purposes of comparability, certain reclassifications have been made to amounts previously reported to conform with the current period presentation.

Shore Bancshares, Inc. has evaluated events and transactions occurring subsequent to the balance sheet date of September 30, 2010 for items that should potentially be recognized or disclosed in these financial statements as prescribed by Topic 855, “Subsequent Events”, of the Financial Accounting Standards Board’s Accounting Standards Codification (“ASC”).

When used in these notes, the term “the Company” refers to Shore Bancshares, Inc. and, unless the context requires otherwise, its consolidated subsidiaries.

Note 2 – Earnings Per Share

Basic earnings/(loss) per common share are calculated by dividing net income/(loss) available to common stockholders by the weighted average number of common shares outstanding during the period. Diluted earnings/(loss) per common share are calculated by dividing net income/(loss) available to common stockholders by the weighted average number of common shares outstanding during the period, adjusted for the dilutive effect of stock-based awards. There is no dilutive effect on the loss per share during loss periods. The following table provides information relating to the calculation of earnings/(loss) per common share:

| (In thousands, except per share data)              | For the Three Months Ended |          | For the Nine Months Ended |          |
|--|----------------------------|----------|---------------------------|----------|
|  | September 30,              |          | September 30,             |          |
|  | 2010                       | 2009     | 2010                      | 2009     |
| Net (loss) income available to common shareholders | \$ (1,400)                 | \$ 1,951 | \$ (2,517)                | \$ 4,181 |
| Weighted average shares outstanding - Basic        | 8,443                      | 8,419    | 8,441                     | 8,412    |
| Dilutive effect of stock-based awards              | -                          | 4        | -                         | 4        |
| Weighted average shares outstanding - Diluted      | 8,443                      | 8,423    | 8,441                     | 8,416    |
| (Loss) earnings per common share - Basic           | \$ (0.17)                  | \$ 0.23  | \$ (0.30)                 | \$ 0.50  |
| (Loss) earnings per common share - Diluted         | \$ (0.17)                  | \$ 0.23  | \$ (0.30)                 | \$ 0.50  |

The calculations of diluted earnings/(loss) per share for the three and nine months ended September 30, 2010 each excluded eight thousand weighted average stock-based awards and that portion of a warrant to purchase 173 thousand weighted average shares of common stock because the effect would have been antidilutive. There were no weighted average stock-based awards excluded from the calculations of diluted earnings per share for the three and nine months ended September 30, 2009. The calculations of diluted earnings per share for the three and nine months ended September 30, 2009 excluded that portion of a warrant to purchase 173 thousand and 168 thousand weighted average shares of common stock, respectively, because the effect would have been antidilutive.

## Note 3 – Investment Securities

The amortized cost and estimated fair values of investment securities are as follows:

| (Dollars in thousands)                                   | Amortized<br>Cost | Gross<br>Unrealized<br>Gains | Gross<br>Unrealized<br>Losses | Estimated<br>Fair<br>Value |
|--|-------------------|------------------------------|-------------------------------|----------------------------|
| Available-for-sale securities:                           |                   |                              |                               |                            |
| September 30, 2010:                                      |                   |                              |                               |                            |
| Obligations of U.S. Government agencies and corporations | \$ 55,902         | \$ 1,648                     | \$ 32                         | \$ 57,518                  |
| Mortgage-backed securities                               | 36,888            | 1,320                        | 91                            | 38,117                     |
| Other equity securities                                  | 561               | 23                           | -                             | 584                        |
| Total  | \$ 93,351         | \$ 2,991                     | \$ 123                        | \$ 96,219                  |

|  |           |          |        |           |
|--|-----------|----------|--------|-----------|
| December 31, 2009:                                       |           |          |        |           |
| Obligations of U.S. Treasury                             | \$ 2,998  | \$ -     | \$ -   | \$ 2,998  |
| Obligations of U.S. Government agencies and corporations | 57,258    | 879      | 397    | 57,740    |
| Mortgage-backed securities                               | 35,579    | 818      | 90     | 36,307    |
| Other equity securities                                  | 546       | 4        | -      | 550       |
| Total  | \$ 96,381 | \$ 1,701 | \$ 487 | \$ 97,595 |

## Held-to-maturity securities:

September 30, 2010:

|  |          |        |      |          |
|--|----------|--------|------|----------|
| Obligations of states and political subdivisions | \$ 7,856 | \$ 273 | \$ 4 | \$ 8,125 |
|--|----------|--------|------|----------|

December 31, 2009:

|  |          |        |       |          |
|--|----------|--------|-------|----------|
| Obligations of states and political subdivisions | \$ 8,940 | \$ 163 | \$ 91 | \$ 9,012 |
|--|----------|--------|-------|----------|

The amortized cost and estimated fair values of investment securities by maturity date at September 30, 2010 are as follows:

| (Dollars in thousands)                 | Available for sale |                         | Held to maturity  |                         |
|--|--------------------|-------------------------|-------------------|-------------------------|
|  | Amortized<br>Cost  | Estimated<br>Fair Value | Amortized<br>Cost | Estimated<br>Fair Value |
| Due in one year or less                | \$ 6,263           | \$ 6,390                | \$ 1,653          | \$ 1,658                |
| Due after one year through five years  | 38,508             | 39,374                  | 4,479             | 4,659                   |
| Due after five years through ten years | 23,595             | 24,661                  | 1,724             | 1,808                   |
| Due after ten years                    | 24,424             | 25,210                  | -                 | -                       |
|  | 92,790             | 95,635                  | 7,856             | 8,125                   |
| Equity securities                      | 561                | 584                     | -                 | -                       |
| Total                                  | \$ 93,351          | \$ 96,219               | \$ 7,856          | \$ 8,125                |

The maturity dates for mortgage-backed securities are determined by expected maturity dates. The maturity dates for the remaining debt securities are determined using contractual maturity dates.





Gross unrealized losses and fair value by length of time that the individual available-for-sale securities have been in a continuous unrealized loss position at September 30, 2010, are as follows:

| (Dollars in thousands)                   | Less than<br>12 Months |                      | More than<br>12 Months |                      | Total         |                      |
|--|------------------------|----------------------|------------------------|----------------------|---------------|----------------------|
|  | Fair<br>Value          | Unrealized<br>Losses | Fair<br>Value          | Unrealized<br>Losses | Fair<br>Value | Unrealized<br>Losses |
| <b>Available-for-sale securities:</b>    |                        |                      |                        |                      |               |                      |
| U.S. Gov't. agencies and<br>corporations | \$ 7,055               | \$ 32                | \$ -                   | \$ -                 | \$ 7,055      | \$ 32                |
| Mortgage-backed securities               | 7,258                  | 91                   | -                      | -                    | 7,258         | 91                   |
| Total                                    | \$ 14,313              | \$ 123               | \$ -                   | \$ -                 | \$ 14,313     | \$ 123               |

The available-for-sale securities have a fair value of approximately \$96.2 million. Of these securities, approximately \$14.3 million have unrealized losses when compared to their amortized cost. The securities with the unrealized losses in the available-for-sale portfolio all have modest duration risk, low credit risk, and minimal losses (approximately 0.13%) when compared to amortized cost. The unrealized losses on debt securities that exist are the result of market changes in interest rates since original purchase. Because the Company does not intend to sell these debt securities and it is not more likely than not that the Company will be required to sell these securities before recovery of their amortized cost bases, which may be at maturity, the Company considers the unrealized losses in the available-for-sale portfolio to be temporary.

Gross unrealized losses and fair value by length of time that the individual held-to-maturity securities have been in a continuous unrealized loss position at September 30, 2010, are as follows:

| (Dollars in thousands)                              | Less than<br>12 Months |                      | More than<br>12 Months |                      | Total         |                      |
|---|------------------------|----------------------|------------------------|----------------------|---------------|----------------------|
|   | Fair<br>Value          | Unrealized<br>Losses | Fair<br>Value          | Unrealized<br>Losses | Fair<br>Value | Unrealized<br>Losses |
| <b>Held-to-maturity securities:</b>                 |                        |                      |                        |                      |               |                      |
| Obligations of states and<br>political subdivisions | \$ 51                  | \$ 1                 | \$ 186                 | \$ 3                 | \$ 237        | \$ 4                 |

The held-to-maturity securities have a fair value of approximately \$8.1 million. Approximately \$237 thousand of these securities have unrealized losses when compared to their amortized cost. All of the securities with unrealized losses are municipal securities with modest duration risk, low credit risk, and minimal losses (approximately 0.05%) when compared to amortized cost. The unrealized losses that exist are the result of market changes in interest rates since the original purchase. Because the Company does not intend to sell these securities and it is not more likely than not that the Company will be required to sell these securities before recovery of their amortized cost bases, which may be at maturity, the Company considers that the unrealized losses in the held-to-maturity portfolio to be temporary.

#### Note 4 – Impaired Loans

A loan is considered impaired if it is probable that the Company will not collect all principal and interest payments according to the loan's contracted terms. The impairment of a loan is measured at the present value of expected future cash flows using the loan's effective interest rate, or at the loan's observable market price or the fair value of the collateral if the loan is collateral dependent. Interest income generally is not recognized on specific impaired loans unless the likelihood of further loss is remote. Interest payments received on such loans are applied as a reduction of the loan's principal balance. Interest income on other nonaccrual loans is recognized only to the extent of interest

payments received.

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Information with respect to impaired loans and the related valuation allowance is shown below:

| (Dollars in thousands)  | September 30,<br>2010 | December 31,<br>2009 | September 30,<br>2009 |
|---|-----------------------|----------------------|-----------------------|
| Impaired loans with a valuation allowance                           | \$ 904                | \$ 2,028             | \$ 548                |
| Impaired loans with no valuation allowance                          | 35,881                | 14,274               | 14,919                |
| Total impaired loans  | \$ 36,785             | \$ 16,302            | \$ 15,467             |
| Allowance for credit losses applicable to impaired loans            | \$ 223                | \$ 468               | \$ 226                |
| Allowance for credit losses applicable to other than impaired loans | 12,930                | 10,408               | 10,497                |
| Total allowance for credit losses                                   | \$ 13,153             | \$ 10,876            | \$ 10,723             |
| Average recorded investment in impaired loans                       | \$ 30,258             | \$ 12,646            | \$ 11,733             |

Gross interest income of \$1.6 million for the first nine months of 2010, \$859 thousand for fiscal year 2009 and \$576 thousand for the first nine months of 2009 would have been recorded if nonaccrual loans had been current and performing in accordance with their original terms. Interest actually recorded on such loans was \$0 for the first nine months of 2010 and \$4 thousand for both fiscal year 2009 and the first nine months of 2009.

Impaired loans do not include groups of smaller balance homogenous loans such as residential mortgage and consumer installment loans that are evaluated collectively for impairment. Reserves for probable credit losses related to these loans are based upon historical loss ratios and are included in the allowance for credit losses.

#### Note 5 – Other Assets and Liabilities

The Company had the following other assets at September 30, 2010 and December 31, 2009.

| (Dollars in thousands)              | September 30, 2010 | December 31, 2009 |
|-------------------------------------|--------------------|-------------------|
| Nonmarketable investment securities | \$ 3,038           | \$ 3,149          |
| Insurance premiums receivable       | 418                | 983               |
| Accrued interest receivable         | 4,714              | 4,804             |
| Deferred income taxes               | 6,719              | 3,337             |
| Interest rate caps (1)              | 1,389              | 6,168             |
| Prepaid FDIC premium expense        | 4,419              | 5,449             |
| Other assets                        | 7,301              | 6,525             |
| Total                               | \$ 27,998          | \$ 30,415         |

The Company had the following other liabilities at September 30, 2010 and December 31, 2009.

| (Dollars in thousands)                           | September 30, 2010 | December 31, 2009 |
|--|--------------------|-------------------|
| Accrued interest payable                         | \$ 926             | \$ 1,781          |
| Counterparty collateral - interest rate caps (1) | 1,656              | 4,847             |
| Other liabilities                                | 7,927              | 9,308             |
| Total  | \$ 10,509          | \$ 15,936         |

(1) See Note 8 for further discussion.

#### Note 6 - Stock-Based Compensation

At September 30, 2010, the Company maintained two equity compensation plans under which it may issue shares of common stock or grant other equity-based awards: (i) the Shore Bancshares, Inc. 2006 Stock and Incentive Compensation Plan (“2006 Equity Plan”); and (ii) the Shore Bancshares, Inc. 1998 Stock Option Plan (the “1998 Option Plan”). The Company's ability to grant options under the 1998 Option Plan expired on March 3, 2008 pursuant to the terms of that plan, but stock options granted thereunder were outstanding as of September 30, 2010.

Stock-based awards granted to date generally are time-based, vest in equal installments on each anniversary of the grant date over a three- to five-year period of time, and, in the case of stock options, expire 10 years from the grant date.

During the three and nine months ended September 30, 2010, the Company recognized pre-tax stock-based compensation expense of \$92 thousand and \$301 thousand, respectively, compared to \$28 thousand and \$74 thousand, respectively, for the same periods last year. Stock-based compensation expense is recognized ratably over the requisite service period for all awards and is based on the grant-date fair value. Unrecognized stock-based compensation expense related to nonvested share-based compensation arrangements was \$515 thousand as of September 30, 2010. The weighted-average period over which this unrecognized expense was expected to be recognized was 1.8 years.

The following table summarizes restricted stock award activity for the Company under the 2006 Equity Plan for the nine months ended September 30, 2010:

|                                  | Number<br>of Shares | Weighted Average<br>Date Fair Value | Grant<br>Value |
|----------------------------------|---------------------|-------------------------------------|----------------|
| Nonvested at beginning of period | 27,405              | \$                                  | 20.23          |
| Granted                          | 24,473              |                                     | 13.41          |
| Vested                           | (7,751)             |                                     | 18.47          |
| Cancelled                        | -                   |                                     | -              |
| Nonvested at end of period       | 44,127              | \$                                  | 16.76          |

The Company estimates the fair value of stock options using the Black-Scholes valuation model with weighted average assumptions for dividend yield, expected volatility, risk-free interest rate and expected lives (in years). The expected dividend yield is calculated by dividing the total expected annual dividend payout by the average stock price. The expected volatility is based on historical volatility of the underlying securities. The risk-free interest rate is based on the Federal Reserve Bank's constant maturities daily interest rate in effect at grant date. The expected life of the options represents the period of time that the Company expects the awards to be outstanding based on historical experience with similar awards. Stock-based compensation expense recognized in the consolidated statements of income for the nine months ended September 30, 2010 and 2009 reflected forfeitures as they occurred.

The following table summarizes stock option activity for the Company for the nine months ended September 30, 2010:

|                                  | Number<br>of Shares | Weighted<br>Average<br>Exercise<br>Price | Aggregate<br>Intrinsic<br>Value |
|----------------------------------|---------------------|--|---------------------------------|
| Outstanding at beginning of year | 10,850              | \$ 13.36                                 |                                 |
| Granted                          | -                   | -  |                                 |
| Exercised                        | -                   | -  |                                 |
| Expired/Cancelled                | (2,430)             | 14.00                                    |                                 |
| Outstanding at end of period     | 8,420               | 13.17                                    | \$ -                            |
| Exercisable at end of period     | 8,420               | \$ 13.17                                 | \$ -                            |

At September 30, 2010, all 8,420 outstanding options were exercisable, had a weighted average exercise price of \$13.17 per share, and had a remaining contract life of 1.6 years.

There was no aggregate intrinsic value in options outstanding and exercisable based on the \$9.48 market value per share of the Company's common stock at September 30, 2010. The total intrinsic value of stock options exercised during the nine months ended September 30, 2010 and 2009 was \$0 and less than \$1 thousand, respectively. Cash

received upon exercise of options during the first nine months of 2010 and 2009 was \$0 and approximately \$1 thousand, respectively.

Note 7 – Fair Value Measurements

ASC 820, “Fair Value Measurements and Disclosures”, provides a framework for measuring and disclosing fair value under GAAP. This accounting guidance requires disclosures about the fair values of assets and liabilities recognized in the balance sheet, whether the measurements are made on a recurring basis or on a nonrecurring basis.

ASC 820 defines fair value as the exchange price that would be received for an asset or paid to transfer a liability (an exit price) in the principal or most advantageous market for the asset or liability in an orderly transaction between market participants on the measurement date. ASC 820 also establishes a fair value hierarchy, which requires an entity to maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair value.

The Company utilizes fair value measurements to record fair value adjustments to certain assets and liabilities and to determine fair value disclosures. Securities available for sale and derivative assets and liabilities are recorded at fair value on a recurring basis. Additionally, from time to time, the Company may be required to record at fair value other assets on a nonrecurring basis, such as loans held for investment (impaired loans) and foreclosed assets (other real estate owned). These nonrecurring fair value adjustments typically involve application of lower of cost or market accounting or write-downs of individual assets.

Under ASC 820, assets and liabilities are grouped at fair value in three levels, based on the markets in which the assets and liabilities are traded and the reliability of the assumptions used to determine their fair values. These hierarchy levels are:

Level 1 inputs – Unadjusted quoted prices in active markets for identical assets or liabilities that the entity has the ability to access at the measurement date.

Level 2 inputs – Inputs other than quoted prices included in Level 1 that are observable for the asset or liability, either directly or indirectly. These might include quoted prices for similar assets or liabilities in active markets, and inputs other than quoted prices that are observable for the asset or liability, such as interest rates and yield curves that are observable at commonly quoted intervals.

Level 3 inputs – Unobservable inputs for determining the fair values of assets or liabilities that reflect an entity's own assumptions about the assumptions that market participants would use in pricing the assets or liabilities.

The following is a description of valuation methodologies used for the Company's assets and liabilities recorded at fair value.

#### Investment Securities Available for Sale

Investment securities available for sale are recorded at fair value on a recurring basis. Fair value measurement is based upon quoted prices, if available. If quoted prices are not available, fair values are measured using independent pricing models or other model-based valuation techniques such as the present value of future cash flows, adjusted for the security's credit rating, prepayment assumptions and other factors such as credit loss assumptions. Level 1 securities include those traded on an active exchange such as the New York Stock Exchange, Treasury securities that are traded by dealers or brokers in active over-the-counter markets and money market funds. Level 2 securities include mortgage-backed securities issued by government sponsored entities, municipal bonds and corporate debt securities. Securities classified as Level 3 include asset-backed securities in less liquid markets.

#### Loans

The Company does not record loans at fair value on a recurring basis; however, from time to time, a loan is considered impaired and an allowance for loan loss is established. Loans for which it is probable that payment of interest and principal will not be made in accordance with the contractual terms of the loan are considered impaired. The fair value of impaired loans is estimated using one of several methods, including the collateral value, market value of similar debt, enterprise value, liquidation value and discounted cash flows. At September 30, 2010, substantially all impaired loans were evaluated based on the fair value of the collateral. Those impaired loans not requiring a specific allowance represent loans for which the fair value of expected repayments or collateral exceed the recorded investment in such loans. Impaired loans that have an allowance established based on the fair value of collateral require classification in the fair value hierarchy. When the fair value of the collateral is based on an observable market price or a current appraised value, the Company records the loan as nonrecurring Level 2. When an appraised value is not available or management determines the fair value of the collateral is further impaired below the appraised value and there is no observable market price, the Company records the loan as nonrecurring Level 3.

**Other Real Estate and Other Assets Owned (Foreclosed Assets)**

Foreclosed assets are adjusted for fair value upon transfer of loans to foreclosed assets. Subsequently, foreclosed assets are carried at the lower of carrying value and fair value. Fair value is based on independent market prices, appraised value of the collateral or management's estimation of the value of the collateral. When the fair value of the collateral is based on an observable market price or a current appraised value, the Company records the foreclosed asset as nonrecurring Level 2. When an appraised value is not available or management determines the fair value of the collateral is further impaired below the appraised value and there is no observable market price, the Company records the foreclosed asset as nonrecurring Level 3.



## Derivative Assets and Liabilities

Derivative instruments held or issued by the Company for risk management purposes are traded in over-the-counter markets where quoted market prices are not readily available. For those derivatives, the Company measures fair value using models that use primarily market observable inputs, such as yield curves and option volatilities, and include the value associated with counterparty credit risk. The Company classifies derivative instruments held or issued for risk management purposes as recurring Level 2. As of September 30, 2010, the Company's derivative instruments consisted solely of interest rate caps. Derivative assets and liabilities are included in other assets and liabilities, respectively, in the accompanying consolidated balance sheets.

## Assets Recorded at Fair Value on a Recurring Basis

The table below presents the recorded amount of assets measured at fair value on a recurring basis at September 30, 2010. There were no transfers between Levels 1 and 2 during the first nine months of 2010.

| (Dollars in thousands)                | Fair Value       | Quoted Prices<br>(Level 1) | Significant<br>Other<br>Observable<br>Inputs<br>(Level 2) | Significant<br>Unobservable<br>Inputs<br>(Level 3) |
|---------------------------------------|------------------|----------------------------|---|--|
| <b>Securities available for sale:</b> |                  |                            |   |  |
| U.S. Government agencies              | \$ 57,518        | \$ -                       | \$ 57,518   | \$ -   |
| Mortgage-backed securities            | 38,117           | -                          | 38,117  | -  |
| Other equity securities               | 584              | -                          | 584   | -  |
| <b>Total</b>                          | <b>\$ 96,219</b> | <b>\$ -</b>                | <b>\$ 96,219</b>  | <b>\$ -</b>  |
| <b>Interest rate caps</b>             | <b>\$ 1,389</b>  | <b>\$ -</b>                | <b>\$ 1,389</b>   | <b>\$ -</b>  |

## Assets Recorded at Fair Value on a Nonrecurring Basis

The table below presents the recorded amount of assets measured at fair value on a nonrecurring basis at September 30, 2010.

| (Dollars in thousands)                          | Fair Value       | Quoted Prices<br>(Level 1) | Significant<br>Other<br>Observable<br>Inputs<br>(Level 2) | Significant<br>Unobservable<br>Inputs<br>(Level 3) |
|---|------------------|----------------------------|---|--|
| <b>Impaired loans</b>                           |                  |                            |   |  |
| Real estate - construction                      | \$ 18,424        | \$ -                       | \$ -  | \$ 18,424  |
| Real estate - residential                       | 11,238           | -                          | -   | 11,238   |
| Real estate - commercial                        | 2,955            | -                          | -   | 2,955  |
| Commercial                                      | 3,851            | -                          | -   | 3,851  |
| Consumer  | 94               | -                          | -   | 94   |
| <b>Total</b>                                    | <b>\$ 36,562</b> | <b>\$ -</b>                | <b>\$ -</b>   | <b>\$ 36,562</b>                                   |
| <b>Other real estate and other assets owned</b> | <b>\$ 1,517</b>  | <b>\$ -</b>                | <b>\$ -</b>   | <b>\$ 1,517</b>                                    |

Impaired loans had a carrying amount of \$36.8 million at September 30, 2010 with a valuation allowance of \$223 thousand.

The following disclosures relate to the fair value of the Company's financial instruments and include the methods and assumptions used to estimate the fair value of each class of financial instruments for which it is practicable to estimate that value:

**Cash and Cash Equivalents**

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

**Investment Securities**

For all investments in debt securities, fair values are based on quoted market prices. If a quoted market price is not available, fair value is estimated using quoted market prices for similar securities.

### Loans

The fair values of categories of fixed rate loans, such as commercial loans, residential mortgage, and other consumer loans, are estimated by discounting the future cash flows using the current rates at which similar loans would be made to borrowers with similar credit ratings and for the same remaining maturities. Other loans, including variable rate loans, are adjusted for differences in loan characteristics.

### Financial Liabilities

The fair value of demand deposits, savings accounts, and certain money market deposits is the amount payable on demand at the reporting date. The fair value of fixed-maturity certificates of deposit is estimated using the rates currently offered for deposits of similar remaining maturities. These estimates do not take into consideration the value of core deposit intangibles. Generally, the carrying amount of short-term borrowings is a reasonable estimate of fair value. The fair values of securities sold under agreements to repurchase (included in short-term borrowings) and long-term debt are estimated using the rates offered for similar borrowings.

### Commitments to Extend Credit and Standby Letters of Credit

The majority of the Company's commitments to grant loans and standby letters of credit are written to carry current market interest rates if converted to loans. Because commitments to extend credit and letters of credit are generally unassignable by the Company or the borrower, they only have value to the Company and the borrower and, therefore, it is impractical to assign any value to these commitments.

The estimated fair values of the Company's financial instruments as of September 30, 2010 and December 31, 2009 are as follows:

| (Dollars in thousands)          | September 30, 2010  |                      | December 31, 2009   |                      |
|---------------------------------|---------------------|----------------------|---------------------|----------------------|
|                                 | Carrying Amount     | Estimated Fair Value | Carrying Amount     | Estimated Fair Value |
| <b>Financial assets:</b>        |                     |                      |                     |                      |
| Cash and cash equivalents       | \$ 74,939           | \$ 74,939            | \$ 75,646           | \$ 75,646            |
| Investment securities           | 104,075             | 104,344              | 106,535             | 106,607              |
| Loans                           | 906,490             | 922,523              | 916,557             | 934,362              |
| Less: allowance for loan losses | (13,153)            | -                    | (10,876)            | -                    |
| <b>Total</b>                    | <b>\$ 1,072,351</b> | <b>\$ 1,101,806</b>  | <b>\$ 1,087,862</b> | <b>\$ 1,116,615</b>  |
| <b>Financial liabilities:</b>   |                     |                      |                     |                      |
| Deposits                        | \$ 982,428          | \$ 987,903           | \$ 990,937          | \$ 999,016           |
| Short-term borrowings           | 17,782              | 17,782               | 20,404              | 20,404               |
| Long-term debt                  | 1,429               | 1,488                | 1,429               | 1,530                |
| <b>Total</b>                    | <b>\$ 1,001,639</b> | <b>\$ 1,007,173</b>  | <b>\$ 1,012,770</b> | <b>\$ 1,020,950</b>  |

### Note 8 – Derivative Instruments and Hedging Activities

ASC 815, "Derivatives and Hedging", defines derivatives, requires that derivatives be carried at fair value on the balance sheet and provides for hedge accounting when certain conditions are met. Changes in the fair values of derivative instruments designated as "cash flow" hedges, to the extent the hedges are highly effective, are recorded in other comprehensive income, net of taxes. Ineffective portions of cash flow hedges, if any, are recognized in current period earnings. The net interest settlement on cash flow hedges is treated as an adjustment of the of the interest income or interest expense of the hedged assets or liabilities. The Company uses derivative instruments to hedge its exposure to changes in interest rates. The Company does not use derivatives for any trading or other speculative

purposes.

During the third quarter of 2009, as part of its overall interest rate risk management strategy, the Company purchased interest rate caps to effectively fix the interest rate on \$70 million of the Company's money market deposit accounts at 2.97% for five years. The interest rate caps qualified for hedge accounting. The aggregate fair value of these derivatives was an asset of \$1.4 million at September 30, 2010 and \$6.2 million at December 31, 2009. For the third quarter and first nine months of 2010, interest expense included a net interest settlement of \$136 thousand and \$236 thousand, respectively.

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By entering into derivative instrument contracts, the Company exposes itself, from time to time, to counterparty credit risk. Counterparty credit risk is the risk that the counterparty will fail to perform under the terms of the derivative contract. When the fair value of a derivative contract is in an asset position, the counterparty has a liability to the Company, which creates credit risk for the Company. The Company attempts to minimize this risk by selecting counterparties with investment grade credit ratings, limiting its exposure to any single counterparty and regularly monitoring its market position with each counterparty. Also to minimize risk, the Company obtained counterparty collateral which was recorded in other liabilities. The counterparty collateral was \$1.7 million at September 30, 2010 and \$4.8 million at December 31, 2009.

#### Note 9 – Commitments

In the normal course of business, to meet the financial needs of its customers, the Company's bank subsidiaries enter into financial instruments with off-balance sheet risk. These financial instruments include commitments to extend credit and standby letters of credit. At September 30, 2010, total commitments to extend credit were approximately \$155.0 million. The comparable amount was \$147.3 million at December 31, 2009. Outstanding letters of credit were approximately \$15.9 million at September 30, 2010 and \$19.0 million at December 31, 2009.

#### Note 10 – Segment Reporting

The Company operates in two primary business segments: Community Banking and Insurance Products and Services. Through the Community Banking business, the Company provides services to consumers and small businesses on the Eastern Shore of Maryland and Delaware through its 19-branch network. Community banking activities include small business services, retail brokerage, and consumer banking products and services. Loan products available to consumers include mortgage, home equity, automobile, marine, and installment loans, credit cards and other secured and unsecured personal lines of credit. Small business lending includes commercial mortgages, real estate development loans, equipment and operating loans, as well as secured and unsecured lines of credit, credit cards, accounts receivable financing arrangements, and merchant card services.

During the third quarter of 2010, goodwill and other intangible assets were tested for impairment. It was determined that goodwill at The Felton Bank, one of the banks in our Community Banking segment, was impaired and the Company recorded goodwill impairment charges of \$1.5 million. As of September 30, 2010, goodwill remaining at The Felton Bank after the \$1.5 million impairment charge was \$1.1 million.

Through the Insurance Products and Services business, the Company provides a full range of insurance products and services to businesses and consumers in the Company's market areas. Products include property and casualty, life, marine, individual health and long-term care insurance. Pension and profit sharing plans and retirement plans for executives and employees are available to suit the needs of individual businesses.

During the testing for goodwill and other intangible assets impairment in the third quarter of 2010, it was determined that goodwill and other intangible assets at TSGIA, Inc., a wholesale insurance agency in our Insurance Products and Services segment, was impaired. The Company recorded goodwill impairment charges of \$1.5 million and other intangible assets impairment charges of \$51 thousand. As of September 30, 2010, goodwill remaining at TSGIA, Inc. after the \$1.5 million goodwill impairment charge was \$653 thousand.

Selected financial information by business segments for the first nine months of 2010 and 2009 is included in the following table:

| (Dollars in thousands)            | Community<br>Banking | Insurance Products<br>and Services | Parent<br>Company | Consolidated<br>Total |
|-----------------------------------|----------------------|------------------------------------|-------------------|-----------------------|
| <b>2010</b>                       |                      |                                    |                   |                       |
| Interest income                   | \$ 41,503            | \$ 129                             | \$ -              | \$ 41,632             |
| Interest expense                  | (9,798)              | -                                  | (61)              | (9,859)               |
| Provision for credit losses       | (16,727)             | -                                  | -                 | (16,727)              |
| Noninterest income                | 5,608                | 8,485                              | -                 | 14,093                |
| Noninterest expense               | (18,959)             | (9,046)                            | (4,633)           | (32,638)              |
| Net intersegment income (expense) | (4,128)              | (385)                              | 4,513             | -                     |
| (Loss) income before taxes        | (2,501)              | (817)                              | (181)             | (3,499)               |
| Income tax benefit (expense)      | 701                  | 230                                | 51                | 982                   |
| Net (loss) income                 | \$ (1,800)           | \$ (587)                           | \$ (130)          | \$ (2,517)            |
| <b>Total assets</b>               | <b>\$ 1,112,841</b>  | <b>\$ 18,509</b>                   | <b>\$ 3,153</b>   | <b>\$ 1,134,503</b>   |
| <b>2009</b>                       |                      |                                    |                   |                       |
| Interest income                   | \$ 43,957            | \$ 52                              | \$ -              | \$ 44,009             |
| Interest expense                  | (13,378)             | -                                  | (59)              | (13,437)              |
| Provision for credit losses       | (5,318)              | -                                  | -                 | (5,318)               |
| Noninterest income                | 5,952                | 9,464                              | -                 | 15,416                |
| Noninterest expense               | (17,806)             | (8,456)                            | (4,611)           | (30,873)              |
| Net intersegment income (expense) | (4,118)              | (362)                              | 4,480             | -                     |
| Income (loss) before taxes        | 9,289                | 698                                | (190)             | 9,797                 |
| Income tax (expense) benefit      | (3,546)              | (267)                              | 73                | (3,740)               |
| Net income                        | \$ 5,743             | \$ 431                             | \$ (117)          | \$ 6,057              |
| <b>Total assets</b>               | <b>\$ 1,133,949</b>  | <b>\$ 19,805</b>                   | <b>\$ 3,931</b>   | <b>\$ 1,157,685</b>   |

#### Note 11 – New Accounting Pronouncements

Accounting Standards Update (“ASU”) No. 2009-16, “Transfers and Servicing (Topic 860) – Accounting for Transfers of Financial Assets”. New accounting guidance under ASU 2009-16 amended prior accounting guidance to enhance reporting about transfers of financial assets, including securitizations, and where companies have continuing exposure to the risks related to transferred financial assets. This guidance eliminates the concept of a “qualifying special-purpose entity” and changes the requirements for derecognizing financial assets. This guidance also requires additional disclosures about all continuing involvements with transferred financial assets including information about gains and losses resulting from transfers during the period. This new accounting guidance became effective January 1, 2010 and did not have a significant impact on the Company’s financial statements.

ASU No. 2009-17, “Consolidations (Topic 810) – Improvements to Financial Reporting by Enterprises Involved with Variable Interest Entities”. New accounting guidance under ASU 2009-17 amended prior guidance to change how a company determines when an entity that is insufficiently capitalized or is not controlled through voting (or similar rights) should be consolidated. The determination of whether a company is required to consolidate an entity is based on, among other things, an entity’s purpose and design and a company’s ability to direct the activities of the entity that most significantly impact the entity’s economic performance. This guidance requires additional disclosures about the reporting entity’s involvement with variable-interest entities and any significant changes in risk exposure due to that

involvement as well as its affect on the entity's financial statements. This new accounting guidance became effective January 1, 2010 and did not have a significant impact on the Company's financial statements.

ASU No. 2010-18, "Effect of a Loan Modification When the Loan is Part of a Pool that is Accounted for as a Single Asset". This Update clarifies that modifications of acquired loans that are accounted for within a pool that have evidence of credit deterioration upon acquisition, do not result in the removal of those loans from the pool even if the modification would otherwise be considered a troubled debt restructuring. An entity will continue to be required to consider whether the pool of assets in which the loan is included is impaired if expected cash flows for the pool change. The amendments do not affect the accounting for loans that are not accounted for within pools. Loans accounted for individually continue to be subject to the troubled debt restructuring accounting provisions. The Company adopted ASU 2010-18, and it did not have a significant impact on the Company's financial statements.

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

Unless the context clearly suggests otherwise, references to "the Company", "we", "our", and "us" in the remainder of this report are to Shore Bancshares, Inc. and its consolidated subsidiaries.

Forward-Looking Information

Portions of this Quarterly Report on Form 10-Q contain forward-looking statements within the meaning of The Private Securities Litigation Reform Act of 1995. Statements that are not historical in nature, including statements that include the words "anticipate", "estimate", "should", "expect", "believe", "intend", and similar expressions, are expressions of our confidence, policies, and strategies, the adequacy of capital levels, and liquidity and are not guarantees of future performance. Such forward-looking statements involve certain risks and uncertainties, including economic conditions, competition in the geographic and business areas in which we operate, inflation, fluctuations in interest rates, legislation, and governmental regulation. These risks and uncertainties are described in detail in the section of the periodic reports that Shore Bancshares, Inc. files with the Securities and Exchange Commission (the "SEC") entitled "Risk Factors" (see Item 1A of Part II of this report). Actual results may differ materially from such forward-looking statements, and we assume no obligation to update forward-looking statements at any time except as required by law.

Introduction

The following discussion and analysis is intended as a review of significant factors affecting the Company's financial condition and results of operations for the periods indicated. This discussion and analysis should be read in conjunction with the unaudited consolidated financial statements and related notes presented in this report, as well as the audited consolidated financial statements and related notes included in the Annual Report of Shore Bancshares, Inc. on Form 10-K for the year ended December 31, 2009.

Shore Bancshares, Inc. is the largest independent financial holding company located on the Eastern Shore of Maryland. It is the parent company of The Talbot Bank of Easton, Maryland located in Easton, Maryland ("Talbot Bank"), CNB located in Centreville, Maryland ("CNB"), and The Felton Bank located in Felton, Delaware ("Felton Bank" and, together with Talbot Bank and CNB, the "Banks"). The Banks operate 19 full service branches in Kent County, Queen Anne's County, Talbot County, Caroline County and Dorchester County in Maryland and Kent County, Delaware. The Company engages in the insurance business through three insurance producer firms, The Avon-Dixon Agency, LLC, Elliott Wilson Insurance, LLC and Jack Martin Associates, Inc.; a wholesale insurance company, TSGIA, Inc.; and two insurance premium finance companies, Mubell Finance, LLC and ESFS, Inc. (all of the foregoing are collectively referred to as the "Insurance Subsidiary"). Each of these entities is a wholly-owned subsidiary of Shore Bancshares, Inc. The Company engages in the mortgage brokerage business under the name "Wye Mortgage Group" through a minority series investment in an unrelated Delaware limited liability company.

The shares of common stock of Shore Bancshares, Inc. are listed on the NASDAQ Global Select Market under the symbol "SHBI".

Shore Bancshares, Inc. maintains an Internet site at [www.shbi.net](http://www.shbi.net) on which it makes available free of charge its Annual Report on Form 10-K, Quarterly Reports on Form 10-Q, Current Reports on Form 8-K, and all amendments to the foregoing as soon as reasonably practicable after these reports are electronically filed with, or furnished to, the SEC.

Critical Accounting Policies

Our financial statements are prepared in accordance with accounting principles generally accepted in the United States of America ("GAAP"). The financial information contained within the financial statements is, to a significant extent, financial information contained that is based on measures of the financial effects of transactions and events that have already occurred. A variety of factors could affect the ultimate value that is obtained either when earning income,



recognizing an expense, recovering an asset or relieving a liability.

#### Allowance for Credit Losses

The allowance for credit losses is an estimate of the losses that may be sustained in the loan portfolio. The allowance is based on two basic principles of accounting: (i) Topic 450, “Contingencies”, of the Financial Accounting Standards Board’s Accounting Standards Codification (“ASC”), which requires that losses be accrued when they are probable of occurring and estimable, and (ii) ASC Topic 310, “Receivables”, which requires that losses be accrued based on the differences between the loan balance and the value of collateral, present value of future cash flows or values that are observable in the secondary market. Management uses many factors, including economic conditions and trends, the value and adequacy of collateral, the volume and mix of the loan portfolio, and our internal loan processes in determining the inherent loss that may be present in our loan portfolio. Actual losses could differ significantly from management’s estimates. In addition, GAAP itself may change from one previously acceptable method to another. Although the economics of transactions would be the same, the timing of events that would impact the transactions could change.

Management has significant discretion in making the adjustments inherent in the determination of the provision and allowance for credit losses, including in connection with the valuation of collateral, the borrower's prospects of repayment, and in establishing allowance factors on the formula allowance and unallocated allowance components of the allowance. The establishment of allowance factors is a continuing exercise, based on management's continuing assessment of the totality of all factors, including, but not limited to, delinquencies, loss history, trends in volume and terms of loans, effects of changes in lending policy, the experience and depth of management, national and local economic trends, concentrations of credit, the quality of the loan review system and the effect of external factors such as competition and regulatory requirements, and their impact on the portfolio, and allowance factors may change from period to period, resulting in an increase or decrease in the amount of the provision or allowance, based upon the same volume and classification of loans. Changes in allowance factors will have a direct impact on the amount of the provision, and a corresponding effect on net income. Errors in management's perception and assessment of these factors and their impact on the portfolio could result in the allowance not being adequate to cover losses in the portfolio, and may result in additional provisions or charge-offs.

Three basic components comprise our allowance for credit losses: (i) a specific allowance; (ii) a formula allowance; and (iii) a nonspecific allowance. Each component is determined based on estimates that can and do change when the actual events occur. The specific allowance is used to individually allocate an allowance to loans identified as impaired. An impaired loan may show deficiencies in the borrower's overall financial condition, payment history, support available from financial guarantors and/or the fair market value of collateral. When a loan is identified as impaired, a specific allowance is established based on our assessment of the loss that may be associated with the individual loan. The formula allowance is used to estimate the loss on internally risk rated loans, exclusive of those identified as impaired. Loans identified as special mention, substandard, doubtful and loss, as well as impaired, are segregated from performing loans. Remaining loans are then grouped by type (commercial, commercial real estate and construction, residential real estate or consumer). Each loan type is assigned an allowance factor based on management's estimate of the risk, complexity and size of individual loans within a particular category. Classified loans are assigned higher allowance factors than non-rated loans due to management's concerns regarding collectibility or management's knowledge of particular elements regarding the borrower. Allowance factors grow with the worsening of the internal risk rating. The nonspecific formula is used to estimate the loss of non-classified loans stemming from more global factors such as delinquencies, loss history, trends in volume and terms of loans, effects of changes in lending policy, the experience and depth of management, national and local economic trends, concentrations of credit, the quality of the loan review system and the effect of external factors such as competition and regulatory requirements. The nonspecific allowance captures losses that have impacted the portfolio but have yet to be recognized in either the formula or specific allowance.

#### Goodwill and Other Intangible Assets

Goodwill represents the excess of the cost of an acquisition over the fair value of the net assets acquired. Other intangible assets represent purchased assets that also lack physical substance but can be distinguished from goodwill because of contractual or other legal rights or because the asset is capable of being sold or exchanged either on its own or in combination with a related contract, asset or liability. Goodwill and other intangible assets with indefinite lives are tested at least annually for impairment, usually during the third quarter, or on an interim basis if circumstances dictate. Intangible assets that have finite lives are amortized over their estimated useful lives and also are subject to impairment testing.

Impairment testing requires that the fair value of each of the Company's reporting units be compared to the carrying amount of its net assets, including goodwill. The Company's reporting units were identified based on an analysis of each of its individual operating segments. If the fair value of a reporting unit is less than book value, an expense may be required to write down the related goodwill or purchased intangibles to record an impairment loss.

During the third quarter of 2010, as part of the Company's annual impairment testing process, goodwill and other intangible assets were tested for impairment and it was determined that there was an impairment. The Company recorded goodwill impairment charges of \$3.0 million and other intangible assets impairment charges of \$51 thousand. Half of the goodwill impairment charges related to the 2004 acquisition of The Felton Bank and the other half of the goodwill charges and all of the other intangible assets impairment charges related to the 2007 acquisition of TSGIA, Inc.

### Fair Value

The Company measures certain financial assets and liabilities at fair value. Significant financial instruments measured at fair value on a recurring basis are investment securities and interest rate caps. Impaired loans and other real estate and other assets owned are significant financial instruments measured at fair value on a nonrecurring basis.

The Company conducts a review each quarter for all investment securities which reflect possible impairment to determine whether unrealized losses are temporary. Valuations for the investment portfolio are determined using quoted market prices, if available. If quoted prices are not available, fair values are measured using methods such as independent pricing models or quotes for similar investment securities.

See Note 7, "Fair Value Measurements", in the Notes to Consolidated Financial Statements for a further discussion of fair value.

### OVERVIEW

The Company reported a net loss for the third quarter of 2010 of \$1.4 million, or diluted loss per common share of \$(0.17), compared to net income of \$2.0 million, or diluted earnings per common share of \$0.23, for the third quarter of 2009. For the second quarter of 2010, the Company reported net income of \$445 thousand, or diluted earnings per common share of \$0.05. The net loss for the third quarter of 2010 included the previously-mentioned goodwill and other intangible assets impairment charges of \$3.1 million. The provision for credit losses for the third quarter of 2010 was \$4.2 million, which was \$2.5 million higher than the provision for the third quarter of 2009 and \$724 thousand lower than the provision for the second quarter of 2010. Annualized return on average assets was (0.49)% for the three months ended September 30, 2010, compared to 0.66% for the same period in 2009. Annualized return on average stockholders' equity was (4.43)% for the third quarter of 2010, compared to 6.03% for the third quarter of 2009. For the second quarter of 2010, annualized return on average assets was 0.16% and return on average equity was 1.42%.

For the first nine months of 2010, the Company reported a net loss of \$2.5 million, or diluted loss per common share of \$(0.30), compared to net income available to common shareholders of \$4.2 million, or diluted earnings per common share of \$0.50, for the first nine months of 2009. The year-to-date 2010 net loss included the \$3.1 million impairment charges and \$11.4 million more in the provision for credit losses when compared to year-to-date September 30, 2009. Annualized return on average assets was (0.30)% for the nine months ended September 30, 2010, compared to 0.50% for the same period in 2009. Annualized return on average stockholders' equity was (2.66)% for the first nine months of 2010, compared to 4.08% for the first nine months of 2009.

During the first nine months of 2009, net income available to common shareholders was negatively impacted by dividends and discount accretion associated with the January 9, 2009 sale and April 15, 2009 repurchase of preferred stock under the U.S. Department of the Treasury's Troubled Asset Relief Program Capital Purchase Program. There were no dividends and accretion during the third quarter of 2009 but \$1.9 million in dividends and accretion during the first nine months of 2009.

### RESULTS OF OPERATIONS

#### Net Interest Income

Net interest income for the three months ended September 30, 2010 was \$10.7 million, an increase of 2.5% when compared to the same period last year. The increase in net interest income when compared to the third quarter of 2009 was primarily due to a decrease in the balances and rates paid on interest-bearing liabilities that more than offset the decline in the balances and yields on earning assets. The net interest margin was 4.00% for the third quarter of 2010, an increase of 21 basis points when compared to the third quarter of 2009. The net interest margin has benefited from

the Company's effort to reduce deposit pricing structures. Net interest income was relatively unchanged from the second quarter of 2010. The net interest margin for the third quarter of 2010 was slightly lower than the 4.03% for the second quarter of 2010.

Interest income was \$13.8 million for the third quarter of 2010, a decrease of 7.2% from the third quarter of 2009. Average earning assets decreased 3.1% during the third quarter of 2010 when compared to the same period in 2009, while yields earned decreased 23 basis points to 5.18%. Average loans decreased 1.7% and the yield earned on loans decreased 29 basis points. Loans comprised 84.8% of total average earning assets for the third quarter of 2010, slightly higher than the 83.6% for the third quarter of 2009. Other earning assets reflected a shift from federal funds sold to investment securities and interest-bearing deposits when comparing quarter-to-date September 30, 2010 and 2009 average balances. Interest income decreased less than 1.0% when compared to the second quarter of 2010. Average earning assets declined slightly during the third quarter of 2010 when compared to the second quarter of 2010, while yields earned decreased 8 basis points.

Interest expense was \$3.2 million for the three months ended September 30, 2010, a decrease of 29.8% when compared to the same period last year. Average interest-bearing liabilities decreased 2.7%, while rates paid decreased 55 basis points to 1.42%. More than half of the Company's interest-bearing deposits are time deposits. For the three months ended September 30, 2010, the average balance of certificates of deposit \$100,000 or more decreased 5.8% when compared to the same period last year, while the average rate paid on these certificates of deposit decreased 91 basis points to 1.91%. Average other time deposits decreased 10.8% and the rate paid on average other time deposits decreased 83 basis points, when comparing the third quarter of 2010 to the third quarter of 2009. When comparing the third quarter of 2010 to the second quarter of 2010, interest expense decreased 3.8% primarily due to rates paid decreasing 8 basis points.

Net interest income for the nine months ended September 30, 2010 was \$31.8 million, an increase of 3.9% when compared to the same period last year. An increase in the volume of average earning assets and a reduction in the cost of funds were sufficient to offset the decline in yields on earning assets. The net interest margin increased from 3.90% for the first nine months of 2009 to 3.99% for the first nine months of 2010.

Interest income was \$41.6 million for the first nine months of 2010, a decrease of 5.4% when compared to the first nine months of 2009. Average earning assets increased 1.4% during the nine months ended September 30, 2010 when compared to the same period in 2009, while yields earned decreased 38 basis points to 5.22%. Average loans decreased slightly during the first nine months of 2010, while the yield earned on loans decreased 33 basis points when compared to the same period of 2009. Loans comprised 84.8% and 86.2% of total average earning assets for the first nine months of 2010 and 2009, respectively. As with the quarter-to-date average balances, other earning assets reflected a shift from federal funds sold to investment securities and interest-bearing deposits when comparing year-to-date September 30, 2010 and 2009 average balances.

Interest expense was \$9.9 million for the nine months ended September 30, 2010, a decrease of 26.6% when compared to the same period last year. Average interest-bearing liabilities increased 3.0%, while rates paid decreased 60 basis points to 1.50%. During the second quarter of 2009, the Company began to participate in the Promontory Insured Network Deposits Program ("IND"). The \$51.0 million increase in average money market and savings deposits for the first three quarters of 2010 over the same period of 2009 included approximately \$37.5 million from the IND program. For the nine months ended September 30, 2010, the average balance of certificates of deposit \$100,000 or more increased 1.4% when compared to the same period last year, while the average rate paid decreased 105 basis points to 2.08%. Average other time deposits decreased 8.8% and the rate paid on average other time deposits decreased 86 basis points when compared to the first nine months of 2009. Expanded levels of FDIC insurance coverage contributed to the shift from other time deposits to certificates of deposit \$100,000 or more.

## Analysis of Interest Rates and Interest Differentials

The following table presents the distribution of the average consolidated balance sheets, interest income/expense, and annualized yields earned and rates paid for the three months ended September 30, 2010 and 2009.

| (Dollars in thousands)                     | For the Three Months Ended<br>September 30, 2010 |                       |                | For the Three Months Ended<br>September 30, 2009 |                       |                |
|--|--|-----------------------|----------------|--|-----------------------|----------------|
|  | Average<br>Balance                               | Income(1)/<br>Expense | Yield/<br>Rate | Average<br>Balance                               | Income(1)/<br>Expense | Yield/<br>Rate |
| <b>Earning assets</b>                      |  |                       |                |  |                       |                |
| Loans (2), (3)                             | \$ 904,293                                       | \$ 13,125             | 5.76%          | \$ 920,241                                       | \$ 14,042             | 6.05%          |
| <b>Investment securities</b>               |  |                       |                |  |                       |                |
| Taxable                                    | 99,572   | 677                   | 2.70           | 89,101   | 800                   | 3.56           |
| Tax-exempt                                 | 5,894  | 75                    | 5.16           | 8,125  | 118                   | 5.76           |
| Federal funds sold                         | 40,638   | 21                    | 0.20           | 81,466   | 31                    | 0.16           |
| Interest-bearing deposits                  | 15,666   | 6                     | 0.15           | 1,605  | 4                     | 0.77           |
| Total earning assets                       | 1,066,063  | 13,904                | 5.18%          | 1,100,538  | 14,995                | 5.41%          |
| Cash and due from banks                    | 21,865   |                       |                | 20,042   |                       |                |
| Other assets                               | 65,081   |                       |                | 57,049   |                       |                |
| Allowance for credit losses                | (13,966)   |                       |                | (11,042)   |                       |                |
| Total assets                               | \$ 1,139,043                                     |                       |                | \$ 1,166,587                                     |                       |                |
| <b>Interest-bearing liabilities</b>        |  |                       |                |  |                       |                |
| Demand deposits                            | \$ 132,023                                       | 80                    | 0.24%          | \$ 125,233                                       | 82                    | 0.26%          |
| Money market and savings deposits          | 259,511  | 526                   | 0.81           | 245,801  | 412                   | 0.67           |
| Certificates of deposit \$100,000 or more  | 258,542  | 1,242                 | 1.91           | 274,580  | 1,954                 | 2.82           |
| Other time deposits                        | 212,098  | 1,269                 | 2.37           | 237,757  | 1,920                 | 3.20           |
| Interest-bearing deposits                  | 862,174  | 3,117                 | 1.44           | 883,371  | 4,368                 | 1.96           |
| Short-term borrowings                      | 16,092   | 17                    | 0.38           | 18,373   | 19                    | 0.42           |
| Long-term debt                             | 1,429  | 16                    | 4.36           | 1,947  | 98                    | 19.90          |
| Total interest-bearing liabilities         | 879,695  | 3,150                 | 1.42%          | 903,691  | 4,485                 | 1.97%          |
| Noninterest-bearing deposits               | 121,844  |                       |                | 117,933  |                       |                |
| Other liabilities                          | 12,196   |                       |                | 16,554   |                       |                |
| Stockholders' equity                       | 125,308  |                       |                | 128,409  |                       |                |
| Total liabilities and stockholders' equity | \$ 1,139,043                                     |                       |                | \$ 1,166,587                                     |                       |                |
| Net interest spread                        |  | \$ 10,754             | 3.76%          |  | \$ 10,510             | 3.44%          |
| Net interest margin                        |  |                       | 4.00%          |  |                       | 3.79%          |
| <b>Tax-equivalent adjustment</b>           |  |                       |                |  |                       |                |
| Loans                                      |  | \$ 42                 |                |  | \$ 41                 |                |
| Investment securities                      |  | 25                    |                |  | 41                    |                |
| Total                                      |  | \$ 67                 |                |  | \$ 82                 |                |

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The following table presents the distribution of the average consolidated balance sheets, interest income/expense, and annualized yields earned and rates paid for the nine months ended September 30, 2010 and 2009.

| (Dollars in thousands)                     | For the Nine Months Ended<br>September 30, 2010 |                       |                | For the Nine Months Ended<br>September 30, 2009 |                       |                |
|--|---|-----------------------|----------------|---|-----------------------|----------------|
|  | Average<br>Balance                              | Income(1)/<br>Expense | Yield/<br>Rate | Average<br>Balance                              | Income(1)/<br>Expense | Yield/<br>Rate |
| <b>Earning assets</b>                      |   |                       |                |   |                       |                |
| Loans (2), (3)                             | \$ 907,965                                      | \$ 39,118             | 5.76%          | \$ 910,842                                      | \$ 41,497             | 6.09%          |
| <b>Investment securities</b>               |   |                       |                |   |                       |                |
| Taxable                                    | 102,100   | 2,405                 | 3.15           | 79,797  | 2,324                 | 3.89           |
| Tax-exempt                                 | 6,369   | 250                   | 5.26           | 8,443   | 371                   | 5.87           |
| Federal funds sold                         | 41,709  | 47                    | 0.15           | 53,227  | 61                    | 0.15           |
| Interest-bearing deposits                  | 12,690  | 11                    | 0.12           | 4,053   | 11                    | 0.35           |
| Total earning assets                       | 1,070,833                                       | 41,831                | 5.22%          | 1,056,362                                       | 44,264                | 5.60%          |
| Cash and due from banks                    | 15,455  |                       |                | 16,960  |                       |                |
| Other assets                               | 66,942  |                       |                | 52,700  |                       |                |
| Allowance for credit losses                | (13,483)  |                       |                | (10,523)  |                       |                |
| Total assets                               | \$ 1,139,747                                    |                       |                | \$ 1,115,499                                    |                       |                |
| <b>Interest-bearing liabilities</b>        |   |                       |                |   |                       |                |
| Demand deposits                            | \$ 130,872                                      | 243                   | 0.25%          | \$ 123,821                                      | 230                   | 0.25%          |
| Money market and savings deposits          | 258,628   | 1,421                 | 0.73           | 207,588   | 937                   | 0.60           |
| Certificates of deposit \$100,000 or more  | 256,470   | 3,986                 | 2.08           | 252,978   | 5,920                 | 3.13           |
| Other time deposits                        | 215,911   | 4,094                 | 2.53           | 236,643   | 6,007                 | 3.39           |
| Interest-bearing deposits                  | 861,881   | 9,744                 | 1.51           | 821,030   | 13,094                | 2.13           |
| Short-term borrowings                      | 16,673  | 68                    | 0.55           | 27,718  | 96                    | 0.46           |
| Long-term debt                             | 1,429   | 47                    | 4.40           | 5,925   | 247                   | 5.57           |
| Total interest-bearing liabilities         | 879,983   | 9,859                 | 1.50%          | 854,673   | 13,437                | 2.10%          |
| Noninterest-bearing deposits               | 119,087   |                       |                | 110,663   |                       |                |
| Other liabilities                          | 14,334  |                       |                | 13,074  |                       |                |
| Stockholders' equity                       | 126,343   |                       |                | 137,089   |                       |                |
| Total liabilities and stockholders' equity | \$ 1,139,747                                    |                       |                | \$ 1,115,499                                    |                       |                |
| Net interest spread                        |   | \$ 31,972             | 3.72%          |   | \$ 30,827             | 3.50%          |
| Net interest margin                        |   |                       | 3.99%          |   |                       | 3.90%          |
| <b>Tax-equivalent adjustment</b>           |   |                       |                |   |                       |                |
| Loans                                      |   | \$ 114                |                |   | \$ 125                |                |
| Investment securities                      |   | 85                    |                |   | 130                   |                |
| Total                                      |   | \$ 199                |                |   | \$ 255                |                |

(1) All amounts are reported on a tax equivalent basis computed using the statutory federal income tax rate of 34.0% for 2010 and 35.0% for 2009 exclusive of the alternative minimum tax rate and nondeductible interest expense.

(2) Average loan balances include nonaccrual loans.

(3) Interest income on loans includes amortized loan fees, net of costs, for each loan category and yield calculations are stated to include all.



Noninterest Income

Noninterest income for the third quarter of 2010 decreased \$76 thousand, or 1.6%, when compared to the third quarter of 2009. The decline in noninterest income during the third quarter of 2010 when compared to the third quarter of 2009 was primarily due to decreases in mortgage broker fees and insurance agency commissions which were partially offset by a \$224 thousand gain relating to the surrender of directors' life insurance policies. The increase of \$75 thousand, or 1.6%, when compared to the second quarter of 2010 was primarily due to the \$224 thousand gain from the life insurance policies which was partially offset by decreases in mortgage broker fees and insurance agency commissions.

Noninterest income for the first nine months of 2010 decreased \$1.3 million, or 8.6%, when compared to the first nine months of 2009. The decrease in noninterest income was mainly due to a decline in mortgage broker fees and insurance agency commissions.

## Noninterest Expense

Noninterest expense for the third quarter of 2010 increased \$2.3 million, or 22.6%, when compared to the third quarter of 2009 mainly due to goodwill impairment charges of \$3.0 million and other intangible assets impairment charges of \$51 thousand. The increase in noninterest expense was somewhat offset by lower expenses accrued for bonus and profit sharing plans. Noninterest expense increased \$2.9 million, or 30.4%, from the second quarter of 2010 primarily due to the goodwill and other intangible assets impairment charges. The increase in noninterest expense was slightly offset by lower expenses related to other real estate owned activities. Excluding the goodwill and other intangible assets impairment charges, total noninterest expense would have decreased 7.0% and 1.1% when compared to the third quarter of 2009 and the second quarter of 2010, respectively.

Noninterest expense for the first nine months of 2010 increased \$1.8 million, or 5.7%, when compared to the first nine months of 2009. The increase in noninterest expense was primarily due to the goodwill and other intangible assets impairment charges and higher expenses related to collection and other real estate owned activities. The increase was partially offset by lower expenses accrued for bonus and profit sharing plans, lower insurance agency commissions expense and lower FDIC insurance premium expense. Excluding the goodwill and other intangible assets impairment charges, total noninterest expense would have decreased 4.2% when compared to the first nine months of 2009.

## Income Taxes

The Company's effective tax rate was a 6.2% benefit for the three months ended September 30, 2010, compared to a 38.0% expense for the same period last year. For the nine months ended September 30, 2010, the effective tax rate was a 28.1% benefit compared to a 38.2% expense for the same period last year. The tax benefit rate for quarter-to-date and year-to-date September 30, 2010 reflected that \$1.5 million of the goodwill impairment was not tax deductible. Management believes that currently there are no additional changes in tax laws or to our tax structure that are likely to have a material impact on our future effective tax rate.

## ANALYSIS OF FINANCIAL CONDITION

### Loans

Loans, net of unearned income, totaled \$906.5 million at September 30, 2010, a 1.1% decrease since December 31, 2009. Average loans were \$904.3 million for the three months ended September 30, 2010, which was 1.7% lower than the comparable amount for the same period last year. For the nine months ended September 30, 2010, average loans were \$908.0 million, which was slightly lower than the comparable amount for the same period in 2009. Loan growth slowed when compared to the prior year as the weakened economy created fewer loan opportunities to originate high-quality credits. At the same time, we are experiencing slowing loan growth. Net loan charge-offs increased \$2.6 million and \$10.5 million for the third quarter and first nine months of 2010, respectively, when compared to the same periods last year.

Our loan portfolio has a concentration of commercial real estate loans. Commercial real estate loans, excluding construction and land development loans, were approximately \$323.4 million, or 35.7% of total loans, at September 30, 2010, compared to \$315.9 million, or 34.5% of total loans, at December 31, 2009. Construction and land development loans were \$149.1 million, or 16.5% of total loans, at September 30, 2010, compared to \$161.4 million, or 17.6% of total loans, at December 31, 2009. We do not engage in foreign or subprime lending activities.

Because most of our loans are secured by real estate, weaknesses in the current local real estate market and construction industry, and deterioration in overall economic conditions have had a material adverse effect on the performance of our loan portfolio and the value of the collateral securing that portfolio. Thus, we have experienced higher provisions for credit losses, loan charge-offs and nonperforming assets because of these weaknesses in the local economy.

#### Allowance for Credit Losses

We have established an allowance for credit losses, which is increased by provisions charged against earnings and recoveries of previously charged-off debts and is decreased by current period charge-offs of uncollectible debts. Management evaluates the adequacy of the allowance for credit losses on a quarterly basis and adjusts the provision for credit losses based upon this analysis. The evaluation of the adequacy of the allowance for credit losses is based on a risk rating system of individual loans, as well as on a collective evaluation of smaller balance homogenous loans based on factors such as past credit loss experience, local economic trends, nonperforming and problem loans, and other factors which may impact collectibility. A loan is placed on nonaccrual when it is specifically determined to be impaired and principal and interest is delinquent for 90 days or more. Please refer to the discussion above under the caption “Critical Accounting Policies” for an overview of the underlying methodology management employs on a quarterly basis to maintain the allowance.

The provision for credit losses for the three months ended September 30, 2010 and 2009 was \$4.2 million and \$1.7 million, respectively. The provision for credit losses for the second quarter of 2010 was \$4.9 million. The provision for credit losses for the first nine months of 2010 and 2009 was \$16.7 million and \$5.3 million, respectively. The continued historically large level of provision expense was the result of the overall increase in nonperforming assets and loan charge-offs, and management's assessment of the worsening in general economic conditions. We continue to emphasize credit quality and believe that our underwriting guidelines are strong. However, the prolonging or deepening of the current economic recession will likely cause us to continue to experience higher levels of provision expense, nonperforming assets and charge-offs. As problem loans are identified, management takes prompt action to quantify and minimize losses and also works with the borrowers in an effort to reach mutually acceptable resolutions.

Net charge-offs were \$4.3 million for the three months ended September 30, 2010, compared to \$1.8 million for the same period last year and \$4.4 million for the second quarter of 2010. While the overall level of charge-offs for the third quarter of 2010 was consistent with the second quarter of 2010, there was a reduction in losses from residential real estate loans and an increase in losses related to construction loans. The majority of losses on construction loans that occurred in the third quarter related to the two significant construction loan relationships discussed below in the nonperforming assets section. The allowance for credit losses as a percentage of average loans increased to 1.45% for the third quarter of 2010, compared to 1.17% for the third quarter of 2009. The comparable ratio was 1.46% for the second quarter of 2010.

Net charge-offs were \$14.5 million for the first nine months of 2010, compared to \$3.9 million for the same period in 2009. The allowance for credit losses as a percentage of average loans increased to 1.45% for the first nine months of 2010 from 1.18% for the same period last year. Based on management's quarterly evaluation of the adequacy of the allowance for credit losses, it believes that the allowance for credit losses and the related provision were adequate at September 30, 2010 to provide for probable losses inherent in our loan portfolio.

The following table presents a summary of the activity in the allowance for credit losses:

| (Dollars in thousands)                  | For the Three Months Ended |           | For the Nine Months Ended |           |
|---|----------------------------|-----------|---------------------------|-----------|
|   | September 30,              |           | September 30,             |           |
|   | 2010                       | 2009      | 2010                      | 2009      |
| Allowance balance – beginning of period | \$ 13,289                  | \$ 10,784 | \$ 10,876                 | \$ 9,320  |
| Charge-offs:                            |                            |           |                           |           |
| Real estate – construction              | (1,931)                    | (148)     | (6,121)                   | (363)     |
| Real estate – residential               | (1,305)                    | (811)     | (4,821)                   | (1,762)   |
| Real estate – commercial                | (242)                      | (522)     | (288)                     | (695)     |
| Commercial                              | (1,060)                    | (250)     | (3,448)                   | (977)     |
| Consumer                                | (102)                      | (109)     | (413)                     | (308)     |
| Totals                                  | (4,640)                    | (1,840)   | (15,091)                  | (4,105)   |
| Recoveries:                             |                            |           |                           |           |
| Real estate – construction              | -                          | -         | 13                        | 2         |
| Real estate – residential               | 138                        | 14        | 212                       | 67        |
| Real estate – commercial                | 6                          | 1         | 108                       | 1         |
| Commercial                              | 116                        | -         | 172                       | 4         |
| Consumer                                | 51                         | 62        | 136                       | 116       |
| Totals                                  | 311                        | 77        | 641                       | 190       |
| Net charge-offs                         | (4,329)                    | (1,763)   | (14,450)                  | (3,915)   |
| Provision for credit losses             | 4,193                      | 1,702     | 16,727                    | 5,318     |
| Allowance balance – end of period       | \$ 13,153                  | \$ 10,723 | \$ 13,153                 | \$ 10,723 |

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|   |            |            |            |            |
|---|------------|------------|------------|------------|
| Average loans outstanding during the period   | \$ 904,293 | \$ 920,241 | \$ 907,965 | \$ 910,842 |
| Net charge-offs (annualized) as a percentage of average loans outstanding during the period | 1.90%      | 0.76%      | 2.13%      | 0.57%      |
| Allowance for credit losses at period end as a percentage of average loans                  | 1.45%      | 1.17%      | 1.45%      | 1.18%      |

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## Nonperforming Assets

Nonperforming assets were \$38.3 million at September 30, 2010, compared to \$18.9 million at December 31, 2009. Nonperforming assets declined \$614 thousand since June 30, 2010. The increase in nonaccrual loans during the first nine months of 2010 was primarily in construction loans and related largely to two borrowing relationships. The Company has a \$5.0 million participation with a regional bank that is matured. Through December 31, 2009, the customer made all interest payments. This loan migrated from 90 days past due to nonaccrual in the first quarter of 2010 and \$745 thousand was subsequently charged off in the third quarter. Also during the first quarter of 2010, a second significant construction loan relationship totaling approximately \$14.0 million was put on nonaccrual and \$3.4 million was charged off in the first quarter with an additional \$717 thousand charged off in the third quarter. Total nonperforming assets to total loans and other real estate and other assets owned increased to 4.22% at September 30, 2010, compared to 2.05% at December 31, 2009. Loans past due 90 days and still accruing at September 30, 2010 decreased to \$3.3 million from \$7.4 million at December 31, 2009 mainly due to the previously-mentioned migration of the \$5.0 million participation from 90 days past due to nonaccrual.

The following table summarizes our nonperforming and past due assets:

| (Dollars in thousands)   | September 30,<br>2010 | December 31,<br>2009 |
|--|-----------------------|----------------------|
| <b>Nonperforming assets</b>  |                       |                      |
| Nonaccrual loans   |                       |                      |
| Real estate – construction   | \$ 18,424             | \$ 7,163             |
| Real estate – residential  | 11,318                | 4,246                |
| Real estate – commercial   | 3,098                 | 2,828                |
| Commercial   | 3,851                 | 2,028                |
| Consumer   | 94                    | 37                   |
| Total nonaccrual loans   | 36,785                | 16,302               |
| Other real estate and other assets owned   | 1,517                 | 2,572                |
| Total nonperforming assets   | 38,302                | 18,874               |
| Loans 90 days past due and still accruing  |                       |                      |
| Real estate – construction   | -                     | 5,096                |
| Real estate – residential  | 2,771                 | 2,274                |
| Real estate – commercial   | 312                   | -                    |
| Commercial   | 154                   | -                    |
| Consumer   | 76                    | 55                   |
| Total loans 90 days past due and still accruing  | 3,313                 | 7,425                |
| Total nonperforming assets and past due loans  | \$ 41,615             | \$ 26,299            |
| Nonperforming assets to total loans and other real estate and other assets owned                     | 4.22%                 | 2.05%                |
| Nonperforming assets to total assets   | 3.38%                 | 1.63%                |
| Nonperforming assets and past due loans, to total loans and other real estate and other assets owned | 4.58%                 | 2.86%                |
| Nonperforming assets and past due loans to total assets  | 3.67%                 | 2.27%                |

#### Investment Securities

Investment securities totaled \$104.1 million at September 30, 2010, a \$2.5 million, or 2.3% decrease since December 31, 2009. The average balance of investment securities was \$105.5 million for the three months ended September 30, 2010, compared to \$97.2 million for the same period in 2009. The tax equivalent yields on investment securities were 2.83% and 3.75% for the three months ended September 30, 2010 and 2009, respectively. The average balance of investment securities was \$108.5 million for the nine months ended September 30, 2010, compared to \$88.2 million for the same period in 2009. The tax equivalent yields on investment securities were 3.27% and 4.08% for the first nine months of 2010 and 2009, respectively. The increases in the 2010 investment securities average balances when compared to the 2009 average balances reflected the investment of excess deposits.

#### Deposits

Total deposits at September 30, 2010 were \$982.4 million, an \$8.5 million, or less than one percent, decrease when compared to the \$990.9 million at December 31, 2009. The decrease was primarily in other time deposits and interest-bearing demand deposits which was attributable to management's effort to reduce deposit pricing structures. Some of these deposits moved to money market and savings deposits which had the largest increase when compared to balances at the end of last year.

#### Short-Term Borrowings

Short-term borrowings at September 30, 2010 and December 31, 2009 were \$17.8 million and \$20.4 million, respectively. Short-term borrowings generally consist of securities sold under agreements to repurchase, overnight borrowings from correspondent banks and short-term advances from the FHLB. Short-term advances are defined as those with original maturities of one year or less. The decline in short-term borrowings since December 31, 2009 was primarily due to the repayment of \$3.4 million drawn on a \$10.0 million line of credit with a commercial bank.

#### Long-Term Debt

At September 30, 2010 and December 31, 2009, the Company had \$1.4 million in long-term debt. This debt was acquisition-related, incurred as part of the purchase price of TSGIA, Inc. and is payable to the seller thereof, who remains the President of that subsidiary. The interest rate on the debt is 4.08% and principal and interest are payable in annual installments for five years.

#### Liquidity and Capital Resources

We derive liquidity through increased customer deposits, maturities in the investment portfolio, loan repayments and income from earning assets. During the second quarter of 2009, we began participating in the IND program which resulted in increased deposits and liquidity. The program has a five year term and has a guaranteed minimum funding level of \$70 million.

To the extent that deposits are not adequate to fund customer loan demand, liquidity needs can be met in the short-term funds markets through arrangements with correspondent banks. Talbot Bank and CNB are also members of the FHLB of Atlanta and Felton Bank is a member of the FHLB of Pittsburgh, and these banks have pledged collateral sufficient to permit additional borrowings of up to approximately \$29.2 million in the aggregate at September 30, 2010. Management is not aware of any trends or demands, commitments, events or uncertainties that are likely to materially affect our future ability to maintain liquidity at satisfactory levels.

Total stockholders' equity was \$122.4 million at September 30, 2010, compared to \$127.8 million at December 31, 2009. The net loss, unrealized losses on cash flow hedging activities and dividends paid all contributed to the decrease in stockholders' equity since the end of 2009. To increase capital, support the Company's growth, and enhance capital ratios, management has reduced dividends in 2010. The Company reduced the quarterly common stock dividend to \$0.06 from \$0.16 per share beginning with the dividend that was payable on February 26, 2010.

Bank regulatory agencies have adopted various capital standards for financial institutions, including risk-based capital standards. The primary objectives of the risk-based capital framework are to provide a more consistent system for comparing capital positions of financial institutions and to take into account the different risks among financial institutions' assets and off-balance sheet items.

Risk-based capital standards have been supplemented with requirements for a minimum Tier 1 capital to average assets ratio (leverage ratio). In addition, regulatory agencies consider the published capital levels as minimum levels and may require a financial institution to maintain capital at higher levels. The Company's capital ratios continued to be well in excess of regulatory minimums.



A comparison of the capital ratios of Shore Bancshares, Inc. (on a consolidated basis) as of September 30, 2010 and December 31, 2009 to the minimum regulatory requirements is presented below:

|                                 | September 30,<br>2010 | December 31,<br>2009 | Minimum<br>Regulatory<br>Requirements |
|---------------------------------|-----------------------|----------------------|---------------------------------------|
| Tier 1 risk-based capital ratio | 11.73%                | 11.45%               | 4.00%                                 |
| Total risk-based capital ratio  | 12.99%                | 12.59%               | 8.00%                                 |
| Leverage ratio                  | 9.46%                 | 9.27%                | 4.00%                                 |

### Item 3. Quantitative and Qualitative Disclosures about Market Risk.

Our primary market risk is to interest rate fluctuation and management has procedures in place to evaluate and mitigate this risk. This risk and these procedures are discussed in Item 7 of Part II of the Annual Report of Shore Bancshares, Inc. on Form 10-K for the year ended December 31, 2009 under the caption “Market Risk Management”. Management believes that there have been no material changes in our market risks, the procedures used to evaluate and mitigate these risks, or our actual and simulated sensitivity positions since December 31, 2009.

### Item 4. Controls and Procedures.

We maintain disclosure controls and procedures that are designed to ensure that information required to be disclosed in the reports that Shore Bancshares, Inc. files under the Securities Exchange Act of 1934 with the SEC, such as this Quarterly Report, is recorded, processed, summarized and reported within the time periods specified in those rules and forms, and that such information is accumulated and communicated to management, including Shore Bancshares, Inc.’s Chief Executive Officer (“CEO”) and the Principal Accounting Officer (“PAO”), as appropriate, to allow for timely decisions regarding required disclosure. A control system, no matter how well conceived and operated, can provide only reasonable, not absolute, assurance that the objectives of the control system are met. Further, the design of a control system must reflect the fact that there are resource constraints, and the benefits of controls must be considered relative to their costs. These inherent limitations include the realities that judgments in decision-making can be faulty, and that breakdowns can occur because of simple error or mistake. Additionally, controls can be circumvented by the individual acts of some persons, by collusion of two or more people, or by management override of the control. The design of any system of controls also is based in part upon certain assumptions about the likelihood of future events, and there can be no assurance that any design will succeed in achieving its stated goals under all potential future conditions; over time, controls may become inadequate because of changes in conditions, or the degree of compliance with the policies or procedures may deteriorate.

An evaluation of the effectiveness of these disclosure controls as of September 30, 2010 was carried out under the supervision and with the participation of management, including the CEO and the PAO. Based on that evaluation, the Company’s management, including the CEO and the PAO, has concluded that our disclosure controls and procedures are, in fact, effective at the reasonable assurance level.

There was no change in our internal control over financial reporting during the third quarter of 2010 that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

## PART II – OTHER INFORMATION

### Item 1A. Risk Factors.

The risks and uncertainties to which our financial condition and operations are subject are discussed in detail in Item 1A of Part I of the Annual Report of Shore Bancshares, Inc. on Form 10-K for the year ended December 31, 2009 and in Item 1A of Part II of Shore Bancshares, Inc.'s Quarterly Report on Form 10-Q for the quarter ended June 30, 2010. Management does not believe that any material changes in our risk factors have occurred since they were last disclosed .

Item 6. Exhibits.

The exhibits filed or furnished with this quarterly report are shown on the Exhibit List that follows the signatures to this report, which list is incorporated herein by reference.

SIGNATURES

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

SHORE BANCSHARES, INC.

Date: November 5, 2010

By: /s/ W. Moorhead Vermilye  
W. Moorhead Vermilye  
President/Chief Executive Officer

Date: November 5, 2010

By: /s/ Susan E. Leaverton  
Susan E. Leaverton, CPA  
Treasurer/Principal Accounting Officer

EXHIBIT INDEX

| Exhibit<br>Number | Description   |
|-------------------|---|
| 31.1              | Certifications of the CEO pursuant to Section 302 of the Sarbanes-Oxley Act (filed herewith). |
| 31.2              | Certifications of the PAO pursuant to Section 302 of the Sarbanes-Oxley Act (filed herewith). |
| 32                | Certification pursuant to Section 906 of the Sarbanes-Oxley Act (furnished herewith).         |

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