SHORE BANCSHARES INC
Form 10-K
March 17, 2008

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

FORM 10-K

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

For the Year Ended December 31, 2007

Commission File No. 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

Securities Registered pursuant to Section 12(b) of the Act:

Title of Each Class:	Name of Each Exchange on Which Registered:
Common stock, par value $.01 per share	Nasdaq Global Select Market

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

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 16(d) of the Act. o

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

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

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer (check one):

Large accelerated filer o Accelerated filer x Non-accelerated filer o Smaller Reporting Company o

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

State the aggregate market value of the voting and non-voting common equity held by non-affiliates computed by reference to the price at which the common equity was last sold, or the average bid and asked price of such common equity, as of the last business day of the registrant's most recently completed second fiscal quarter: $203,456,742.

The number of shares outstanding of the registrant's common stock as of the latest practicable date: 8,395,450 as of March 3, 2008.

Documents Incorporated by Reference

Certain information required by Part III of this annual report is incorporated herein by reference to the definitive proxy statement for the 2008 Annual Meeting of Stockholders to be held on April 23, 2008.

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This Annual Report of Shore Bancshares, Inc. on Form 10-K contains forward-looking statements within the meaning of The Private Securities Litigation Reform Act of 1995. Readers of this report should be aware of the speculative nature of "forward-looking statements." Statements that are not historical in nature, including the words "anticipate," "estimate," "should," "expect," "believe," "intend," and similar expressions, are based on current expectations, estimates and projections about (among other things) the industry and the markets in which the Company and its subsidiaries operate; they are not guarantees of future performance. Whether actual results will conform to expectations and predictions is subject to known and unknown risks and uncertainties, including risks and uncertainties discussed in this Form 10-K, general economic, market or business conditions; changes in interest rates, deposit flow, the cost of funds, and demand for loan products and financial services; changes in our competitive position or competitive actions by other companies; changes in the quality or composition of loan and investment portfolios; the ability to mange growth; changes in laws or regulations or policies of federal and state regulators and agencies; and other circumstances beyond the Company's control. Consequently, all of the forward-looking statements made in this document are qualified by these cautionary statements, and there can be no assurance that the actual results anticipated will be realized, or if substantially realized, will have the expected consequences on the Company's business or operations. For a more complete discussion of these and other risk factors, see Item 1A of Part I of this report. Except as required by applicable laws, we do not intend to publish updates or revisions of forward-looking statements it makes to reflect new information, future events or otherwise.

Except as expressly provided otherwise, the term "Company" as used in this report refers to Shore Bancshares, Inc. and the terms "we", "us" and "our" refer collectively to Shore Bancshares, Inc. and its consolidated subsidiaries.

PART I

Item 1. Business.

BUSINESS

General

The Company was incorporated under the laws of Maryland on March 15, 1996 and is a financial holding company registered under the Bank Holding Company Act of 1956, as amended (the "BHC Act"). The Company's primary business is acting as the parent company to several financial institution and insurance entities. The Company engages in the banking business through The Centreville National Bank of Maryland, a national banking association ("Centreville National Bank"), The Talbot Bank of Easton, Maryland, a Maryland commercial bank ("Talbot Bank"), and The Felton Bank, a Delaware commercial bank ("Felton Bank" and, together with Centreville National Bank and Talbot Bank, the "Banks"). The Company engages in the insurance business through two general insurance producer firms, The Avon-Dixon Agency, LLC, a Maryland limited liability company, and Elliott Wilson Insurance, LLC, a Maryland limited liability company; one marine insurance producer firm, Jack Martin & Associates, Inc., a Maryland corporation; three wholesale insurance firms, Tri-State General Insurance Agency, LTD, a Maryland corporation, Tri-State General Insurance Agency of New Jersey, Inc., a New Jersey corporation, and Tri-State General Insurance Agency of Virginia, Inc., a Virginia corporation; and two insurance premium finance companies, Mubell Finance, LLC, a Maryland limited liability company, and ESFS, Inc., a Maryland corporation (all of the foregoing are collectively referred to as the "Insurance Subsidiary"). On March 1, 2008, the Company established a mortgage broker subsidiary, Wye Mortgage Group, LLC (the "Mortgage Group"). The Company also has two inactive subsidiaries, Wye Financial Services, LLC and Shore Pension Services, LLC, both of which were organized under Maryland law.

Talbot Bank owns all of the issued and outstanding securities of Dover Street Realty, Inc., a Maryland corporation that engages in the business of holding and managing real property acquired by Talbot Bank as a result of loan foreclosures. Centreville National Bank, a national banking association, owns 20% of the issued and outstanding common stock of Delmarva Data Bank Processing Center, Inc. ("Delmarva Data"), a Maryland corporation that provides

data processing services to banks located in Maryland, Delaware, Virginia and the District of Columbia, including Centreville National Bank and Talbot Bank.

We operate in two business segments: community banking and insurance products and services. Financial information related to our operations in these segments for each of the two years ended December 31, 2007 is provided in Note 24 to the Company's Consolidated Financial Statements included in Item 8 of Part II of this report.

Banking Products and Services

Centreville National Bank is a national banking association that commenced operations in 1876. Talbot Bank is a Maryland commercial bank that commenced operations in 1885 and was acquired by the Company in its December 2000 merger with Talbot Bancshares, Inc. ("Talbot Bancshares"). Felton Bank is a Delaware commercial bank that commenced operations in 1908 and was acquired by the Company in April 2004 when it merged with Midstate Bancorp, Inc. The Banks operate 17 full service branches and 21 ATMs and provide a full range of commercial and consumer banking products and services to individuals, businesses, and other organizations in the Maryland counties of Kent, Queen Anne's, Caroline, Talbot and Dorchester and in Kent County, Delaware. The

Banks' deposits are insured by the Federal Deposit Insurance Corporation (the "FDIC").

The Banks are independent community banks and serve businesses and individuals in their respective market areas. Services offered are essentially the same as those offered by larger regional institutions that compete with the Banks. Services provided to businesses include commercial checking, savings, certificate of deposit and overnight investment sweep accounts. The Banks offer all forms of commercial lending, including secured and unsecured loans, working capital loans, lines of credit, term loans, accounts receivable financing, real estate acquisition development, construction loans and letters of credit. Merchant credit card clearing services are available as well as direct deposit of payroll, internet banking and telephone banking services.

Services to individuals include checking accounts, various savings programs, mortgage loans, home improvement loans, installment and other personal loans, credit cards, personal lines of credit, automobile and other consumer financing, safe deposit boxes, debit cards, 24 hour telephone banking, PC and internet banking, and 24-hour automatic teller machine services. The Banks also offer nondeposit products, such as mutual funds and annuities, and discount brokerage services to their customers. Additionally, the Banks have Saturday hours and extended hours on certain evenings during the week for added customer convenience.

Lending Activities

The Banks originate secured and unsecured loans for business purposes. Commercial loans are typically secured by real estate, accounts receivable, inventory equipment and/or other assets of the business. Commercial loans generally involve a greater degree of credit risk than one to four family residential mortgage loans. Repayment is often dependent on the successful operation of the business and may be affected by adverse conditions in the local economy or real estate market. The financial condition and cash flow of commercial borrowers is therefore carefully analyzed during the loan approval process, and continues to be monitored by obtaining business financial statements, personal financial statements and income tax returns. The frequency of this ongoing analysis depends upon the size and complexity of the credit and collateral that secures the loan. It is also the Company's general policy to obtain personal guarantees from the principals of the commercial loan borrowers.

Commercial real estate loans are primarily those secured by office condominiums, retail buildings, warehouses and general purpose business space. Low loan to value ratio standards, as well as the thorough financial analysis performed and the Banks' knowledge of the local economy in which they lend are employed to help reduce the risk associated with these loans.

The Banks provide residential real estate construction loans to builders and individuals for single family dwellings. Residential construction loans are usually granted based upon "as completed" appraisals and are secured by the property under construction. Additional collateral may be taken if loan to value ratios exceed 80%. Site inspections are performed to determine pre-specified stages of completion before loan proceeds are disbursed. These loans typically have maturities of six to 12 months and may have fixed or variable rate features. Permanent financing options for individuals include fixed and variable rate loans with three- and five-year balloon features and one-, three- and five-year adjustable rate mortgage loans. The risk of loss associated with real estate construction lending is controlled through conservative underwriting procedures such as loan to value ratios of 80% or less, obtaining additional collateral when prudent, and closely monitoring construction projects to control disbursement of funds on loans.

The Banks originate fixed and variable rate residential mortgage loans. As with any consumer loan, repayment is dependent on the borrower's continuing financial stability, which can be adversely impacted by job loss, divorce, illness, or personal bankruptcy. Underwriting standards recommend loan to value ratios not to exceed 80% based on appraisals performed by approved appraisers. The Banks rely on title insurance to protect their lien priorities and protect the property securing the loans by requiring fire and casualty insurance.

The Mortgage Group, which operated in 2007 as a division of Centreville National Bank, brokers long-term fixed rate residential mortgage loans for sale on the secondary market for which it receives commissions upon settlement.

A variety of consumer loans are offered to customers, including home equity loans, credit cards and other secured and unsecured lines of credit and term loans. Careful analysis of an applicant's creditworthiness is performed before granting credit, and on going monitoring of loans outstanding is performed in an effort to minimize risk of loss by identifying problem loans early.

*Deposit Activitie*s

The Banks offer a full array of deposit products including checking, savings and money market accounts, regular and IRA certificates of deposit, and Christmas Savings accounts. The Banks also offer the CDARS program, providing up to $20 million of FDIC insurance to our customers. In addition, we offer our commercial customers packages which include Cash Management services and various checking opportunities.

Trust Services

Centreville National Bank established a trust department during the second quarter of 2005 and markets trust, asset management and financial planning services to customers within our market areas.

Insurance Activities

The Avon-Dixon Agency, LLC, Elliott Wilson Insurance, LLC, and Mubell Finance, LLC were formed as a result of the Company's acquisition of the assets of The Avon-Dixon Agency, Inc., Elliott Wilson Insurance, Inc., Avon-Dixon Financial Services, Inc., Joseph M. George & Son, Inc. and 59th Street Finance Company on May 1, 2002. In November 2002, The Avon-Dixon Agency, LLC acquired certain assets of W. M. Freestate & Son, Inc., a full-service insurance producer firm located in Centreville, Maryland. Jack Martin & Associates, Inc., Tri-State General Insurance Agency, LTD, Tri-State General Insurance Agency of New Jersey, Inc., Tri-State General Insurance Agency of Virginia, Inc., and ESFS, Inc. were acquired on October 1, 2007.

The Insurance Subsidiaries offer a full range of insurance products and services to customers, including insurance premium financing.

Seasonality

Management does not believe that our business activities are seasonal in nature. Demand for our products and services may vary depending on local and national economic conditions, but management believes that any variation will not have a material impact on our planning or policy-making strategies.

Employees

At February 29, 2008, we employed 373 persons, of which 328 were employed on a full-time basis.

COMPETITION

The banking business, in all of its phases, is highly competitive. Within our market areas, we compete with commercial banks (including local banks and branches or affiliates of other larger banks), savings and loan associations and credit unions for loans and deposits, with money market and mutual funds and other investment alternatives for deposits, with consumer finance companies for loans, with insurance companies, agents and brokers for insurance products, and with other financial institutions for various types of products and services. There is also competition for commercial and retail banking business from banks and financial institutions located outside our market areas.

The primary factors in competing for deposits are interest rates, personalized services, the quality and range of financial services, convenience of office locations and office hours. The primary factors in competing for loans are interest rates, loan origination fees, the quality and range of lending services and personalized services. The primary factors in competing for insurance customers are competitive rates, the quality and range of insurance products offered, and quality, personalized service.

To compete with other financial services providers, we rely principally upon local promotional activities, including advertisements in local newspapers, trade journals and other publications and on the radio, personal relationships established by officers, directors and employees with customers, and specialized services tailored to meet its customers' needs. In those instances in which we are unable to accommodate the needs of a customer, we will arrange for those services to be provided by other financial services providers with which we have a relationship. We additionally rely on referrals from satisfied customers.

The following tables set forth deposit data for FDIC-insured institutions in Kent, Queen Anne’s, Caroline, Talbot and Dorchester Counties in Maryland and for Kent County in Delaware as of June 30, 2007, the most recent date for which comparative information is available.

Kent County, Maryland		Deposits (in thousands)	% of Total
Peoples Bank of Kent County, Maryland	$	159,916	33.65%
Mercantile Shore Bank		151,864	31.96
Chesapeake Bank and Trust Co.		65,641	13.81
Branch Banking & Trust		40,988	8.63
The Centreville National Bank of Maryland		**30,488**	**6.42**
SunTrust Bank		26,298	5.53
Total	$	475,195	100.00%

Source: FDIC DataBook

Queen Anne's County, Maryand		Deposits (in thousands)	% of Total
The Queenstown Bank of Maryland	$	305,135	40.78%
The Centreville National Bank of Maryland		**203,292**	**27.17**
Bank of America, National Association		63,337	8.46
Mercantile Shore Bank		61,797	8.26
Bank Annapolis		47,090	6.29
M&T		43,002	5.75
Branch Banking & Trust		22,681	3.03
Sun Trust Bank		1,453	0.19
Branch Banking & Trust		551	0.07
Total	$	748,338	100.00%

Source: FDIC DataBook

Caroline County, Maryland		Deposits (in thousands)	% of Total
Provident State Bank of Preston, Maryland	$	141,019	34.70%
Mercantile Shore Bank		111,578	27.45
The Centreville National Bank of Maryland		**53,040**	**13.05**
Branch Banking & Trust		44,997	11.07
M&T		29,348	7.22
Bank of America, National Association		16,761	4.13
Easton Bank & Trust		9,667	2.38
Total	$	406,410	100.00%

Source: FDIC DataBook

Talbot County, Maryland		Deposits (in thousands)	% of Total
The Talbot Bank of Easton, Maryland	**$**	**391,978**	**41.71%**
Mercantile Shore Bank		166,474	17.72

Easton Bank & Trust		102,444	10.90
Bank of America, National Association		91,452	9.73
Branch Banking & Trust		53,487	5.69
SunTrust Bank		43,884	4.67
M&T		28,660	3.05
The Queenstown Bank of Maryland		27,754	2.96
First Mariner Bank		15,233	1.62
Chevy Chase Bank		13,067	1.39
Provident State Bank of Preston, Maryland		5,259	0.56
Total	$	939,692	100.00%

Source: FDIC DataBook

Dorchester County, Maryland	Deposits (in thousands)	% of Total
The National Bank of Cambridge	$ 181,676	30.69%
Bank of the Eastern Shore	173,827	29.36
Hebron Savings Bank	57,907	9.78
Branch Banking & Trust	46,379	7.83
Provident State Bank of Preston, Maryland	40,541	6.85
Bank of America, National Association	30,189	5.10
M&T	22,780	3.85
SunTrust Bank	19,552	3.30
The Talbot Bank of Easton, Maryland	**19,161**	**3.24**
Total	$ 592,012	100.00%

Source: FDIC DataBook

Kent County, Delaware	Deposits (in thousands)	% of Total
Wilmington Trust	$ 540,918	31.14%
PNC Bank Delaware	262,477	15.11
Citizens Bank	253,693	14.61
First NB of Wyoming	232,256	13.37
Wachovia Bank of Delaware	160,788	9.26
The Felton Bank	**69,627**	**4.01**
Artisans Bank	66,178	3.81
Wilmington Savings Fund Society	66,041	3.80
Commerce Bank National Assn	43,187	2.49
County Bank	36,561	2.10
Fort Sill National Bank	5,230	0.30
Total	$ 1,736,956	100.00%

Source: FDIC DataBook

For further information about competition in our market areas, see the Risk Factor entitled “We operate in a highly competitive market” in Item 1A of Part I of this annual report.

SUPERVISION AND REGULATION

The following is a summary of the material regulations and policies applicable to us and is not intended to be a comprehensive discussion. Changes in applicable laws and regulations may have a material effect on our business, financial condition and results of operation.

General

The Company is a financial holding company registered with the Board of Governors of the Federal Reserve System (the “FRB”) under the BHC Act and, as such, is subject to the supervision, examination and reporting requirements of the BHC Act and the regulations of the FRB.

Talbot Bank is a Maryland commercial bank subject to the banking laws of Maryland and to regulation by the Commissioner of Financial Regulation of Maryland, who is required by statute to make at least one examination in each calendar year (or at 18-month intervals if the Commissioner determines that an examination is unnecessary in a particular calendar year). Centreville National Bank is a national banking association subject to federal banking laws and regulations enforced and/or promulgated by the Office of the Comptroller of the Currency (the "OCC"), which is required by statute to make at least one examination in each calendar year. Felton Bank is a Delaware commercial bank subject to the banking laws of Delaware and to regulation by the Delaware Office of the State Bank Commissioner, who is entitled by statute to make examinations of Felton Bank as and when deemed necessary or expedient. The primary federal regulator of both Talbot Bank and Felton Bank is the FDIC, which is also entitled to conduct regular examinations. The deposits of the Banks are insured by the FDIC, so certain laws and regulations administered by the FDIC also govern their deposit taking operations. In addition to the foregoing, the Banks are subject to numerous state and federal statutes and regulations that affect the business of banking generally.

Nonbank affiliates of the Company are subject to examination by the FRB, and, as affiliates of the Banks, may be subject to examination by the Banks' regulators from time to time. In addition, the Insurance Subsidiaries are each subject to licensing and regulation by the insurance authorities of the states in which they do business. Retail sales of insurance products by the Insurance Subsidiaries to customers of the Banks are also subject to the requirements of the Interagency Statement on Retail Sales of Nondeposit Investment Products promulgated in 1994, as amended, by the FDIC, the FRB, the OCC, and the Office of Thrift Supervision. The Mortgage Group is subject to supervision by the banking agencies of the states in which it does business. Wye Financial Services, LLC is subject to the registration and examination requirements of federal and state laws governing investment advisers.

Regulation of Financial Holding Companies

In November 1999, the federal Gramm-Leach-Bliley Act (the "GLBA") was signed into law. Effective in pertinent part on March 11, 2000, GLBA revised the BHC Act and repealed the affiliation provisions of the Glass-Steagall Act of 1933, which, taken together, limited the securities, insurance and other non-banking activities of any company that controls an FDIC insured financial institution. Under GLBA, a bank holding company can elect, subject to certain qualifications, to become a "financial holding company." GLBA provides that a financial holding company may engage in a full range of financial activities, including insurance and securities sales and underwriting activities, and real estate development, with new expedited notice procedures.

Under FRB policy, the Company is expected to act as a source of strength to its subsidiary banks, and the FRB may charge the Company with engaging in unsafe and unsound practices for failure to commit resources to a subsidiary bank when required. In addition, under the Financial Institutions Reform, Recovery and Enforcement Act of 1989 ("FIRREA"), depository institutions insured by the FDIC can be held liable for any losses incurred by, or reasonably anticipated to be incurred by, the FDIC in connection with (i) the default of a commonly controlled FDIC-insured depository institution or (ii) any assistance provided by the FDIC to a commonly controlled FDIC-insured depository institution in danger of default. Accordingly, in the event that any insured subsidiary of the Company causes a loss to the FDIC, other insured subsidiaries of the Company could be required to compensate the FDIC by reimbursing it for the estimated amount of such loss. Such cross guaranty liabilities generally are superior in priority to obligations of a financial institution to its stockholders and obligations to other affiliates.

Regulation of Banks

Federal and state banking regulators may prohibit the institutions over which they have supervisory authority from engaging in activities or investments that the agencies believes are unsafe or unsound banking practices. These banking regulators have extensive enforcement authority over the institutions they regulate to prohibit or correct activities that violate law, regulation or a regulatory agreement or which are deemed to be unsafe or unsound practices. Enforcement actions may include the appointment of a conservator or receiver, the issuance of a cease and desist order, the termination of deposit insurance, the imposition of civil money penalties on the institution, its directors, officers, employees and institution-affiliated parties, the issuance of directives to increase capital, the issuance of formal and informal agreements, the removal of or restrictions on directors, officers, employees and institution-affiliated parties, and the enforcement of any such mechanisms through restraining orders or other court actions.

The Company and its affiliates are subject to the provisions of Section 23A and Section 23B of the Federal Reserve Act. Section 23A limits the amount of loans or extensions of credit to, and investments in, the Company and its nonbank affiliates by the Banks. Section 23B requires that transactions between any of the Banks and the Company and its nonbank affiliates be on terms and under circumstances that are substantially the same as with non-affiliates.

The Banks are also subject to certain restrictions on extensions of credit to executive officers, directors, and principal stockholders or any related interest of such persons, which generally require that such credit extensions be made on

substantially the same terms as are available to third parties dealing with the Banks and not involve more than the normal risk of repayment. Other laws tie the maximum amount that may be loaned to any one customer and its related interests to capital levels.

As part of the Federal Deposit Insurance Company Improvement Act of 1991 (“FDICIA”), each federal banking regulator adopted non-capital safety and soundness standards for institutions under its authority. These standards include internal controls, information systems and internal audit systems, loan documentation, credit underwriting, interest rate exposure, asset growth, and compensation, fees and benefits. An institution that fails to meet those standards may be required by the agency to develop a plan acceptable to meet the standards. Failure to submit or implement such a plan may subject the institution to regulatory sanctions. The Company, on behalf of the Banks, believes that the Banks meet substantially all standards that have been adopted. FDICIA also imposes new capital standards on insured depository institutions.

The Community Reinvestment Act (“CRA”) requires that, in connection with the examination of financial institutions within their jurisdictions, the federal banking regulators evaluate the record of the financial institution in meeting the credit needs of their communities including low and moderate income neighborhoods, consistent with the safe and sound operation of those banks. These factors are also considered by all regulatory agencies in evaluating mergers, acquisitions and applications to open a branch or facility.

As of the date of its most recent examination report, each of the Banks has a CRA rating of "Satisfactory."

Capital Requirements

FDICIA established a system of prompt corrective action to resolve the problems of undercapitalized institutions. Under this system, federal banking regulators are required to rate supervised institutions on the basis of five capital categories: "well -capitalized," "adequately capitalized," "undercapitalized," "significantly undercapitalized," and "critically undercapitalized;" and to take certain mandatory actions, and are authorized to take other discretionary actions, with respect to institutions in the three undercapitalized categories. The severity of the actions will depend upon the category in which the institution is placed. A depository institution is "well capitalized" if it has a total risk based capital ratio of 10% or greater, a Tier 1 risk based capital ratio of 6% or greater, and a leverage ratio of 5% or greater and is not subject to any order, regulatory agreement, or written directive to meet and maintain a specific capital level for any capital measure. An "adequately capitalized" institution is defined as one that has a total risk based capital ratio of 8% or greater, a Tier 1 risk based capital ratio of 4% or greater and a leverage ratio of 4% or greater (or 3% or greater in the case of a bank with a composite CAMELS rating of 1).

FDICIA generally prohibits a depository institution from making any capital distribution, including the payment of cash dividends, or paying a management fee to its holding company if the depository institution would thereafter be undercapitalized. Undercapitalized depository institutions are subject to growth limitations and are required to submit capital restoration plans. For a capital restoration plan to be acceptable, the depository institution's parent holding company must guarantee (subject to certain limitations) that the institution will comply with such capital restoration plan.

Significantly undercapitalized depository institutions may be subject to a number of other requirements and restrictions, including orders to sell sufficient voting stock to become adequately capitalized and requirements to reduce total assets and stop accepting deposits from correspondent banks. Critically undercapitalized depository institutions are subject to the appointment of a receiver or conservator; generally within 90 days of the date such institution is determined to be critically undercapitalized.

As of December 31, 2007, the Banks were each deemed to be "well capitalized." For more information regarding the capital condition of the Company, see Note 17 of Consolidated Financial Statements appearing in Item 8 of Part II of this report.

Deposit Insurance

The deposits of the Banks are insured to a maximum of $100,000 per depositor through the Deposit Insurance Fund, which is administered by the FDIC, and the Banks are required to pay semi-annual deposit insurance premium assessments to the FDIC. The Banks paid a total of $99,000 in FDIC premiums during 2007. The Deposit Insurance Fund was created pursuant to the Federal Deposit Insurance Reform Act of 2005, which was signed into law on February 8, 2006. Under this new law, (i) the current $100,000 deposit insurance coverage will be indexed for inflation (with adjustments every five years, commencing January 1, 2011), and (ii) deposit insurance coverage for retirement accounts was increased to $250,000 per participant subject to adjustment for inflation. In addition, the FDIC will be given greater latitude in setting the assessment rates for insured depository institutions which could be used to impose minimum assessments. The law also allows "eligible insured depository institutions" to share in a one-time assessment credit pool. The Banks' portion of the one-time credit assessment was $541,000.

USA PATRIOT Act

Congress adopted the USA PATRIOT Act (the "Patriot Act") on October 26, 2001 in response to the terrorist attacks that occurred on September 11, 2001. Under the Patriot Act, certain financial institutions, including banks, are

required to maintain and prepare additional records and reports that are designed to assist the government's efforts to combat terrorism. The Patriot Act includes sweeping anti-money laundering and financial transparency laws and required additional regulations, including, among other things, standards for verifying client identification when opening an account and rules to promote cooperation among financial institutions, regulators and law enforcement entities in identifying parties that may be involved in terrorism or money laundering.

Federal Securities Laws

The shares of the Company's common stock are registered with the Securities and Exchange Commission (the "SEC") under Section 12(b) of the Securities Exchange Act of 1934, as amended (the "Exchange Act"), and listed on the Nasdaq Global Select Market. The Company is subject to information reporting requirements, proxy solicitation requirements, insider trading restrictions and other requirements of the Exchange Act, including the requirements imposed under the federal Sarbanes-Oxley Act of 2002. Among other things, loans to and other transactions with insiders are subject to restrictions and heightened disclosure, directors and certain committees of the Board must satisfy certain independence requirements, and the Corporation is generally required to comply with certain corporate governance requirements.

Governmental Monetary and Credit Policies and Economic Controls

The earnings and growth of the banking industry and ultimately of the Bank are affected by the monetary and credit policies of governmental authorities, including the FRB. An important function of the FRB is to regulate the national supply of bank credit in order to control recessionary and inflationary pressures. Among the instruments of monetary policy used by the FRB to implement these objectives are open market operations in U.S. Government securities, changes in the federal funds rate, changes in the discount rate of member bank borrowings, and changes in reserve requirements against member bank deposits. These means are used in varying combinations to influence overall growth of bank loans, investments and deposits and may also affect interest rates charged on loans or paid for deposits. The monetary policies of the FRB authorities have had a significant effect on the operating results of commercial banks in the past and are expected to continue to have such an effect in the future. In view of changing conditions in the national economy and in the money markets, as well as the effect of actions by monetary and fiscal authorities, including the FRB, no prediction can be made as to possible future changes in interest rates, deposit levels, loan demand or their effect on the business and earnings of the Company and its subsidiaries.

AVAILABLE INFORMATION

The Company maintains an Internet site at 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. In addition, stockholders may access these reports and documents on the SEC's web site at www.sec.gov.

Item 1A. RISK FACTORS

The following factors may impact our business, financial condition and results of operations and should be considered carefully in evaluating an investment in shares of common stock of the Company.

Risks Relating to the Business of the Company and its Affiliates

The Company's future depends on the successful growth of its subsidiaries

The Company's primary business activity for the foreseeable future will be to act as the holding company of Talbot Bank, Centreville National Bank, Felton Bank, and its other subsidiaries. Therefore, the Company's future profitability will depend on the success and growth of these subsidiaries. In the future, part of the Company's growth may come from buying other banks and buying or establishing other companies. Such entities may not be profitable after they are purchased or established, and they may lose money, particularly at first. A new bank or company may bring with it unexpected liabilities, bad loans, or bad employee relations, or the new bank or company may lose customers.

A majority of our business is concentrated in Maryland and Delaware; a significant amount of our business is concentrated in real estate lending

Because most of our loans are made to customers who reside on the Eastern Shore of Maryland and in Delaware, a decline in local economic conditions may have a greater effect on our earnings and capital than on the earnings and capital of larger financial institutions whose loan portfolios are geographically diverse. Further, we make many real estate secured loans, including construction and land development loans, all of which are in greater demand when interest rates are low and economic conditions are good. There can be no guarantee that good economic conditions or low interest rates will continue to exist. Moreover, the market values of the real estate securing our loans may deteriorate due to a number of unpredictable factors, which could cause us to lose money in the event a borrower failed to repay a loan and we were forced to foreclose on the property. Additionally, the Board of Governors of the Federal Reserve System and the Federal Deposit Insurance Corporation, along with the other federal banking

regulators, issued final guidance on December 6, 2006 entitled "Concentrations in Commercial Real Estate Lending, Sound Risk Management Practices" directed at institutions that have particularly high concentrations of commercial real estate loans within their lending portfolios. This guidance suggests that institutions whose commercial real estate loans exceed certain percentages of capital should implement heightened risk management practices appropriate to their concentration risk and may be required to maintain higher capital ratios than institutions with lower concentrations in commercial real estate lending. Based on our commercial real estate concentration as of December 31, 2006, we may be subject to further supervisory analysis during future examinations. Although we continuously evaluate our concentration and risk management strategies, we cannot guarantee that any risk management practices we implement will be effective to prevent losses relating to our commercial real estate portfolio. Management cannot predict the extent to which this guidance will impact our operations or capital requirements.

Interest rates and other economic conditions will impact our results of operation

Our results of operations may be materially and adversely affected by changes in prevailing economic conditions, including declines in real estate values, rapid changes in interest rates and the monetary and fiscal policies of the federal government. Our profitability is in part a function of the spread between the interest rates earned on assets and the interest rates paid on deposits and other interest-bearing liabilities (*i.e.*, net interest income), including advances from the Federal Home Loan Bank of Atlanta. Interest rate risk arises from mismatches (*i.e.*, the interest sensitivity gap) between the dollar amount of repricing or maturing assets and liabilities and is measured in terms of the ratio of the interest rate sensitivity gap to total assets. More assets repricing or maturing than liabilities over a given time period is considered asset-sensitive and is reflected as a positive gap, and more liabilities repricing or maturing than assets over a given time period is considered liability-sensitive and is reflected as negative gap. An asset-sensitive position (*i.e.*, a positive gap) could enhance earnings in a rising interest rate environment and could negatively impact earnings in a falling interest rate environment, while a liability-sensitive position (*i.e.*, a negative gap) could enhance earnings in a falling interest rate environment and negatively impact earnings in a rising interest rate environment. Fluctuations in interest rates are not predictable or controllable. We have attempted to structure our asset and liability management strategies to mitigate the impact on net interest income of changes in market interest rates, but there can be no assurance that these attempts will be successful in the event of such changes.

The Banks may experience loan losses in excess of their allowances

The risk of credit losses on loans varies with, among other things, general economic conditions, the type of loan being made, the creditworthiness of the borrower over the term of the loan and, in the case of a collateralized loan, the value and marketability of the collateral for the loan. Management of each of the Banks bases that Bank’s allowance for loan losses upon, among other things, historical experience, an evaluation of economic conditions and regular reviews of delinquencies and loan portfolio quality. Based upon such factors, management makes various assumptions and judgments about the ultimate collectability of the loan portfolio and provides an allowance for loan losses based upon a percentage of the outstanding balances and for specific loans when their ultimate collectability is considered questionable. If management’s assumptions and judgments prove to be incorrect and the allowance for loan losses is inadequate to absorb future losses, or if the bank regulatory authorities, as a part of their examination process, require our bank subsidiaries to increase their respective allowance for loan losses, our earnings and capital could be significantly and adversely affected. Although management uses the best information available to make determinations with respect to the allowance for loan losses, future adjustments may be necessary if economic conditions differ substantially from the assumptions used or adverse developments arise with respect to the Banks’ non-performing or performing loans. Material additions to the allowance for loan losses of one of the Banks would result in a decrease in that Bank’s net income and capital and could have a material adverse effect on our financial condition.

The market value of our investments might decline

As of December 31, 2007, we had classified 88% of our investment securities as available-for-sale pursuant to Statement of Financial Accounting Standards No. 115 (“SFAS 115”) relating to accounting for investments. SFAS 115 requires that unrealized gains and losses in the estimated value of the available-for-sale portfolio be “marked to market” and reflected as a separate item in stockholders’ equity (net of tax) as accumulated other comprehensive income. The remaining investment securities are classified as held-to-maturity in accordance with SFAS 115 and are stated at amortized cost.

In the past, gains on sales of investment securities have not been a significant source of income for us. There can be no assurance that future market performance of our investment portfolio will enable us to realize income from sales of securities. Stockholders’ equity will continue to reflect the unrealized gains and losses (net of tax) of these investments. There can be no assurance that the market value of our investment portfolio will not decline, causing a corresponding

decline in stockholders' equity.

Management believes that several factors will affect the market values of our investment portfolio. These include, but are not limited to, changes in interest rates or expectations of changes, the degree of volatility in the securities markets, inflation rates or expectations of inflation and the slope of the interest rate yield curve (the yield curve refers to the differences between shorter-term and longer-term interest rates; a positively sloped yield curve means shorter-term rates are lower than longer-term rates). Also, the passage of time will affect the market values of our investment securities, in that the closer they are to maturing, the closer the market price should be to par value. These and other factors may impact specific categories of the portfolio differently, and management cannot predict the effect these factors may have on any specific category.

The banking industry is heavily regulated; significant regulatory changes could adversely affect our operations

Our operations are and will be affected by current and future legislation and by the policies established from time to time by various federal and state regulatory authorities. The Company is subject to supervision by the FRB; Talbot Bank is subject to supervision and periodic examination by the Maryland Commissioner and the FDIC; Centreville National Bank is subject to supervision and periodic examination by the OCC and the FDIC; and Felton Bank is subject to supervision and periodic examination

by the Delaware Commissioner and the FDIC. Banking regulations, designed primarily for the safety of depositors, may limit a financial institution's growth and the return to its investors by restricting such activities as the payment of dividends, mergers with or acquisitions by other institutions, investments, loans and interest rates, interest rates paid on deposits, expansion of branch offices, and the offering of securities or trust services. The Company and the Banks are also subject to capitalization guidelines established by federal law and could be subject to enforcement actions to the extent that those institutions are found by regulatory examiners to be undercapitalized. It is not possible to predict what changes, if any, will be made to existing federal and state legislation and regulations or the effect that such changes may have on our future business and earnings prospects. Management also cannot predict the nature or the extent of the effect on our business and earnings of future fiscal or monetary policies, economic controls, or new federal or state legislation. Further, the cost of compliance with regulatory requirements may adversely affect our ability to operate profitably.

We operate in a highly competitive market

We operate in a competitive environment, competing for loans, deposits, insurance products and customers with commercial banks, savings associations and other financial entities. Competition for deposits comes primarily from other commercial banks, savings associations, credit unions, money market and mutual funds and other investment alternatives. Competition for loans comes primarily from other commercial banks, savings associations, mortgage banking firms, credit unions and other financial intermediaries. Competition for other products, such as insurance and securities products, comes from other banks, securities and brokerage companies, insurance companies, insurance agents and brokers, and other nonbank financial service providers in our market areas. Many of these competitors are much larger in terms of total assets and capitalization, have greater access to capital markets, and/or offer a broader range of financial services than those offered by us. In addition, banks with a larger capitalization and financial intermediaries not subject to bank regulatory restrictions have larger lending limits and are thereby able to serve the needs of larger customers. Our growth and profitability will depend upon our ability to attract and retain skilled managerial, marketing and technical personnel. Competition for qualified personnel in the financial services industry is intense, and there can be no assurance that we will be successful in attracting and retaining such personnel.

In addition, current banking laws facilitate interstate branching, merger activity among banks, and expanded activities. Since September 1995, certain bank holding companies have been authorized to acquire banks throughout the United States. Since June 1, 1997, certain banks have been permitted to merge with banks organized under the laws of different states. As a result, interstate banking is now an accepted element of competition in the banking industry and the Corporation may be brought into competition with institutions with which it does not presently compete. Moreover, as discussed above, the GLBA revised the BHC Act in 2000 and repealed the affiliation provisions of the Glass-Steagall Act of 1933, which, taken together, limited the securities, insurance and other non-banking activities of any company that controls an FDIC-insured financial institution. These laws may increase the competition we face in our market areas in the future, although management cannot predict the degree to which such competition will impact our financial conditions or results of operations.

The loss of key personnel could disrupt our operations and result in reduced earnings

Our growth and profitability will depend upon our ability to attract and retain skilled managerial, marketing and technical personnel. Competition for qualified personnel in the financial services industry is intense, and there can be no assurance that we will be successful in attracting and retaining such personnel. Our current executive officers provide valuable services based on their many years of experience and in-depth knowledge of the banking industry. Due to the intense competition for financial professionals, these key personnel would be difficult to replace and an unexpected loss of their services could result in a disruption to the continuity of operations and a possible reduction in earnings.

We may be subject to claims

We may from time to time be subject to claims from customers for losses due to alleged breaches of fiduciary duties, errors and omissions of employees, officers and agents, incomplete documentation, the failure to comply with

applicable laws and regulations, or many other reasons. Also, our employees may knowingly or unknowingly violate laws and regulations. Management may not be aware of any violations until after their occurrence. This lack of knowledge may not insulate the Company or our subsidiaries from liability. Claims and legal actions may result in legal expenses and liabilities that may reduce our profitability and hurt our financial condition.

We may be adversely affected by recent legislation

As discussed above, the GLBA repealed restrictions on banks affiliating with securities firms and permits bank holding companies that become financial holding companies to engage in additional financial activities, including insurance and securities underwriting and agency activities, merchant banking, and insurance company portfolio investment activities that are currently not permitted for bank holding companies. Although the Company is a financial holding company, this law may increase the competition we face from larger banks and other companies. It is not possible to predict the full effect that this law will have on us.

The Sarbanes-Oxley Act of 2002 requires management of publicly traded companies to perform an annual assessment of their internal controls over financial reporting and to report on whether the system is effective as of the end of the Company's fiscal year. Disclosure of significant deficiencies or material weaknesses in internal controls could cause an unfavorable impact to shareholder value by affecting the market value of our stock.

The Patriot Act reinforced the importance of implementing and following procedures required by the Bank Secrecy Act and money laundering issues. Non-compliance with this act or failure to file timely and accurate documentation could expose the company to adverse publicity as well as fines and penalties assessed by regulatory agencies.

We may not be able to keep pace with developments in technology

We use various technologies in our business, including telecommunication, data processing, computers, automation, internet-based banking, and debit cards. Technology changes rapidly. Our ability to compete successfully with other banks and non-bank entities may depend on whether we can exploit technological changes. We may not be able to exploit technological changes, and any investment we do make may not make us more profitable.

Risks Relating to the Company's Common Stock

The Company's ability to pay dividends is limited

The Company's stockholders are entitled to dividends on their shares of common stock if, when, and as declared by the Company's Board of Directors out of funds legally available for that purpose. The Company's current ability to pay dividends to stockholders is largely dependent upon the receipt of dividends from the Banks. Both federal and state laws impose restrictions on the ability of the Banks to pay dividends. Federal law prohibits the payment of a dividend by an insured depository institution if the depository institution is considered "undercapitalized" or if the payment of the dividend would make the institution "undercapitalized". For a Maryland state-chartered bank, dividends may be paid out of undivided profits or, with the prior approval of the Maryland Commissioner, from surplus in excess of 100% of required capital stock. If, however, the surplus of a Maryland bank is less than 100% of its required capital stock, then cash dividends may not be paid in excess of 90% of net earnings. National banking associations are generally limited, subject to certain exceptions, to paying dividends out of undivided profits. For a Delaware state-chartered bank, dividends may be paid out of net profits, but only if its surplus fund is equal to or greater than 50% of its required capital stock. If a Delaware bank's surplus is less than 100% of capital stock when it declares a dividend, then it must carry 25% of its net profits of the preceding period for which the dividend is paid to its surplus fund until the surplus amounts to 100% of its capital stock. In addition to these specific restrictions, bank regulatory agencies also have the ability to prohibit proposed dividends by a financial institution that would otherwise be permitted under applicable regulations if the regulatory body determines that such distribution would constitute an unsafe or unsound practice. Because of these limitations, there can be no guarantee that the Company's Board will declare dividends in any fiscal quarter.

The shares of the Company's common stock are not insured

Investments in the shares of the common stock of the Company are not deposits and are not insured against loss by the government.

The shares of the Company's common stock are not heavily traded

The shares of common stock of the Company are listed on the Nasdaq Global Select Market and are not heavily traded. Stock that is not heavily traded can be more volatile than stock trading in an active public market. Factors such as our financial results, the introduction of new products and services by us or our competitors, and various factors affecting the banking industry generally may have a significant impact on the market price of the shares our common

stock. Management cannot predict the extent to which an active public market for our common stock will develop or be sustained in the future. In recent years, the stock market has experienced a high level of price and volume volatility, and market prices for the stock of many companies have experienced wide price fluctuations that have not necessarily been related to their operating performance. Therefore, the Company's stockholders may not be able to sell their shares at the volumes, prices, or times that they desire.

The Company's Articles of Incorporation and Bylaws and Maryland law may discourage a corporate takeover

The Company's Amended and Restated Articles of Incorporation (the "Charter") and Amended and Restated Bylaws contain certain provisions designed to enhance the ability of the Board of Directors to deal with attempts to acquire control of the Company. These Charter and Bylaws provide for the classification of the Board into three classes; directors of each class generally serve for staggered three-year periods. No director may be removed except for cause and then only by a vote of at least two-thirds of the total eligible stockholder votes. The Charter gives the Board certain powers in respect of the Company's securities. First, the

Board has the authority to classify and reclassify unissued shares of stock of any class or series of stock by setting, fixing, eliminating, or altering in any one or more respects the preferences, rights, voting powers, restrictions and qualifications of, dividends on, and redemption, conversion, exchange, and other rights of, such securities. Second, a majority of the Board, without action by the stockholders, may amend the Charter to increase or decrease the aggregate number of shares of stock or the number of shares of stock of any class that the Company has authority to issue. The Board could use these powers, along with its authority to authorize the issuance of securities of any class or series, to issue securities having terms favorable to management to persons affiliated with or otherwise friendly to management. In addition to the foregoing, Maryland law contains anti-takeover provisions governing acquisitions of the Company's securities by and business combinations with certain "interested" stockholders.

Although these provisions do not preclude a takeover, they may have the effect of discouraging a future takeover attempt which would not be approved by the board of directors, but pursuant to which stockholders might receive a substantial premium for their shares over then-current market prices. As a result, stockholders who might desire to participate in such a transaction might not have the opportunity to do so. Such provisions will also render the removal of the Board of Directors and of management more difficult and, therefore, may serve to perpetuate current management. As a result of the foregoing, such provisions could potentially adversely affect the market price of the shares of common stock of the Company.

Item 1B. Unresolved Staff Comments

None.

Item 2. Properties.

Our offices are listed in the tables below. The Company's main office is the same as Talbot Bank's main office. The Company owns real property at 28969 Information Lane in Easton, Maryland, which houses the Operations, Information Technology and Finance departments of the Company and its subsidiaries, and certain operations of The Avon-Dixon Agency, LLC.

The Talbot Bank of Easton, Maryland

	Branches	
Main Office 18 East Dover Street Easton, Maryland 21601	Tred Avon Square Branch 212 Marlboro Road Easton, Maryland 21601	St. Michaels Branch 1013 South Talbot Street St. Michaels, Maryland 21663
Elliott Road Branch 8275 Elliott Road Easton, Maryland 21601	Sunburst Branch 424 Dorchester Avenue Cambridge, Maryland 21613	
	ATMs	
Memorial Hospital at Easton 219 South Washington Street Easton, Maryland 21601	Sailwinds Amoco 511 Maryland Avenue Cambridge, Maryland 21613	Talbottown 218 North Washington Street Easton, Maryland 21601

The Centreville National Bank of Maryland

	Branches	
Main Office	Route 213 South Office	Stevensville Office

109 North Commerce Street Centreville, Maryland 21617	2609 Centreville Road Centreville, Maryland 21617	408 Thompson Creek Road Stevensville, Maryland 21666
Chestertown Office 305 East High Street Chestertown, Maryland 21620	Hillsboro Office 21913 Shore Highway Hillsboro, Maryland 21641	Denton Office 850 South 5th Street Denton, Maryland 21629
Chester Office 300 Castle Marina Road Chester, Maryland 21619	Grasonville Office 202 Pullman Crossing Grasonville, Maryland 21638	Washington Square Office 899 Washington Avenue Chestertown, Maryland 21620

ATM

Queenstown Harbor Golf Links
Queenstown, Maryland
21658

The Felton Bank

Main Office 120 West Main Street Felton, Delaware 19943	Milford Office 698-A North Dupont Highway Milford, Delaware 19963	Camden Wal-Mart Supercenter 263 Wal-Mart Drive Camden, Delaware 19934

The Avon-Dixon Agency, LLC

Easton Office 28969 Information Lane Easton, Maryland 21601	Grasonville Office 202 Pullman Crossing Grasonville, Maryland 21638	Centreville Office 105 Lawyers Row Centreville, Maryland 21617
Elliott-Wilson Insurance, LLC	***Mubell Finance, LLC***	***Wye Financial Services, LLC***
106 North Harrison Street Easton, Maryland 21601	106 North Harrison Street Easton, Maryland 21601	17 East Dover Street, Suite 101 Easton, Maryland 21601

Jack Martin & Associates, Inc. 326 First Street Annapolis, Maryland 21403	***Tri-State General Insurance Agencies and ESFS, Inc.*** One Plaza East, 4th Floor Salisbury, Maryland 21802

Talbot Bank owns the real property on which all of its offices are located, except that it operates under leases at its St. Michaels Branch. Centreville National Bank owns the real property on which all of its offices are located. Felton Bank leases the real property on which its main and Camden offices are located and owns its Milford branch location subject to a land lease. The Insurance Subsidiaries do not own any real property, but operate under leases. Wye Financial occupies space in Talbot Bank's main office. For information about rent expense for all leased premises, see Note 6 to the Consolidated Financial Statements appearing in Item 8 of Part II of this report.

Item 3. Legal Proceedings

We are at times, in the ordinary course of business, subject to legal actions. Management, upon the advice of counsel, believes that losses, if any, resulting from current legal actions will not have a material adverse effect on our financial condition or results of operation.

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

None.

PART II

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

MARKET PRICE, HOLDERS AND CASH DIVIDENDS

The shares of the common stock of the Company are listed on the Nasdaq Global Select Market under the symbol "SHBI". As of March 3, 2008, the Company had approximately 1,703 holders of record. The high and low sales prices for the shares of common stock of the Company, as reported on the Nasdaq Global Select Market, and the cash dividends declared on those shares for each quarterly period of 2007 and 2006 are set forth in the table below.

	2007			2006		
	Price Range		Dividends	Price Range		Dividends
	High	Low	Paid	High	Low	Paid
First Quarter	**$ 30.76**	**$ 23.54**	**$ .16**	$ 23.67	$ 20.67	$ .14
Second Quarter	**29.15**	**23.98**	**.16**	29.96	23.36	.15
Third Quarter	**27.05**	**20.52**	**.16**	29.20	25.51	.15
Fourth Quarter	**24.72**	**20.00**	**.16**	31.00	27.70	.15
			$ .64			$ .59

On March 3, 2008, the closing sales price for the shares of common stock was $20.78 per share.

Stockholders received cash dividends totaling $5,364,000 in 2007 and $4,908,000 in 2006. The ratio of dividends per share to earnings per share was 39.75% in 2007, compared to 36.42% in 2006. Cash dividends are typically declared on a quarterly basis and are at the discretion of the Board of Directors, based upon such factors as operating results, financial condition, capital adequacy, regulatory requirements, and stockholder return. The Company's ability to pay dividends is limited by federal and Maryland law and is generally dependent on the ability of the Company's subsidiaries, particularly the Banks, to declare dividends to the Company. For more information regarding these limitations, see Item 1A of Part I of this report under the heading, "The Company's ability to pay dividends is limited".

The transfer agent for the Company's common stock is:

Registrar & Transfer Company
10 Commerce Drive
Cranford, New Jersey 07016
Investor Relations: 1-800-368-5948
E-mail for investor inquiries: info@rtco.com.

The performance graph below compares the cumulative total shareholder return on the common stock of the Company with the cumulative total return on the equity securities included in the NASDAQ Composite Index (reflecting overall stock market performance), the NASDAQ Bank Index (reflecting changes in banking industry stocks), and the SNL Small Cap Bank Index (reflecting changes in stocks of banking institutions of a size similar to the Company) assuming in each case an initial $100 investment on December 31, 2002 and reinvestment of dividends as of the end of the Company's fiscal years. Returns are shown on a total return basis. The performance graph represents past performance and should not be considered to be an indication of future performance.

			Period Ending			
Index	**12/31/02**	**12/31/03**	**12/31/04**	**12/31/05**	**12/31/06**	**12/31/07**
Shore Bancshares, Inc.	100.00	165.59	161.47	144.67	211.00	157.48
NASDAQ Composite	100.00	150.01	162.89	165.13	180.85	198.60
NASDAQ Bank	100.00	129.93	144.21	137.97	153.15	119.35
SNL Small Cap Bank Index	100.00	140.14	171.73	169.14	193.05	139.58

ISSUER REPURCHASES

On February 2, 2006, the Company's Board of Directors authorized the Company to repurchase up to 165,000 shares of its common stock over a period not to exceed 60 months. Shares may be repurchased in the open market or in privately negotiated transactions at such times and in such amounts per transaction as the President of the Company determines to be appropriate, subject to Board oversight. The Company intends to use the repurchased shares to fund the Company's employee benefit plans and for other general corporate purposes. The Company repurchased 10,234 shares of its common stock during the first three quarters of 2007. No shares were repurchased during the fourth quarter of 2007 or during 2006.

EQUITY COMPENSATION PLAN INFORMATION

The Company has three equity compensation plans under which it may issue equity awards to employees, officers, and/or directors of the Company and its subsidiaries: (i) the Shore Bancshares, Inc. 2006 Stock and Incentive Compensation Plan (the "2006 Plan"), which authorizes the grant of stock options, stock appreciation rights, stock awards, stock units, and performance units; (ii) the Shore Bancshares, Inc. 1998 Stock Option Plan, which authorizes the grant of stock options; and (iii) the Shore Bancshares, Inc. 1998 Employee Stock Purchase Plan, which authorizes the grant of stock options. Each of these plans was approved by the Company's Board of Directors and its stockholders.

Additionally, the Company assumed the Talbot Bancshares, Inc. Employee Stock Option Plan (the "Talbot Plan") and outstanding options granted thereunder when it merged with Talbot Bancshares in 2000. Although the Talbot Plan was adopted by the stockholders of Talbot Bancshares, it was not specifically adopted by the Company's stockholders as part of the merger. The Talbot Plan expired on April 9, 2007, and no stock options granted thereunder remain outstanding.

The following table contains information about these equity compensation plans as of December 31, 2007:

Plan Category	Number of securities to be issued upon exercise of outstanding options, warrants, and rights (a)	Weighted-average exercise price of outstanding options, warrants, and rights (b)	Number of securities remaining available for future issuance under equity compensation plans (excluding securities reflected in column (a)) (c)
Equity compensation plans approved by security holders (1)	33,797	$ 15.67	699,281
Equity compensation plans not approved by security holders	0	$ 0.00	0
Total	33,797	$ 15.67	699,281

(1) In addition to stock options and stock appreciation rights, the 2006 Plan permits the grant of stock awards, stock units, and performance units, and the shares available for issuance shown in column (c) may be granted pursuant to such awards. Subject to the anti-dilution provisions of the Omnibus Plan, the maximum number of shares of

restricted stock that may be granted to any participant in any calendar year is 45,000; the maximum number of restricted stock units that may be granted to any one participant in any calendar year is 45,000; and the maximum dollar value of performance units that may be granted to any one participant in any calendar year is $1,500,000. As of December 31, 2007, the Company has granted 4,245 shares of restricted stock that are not reflected in column (a) of this table.

Item 6. Selected Financial Data.

The following table sets forth certain selected financial data for the five years ended December 31, 2007 and is qualified in its entirety by the detailed statistical and other information contained in this report, including "Management's Discussion and Analysis of Financial Condition and Results of Operations" appearing in Item 7 of Part II of this report and the financial statements and notes thereto appearing in Item 8 of Part II of this report.

	Years Ended December 31,				
(Dollars in thousands, except per share data)	**2007**	2006	2005	2004	2003
RESULTS OF OPERATIONS:					
Interest income	**$ 65,141**	$ 57,971	$ 47,384	$ 38,291	$ 34,339
Interest expense	**24,105**	19,074	11,899	9,010	9,743
Net interest income	**41,036**	38,897	35,485	29,281	24,596
Provision for credit losses	**1,724**	1,493	810	931	335
Net interest income after provision for credit losses	**39,312**	37,404	34,675	28,350	24,261
Noninterest income	**14,679**	12,839	11,498	10,224	9,845
Noninterest expense	**32,539**	28,535	25,431	22,535	19,344
Income before income taxes	**21,452**	21,708	20,742	16,039	14,762
Income tax expense	**8,002**	8,154	7,854	5,841	5,266
NET INCOME	**$ 13,450**	$ 13,554	$ 12,888	$ 10,198	$ 9,496
PER SHARE DATA:					
Net income - basic	**$ 1.61**	$ 1.62	$ 1.55	$ 1.24	$ 1.18
Net income - diluted	**1.60**	1.61	1.54	1.23	1.16
Dividends paid	**0.64**	0.59	0.54	0.48	0.44
Book value (at year end)	**14.35**	13.28	12.17	11.24	10.31
Tangible book value (at year end) (1)	**11.68**	11.67	10.51	9.53	9.37
FINANCIAL CONDITION (at year end):					
Assets	**$ 956,911**	$ 945,649	$ 851,638	$ 790,598	$ 705,379
Deposits	**765,895**	774,182	704,958	658,672	592,409
Total loans, net of unearned income and allowance for credit losses	**768,799**	693,419	622,227	590,766	470,895
Long-term debt	**12,485**	25,000	4,000	5,000	5,000
Stockholders' equity	**120,235**	111,327	101,448	92,976	83,527
PERFORMANCE RATIOS (for the year):					
Return on average assets	**1.42%**	1.52%	1.51%	1.32%	1.40%
Return on average stockholders' equity	**11.79**	12.66	13.20	11.17	11.70
Net interest margin	**4.64**	4.70	4.69	4.10	3.91
Efficiency ratio (2)	**58.40**	55.15	54.13	57.04	56.17
Dividend payout ratio	**39.75**	36.42	34.84	38.71	37.29

Average stockholders’ equity to average total assets	**12.04**	11.98	11.86	11.79	11.96

(1) Total stockholders’ equity, net of goodwill and other intangible assets, divided by the number of shares of common stock outstanding at year end.

(2) Noninterest expense as a percentage of total revenue (net interest income plus total noninterest income). Lower ratios indicate improved productivity.

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

The following discussion compares the Company's financial condition at December 31, 2007 to its financial condition at December 31, 2006 and the results of operations for the years ended December 31, 2007, 2006, and 2005. This discussion should be read in conjunction with the Consolidated Financial Statements and the Notes thereto appearing in Item 8 of Part II of this report.

PERFORMANCE OVERVIEW

The Company recorded a slight decline in net income for 2007 when compared to 2006. Net income for the year ended December 31, 2007 was $13.45 million, compared to $13.55 million and $12.89 million for the years ended December 31, 2006 and 2005, respectively. Basic earnings per share for 2007 was $1.61, a decrease of 0.6% from 2006. Basic earnings per share was $1.62 and $1.55 for 2006 and 2005, respectively. Diluted earnings per share for 2007 was $1.60, a decrease of 0.6% when compared to 2006. Diluted earnings per share was $1.61 and $1.54 for 2006 and 2005, respectively.

Return on average assets was 1.42% for 2007, compared to 1.52% for 2006 and 1.51% for 2005. Return on stockholders' equity for 2007 was 11.79%, compared to 12.66% for 2006 and 13.20% for 2005. Comparing the year ended December 31, 2007 to the year ended December 31, 2006, average assets increased 6.0% to $947.1 million, average loans increased 9.7% to $728.8 million, average deposits increased 5.2% to $769.6 million, and average stockholders' equity increased 6.5% to $114.0 million.

CRITICAL ACCOUNTING POLICIES

The Company's consolidated financial statements are prepared in accordance with accounting principles generally accepted in the United States of America and follow general practices within the industries in which it operates. Application of these principles requires management to make estimates, assumptions, and judgments that affect the amounts reported in the financial statements and accompanying notes. These estimates, assumptions, and judgments are based on information available as of the date of the financial statements; accordingly, as this information changes, the financial statements could reflect different estimates, assumptions, and judgments. Certain policies inherently have a greater reliance on the use of estimates, assumptions, and judgments and as such have a greater possibility of producing results that could be materially different than originally reported. Estimates, assumptions, and judgments are necessary when assets and liabilities are required to be recorded at fair value, when a decline in the value of an asset not carried on the financial statements at fair value warrants an impairment write-down or valuation reserve to be established, or when an asset or liability needs to be recorded contingent upon a future event. Carrying assets and liabilities at fair value inherently results in more financial statement volatility. The fair values and the information used to record valuation adjustments for certain assets and liabilities are based either on quoted market prices or are provided by other third-party sources, when available.

The most significant accounting policies that the Company follows are presented in Note 1 to the Consolidated Financial Statements. These policies, along with the disclosures presented in the other financial statement notes and in this discussion, provide information on how significant assets and liabilities are valued in the financial statements and how those values are determined. Based on the valuation techniques used and the sensitivity of financial statement amounts to the methods, assumptions, and estimates underlying those amounts, management has determined that the accounting policy with respect to the allowance for credit losses to be the accounting area that requires the most subjective or complex judgments, and, as such, could be most subject to revision as new information becomes available. Accordingly, the allowance for credit losses is considered to be a critical accounting policy, as discussed below.

The allowance for credit losses represents management's estimate of credit losses inherent in the loan portfolio as of the balance sheet date. Determining the amount of the allowance for credit losses is considered a critical accounting estimate because it requires significant judgment and the use of estimates related to the amount and timing of expected future cash flows on impaired loans, estimated losses on pools of homogeneous loans based on historical loss experience, and consideration of current economic trends and conditions, all of which may be susceptible to significant change. The loan portfolio also represents the largest asset type on the consolidated balance sheets. Note 1 to the Consolidated Financial Statements describes the methodology used to determine the allowance for credit losses and a discussion of the factors driving changes in the amount of the allowance for credit losses is included in the Provision for Credit Losses and Risk Management section of this discussion.

RECENT ACCOUNTING PRONOUNCEMENTS AND DEVELOPMENTS

Note 1 to the Consolidated Financial Statements discusses new accounting policies that the Company adopted during 2007 and the expected impact of accounting policies recently issued or proposed but not yet required to be adopted. To the extent the adoption of new accounting standards materially affects our financial condition, results of operations or liquidity, the impacts are discussed in the applicable section(s) of this discussion and Notes to the Consolidated Financial Statements.

RESULTS OF OPERATIONS

Net Interest Income and Net Interest Margin

Net interest income remains the most significant component of our earnings. It is the excess of interest and fees earned on loans, federal funds sold, and investment securities over interest paid on deposits and borrowings. Tax equivalent net interest income for 2007 was $41.4 million, representing a 5.6% increase over 2006. Tax equivalent net interest income for 2006 was $39.2 million, a 9.6% increase over 2005. An increase in the volume of earning assets was the reason for the growth in 2007; the increase in yields on earning assets was not enough to offset the increase in rates paid on interest bearing liabilities. An increase in the volume and yield on earning assets were the reasons for the growth in 2006. The tax equivalent yield on earning assets was 7.34% for 2007, compared to 6.98% and 6.25% for 2006 and 2005, respectively. Average earning assets increased to $893.0 million during 2007, compared to $835.5 million and $763.2 million for 2006 and 2005, respectively.

Interest rates remained unchanged by the FRB for much of 2007. On September 18, 2007, the FRB reduced the fed funds rate by 50 basis points, followed by another 25 basis-point cut on October 31, 2007 and a final 25 basis-point cut on December 11, 2007, for a total reduction in the fed funds rate of 100 basis points in four months. Conversely, in 2006, the FRB raised short-term interest rates by 100 basis points. The New York Prime rate, the primary index used for variable rate loans, also declined by 100 basis points during the year ended December 31, 2007 following an increase of 100 basis points for the prior year. These rate changes had and likely will have a direct impact on our overall loan yields.

The rate paid for interest bearing liabilities was 3.36% for the year ended December 31, 2007, representing an increase of 50 basis points over the 2.86% paid for the year ended December 31, 2006. In 2006, the overall rate paid for interest bearing liabilities increased 92 basis points when compared to the rate paid for the year ended December 31, 2005.

The following table sets forth the major components of net interest income, on a tax equivalent basis, for the years ended December 31, 2007, 2006 and 2005.

	2007			2006			2005		
(Dollars in thousands)	Average Balance	Interest (1)	Yield/ Rate	Average Balance	Interest (1)	Yield/ Rate	Average Balance	Interest (1)	Yield/ Rate
Earning Assets:									
Investment securities:									
Taxable	**$ 112,384**	**$ 5,105**	**4.54%**	$ 110,354	$ 4,486	4.07%	$ 106,523	$ 3,796	3.56%
Non-taxable	**13,424**	**786**	**5.85**	13,593	791	5.82	15,074	879	5.83
Loans (2) (3)	**728,766**	**57,637**	**7.91**	664,244	50,633	7.62	607,017	41,867	6.90
Interest bearing deposits	**17,086**	**893**	**5.23**	18,665	939	5.03	3,002	111	3.69
Federal funds sold	**21,312**	**1,108**	**5.20**	28,663	1,459	5.09	31,571	1,058	3.35
Total earning assets	**892,972**	**65,529**	**7.34%**	835,519	58,308	6.98%	763,187	47,711	6.25%
Cash and due from banks	**16,938**			20,589			25,231		
Other assets	**44,136**			42,962			39,821		
Allowance for credit losses	**(6,898)**			(5,653)			(4,919)		
Total assets	**$ 947,148**			$ 893,417			$ 823,320		
Interest bearing liabilities:									
Demand deposits	**$ 112,553**	**1,069**	**0.95%**	$ 104,371	702	0.67%	$ 110,977	552	0.50%
Savings deposits	**177,256**	**3,175**	**1.79**	189,699	2,724	1.44	200,980	1,760	0.88
Certificates of deposit $100,000 or more	**159,532**	**7,748**	**4.86**	135,568	5,988	4.42	96,077	3,444	3.59
Other time deposits	**213,823**	**9,701**	**4.54**	191,234	7,714	4.03	172,724	5,347	3.10
Interest bearing deposits	**663,164**	**21,693**	**3.27**	620,872	17,128	2.76	580,758	11,103	1.91
Short-term borrowings	**33,138**	**1,264**	**3.81**	29,302	1,002	3.42	28,794	692	2.40
Long-term debt	**21,271**	**1,148**	**5.40**	17,831	944	5.29	2,207	104	4.71
Total interest bearing liabilities	**717,573**	**24,105**	**3.36%**	668,005	19,074	2.86%	611,759	11,899	1.94%
Noninterest bearing deposits	**106,462**			110,657			107,306		
Other liabilities	**9,074**			7,709			6,598		
Stockholders' equity	**114,039**			107,046			97,657		
Total liabilities and stockholders' equity	**$ 947,148**			$ 893,417			$ 823,320		
Net interest spread		**$ 41,424**	**3.98%**		$ 39,234	4.12%		$ 35,812	4.31%
Net interest margin			**4.64%**			4.70%			4.69%

(1) All amounts are reported on a tax equivalent basis computed using the statutory federal income tax rate of 35% exclusive of the alternative minimum tax rate and nondeductible interest expense. The taxable equivalent

adjustment amounts utilized in the above table to compute yields aggregated $388,000 in 2007, $337,000 in 2006, and $327,000 in 2005.

(2) Average loan balances include nonaccrual loans.

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

The tax equivalent yield on loans increased to 7.91% for 2007, compared to 7.62% for 2006. On a tax equivalent basis, interest income totaled $65.5 million for 2007, compared to $58.3 million for 2006. An increase in both the volume and yield on loans was the reason for the increases in both 2007 and 2006. Yields on investment securities, interest bearing deposits and federal funds sold all increased during 2007 and 2006. In 2007, increased volumes and yields on earning assets generated $7.2 million in additional interest income. Of that amount, $7.0 million was attributable to loans. The increased loan volume in 2007 generated an additional $5.1 million in interest income, while $1.9 million was attributable to the increased yield on loans in 2007.

Interest expense for 2007 increased $5.0 million when compared to 2006, and increased 7.2 million in 2006 over 2005. Higher rates paid for interest bearing liabilities, primarily deposits, resulted in a $2.7 million increase in interest expense for 2007 when compared to 2006. In 2006, higher rates paid for interest bearing liabilities resulted in a $4.3 million increase in interest expense when compared to 2005. The increased volume of deposits and other interest bearing liabilities in 2007 resulted in additional interest expense of $2.3 million, compared to an increase in interest expense of $2.9 million in 2006 resulting from increased volume of deposits and other interest bearing liabilities over 2005. The average rate paid for certificates of deposit of $100,000 or more increased 44 basis points to 4.86% for 2007 from 4.42% for 2006. The rate paid for all other time deposits increased to 4.54% for 2007, compared to 4.03% for 2006. The rate paid for short-term borrowings, which consist primarily of securities sold under agreements to repurchase, was 3.81% for 2007, compared to 3.42% and 2.40% in 2006 and 2005, respectively.

Growth in average earning assets was $57.5 million or 6.9% for the year ended December 31, 2007. Average loans increased

$64.5 million or 9.7%, totaling $728.8 million for the year ended December 31, 2007, compared to an increase of $57.2 million or 9.4% for 2006. For the year ended December 31, 2007, average investment securities increased $1.9 million and federal funds sold and interest bearing deposits in other banks decreased $8.9 million when compared to 2006. In 2006, average earning assets increased $72.3 million or 9.5% when compared to 2005, driven primarily by growth in loans. As a percentage of total average earning assets, loans and investment securities totaled 81.6% and 14.1%, respectively, for 2007, compared to 79.5% and 14.8%, respectively, for 2006.

The following Rate/Volume Variance Analysis identifies the portion of the changes in tax equivalent net interest income attributable to changes in volume of average balances or to changes in the yield on earning assets and rates paid on interest bearing liabilities.

	2007 over (under) 2006			2006 over (under) 2005		
	Total	**Caused By**		Total	Caused By	
(Dollars in thousands)	**Variance**	**Rate**	**Volume**	Variance	Rate	Volume
Interest income from earning assets:						
Interest bearing deposits	**$ (46)**	**$ 40**	**$ (86)**	$ 828	$ 54	$ 774
Federal funds sold	**(351)**	**30**	**(381)**	401	506	(105)
Taxable investment securities	**619**	**549**	**70**	690	546	144
Non-taxable investment securities	**(5)**	**5**	**(10)**	(88)	(2)	(86)
Loans	**7,004**	**1,878**	**5,126**	8,767	4,624	4,143
Total interest income	**7,221**	**2,502**	**4,719**	10,598	5,728	4,870
Interest expense on deposits and borrowed funds:						
Interest bearing demand deposits	**367**	**317**	**50**	151	185	(34)
Savings deposits	**451**	**647**	**(196)**	964	1,060	(96)
Time deposits	**3,747**	**1,655**	**2,092**	4,910	2,666	2,244
Short-term borrowings	**262**	**52**	**210**	311	363	(52)
Long-term debt	**204**	**19**	**185**	840	15	825
Total interest expense	**5,031**	**2,690**	**2,341**	7,176	4,289	2,887
Net interest income	**$ 2,190**	**$ (188)**	**$ 2,378**	$ 3,422	$ 1,439	$ 1,983

The rate and volume variance for each category has been allocated on a consistent basis between rate and volume variances, based on a percentage of rate, or volume, variance to the sum of the absolute two variances.

Our net interest margin (*i.e.*, tax equivalent net interest income divided by average earning assets) represents the net yield on earning assets. The net interest margin is managed through loan and deposit pricing and asset/liability strategies. The net interest margin was 4.64% for 2007, compared to 4.70% for 2006 and 4.69% for 2005. The increased cost of interest bearing liabilities in 2007 slightly decreased the net interest margin from the prior year. The net interest spread, which is the difference between the average yield on earning assets and the rate paid for interest bearing liabilities, decreased from 4.12% for 2006 to 3.98% for 2007.

Noninterest Income

Noninterest income increased $1.8 million or 14.3% in 2007, compared to an increase of $1.3 million or 11.7% in 2006. The increase was primarily related to the acquisition of two insurance entities during the fourth quarter of 2007. Service charges on deposit accounts increased 7.5% or $235 thousand in 2007, compared to an increase of 9.0% or $259 thousand in 2006. These increases resulted primarily from new and enhanced overdraft products offered to

customers, which generated additional income of $263 thousand and $293 thousand in 2007 and 2006, respectively. Other service charges and fees increased $677 thousand in 2007 following an increase of $325 thousand in 2006. The 2007 increase was the result of an increase in interchange income relating to bank debit and ATM cards ($166 thousand), and fee income generated by the trust division ($303 thousand). The Insurance Subsidiaries generated income of $7.7 million in 2007, compared to $6.7 million and $6.4 million in 2006 and 2005, respectively. The Company recognized $5 thousand in gains on sales of securities in 2007, compared to $3 thousand in 2006 and $4 thousand in 2005. Other noninterest income decreased slightly, following an increase of $421 thousand or 42.6% in 2006. The 2006 increase was attributable in part to increased income generated from the sale of loans on the secondary market, which totaled $691 thousand compared to $494 thousand in 2005. The Company also recorded gains on life insurance policies of $174 thousand in 2006 related to a deferred compensation plan.

The following table summarizes our noninterest income for the years ended December 31:

	Years Ended			Change from Prior Year			
				2007/06		2006/05	
(Dollars in thousands)	2007	2006	2005	Amount	Percent	Amount	Percent
Service charges on deposit accounts	$ 3,372	$ 3,137	$ 2,878	$ 235	7.5%	$ 259	9.0%
Other service charges and fees	2,195	1,518	1,193	677	44.6	325	27.2
Gain on sale of securities	5	3	4	2	66.7	(1)	(25.0)
Earnings from unconsolidated subsidiaries	-	27	50	(27)	(100.0)	(23)	(46.0)
Insurance agency commissions	7,698	6,744	6,384	954	14.1	360	5.6
Other noninterest income	1,409	1,410	989	(1)	(0.1)	421	42.6
Total	$ 14,679	$ 12,839	$ 11,498	$ 1,840	14.3%	$ 1,341	11.7%

Noninterest Expense

Total noninterest expense increased $4.0 million or 14.0% in 2007, compared to an increase of $3.1 million or 12.2% in 2006. The increase was primarily attributable to the operating costs ($1.7 million) of the two insurance entities acquired during the fourth quarter of 2007 and increased salaries and benefits costs ($1.5 million) for the Company's other subsidiaries. The majority of the noninterest expense increases in 2007 and 2006 were related to salaries and employee benefits expense. In 2007, the salaries and benefits cost increases that were not related to acquisitions resulted from an increase in the number of full-time equivalent employees, the increased cost of operating two additional bank branches, increased commission expense related to the increased income from the trust and advisory services and secondary market mortgage programs, the additional costs associated with segregating the CEO positions at the Company and The Talbot Bank, and the costs associated with hiring a new CEO at Talbot Bank in the third quarter of 2006. The 2006 increase in salaries and benefits cost resulted from an increase in the number of full-time equivalent employees, annual increases in salaries and rising benefit costs, the hiring of a new CEO at Talbot Bank, and the addition of one Centreville National Bank branch in Kent County, Maryland. Increases in occupancy and equipment expense, data processing and other noninterest expenses in 2007 and 2006 were attributable to our overall growth. Amortization of other intangible assets relate to Felton Bank and the operation of the Insurance Subsidiaries. See Note 8 to the Consolidated Financial Statements for further information regarding the impact of goodwill and other intangible assets on the financial statements. We had 338 full-time equivalent employees at December 31, 2007, compared to 292 and 276 at December 31, 2006 and 2005, respectively.

The following table summarizes our noninterest expense for the years ended December 31:

	Years Ended			Change from Prior Year			
				2007/06		2006/05	
(Dollars in thousands)	2007	2006	2005	Amount	Percent	Amount	Percent
Salaries and employee benefits	$ 19,991	$ 17,693	$ 15,755	$ 2,298	13.0%	$ 1,938	12.3%
Occupancy and equipment	3,274	2,948	2,652	326	11.1	296	11.2
Data processing	1,820	1,559	1,414	261	16.7	145	10.3
Directors' fees	605	536	590	69	12.9	(54)	(9.2)
Amortization of other intangible assets	333	337	337	(4)	(1.2)	-	-
Other noninterest expenses	6,516	5,462	4,683	1,054	19.3	779	16.6
Total	$ 32,539	$ 28,535	$ 25,431	$ 4,004	14.0%	$ 3,104	12.2%

Income Taxes

Income tax expense was $8.0 million for 2007, compared to $8.2 million for 2006 and $7.9 million for 2005. The effective tax rates on earnings were 37.3%, 37.6% and 37.9% for 2007, 2006, and 2005, respectively.

REVIEW OF FINANCIAL CONDITION

Asset and liability composition, asset quality, capital resources, liquidity, market risk and interest sensitivity are all factors that affect our financial condition.

Assets

Total assets increased 1.2% to $956.9 million at December 31, 2007, compared to an increase of 11.0% for 2006. Average total assets for the year ended December 31, 2007 were $947.1 million, an increase of 6.0% over 2006. Average total assets increased 8.5% in 2006, totaling $893.4 million for the year. The loan portfolio is the primary source of our income, and it represented 81.6% and 79.5% of average earning assets at December 31, 2007 and 2006, respectively.

Funding for loans is provided primarily by core deposits. Additional funding is obtained through short-term and long-term borrowings. Total deposits decreased 1.1% to $765.9 million at December 31, 2007, compared to a 9.8% increase for 2006.

The following table sets forth the average balance of the components of average earning assets as a percentage of total average earning assets for the year ended December 31.

	2007	2006	2005	2004	2003
Investment securities	**14.1%**	14.8%	15.9%	19.7%	20.8%
Loans	**81.6**	79.6	79.6	76.8	71.7
Interest bearing deposits with other banks	**1.9**	2.2	0.4	0.7	3.1
Federal funds sold	**2.4**	3.4	4.1	2.8	4.4
	100.0%	100.0%	100.0		