

SHORE BANCSHARES INC
Form 10-Q
August 09, 2012

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

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

For the Quarterly Period Ended June 30, 2012

OR

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

For the transition period from _____ to _____

Commission file number 0-22345

SHORE BANCSHARES, INC.

(Exact name of registrant as specified in its charter)

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Maryland 52-1974638
(State or Other Jurisdiction of (I.R.S. Employer
Incorporation or Organization) Identification No.)

18 East Dover Street, Easton, Maryland 21601
(Address of Principal Executive Offices) (Zip Code)

(410) 763-7800

Registrant's Telephone Number, Including Area Code

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

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

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes x No £

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

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Large accelerated filer Accelerated filer x
Non-accelerated filer Smaller reporting company
(Do not check if a
smaller reporting
company)

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

APPLICABLE ONLY TO CORPORATE ISSUERS

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date: 8,457,359 shares of common stock outstanding as of July 31, 2012.

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PART I – FINANCIAL INFORMATION

Item 1. Financial Statements.

SHORE BANCSHARES, INC.

CONSOLIDATED BALANCE SHEETS

(Dollars in thousands, except per share amounts)

| | June 30, 2012 (Unaudited) | December 31, 2011 |
|------------------------------------------------------------------------------------------------------------------------------------|---------------------------------|-------------------------|
| ASSETS | | |
| Cash and due from banks | \$23,037 | \$22,986 |
| Interest-bearing deposits with other banks | 137,267 | 99,776 |
| Federal funds sold | 9,269 | 4,980 |
| Investment securities: | | |
| Available for sale, at fair value | 133,244 | 129,780 |
| Held to maturity, at amortized cost – fair value of \$5,425 (2012) and \$6,732 (2011) | 5,168 | 6,480 |
| Loans | 809,958 | 841,050 |
| Less: allowance for credit losses | (12,990) | (14,288) |
| Loans, net | 796,968 | 826,762 |
| Premises and equipment, net | 15,398 | 14,662 |
| Goodwill | 12,454 | 12,454 |
| Other intangible assets, net | 3,986 | 4,208 |
| Other real estate and other assets owned, net | 11,499 | 9,385 |
| Other assets | 27,043 | 26,720 |
| TOTAL ASSETS | \$1,175,333 | \$1,158,193 |
| LIABILITIES | | |
| Deposits: | | |
| Noninterest-bearing | \$149,472 | \$133,801 |
| Interest-bearing | 883,231 | 876,118 |
| Total deposits | 1,032,703 | 1,009,919 |
| Short-term borrowings | 13,826 | 17,817 |
| Other liabilities | 8,882 | 8,753 |
| Long-term debt | 455 | 455 |
| TOTAL LIABILITIES | 1,055,866 | 1,036,944 |
| STOCKHOLDERS' EQUITY | | |
| Common stock, par value \$.01 per share; shares authorized – 35,000,000; shares issued and outstanding – 8,457,359 (2012 and 2011) | 85 | 85 |

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| | | |
|--------------------------------------------|-------------|-------------|
| Additional paid in capital | 32,087 | 32,052 |
| Retained earnings | 87,973 | 90,801 |
| Accumulated other comprehensive loss | (678 |) (1,689) |
| TOTAL STOCKHOLDERS' EQUITY | 119,467 | 121,249 |
| TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY | \$1,175,333 | \$1,158,193 |

See accompanying notes to Consolidated Financial Statements.

SHORE BANCSHARES, INC.

CONSOLIDATED STATEMENTS OF OPERATIONS (Unaudited)

(Dollars in thousands, except per share amounts)

| | For the Three Months Ended June 30, | | For the Six Months Ended June 30, | |
|--------------------------------------------------------------|-------------------------------------------|--------------|-----------------------------------------|--------------|
| | 2012 | 2011 | 2012 | 2011 |
| INTEREST INCOME | | | | |
| Interest and fees on loans | \$ 10,890 | \$ 11,896 | \$ 21,901 | \$ 23,897 |
| Interest and dividends on investment securities: | | | | |
| Taxable | 707 | 782 | 1,464 | 1,439 |
| Tax-exempt | 32 | 40 | 70 | 78 |
| Interest on federal funds sold | 2 | 5 | 4 | 21 |
| Interest on deposits with other banks | 61 | 12 | 109 | 18 |
| Total interest income | 11,692 | 12,735 | 23,548 | 25,453 |
| INTEREST EXPENSE | | | | |
| Interest on deposits | 2,643 | 2,769 | 5,284 | 5,602 |
| Interest on short-term borrowings | 11 | 13 | 26 | 26 |
| Interest on long-term debt | 5 | 11 | 10 | 21 |
| Total interest expense | 2,659 | 2,793 | 5,320 | 5,649 |
| NET INTEREST INCOME | | | | |
| Provision for credit losses | 9,033 | 9,942 | 18,228 | 19,804 |
| | 3,525 | 5,395 | 11,895 | 11,785 |
| NET INTEREST INCOME AFTER PROVISION FOR CREDIT LOSSES | 5,508 | 4,547 | 6,333 | 8,019 |
| NONINTEREST INCOME | | | | |
| Service charges on deposit accounts | 622 | 744 | 1,270 | 1,448 |
| Trust and investment fee income | 446 | 418 | 869 | 794 |
| Gains on sales of investment securities | - | 2 | - | 81 |
| Insurance agency commissions | 2,406 | 2,475 | 5,095 | 4,985 |
| Other noninterest income | 1,103 | 742 | 1,917 | 1,468 |
| Total noninterest income | 4,577 | 4,381 | 9,151 | 8,776 |
| NONINTEREST EXPENSE | | | | |
| Salaries and wages | 4,376 | 4,104 | 8,792 | 8,350 |
| Employee benefits | 956 | 886 | 2,126 | 2,039 |
| Occupancy expense | 638 | 568 | 1,325 | 1,164 |
| Furniture and equipment expense | 212 | 291 | 463 | 563 |
| Data processing | 694 | 680 | 1,360 | 1,531 |
| Directors' fees | 127 | 112 | 236 | 219 |

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| | | | | |
|--------------------------------------------|--------|-----------|------------|------------|
| Amortization of other intangible assets | 96 | 128 | 222 | 257 |
| Insurance agency commissions expense | 344 | 357 | 729 | 732 |
| FDIC insurance premium expense | 344 | 404 | 617 | 864 |
| Other noninterest expenses | 1,876 | 1,664 | 4,291 | 3,366 |
| Total noninterest expense | 9,663 | 9,194 | 20,161 | 19,085 |
| | | | | |
| INCOME (LOSS) BEFORE INCOME TAXES | 422 | (266) | (4,677) | (2,290) |
| Income tax expense (benefit) | 129 | (33) | (1,934) | (974) |
| | | | | |
| NET INCOME (LOSS) | \$293 | \$(233) | \$(2,743) | \$(1,316) |
| | | | | |
| Basic net income (loss) per common share | \$0.03 | \$(0.03) | \$(0.32) | \$(0.16) |
| Diluted net income (loss) per common share | \$0.03 | \$(0.03) | \$(0.32) | \$(0.16) |
| Dividends paid per common share | \$- | \$0.01 | \$0.01 | \$0.07 |

See accompanying notes to Consolidated Financial Statements.

SHORE BANCSHARES, INC.

CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (LOSS) (Unaudited)

(Dollars in thousands)

| | For the Three Months Ended June 30, 2012 | | For the Six Months Ended June 30, 2011 | |
|-------------------------------------------------------------------|---------------------------------------------------|----------|-------------------------------------------------|-----------|
| Net income (loss) | \$293 | \$(233) | \$(2,743) | \$(1,316) |
| Other comprehensive income | | | | |
| Securities available for sale: | | | | |
| Unrealized holding gains on available-for-sale securities | 534 | 1,204 | 915 | 832 |
| Tax effect | (216) | (490) | (369) | (340) |
| Reclassification of gains recognized in net income | - | (2) | - | (81) |
| Tax effect | - | 1 | - | 33 |
| Net of tax amount | 318 | 713 | 546 | 444 |
| Cash flow hedging activities: | | | | |
| Unrealized holding gains (losses) on cash flow hedging activities | 421 | (714) | 780 | (337) |
| Tax effect | (170) | 288 | (315) | 135 |
| Net of tax amount | 251 | (426) | 465 | (202) |
| Total other comprehensive income | 569 | 287 | 1,011 | 242 |
| Comprehensive income (loss) | \$862 | \$54 | \$(1,732) | \$(1,074) |

See accompanying notes to Consolidated Financial Statements.

SHORE BANCSHARES, INC.

CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY (Unaudited)

For the Six Months Ended June 30, 2012 and 2011

(Dollars in thousands, except per share amounts)

| | Common Stock | Warrant | Additional Paid in Capital | Retained Earnings | Accumulated Other Comprehensive Income (Loss) | Total Stockholders' Equity |
|-----------------------------------------------------------------|-----------------|----------|----------------------------------|----------------------|-----------------------------------------------------------|----------------------------------|
| Balances, January 1, 2012 | \$ 85 | \$ - | \$ 32,052 | \$ 90,801 | \$ (1,689) |) \$ 121,249 |
| Comprehensive loss: | | | | | | |
| Net loss | - | - | - | (2,743) | - | (2,743) |
| Unrealized gains on available-for-sale securities, net of taxes | - | - | - | - | 546 | 546 |
| Unrealized gains on cash flow hedging activities, net of taxes | - | - | - | - | 465 | 465 |
| Total comprehensive loss | | | | | | (1,732) |
| Stock-based compensation | - | - | 35 | - | - | 35 |
| Cash dividends paid (\$0.01 per share) | - | - | - | (85) | - | (85) |
| Balances, June 30, 2012 | \$ 85 | \$ - | \$ 32,087 | \$ 87,973 | \$ (678) |) \$ 119,467 |
| Balances, January 1, 2011 | \$ 84 | \$ 1,543 | \$ 30,242 | \$ 92,458 | \$ (1,814) |) \$ 122,513 |
| Comprehensive loss: | | | | | | |
| Net loss | - | - | - | (1,316) | - | (1,316) |
| Unrealized gains on available-for-sale securities, net of taxes | - | - | - | - | 444 | 444 |
| Unrealized losses on cash flow hedging activities, net of taxes | - | - | - | - | (202) | (202) |
| Total comprehensive loss | | | | | | (1,074) |
| Shares issued for employee stock-based awards | 1 | - | (1) | - | - | - |
| Stock-based compensation | - | - | 93 | - | - | 93 |
| Cash dividends paid (\$0.07 per share) | - | - | - | (591) | - | (591) |

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| | | | | | | | |
|-------------------------|-------|----------|-----------|-----------|-----------|---|------------|
| Balances, June 30, 2011 | \$ 85 | \$ 1,543 | \$ 30,334 | \$ 90,551 | \$ (1,572 |) | \$ 120,941 |
|-------------------------|-------|----------|-----------|-----------|-----------|---|------------|

See accompanying notes to Consolidated Financial Statements.

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SHORE BANCSHARES, INC.

CONSOLIDATED STATEMENTS OF CASH FLOWS (Unaudited)

(Dollars in thousands)

| | For the Six Months Ended June 30, | |
|---------------------------------------------------------------------------------------------|-----------------------------------------|------------|
| | 2012 | 2011 |
| CASH FLOWS FROM OPERATING ACTIVITIES: | | |
| Net loss | \$(2,743) | \$(1,316) |
| Adjustments to reconcile net loss to net cash provided by operating activities: | | |
| Provision for credit losses | 11,895 | 11,785 |
| Depreciation and amortization | 1,324 | 1,269 |
| Discount accretion on debt securities | (39) | (44) |
| Stock-based compensation expense | 141 | 137 |
| Excess tax expense from stock-based arrangements | (106) | (44) |
| Deferred income tax expense (benefit) | 238 | (1,306) |
| Gains on sales of investment securities | - | (81) |
| Gains on disposals of premises and equipment | (226) | (3) |
| Losses on sales of other real estate owned | 862 | 235 |
| Net changes in: | | |
| Accrued interest receivable | 289 | 807 |
| Other assets | (972) | (88) |
| Accrued interest payable | 19 | 15 |
| Other liabilities | 110 | (699) |
| Net cash provided by operating activities | 10,792 | 10,667 |
| CASH FLOWS FROM INVESTING ACTIVITIES: | | |
| Proceeds from maturities and principal payments of investment securities available for sale | 21,308 | 25,058 |
| Proceeds from sales of investment securities available for sale | - | 12,073 |
| Purchases of investment securities available for sale | (24,238) | (44,418) |
| Proceeds from maturities and principal payments of investment securities held to maturity | 1,305 | 186 |
| Net change in loans | 13,529 | 3,365 |
| Purchases of premises and equipment | (1,381) | (420) |
| Proceeds from sales of premises and equipment | 307 | 4 |
| Proceeds from sales of other real estate owned | 1,395 | 644 |
| Net cash provided by (used in) investing activities | 12,225 | (3,508) |
| CASH FLOWS FROM FINANCING ACTIVITIES: | | |
| Net change in noninterest-bearing deposits | 15,671 | 6,601 |
| Net change in interest-bearing deposits | 7,113 | (12,674) |
| Net change in short-term borrowings | (3,991) | 2,210 |
| Excess tax expense from stock-based arrangements | 106 | 44 |
| Common stock dividends paid | (85) | (591) |

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| | | |
|-----------------------------------------------------|-----------|----------|
| Net cash provided by (used in) financing activities | 18,814 | (4,410) |
| Net increase in cash and cash equivalents | 41,831 | 2,749 |
| Cash and cash equivalents at beginning of period | 127,742 | 77,964 |
| Cash and cash equivalents at end of period | \$169,573 | \$80,713 |
| Supplemental cash flows information: | | |
| Interest paid | \$5,302 | \$5,635 |
| Income taxes paid | \$109 | \$1,861 |
| Transfers from loans to other real estate owned | \$4,371 | \$5,055 |

See accompanying notes to Consolidated Financial Statements.

Shore Bancshares, Inc.

Notes to Consolidated Financial Statements

For the Three and Six Months Ended June 30, 2012 and 2011

(Unaudited)

Note 1 - Basis of Presentation

The consolidated financial statements include the accounts of Shore Bancshares, Inc. and its subsidiaries with all significant intercompany transactions eliminated. The consolidated financial statements conform to accounting principles generally accepted in the United States of America (“GAAP”) and to prevailing practices within the banking industry. The accompanying interim financial statements are unaudited; however, in the opinion of management all adjustments necessary to present fairly the consolidated financial position at June 30, 2012, the consolidated results of operations and comprehensive income (loss) for the three and six months ended June 30, 2012 and 2011, and changes in stockholders’ equity and cash flows for the six months ended June 30, 2012 and 2011, have been included. All such adjustments are of a normal recurring nature. The amounts as of December 31, 2011 were derived from the 2011 audited financial statements. The results of operations for the three and six months ended June 30, 2012 are not necessarily indicative of the results to be expected for any other interim period or for the full year. This Quarterly Report on Form 10-Q should be read in conjunction with the Annual Report of Shore Bancshares, Inc. on Form 10-K for the year ended December 31, 2011. For purposes of comparability, certain reclassifications have been made to amounts previously reported to conform with the current period presentation.

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

Recent Accounting Pronouncements

Accounting Standards Update (“ASU”) 2011-03, “Reconsideration of Effective Control for Repurchase Agreements.” ASU 2011-03 affects all entities that enter into agreements to transfer financial assets that both entitle and obligate the transferor to repurchase or redeem the financial assets before their maturity. The amendments in ASU 2011-03 remove from the assessment of effective control the criterion relating to the transferor’s ability to repurchase or redeem financial assets on substantially the agreed terms, even in the event of default by the transferee. ASU 2011-03 also eliminates the requirement to demonstrate that the transferor possesses adequate collateral to fund substantially all the cost of purchasing replacement financial assets. ASU 2011-03 became effective for the Company on January 1, 2012 and did not have a significant impact on the Company’s financial statements.

ASU 2011-04, "Fair Value Measurement - Amendments to Achieve Common Fair Value Measurements and Disclosure Requirements in U.S. GAAP and IFRSs." ASU 2011-04 amends Topic 820, "Fair Value Measurements and Disclosures," to converge the fair value measurement guidance in U.S. Generally Accepted Accounting Principles and International Financial Reporting Standards. ASU 2011-04 clarifies the application of existing fair value measurement requirements, changes certain principles in Topic 820 and requires additional fair value disclosures. ASU 2011-04 became effective for the Company on January 1, 2012 and, aside from new disclosures included in Note 8 – Fair Value Measurements, did not have a significant impact on the Company's financial statements.

ASU 2011-08, "Intangibles - Goodwill and Other - Testing Goodwill for Impairment." ASU 2011-08 amends Topic 350, "Intangibles – Goodwill and Other," to give entities the option to first assess qualitative factors to determine whether the existence of events or circumstances leads to a determination that it is more likely than not that the fair value of a reporting unit is less than its carrying amount. If, after assessing the totality of events or circumstances, an entity determines it is not more likely than not that the fair value of a reporting unit is less than its carrying amount, then performing the two-step impairment test is unnecessary. However, if an entity concludes otherwise, then it is required to perform the first step of the two-step impairment test by calculating the fair value of the reporting unit and comparing the fair value with the carrying amount of the reporting unit. ASU 2011-08 became effective for the Company on January 1, 2012 and did not have a significant impact on the Company's financial statements.

Note 2 – Earnings/(Loss) Per Share

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

| | For the Three Months Ended June 30, | | For the Six Months Ended June 30, | |
|-----------------------------------------------|-------------------------------------------|-----------|-----------------------------------------|-----------|
| (In thousands, except per share data) | 2012 | 2011 | 2012 | 2011 |
| Net income (loss) | \$293 | \$(233) | \$(2,743) | \$(1,316) |
| Weighted average shares outstanding - Basic | 8,457 | 8,446 | 8,457 | 8,445 |
| Dilutive effect of common stock equivalents | - | - | - | - |
| Weighted average shares outstanding - Diluted | 8,457 | 8,446 | 8,457 | 8,445 |
| Earnings (loss) per common share - Basic | \$0.03 | \$(0.03) | \$(0.32) | \$(0.16) |
| Earnings (loss) per common share - Diluted | \$0.03 | \$(0.03) | \$(0.32) | \$(0.16) |

The calculations of diluted earnings/(loss) per share for the three and six months ended June 30, 2012 excluded 57 thousand and 37 thousand weighted average common stock equivalents, respectively, because the effect of including them would have been antidilutive. The calculations of diluted earnings/(loss) per share for the three and six months ended June 30, 2011 each excluded 180 thousand weighted average common stock equivalents because the effect of including them would have been antidilutive.

Note 3 – Investment Securities

The following table provides information on the amortized cost and estimated fair values of investment securities.

| (Dollars in thousands) | Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses | Estimated Fair Value |
|----------------------------------------------------------|-------------------|------------------------------|-------------------------------|----------------------------|
| Available-for-sale securities: | | | | |
| June 30, 2012: | | | | |
| Obligations of U.S. Government agencies and corporations | \$ 34,300 | \$ 914 | \$ 1 | \$ 35,213 |
| Mortgage-backed securities | 95,146 | 2,303 | 35 | 97,414 |
| Equity securities | 585 | 32 | - | 617 |
| Total | \$ 130,031 | \$ 3,249 | \$ 36 | \$ 133,244 |

December 31, 2011:

| | | | | |
|----------------------------------------------------------|------------|----------|--------|------------|
| Obligations of U.S. Government agencies and corporations | \$ 41,360 | \$ 803 | \$ 15 | \$ 42,148 |
| Mortgage-backed securities | 85,545 | 1,587 | 99 | 87,033 |
| Equity securities | 577 | 22 | - | 599 |
| Total | \$ 127,482 | \$ 2,412 | \$ 114 | \$ 129,780 |

Held-to-maturity securities:

June 30, 2012:

| | | | | |
|--------------------------------------------------|----------|--------|------|----------|
| Obligations of states and political subdivisions | \$ 5,168 | \$ 257 | \$ - | \$ 5,425 |
|--------------------------------------------------|----------|--------|------|----------|

December 31, 2011:

| | | | | |
|--------------------------------------------------|----------|--------|------|----------|
| Obligations of states and political subdivisions | \$ 6,480 | \$ 252 | \$ - | \$ 6,732 |
|--------------------------------------------------|----------|--------|------|----------|

The following table provides information about gross unrealized losses and fair value by length of time that the individual available-for-sale securities have been in a continuous unrealized loss position at June 30, 2012.

| (Dollars in thousands) | Less than 12 Months | | More than 12 Months | | Total | |
|---------------------------------------|------------------------|----------------------|------------------------|----------------------|---------------|----------------------|
| | Fair Value | Unrealized Losses | Fair Value | Unrealized Losses | Fair Value | Unrealized Losses |
| Available-for-sale securities: | | | | | | |
| U.S. Gov't. agencies and corporations | \$ 3,999 | \$ 1 | \$ - | \$ - | \$ 3,999 | \$ 1 |
| Mortgage-backed securities | 13,421 | 35 | - | - | 13,421 | 35 |
| Total | \$ 17,420 | \$ 36 | \$ - | \$ - | \$ 17,420 | \$ 36 |

Total available-for-sale securities have a fair value of approximately \$133.2 million. Of these securities, approximately \$17.4 million have unrealized losses when compared to their amortized cost. All of the securities with the unrealized losses in the available-for-sale portfolio have modest duration risk, low credit risk, and minimal losses (approximately 0.03%) when compared to total amortized cost. The unrealized losses on debt securities that exist are the result of market changes in interest rates since original purchase. Because the Company does not intend to sell these debt securities and it is not more likely than not that the Company will be required to sell these securities before recovery of their amortized cost bases, which may be at maturity, the Company considers the unrealized losses in the available-for-sale portfolio to be temporary. There were no unrealized losses in the held-to-maturity securities portfolio at June 30, 2012.

The following table provides information on the amortized cost and estimated fair values of investment securities by maturity date at June 30, 2012.

| (Dollars in thousands) | Available for sale | | Held to maturity | |
|----------------------------------------|--------------------|----------------------|------------------|----------------------|
| | Amortized Cost | Estimated Fair Value | Amortized Cost | Estimated Fair Value |
| Due in one year or less | \$8,012 | \$8,047 | \$1,976 | \$ 1,989 |
| Due after one year through five years | 14,238 | 14,284 | 1,680 | 1,748 |
| Due after five years through ten years | 4,995 | 5,157 | 502 | 575 |
| Due after ten years | 102,201 | 105,139 | 1,010 | 1,113 |
| | 129,446 | 132,627 | 5,168 | 5,425 |
| Equity securities | 585 | 617 | - | - |
| Total | \$130,031 | \$133,244 | \$5,168 | \$ 5,425 |

The maturity dates for debt securities are determined using contractual maturity dates.

Note 4 – Loans and allowance for credit losses

The Company makes residential mortgage, commercial and consumer loans to customers primarily in Talbot County, Queen Anne's County, Kent County, Caroline County and Dorchester County in Maryland and in Kent County, Delaware. The following table provides information about the principal classes of the loan portfolio at June 30, 2012 and December 31, 2011.

| (Dollars in thousands) | June 30, 2012 | December 31, 2011 |
|-----------------------------|---------------|-------------------|
| Construction | \$111,067 | \$119,883 |
| Residential real estate | 306,093 | 321,604 |
| Commercial real estate | 315,644 | 315,439 |
| Commercial | 63,004 | 69,485 |
| Consumer | 14,150 | 14,639 |
| Total loans | 809,958 | 841,050 |
| Allowance for credit losses | (12,990) | (14,288) |
| Total loans, net | \$796,968 | \$826,762 |

Loans are stated at their principal amount outstanding net of any deferred fees and costs. Interest income on loans is accrued at the contractual rate based on the principal amount outstanding. Fees charged and costs capitalized for

originating loans are being amortized substantially on the interest method over the term of the loan. A loan is placed on nonaccrual when it is specifically determined to be impaired or when principal or interest is delinquent for 90 days or more, unless the loan is well secured and in the process of collection. Any unpaid interest previously accrued on those loans is reversed from income. Interest payments received on nonaccrual loans are applied as a reduction of the loan principal balance unless collectability of the principal amount is reasonably assured, in which case interest is recognized on a cash basis. Loans are returned to accrual status when all principal and interest amounts contractually due are brought current and future payments are reasonably assured.

A loan is considered impaired if it is probable that the Company will not collect all principal and interest payments according to the loan's contractual terms. An impaired loan may show deficiencies in the borrower's overall financial condition, payment history, support available from financial guarantors and/or the fair market value of collateral. The impairment of a loan is measured at the present value of expected future cash flows using the loan's effective interest rate, or at the loan's observable market price or the fair value of the collateral if the loan is collateral dependent. Generally, the Company measures impairment on such loans by reference to the fair value of the collateral. Income on impaired loans is recognized on a cash basis, and payments are first applied against the principal balance outstanding (i.e., placing impaired loans on nonaccrual status). Generally, interest income is not recognized on specific impaired loans unless the likelihood of further loss is remote. The allowance for credit losses includes specific reserves related to impaired loans. Impaired loans do not include groups of smaller balance homogenous loans such as residential mortgage and consumer installment loans that are evaluated collectively for impairment. Reserves for probable credit losses related to these loans are based on historical loss ratios and are included in the formula portion of the allowance for credit losses.

Loans are evaluated on a case-by-case basis for impairment. Once the amount of impairment has been determined, the uncollectible portion is charged off. As seen in the table below, the difference between the unpaid principal balance and the recorded investment is the amount of partial charge-offs that have been taken. In some cases, a specific allocation within the allowance for credit losses is made until such time that a charge-off is made.

A loan is considered a troubled debt restructuring if a borrower is experiencing financial difficulties and a creditor has granted a concession. Concessions may include interest rate reductions or below market interest rates, principal forgiveness, restructuring amortization schedules and other actions intended to minimize potential losses.

The following tables provide information on impaired loans and any related allowance by loan class as of June 30, 2012 and December 31, 2011.

| (Dollars in thousands) | Unpaid principal balance | Recorded investment with no allowance | Recorded investment with an allowance | Related allowance | Average recorded investment |
|---------------------------------------|--------------------------|---------------------------------------|---------------------------------------|-------------------|-----------------------------|
| June 30, 2012 | | | | | |
| Impaired nonaccrual loans: | | | | | |
| Construction | \$23,220 | \$ 14,258 | \$ - | \$ - | \$ 15,214 |
| Residential real estate | 24,948 | 19,588 | 812 | 420 | 20,221 |
| Commercial real estate | 15,398 | 9,376 | 2,260 | 500 | 12,968 |
| Commercial | 2,178 | 1,609 | - | - | 1,905 |
| Consumer | 59 | 55 | - | - | 46 |
| Total | 65,803 | 44,886 | 3,072 | 920 | 50,354 |
| Impaired accruing restructured loans: | | | | | |
| Construction | 17,078 | 17,078 | - | - | 12,704 |
| Residential real estate | 5,008 | 5,008 | - | - | 3,580 |
| Commercial real estate | 15,077 | 15,077 | - | - | 12,510 |
| Commercial | 68 | 68 | - | - | 51 |
| Consumer | - | - | - | - | - |
| Total | 37,231 | 37,231 | - | - | 28,845 |
| Total impaired loans: | | | | | |
| Construction | 40,298 | 31,336 | - | - | 27,918 |
| Residential real estate | 29,956 | 24,596 | 812 | 420 | 23,801 |
| Commercial real estate | 30,475 | 24,453 | 2,260 | 500 | 25,478 |
| Commercial | 2,246 | 1,677 | - | - | 1,956 |
| Consumer | 59 | 55 | - | - | 46 |
| Total | \$ 103,034 | \$ 82,117 | \$ 3,072 | \$ 920 | \$ 79,199 |

| (Dollars in thousands) | Unpaid principal balance | Recorded investment with no allowance | Recorded investment with an allowance | Related allowance | Average recorded investment |
|---------------------------------------|--------------------------|---------------------------------------|---------------------------------------|-------------------|-----------------------------|
| December 31, 2011 | | | | | |
| Impaired nonaccrual loans: | | | | | |
| Construction | \$ 22,883 | \$ 14,005 | \$ 1,550 | \$ 170 | \$ 16,555 |
| Residential real estate | 22,431 | 16,925 | 3,181 | 1,296 | 15,430 |
| Commercial real estate | 17,372 | 14,012 | - | - | 14,624 |
| Commercial | 2,119 | 1,669 | - | - | 2,539 |
| Consumer | 30 | 28 | - | - | 32 |
| Total | 64,835 | 46,639 | 4,731 | 1,466 | 49,180 |
| Impaired accruing restructured loans: | | | | | |
| Construction | 11,781 | 11,781 | - | - | 10,663 |
| Residential real estate | 3,792 | 3,792 | - | - | 6,093 |
| Commercial real estate | 9,566 | 9,566 | - | - | 7,960 |
| Commercial | 69 | 69 | - | - | 111 |
| Consumer | - | - | - | - | - |
| Total | 25,208 | 25,208 | - | - | 24,827 |
| Total impaired loans: | | | | | |
| Construction | 34,664 | 25,786 | 1,550 | 170 | 27,218 |
| Residential real estate | 26,223 | 20,717 | 3,181 | 1,296 | 21,523 |
| Commercial real estate | 26,938 | 23,578 | - | - | 22,584 |
| Commercial | 2,188 | 1,738 | - | - | 2,650 |
| Consumer | 30 | 28 | - | - | 32 |
| Total | \$ 90,043 | \$ 71,847 | \$ 4,731 | \$ 1,466 | \$ 74,007 |

The following tables provide information on troubled debt restructurings by loan class as of June 30, 2012 and December 31, 2011. The amounts include nonaccrual troubled debt restructurings.

| (Dollars in thousands) | Number of contracts | Premodification outstanding recorded investment | Postmodification outstanding recorded investment |
|-------------------------------|---------------------|-------------------------------------------------|--------------------------------------------------|
| Troubled debt restructurings: | | | |
| June 30, 2012 | | | |
| Construction | 14 | \$ 21,873 | \$ 18,366 |
| Residential real estate | 26 | 13,530 | 12,283 |
| Commercial real estate | 19 | 21,814 | 18,633 |
| Commercial | 2 | 125 | 114 |
| Consumer | 1 | 30 | 28 |
| Total | 62 | \$ 57,372 | \$ 42,218 |
| December 31, 2011 | | | |
| Construction | 9 | \$ 12,981 | \$ 12,539 |
| Residential real estate | 20 | 11,471 | 10,359 |
| Commercial real estate | 20 | 15,874 | 14,175 |
| Commercial | 1 | 69 | 69 |
| Consumer | - | - | - |
| Total | 50 | \$ 40,395 | \$ 37,142 |

| (Dollars in thousands) | Number of contracts | Recorded investment |
|-----------------------------------------------------------|---------------------|---------------------|
| Troubled debt restructurings that subsequently defaulted: | | |
| June 30, 2012 | | |
| Construction | 4 | \$ 1,288 |
| Residential real estate | 12 | 8,163 |
| Commercial real estate | 5 | 3,557 |
| Commercial | 1 | 46 |
| Consumer | 1 | 28 |
| Total | 23 | \$ 13,082 |
| December 31, 2011 | | |
| Construction | 3 | \$ 758 |
| Residential real estate | 10 | 7,353 |
| Commercial real estate | 5 | 6,751 |
| Commercial | - | - |
| Consumer | - | - |
| Total | 18 | \$ 14,862 |

Management uses risk ratings as part of its monitoring of the credit quality in the Company's loan portfolio. Loans that are identified as special mention, substandard and doubtful are adversely rated and are assigned higher risk ratings than favorably rated loans.

The following tables provide information on loan risk ratings as of June 30, 2012 and December 31, 2011.

| (Dollars in thousands) | Pass/Performing | Special mention | Substandard | Doubtful | Nonaccrual | Total |
|-------------------------|-----------------|-----------------|-------------|----------|------------|------------|
| June 30, 2012 | | | | | | |
| Construction | \$ 47,029 | \$ 26,633 | \$ 23,147 | \$ - | \$ 14,258 | \$ 111,067 |
| Residential real estate | 249,611 | 17,208 | 18,438 | 436 | 20,400 | 306,093 |
| Commercial real estate | 257,072 | 19,447 | 27,489 | - | 11,636 | 315,644 |
| Commercial | 56,049 | 3,669 | 1,616 | 61 | 1,609 | 63,004 |
| Consumer | 13,846 | 185 | 64 | - | 55 | 14,150 |
| Total | \$ 623,607 | \$ 67,142 | \$ 70,754 | \$ 497 | \$ 47,958 | \$ 809,958 |

| (Dollars in thousands) | Pass/Performing | Special mention | Substandard | Doubtful | Nonaccrual | Total |
|-------------------------|-----------------|-----------------|-------------|----------|------------|------------|
| December 31, 2011 | | | | | | |
| Construction | \$ 50,403 | \$ 30,373 | \$ 23,552 | \$ - | \$ 15,555 | \$ 119,883 |
| Residential real estate | 261,910 | 13,467 | 25,676 | 445 | 20,106 | 321,604 |
| Commercial real estate | 257,247 | 16,001 | 28,179 | - | 14,012 | 315,439 |
| Commercial | 59,178 | 3,813 | 4,748 | 77 | 1,669 | 69,485 |
| Consumer | 14,520 | 32 | 59 | - | 28 | 14,639 |
| Total | \$ 643,258 | \$ 63,686 | \$ 82,214 | \$ 522 | \$ 51,370 | \$ 841,050 |

The following tables provide information on the aging of the loan portfolio as of June 30, 2012 and December 31, 2011.

| (Dollars in thousands) | Accruing | | | | Total past due | Non-accrual | Total |
|-------------------------|-----------|---------------------|---------------------|--------------------------|----------------|-------------|-----------|
| | Current | 30-59 days past due | 60-89 days past due | 90 days or more past due | | | |
| June 30, 2012 | | | | | | | |
| Construction | \$95,937 | \$- | \$872 | \$- | \$872 | \$ 14,258 | \$111,067 |
| Residential real estate | 279,299 | 4,133 | 1,029 | 1,232 | 6,394 | 20,400 | 306,093 |
| Commercial real estate | 297,782 | 2,287 | 1,898 | 2,041 | 6,226 | 11,636 | 315,644 |
| Commercial | 61,278 | 46 | 9 | 62 | 117 | 1,609 | 63,004 |
| Consumer | 13,837 | 51 | 23 | 184 | 258 | 55 | 14,150 |
| Total | \$748,133 | \$6,517 | \$3,831 | \$3,519 | \$13,867 | \$ 47,958 | \$809,958 |
| Percent of total loans | 92.4 % | 0.8 % | 0.5 % | 0.4 % | 1.7 % | 5.9 % | |

| (Dollars in thousands) | Accruing | | | | Total past due | Non-accrual | Total |
|-------------------------|-----------|---------------------|---------------------|--------------------------|----------------|-------------|-----------|
| | Current | 30-59 days past due | 60-89 days past due | 90 days or more past due | | | |
| December 31, 2011 | | | | | | | |
| Construction | \$102,441 | \$1,246 | \$316 | \$325 | \$1,887 | \$ 15,555 | \$119,883 |
| Residential real estate | 289,459 | 4,417 | 5,291 | 2,331 | 12,039 | 20,106 | 321,604 |
| Commercial real estate | 289,760 | 10,073 | 1,594 | - | 11,667 | 14,012 | 315,439 |
| Commercial | 64,581 | 1,350 | 1,819 | 66 | 3,235 | 1,669 | 69,485 |
| Consumer | 14,492 | 112 | 6 | 1 | 119 | 28 | 14,639 |
| Total | \$760,733 | \$17,198 | \$9,026 | \$2,723 | \$28,947 | \$ 51,370 | \$841,050 |
| Percent of total loans | 90.5 % | 2.0 % | 1.1 % | 0.3 % | 3.4 % | 6.1 % | |

The Company has established an allowance for credit losses, which is increased by provisions charged against earnings and recoveries of previously charged-off debts and is decreased by current period charge-offs of uncollectible debts. Management evaluates the adequacy of the allowance for credit losses on a quarterly basis and adjusts the provision for credit losses based on this analysis. Allocation of a portion of the allowance to one loan class does not preclude its availability to absorb losses in other loan classes.

The following tables provide a summary of the activity in the allowance for credit losses allocated by loan class for the three months ended June 30, 2012 and 2011.

| (Dollars in thousands) | Construction | Residential real estate | Commercial real estate | Commercial | Consumer | Unallocated | Total |
|---------------------------------------------|--------------|----------------------------|---------------------------|------------|----------|-------------|----------|
| For the three months ended June 30, 2012 | | | | | | | |
| Allowance for credit losses: | | | | | | | |
| Beginning balance | \$ 3,344 | \$ 4,448 | \$ 3,549 | \$ 1,539 | \$ 581 | \$ 83 | \$13,544 |
| Charge-offs | (714) | (1,554) | (745) | (1,085) | (162) | - | (4,260) |
| Recoveries | - | 43 | - | 133 | 5 | - | 181 |
| Net charge-offs | (714) | (1,511) | (745) | (952) | (157) | - | (4,079) |
| Provision | 215 | 1,300 | 1,148 | 476 | 61 | 325 | 3,525 |
| Ending balance | \$ 2,845 | \$ 4,237 | \$ 3,952 | \$ 1,063 | \$ 485 | \$ 408 | \$12,990 |

| (Dollars in thousands) | Construction | Residential real estate | Commercial real estate | Commercial | Consumer | Unallocated | Total |
|---------------------------------------------|--------------|----------------------------|---------------------------|------------|----------|-------------|----------|
| For the three months ended June 30, 2011 | | | | | | | |
| Allowance for credit losses: | | | | | | | |
| Beginning balance | \$ 3,324 | \$ 5,420 | \$ 5,280 | \$ 2,776 | \$ 591 | \$ 80 | \$17,471 |
| Charge-offs | (728) | (2,390) | (2,265) | (1,525) | (40) | - | (6,948) |
| Recoveries | - | 34 | 5 | 380 | 21 | - | 440 |
| Net charge-offs | (728) | (2,356) | (2,260) | (1,145) | (19) | - | (6,508) |
| Provision | 937 | 1,120 | 2,231 | 1,079 | 33 | (5) | 5,395 |
| Ending balance | \$ 3,533 | \$ 4,184 | \$ 5,251 | \$ 2,710 | \$ 605 | \$ 75 | \$16,358 |

The following tables provide a summary of the activity in the allowance for credit losses allocated by loan class for the six months ended June 30, 2012 and 2011.

| (Dollars in thousands) | Construction | Residential real estate | Commercial real estate | Commercial | Consumer | Unallocated | Total |
|-------------------------------------------|--------------|----------------------------|---------------------------|------------|----------|-------------|----------|
| For the six months ended June 30, 2012 | | | | | | | |
| Allowance for credit losses: | | | | | | | |
| Beginning balance | \$ 3,745 | \$ 5,014 | \$ 3,415 | \$ 1,498 | \$ 594 | \$ 22 | \$14,288 |
| Charge-offs | (1,786) | (5,673) | (1,435) | (4,440) | (177) | - | (13,511) |
| Recoveries | - | 94 | 7 | 208 | 9 | - | 318 |
| Net charge-offs | (1,786) | (5,579) | (1,428) | (4,232) | (168) | - | (13,193) |
| Provision | 886 | 4,802 | 1,965 | 3,797 | 59 | 386 | 11,895 |
| Ending balance | \$ 2,845 | \$ 4,237 | \$ 3,952 | \$ 1,063 | \$ 485 | \$ 408 | \$12,990 |

| (Dollars in thousands) | Construction | Residential real estate | Commercial real estate | Commercial | Consumer | Unallocated | Total |
|-------------------------------------------|--------------|----------------------------|---------------------------|------------|----------|-------------|----------|
| For the six months ended June 30, 2011 | | | | | | | |
| Allowance for credit losses: | | | | | | | |
| Beginning balance | \$ 3,327 | \$ 4,833 | \$ 3,665 | \$ 1,422 | \$ 637 | \$ 343 | \$14,227 |
| Charge-offs | (1,414) | (4,481) | (2,493) | (1,771) | (115) | - | (10,274) |
| Recoveries | 49 | 68 | 5 | 457 | 41 | - | 620 |
| Net charge-offs | (1,365) | (4,413) | (2,488) | (1,314) | (74) | - | (9,654) |
| Provision | 1,571 | 3,764 | 4,074 | 2,602 | 42 | (268) | 11,785 |
| Ending balance | \$ 3,533 | \$ 4,184 | \$ 5,251 | \$ 2,710 | \$ 605 | \$ 75 | \$16,358 |

The following tables include impairment information relating to loans and the allowance for credit losses as of June 30, 2012 and 2011.

| (Dollars in thousands) | Construction | Residential real estate | Commercial real estate | Commercial | Consumer | Unallocated | Total |
|---------------------------------------------|--------------|----------------------------|---------------------------|------------|-----------|-------------|------------|
| June 30, 2012 | | | | | | | |
| Loans individually evaluated for impairment | \$ 31,336 | \$ 25,408 | \$ 26,713 | \$ 1,677 | \$ 55 | \$ - | \$ 85,189 |
| Loans collectively evaluated for impairment | 79,731 | 280,685 | 288,931 | 61,327 | 14,095 | - | 724,769 |
| Total loans | \$ 111,067 | \$ 306,093 | \$ 315,644 | \$ 63,004 | \$ 14,150 | \$ - | \$ 809,958 |
| Allowance for credit losses allocated to: | | | | | | | |
| Loans individually evaluated for impairment | \$ - | \$ 420 | \$ 500 | \$ - | \$ - | \$ - | \$ 920 |
| Loans collectively evaluated for impairment | 2,845 | 3,817 | 3,452 | 1,063 | 485 | 408 | 12,070 |
| Total allowance for credit losses | \$ 2,845 | \$ 4,237 | \$ 3,952 | \$ 1,063 | \$ 485 | \$ 408 | \$ 12,990 |

| (Dollars in thousands) | Construction | Residential real estate | Commercial real estate | Commercial | Consumer | Unallocated | Total |
|---------------------------------------------|--------------|----------------------------|---------------------------|------------|-----------|-------------|------------|
| June 30, 2011 | | | | | | | |
| Loans individually evaluated for impairment | \$ 18,129 | \$ 12,187 | \$ 15,141 | \$ 2,990 | \$ 29 | \$ - | \$ 48,476 |
| Loans collectively evaluated for impairment | 110,011 | 319,947 | 312,166 | 71,495 | 15,236 | - | 828,855 |
| Total loans | \$ 128,140 | \$ 332,134 | \$ 327,307 | \$ 74,485 | \$ 15,265 | \$ - | \$ 877,331 |
| Allowance for credit losses allocated to: | | | | | | | |
| Loans individually evaluated for impairment | \$ - | \$ 289 | \$ 506 | \$ 567 | \$ - | \$ - | \$ 1,362 |
| Loans collectively evaluated for impairment | 3,533 | 3,895 | 4,745 | 2,143 | 605 | 75 | 14,996 |
| Total allowance for credit losses | \$ 3,533 | \$ 4,184 | \$ 5,251 | \$ 2,710 | \$ 605 | \$ 75 | \$ 16,358 |

Note 5 – Other Assets

The Company had the following other assets at June 30, 2012 and December 31, 2011.

| (Dollars in thousands) | June 30, 2012 | December 31, 2011 |
|-------------------------------------|------------------|----------------------|
| Nonmarketable investment securities | \$2,874 | \$ 2,866 |
| Insurance premiums receivable | 563 | 876 |
| Accrued interest receivable | 3,644 | 3,933 |
| Income taxes receivable | 2,711 | 719 |
| Deferred income taxes | 8,113 | 9,036 |
| Interest rate caps (1) | 68 | 250 |
| Prepaid expenses | 3,060 | 3,641 |
| Other assets | 6,010 | 5,399 |
| Total | \$27,043 | \$ 26,720 |

(1) See Note 9 for further discussion.

Note 6 – Other Liabilities

The Company had the following other liabilities at June 30, 2012 and December 31, 2011.

| (Dollars in thousands) | June 30, 2012 | December 31, 2011 |
|--------------------------|---------------------|----------------------|
| Accrued interest payable | \$588 | \$ 569 |
| Other liabilities | 8,294 | 8,184 |
| Total | \$8,882 | \$ 8,753 |

Note 7 - Stock-Based Compensation

As of June 30, 2012, the Company maintained the Shore Bancshares, Inc. 2006 Stock and Incentive Compensation Plan (“2006 Equity Plan”) under which it may issue shares of common stock or grant other equity-based awards. The Company’s ability to grant options under the Shore Bancshares, Inc. 1998 Stock Option Plan (the “1998 Option Plan”) expired on March 3, 2008 and all of the remaining 7,125 outstanding options expired on May 9, 2012.

Stock-based awards granted to date generally are time-based, vest in equal installments on each anniversary of the grant date over a three- to five-year period of time, and, in the case of stock options, expire 10 years from the grant date. Stock-based compensation expense is recognized ratably over the requisite service period for all awards, is based on the grant-date fair value and reflects forfeitures as they occur.

During the first quarter of 2012, the Company granted options to purchase 54,216 shares of the Company’s common stock pursuant to the 2006 Equity Plan. The options have an exercise price of \$6.64 and vest 50% after two years from date of grant and 50% after three years from date of grant.

The following tables provide information on stock-based compensation expense for the first three and six months of 2012 and 2011.

| | For the Three Months Ended June 30, | | For the Six Months Ended June 30, | |
|----------------------------------|-------------------------------------------------|-------|--------------------------------------------|-------|
| (Dollars in thousands) | 2012 | 2011 | 2012 | 2011 |
| Stock-based compensation expense | \$44 | \$ 68 | \$141 | \$137 |

| (Dollars in thousands) | June 30, | |
|---------------------------------------------------------------------------|-----------|-----------|
| | 2012 | 2011 |
| Unrecognized stock-based compensation expense | \$211 | \$368 |
| Weighted average period unrecognized expense is expected to be recognized | 2.3 years | 1.1 years |

The following table summarizes restricted stock award activity for the Company under the 2006 Equity Plan for the six months ended June 30, 2012.

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| | Number of Shares | Weighted Average Grant Date Fair Value |
|----------------------------------|------------------------|----------------------------------------------------|
| Nonvested at beginning of period | 45,779 | \$ 13.20 |
| Granted | - | - |
| Vested | (39,231) | 12.92 |
| Cancelled | - | - |
| Nonvested at end of period | 6,548 | \$ 14.89 |

The following table summarizes stock option activity for the Company under the 2006 Equity Plan for the six months ended June 30, 2012.

| | Number of Shares | Weighted Average Exercise Price | Aggregate Intrinsic Value | Weighted Average Grant Date Fair Value |
|------------------------------------|------------------------|------------------------------------------|---------------------------------|-------------------------------------------------------|
| Outstanding at beginning of period | - | \$ - | | \$ - |
| Granted | 54,216 | 6.64 | | 3.44 |
| Exercised | - | - | | - |
| Expired/Cancelled | - | - | | - |
| Outstanding at end of period | 54,216 | \$ 6.64 | \$ - | \$ 3.44 |
| Exercisable at end of period | - | \$ - | \$ - | \$ - |

The Company estimates the fair value of stock options using the Black-Scholes valuation model with weighted average assumptions for dividend yield, expected volatility, risk-free interest rate and expected contract life (in years). The expected dividend yield is calculated by dividing the total expected annual dividend payout by the average stock price. The expected volatility is based on historical volatility of the underlying securities. The risk-free interest rate is based on the Federal Reserve Bank's constant maturities daily interest rate in effect at grant date. The expected contract life of the options represents the period of time that the Company expects the awards to be outstanding based on historical experience with similar awards. The following weighted average assumptions were used as inputs to the Black-Scholes valuation model for options granted in 2012.

| | |
|-----------------------------------|--------|
| Dividend yield | 0.60% |
| Expected volatility | 58.65% |
| Risk-free interest rate | 1.69% |
| Expected contract life (in years) | 5.83 |

There was no aggregate intrinsic value of the options outstanding under the 2006 Equity Plan based on the \$5.98 market value per share of Shore Bancshares, Inc.'s common stock at June 30, 2012. Since there were no options exercised during the first six months of 2012 or 2011, there was no intrinsic value associated with stock options exercised and no cash received on exercise of options. At June 30, 2012, the weighted average remaining contract life of options outstanding was 9.7 years.

Note 8 – Fair Value Measurements

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

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

Under fair value accounting guidance, assets and liabilities are grouped at fair value in three levels, based on the markets in which the assets and liabilities are traded and the reliability of the assumptions used to determine their fair

values. These hierarchy levels are:

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

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

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

Below is a discussion on the Company's assets measured at fair value on a recurring basis.

Investment Securities Available for Sale

Fair value measurement for investment securities available for sale is based on quoted prices from an independent pricing service. The fair value measurements consider observable data that may include present value of future cash flows, prepayment assumptions, credit loss assumptions and other factors. The Company classifies its investments in U.S. Treasury securities as Level 1 in the fair value hierarchy, and it classifies its investments in U.S. Government agencies securities and mortgage-backed securities issued or guaranteed by U.S. Government sponsored entities as Level 2.

Derivative Assets

Derivative instruments held by the Company for risk management purposes are traded in over-the-counter markets where quoted market prices are not readily available. For those derivatives, the Company measures fair value using third-party models that use primarily market observable inputs, such as yield curves and option volatilities, and include the value associated with counterparty credit risk. The Company classifies its derivative instruments held for risk management purposes as Level 2 in the fair value hierarchy. As of June 30, 2012 and December 31, 2011, the Company's derivative instruments consisted solely of interest rate caps. These derivative assets are included in other assets in the accompanying consolidated balance sheets.

The tables below present the recorded amount of assets measured at fair value on a recurring basis at June 30, 2012 and December 31, 2011. No assets were transferred from one hierarchy level to another during the first six months of 2012 or 2011.

| (Dollars in thousands) | Fair Value | Quoted Prices (Level 1) | Significant Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) |
|--------------------------------|------------|-------------------------|-----------------------------------------------|-------------------------------------------|
| June 30, 2012 | | | | |
| Securities available for sale: | | | | |
| U.S. Government agencies | \$35,213 | \$ - | \$35,213 | \$ - |
| Mortgage-backed securities | 97,414 | - | 97,414 | - |
| Other equity securities | 617 | - | 617 | - |
| Total | \$133,244 | \$ - | \$133,244 | \$ - |
| Interest rate caps | \$68 | \$ - | \$68 | \$ - |

| (Dollars in thousands) | Fair Value | Quoted Prices (Level 1) | Significant Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) |
|--------------------------------|------------|-------------------------|-----------------------------------------------|-------------------------------------------|
| December 31, 2011 | | | | |
| Securities available for sale: | | | | |
| U.S. Government agencies | \$42,148 | \$ - | \$42,148 | \$ - |
| Mortgage-backed securities | 87,033 | - | 87,033 | - |
| Other equity securities | 599 | - | 599 | - |
| Total | \$129,780 | \$ - | \$129,780 | \$ - |
| Interest rate caps | \$250 | \$ - | \$250 | \$ - |

Below is a discussion on the Company's assets measured at fair value on a nonrecurring basis.

Loans

The Company does not record loans at fair value on a recurring basis; however, from time to time, a loan is considered impaired and a valuation allowance may be established if there are losses associated with the loan. Loans are considered impaired if it is probable that payment of interest and principal will not be made in accordance with contractual terms. The fair value of impaired loans can be estimated using one of several methods, including the

collateral value, market value of similar debt, liquidation value and discounted cash flows. At June 30, 2012 and December 31, 2011, substantially all impaired loans were evaluated based on the fair value of the collateral and were classified as Level 3 in the fair value hierarchy.

Other Real Estate and Other Assets Owned (Foreclosed Assets)

Foreclosed assets are adjusted for fair value upon transfer of loans to foreclosed assets. Subsequently, foreclosed assets are carried at the lower of carrying value and fair value. Fair value is based on independent market prices, appraised value of the collateral or management's estimation of the value of the collateral. At June 30, 2012 and December 31, 2011, foreclosed assets were classified as Level 3 in the fair value hierarchy.

The tables below summarize the changes in the recorded amount of assets measured at fair value on a nonrecurring basis for the six months ended June 30, 2012 and June 30, 2011. All assets measured at fair value on a nonrecurring basis were classified as Level 3 in the fair value hierarchy for the periods presented.

| (Dollars in thousands) | Construction | Residential real estate | Commercial real estate | Commercial | Consumer | Total |
|-------------------------------------------|--------------|----------------------------|---------------------------|------------|----------|----------|
| For the six months ended June 30, 2012 | | | | | | |
| Impaired loans: | | | | | | |
| Beginning balance | \$ 27,166 | \$ 22,602 | \$ 23,578 | \$ 1,738 | \$ 28 | \$75,112 |
| Charge-offs | (1,775) | (5,356) | (1,435) | (1,264) | - | (9,830) |
| Payments | (715) | (3,185) | (1,375) | (80) | (3) | (5,358) |
| Transfers to other real estate owned | (1,620) | (763) | (1,334) | (30) | - | (3,747) |
| Returned to performing status | - | - | - | - | - | - |
| Changed to nonaccrual status | (666) | (786) | - | - | - | (1,452) |
| Additions | 8,776 | 11,600 | 7,279 | 1,313 | 30 | 28,998 |
| Changes in allowance | 90 | 876 | (500) | (30) | - | 436 |
| Ending balance | \$ 31,256 | \$ 24,988 | \$ 26,213 | \$ 1,647 | \$ 55 | \$84,159 |

| (Dollars in thousands) | Construction | Residential real estate | Commercial real estate | Commercial | Consumer | Total |
|-------------------------------------------|--------------|----------------------------|---------------------------|------------|----------|----------|
| For the six months ended June 30, 2011 | | | | | | |
| Impaired loans: | | | | | | |
| Beginning balance | \$ 28,175 | \$ 15,327 | \$ 13,280 | \$ 4,374 | \$ 30 | \$61,186 |
| Charge-offs | (1,396) | (4,300) | (2,487) | (1,769) | - | (9,952) |
| Payments | (837) | (4,931) | (2,329) | (542) | (1) | (8,640) |
| Transfers to other real estate owned | (1,719) | (522) | (2,577) | (184) | - | (5,002) |
| Returned to performing status | - | (1,907) | - | - | - | (1,907) |
| Changed to nonaccrual status | (419) | (2,162) | (1,800) | - | - | (4,381) |
| Additions | 4,403 | 18,391 | 15,723 | 1,111 | - | 39,628 |
| Changes in allowance | - | (86) | (506) | (567) | - | (1,159) |
| Ending balance | \$ 28,207 | \$ 19,810 | \$ 19,304 | \$ 2,423 | \$ 29 | \$69,773 |

| (Dollars in thousands) | For the Six Months Ended | |
|--------------------------|-----------------------------|---------|
| | June 30, 2012 | 2011 |
| Other real estate owned: | | |
| Beginning balance | \$9,385 | \$3,702 |
| Sales | (1,404) | (712) |
| Write-downs | (853) | (168) |
| Additions | 4,371 | 5,055 |
| Ending balance | \$11,499 | \$7,877 |

The following information relates to the estimated fair values of financial assets and liabilities that are reported in the Company's consolidated balance sheets at their carrying amounts. The discussion below describes the methods and assumptions used to estimate the fair value of each class of financial asset and liability for which it is practicable to estimate that value.

Cash and Cash Equivalents

Cash equivalents include interest-bearing deposits with other banks and federal funds sold. For these short-term instruments, the carrying amount is a reasonable estimate of fair value.

Investment Securities Held to Maturity

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

Loans

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

Financial Liabilities

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

Commitments to Extend Credit and Standby Letters of Credit

The majority of the Company's commitments to grant loans and standby letters of credit are written to carry current market interest rates if converted to loans. In general, commitments to extend credit and letters of credit are not assignable by the Company or the borrower, so they generally have value only to the Company and the borrower. Therefore, it is impractical to assign any value to these commitments.

The following table provides information on the estimated fair values of the Company's financial assets and liabilities that are reported at their carrying amounts. The financial assets and liabilities have been segregated by their classification level in the fair value hierarchy.

| (Dollars in thousands) | June 30, 2012 | | December 31, 2011 | |
|----------------------------------------|-----------------|----------------------|-------------------|----------------------|
| | Carrying Amount | Estimated Fair Value | Carrying Amount | Estimated Fair Value |
| Financial assets | | | | |
| Level 2 inputs | | | | |
| Cash and cash equivalents | \$ 169,573 | \$ 169,573 | \$ 127,742 | \$ 127,742 |
| Investment securities held to maturity | 5,168 | 5,425 | 6,480 | 6,732 |
| Level 3 inputs | | | | |
| Loans, net | 796,968 | 826,149 | 826,762 | 856,917 |
| Financial liabilities | | | | |
| Level 2 inputs | | | | |
| Deposits | \$ 1,032,703 | \$ 1,036,353 | \$ 1,009,919 | \$ 1,013,964 |
| Short-term borrowings | 13,826 | 13,826 | 17,817 | 17,817 |
| Long-term debt | 455 | 460 | 455 | 470 |

Note 9 – Derivative Instruments and Hedging Activities

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

During the second quarter of 2009, as part of its overall interest rate risk management strategy, the Company purchased interest rate caps for \$7.1 million to effectively fix the interest rate at 2.97% for five years on \$70 million of the Company's money market deposit accounts. The interest rate caps qualified for hedge accounting. The aggregate fair value of these derivatives was an asset of \$68 thousand at June 30, 2012 and \$250 thousand at December 31, 2011. The change in fair value included a \$780 thousand adjustment to record unrealized holding gains on the interest rate caps and a \$962 thousand charge to interest expense associated with the hedged money market deposit accounts. For the first six months of 2011, the change in fair value included a \$337 thousand adjustment to record unrealized holding losses and a \$559 thousand charge to interest expense. The Company expects that the charge to interest expense associated with the hedged deposits over the next 12 months will be approximately \$2.1 million.

By entering into derivative instrument contracts, the Company exposes itself, from time to time, to counterparty credit risk. Counterparty credit risk is the risk that the counterparty will fail to perform under the terms of the derivative contract. When the fair value of a derivative contract is in an asset position, the counterparty has a liability to the Company, which creates credit risk for the Company. The Company attempts to minimize this risk by selecting counterparties with investment grade credit ratings, limiting its exposure to any single counterparty and regularly monitoring its market position with each counterparty. Collateral required by the counterparties, recorded in other liabilities, was \$428 thousand at both June 30, 2012 and December 31, 2011.

Note 10 – Financial Instruments with Off-Balance Sheet Risk

In the normal course of business, to meet the financial needs of its customers, the Company's bank subsidiaries enter into financial instruments with off-balance sheet risk. These financial instruments include commitments to extend credit and standby letters of credit. Commitments to extend credit are agreements to lend to a customer as long as there is no violation of any condition established in the contract. Letters of credit are conditional commitments issued by the Company to guarantee the performance of a customer to a third party. Letters of credit and other commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. Because many of the letters of credit and commitments are expected to expire without being drawn upon, the total commitment amount does not necessarily represent future cash requirements.

The following table provides information on commitments outstanding at June 30, 2012 and December 31, 2011.

| (Dollars in thousands) | June 30, 2012 | December 31, 2011 |
|------------------------------|------------------|----------------------|
| Commitments to extend credit | \$ 146,547 | \$ 136,222 |
| Letters of credit | 12,013 | 11,311 |
| Total | \$ 158,560 | \$ 147,533 |

Note 11 – Segment Reporting

The Company operates two primary business segments: Community Banking and Insurance Products and Services. Through the Community Banking business, the Company provides services to consumers and small businesses on the Eastern Shore of Maryland and Delaware through its 18-branch network. Community banking activities include small business services, retail brokerage, trust services and consumer banking products and services. Loan products available to consumers include mortgage, home equity, automobile, marine, and installment loans, credit cards and other secured and unsecured personal lines of credit. Small business lending includes commercial mortgages, real estate development loans, equipment and operating loans, as well as secured and unsecured lines of credit, credit cards, accounts receivable financing arrangements, and merchant card services.

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

The following table includes selected financial information by business segments for the first six months of 2012 and 2011.

| (Dollars in thousands) | Community Banking | Insurance Products and Services | Parent Company | Consolidated Total |
|-----------------------------------|----------------------|------------------------------------------|-------------------|-----------------------|
| 2012 | | | | |
| Interest income | \$23,509 | \$ 39 | \$ - | \$ 23,548 |
| Interest expense | (5,309) | - | (11) | (5,320) |
| Provision for credit losses | (11,895) | - | - | (11,895) |
| Noninterest income | 3,706 | 5,395 | 50 | 9,151 |
| Noninterest expense | (12,157) | (4,967) | (3,037) | (20,161) |
| Net intersegment (expense) income | (2,687) | (257) | 2,944 | - |
| (Loss) income before taxes | (4,833) | 210 | (54) | (4,677) |
| Income tax benefit (expense) | 2,001 | (89) | 22 | 1,934 |
| Net (loss) income | \$(2,832) | \$ 121 | \$ (32) | \$(2,743) |
| Total assets | \$ 1,156,644 | \$ 16,903 | \$ 1,786 | \$ 1,175,333 |
| 2011 | | | | |
| Interest income | \$25,387 | \$ 66 | \$ - | \$ 25,453 |
| Interest expense | (5,628) | - | (21) | (5,649) |
| Provision for credit losses | (11,785) | - | - | (11,785) |
| Noninterest income | 3,422 | 5,284 | 70 | 8,776 |
| Noninterest expense | (11,390) | (4,743) | (2,952) | (19,085) |
| Net intersegment (expense) income | (2,876) | (244) | 3,120 | - |
| (Loss) income before taxes | (2,870) | 363 | 217 | (2,290) |
| Income tax benefit (expense) | 1,220 | (154) | (92) | 974 |
| Net (loss) income | \$(1,650) | \$ 209 | \$ 125 | \$(1,316) |
| Total assets | \$ 1,102,389 | \$ 18,933 | \$ 2,869 | \$ 1,124,191 |

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

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

Forward-Looking Information

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

Introduction

The following discussion and analysis is intended as a review of significant factors affecting the Company’s financial condition and results of operations for the periods indicated. This discussion and analysis should be read in conjunction with the unaudited consolidated financial statements and related notes presented in this report, as well as the audited consolidated financial statements and related notes included in the Annual Report of Shore Bancshares, Inc. on Form 10-K for the year ended December 31, 2011.

Shore Bancshares, Inc. is the largest independent financial holding company located on the Eastern Shore of Maryland. It is the parent company of The Talbot Bank of Easton, Maryland located in Easton, Maryland (“Talbot Bank”) and CNB located in Centreville, Maryland (together with Talbot Bank, the “Banks”). Until January 1, 2011, the Company also served as the parent company to The Felton Bank located in Felton, Delaware. On January 1, 2011, The Felton Bank merged into CNB, with CNB as the surviving bank. The Banks operate 18 full service branches in Kent County, Queen Anne’s County, Talbot County, Caroline County and Dorchester County in Maryland and Kent County, Delaware. The Company engages in the insurance business through three insurance producer firms, The Avon-Dixon Agency, LLC, Elliott Wilson Insurance, LLC and Jack Martin Associates, Inc.; a wholesale insurance company, TSGIA, Inc.; and two insurance premium finance companies, Mubell Finance, LLC and ESFS, Inc. (all of the foregoing are collectively referred to as the “Insurance Subsidiary”). Each of these entities is a wholly-owned subsidiary of Shore Bancshares, Inc. The Company engages in the mortgage brokerage business under the name “Wye Mortgage Group” through a minority series investment in an unrelated Delaware limited liability company.

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

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

Critical Accounting Policies

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

Allowance for Credit Losses

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

Three basic components comprise our allowance for credit losses: (i) a specific allowance; (ii) a formula allowance; and (iii) a nonspecific allowance. Each component is determined based on estimates that can and do change when the actual events occur. The specific allowance is established against impaired loans (i.e., nonaccrual loans and troubled debt restructurings) based on our assessment of the losses that may be associated with the individual loans. The specific allowance remains until charge-offs are made. An impaired loan may show deficiencies in the borrower's overall financial condition, payment history, support available from financial guarantors and/or the fair market value of collateral. The formula allowance is used to estimate the loss on internally risk-rated loans, exclusive of those identified as impaired. Loans are grouped by type (construction, commercial real estate, residential real estate, commercial or consumer). Each loan type is assigned an allowance factor based on management's estimate of the risk, complexity and size of individual loans within a particular category. Loans identified as special mention, substandard, and doubtful are adversely rated. These loans are assigned higher allowance factors than favorably rated loans due to management's concerns regarding collectability or management's knowledge of particular elements regarding the borrower. The nonspecific allowance captures losses that have impacted the portfolio but have yet to be recognized in either the specific or formula allowance.

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

Goodwill and Other Intangible Assets

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

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

be required to write down the related goodwill or purchased intangibles to record an impairment loss.

Fair Value

The Company measures certain financial assets and liabilities at fair value. Significant financial assets measured at fair value on a recurring basis are investment securities and interest rate caps. Impaired loans and other real estate owned are significant financial assets measured at fair value on a nonrecurring basis. See Note 8, "Fair Value Measurements", in the Notes to Consolidated Financial Statements for a further discussion of fair value.

OVERVIEW

The Company reported net income of \$293 thousand for the second quarter of 2012, or diluted income per common share of \$0.03, compared to a net loss of \$233 thousand, or diluted loss per common share of \$(0.03), for the second quarter of 2011. For the first quarter of 2012, the Company reported a net loss of \$3.0 million, or diluted loss per common share of \$(0.36). The provision for credit losses for the second quarter of 2012 was \$3.5 million, which was \$1.9 million and \$4.8 million lower than the provision for the second quarter of 2011 and the first quarter of 2012, respectively. Annualized return on average assets was 0.10% for the three months ended June 30, 2012, compared to (0.08)% for the same period in 2011. Annualized return on average stockholders' equity was 0.99% for the second quarter of 2012, compared to (0.77)% for the second quarter of 2011. For the first quarter of 2012, annualized return on average assets was (1.05)% and return on average equity was (10.04)%.

For the first six months of 2012, the Company reported a net loss of \$2.7 million, or diluted loss per common share of \$(0.32), compared to a net loss of \$1.3 million, or diluted loss per common share of \$(0.16), for the first six months of 2011. Annualized return on average assets was (0.47)% for the six months ended June 30, 2012, compared to (0.24)% for the same period in 2011. Annualized return on average stockholders' equity was (4.59)% for the first six months of 2012, compared to (2.18)% for the first six months of 2011.

RESULTS OF OPERATIONS

Net Interest Income

Net interest income for the second quarter of 2012 was \$9.0 million, compared to \$9.9 million for the second quarter of 2011 and \$9.2 million for the first quarter of 2012. The decrease in net interest income when compared to the second quarter of 2011 and the first quarter of 2012 was primarily due to lower yields earned on average earning assets and a decline in higher-yielding average loan balances. The net interest margin was 3.36% for the second quarter of 2012, 3.80% for the second quarter of 2011 and 3.42% for the first quarter of 2012, a decrease of 44 basis points and 6 basis points, respectively. Loan charge-offs continued to negatively impact our net interest income and net interest margin.

Interest income was \$11.7 million for the second quarter of 2012, a decrease of 8.2% from the second quarter of 2011. Average earning assets (loans, investment securities, federal funds sold and interest-bearing deposits with other banks) increased 2.8% during the second quarter of 2012 when compared to the same period in 2011, while yields earned decreased 51 basis points to 4.35%, mainly due to loan activity. Average loans decreased 7.4% and the yield earned on loans decreased 5 basis points from 5.43% to 5.38%. Loans comprised 75.2% of total average earning assets for the second quarter of 2012, compared to 83.5% for the second quarter of 2011. Taxable investment securities grew \$23.9 million, or 22.4%, although yields declined 76 basis points because the reinvestment rates on investment securities purchased during 2012 were lower than the yields on the investment securities that matured during the period. Excess cash shifted from federal funds sold (decreasing \$13.1 million) to interest-bearing deposits (increasing \$85.0 million) to take advantage of higher yields on interest-bearing deposits. Interest income decreased 1.4% when compared to the first quarter of 2012. Average earning assets remained relatively unchanged during the second quarter of 2012 when compared to the first quarter of 2012, and yields earned declined 5 basis points.

Interest expense was \$2.7 million for the three months ended June 30, 2012, a decrease of 4.8% when compared to the same period last year. Average interest-bearing liabilities (deposits and borrowings) increased 2.8% while rates paid decreased 9 basis points to 1.20%, primarily due to changes in time deposits (certificates of deposit \$100,000 or more and other time deposits). For the three months ended June 30, 2012, the average balance of certificates of deposit \$100,000 or more and other time deposits each decreased approximately 1.0% when compared to the same period last year, and the average rate paid on these time deposits decreased 21 and 29 basis points, respectively, reflecting current market conditions. The decrease in average time deposits was more than offset by an increase in interest-bearing

demand deposits (10.8%) and money market and savings deposits (5.6%), reflecting a shift in customer investment needs. Interest on money market and savings deposits included an adjustment to expense related to interest rate caps and the hedged deposits associated with them. This adjustment increased interest expense \$502 thousand for the second quarter of 2012 and \$299 thousand for the second quarter of 2011. See Note 9, "Derivative Instruments and Hedging Activities", in the Notes to Consolidated Financial Statements for additional information. When comparing the second quarter of 2012 to the first quarter of 2012, interest expense remained relatively unchanged with average balances of total interest-bearing liabilities decreasing less than 1.0% and the interest rate paid on interest-bearing liabilities staying at 1.20%.

Net interest income for the six months ended June 30, 2012 was \$18.2 million, a decrease of 8.0% when compared to the same period last year. As with the quarterly results, the decrease was mainly due to lower yields earned on average earning assets and a decline in higher-yielding average loan balances. The net interest margin was 3.39% for the first six months of 2012 and 3.79% for the first six months of 2011.

Interest income was \$23.5 million for the first six months of 2012, a decrease of 7.5% when compared to the first six months of 2011. Average earning assets increased 2.6% during the six months ended June 30, 2012 when compared to the same period in 2011, while yields earned decreased 50 basis points to 4.37% primarily due to the impact of loan activity. When comparing the six-month period ended June 30, 2012 to the same period of last year, average loans decreased 6.8% and the yield earned on loans decreased 11 basis points. Loans comprised 75.9% and 83.5% of total average earning assets for the first six months of 2012 and 2011, respectively.

Interest expense was \$5.3 million for the six months ended June 30, 2012, a decrease of 5.8% when compared to the same period last year. Average interest-bearing liabilities increased 2.4%, while rates paid decreased 11 basis points to 1.20% primarily due to time deposit activity. For the six months ended June 30, 2012, the average balance of certificates of deposit \$100,000 or more and other time deposits decreased 4.1% and 1.9%, respectively, when compared to the same period last year, and the average rate paid on these deposits decreased 23 and 28 basis points, respectively.

Analysis of Interest Rates and Interest Differentials

The following table presents the distribution of the average consolidated balance sheets, interest income/expense, and annualized yields earned and rates paid for the three months ended June 30, 2012 and 2011.

| (Dollars in thousands) | For the Three Months Ended June 30, 2012 | | | For the Three Months Ended June 30, 2011 | | |
|---------------------------------------------------|---------------------------------------------|-----------------------|----------------|---------------------------------------------|-----------------------|----------------|
| | Average Balance | Income(1)/ Expense | Yield/ Rate | Average Balance | Income(1)/ Expense | Yield/ Rate |
| Earning assets | | | | | | |
| Loans (2), (3) | \$816,553 | \$ 10,917 | 5.38 % | \$881,976 | \$ 11,935 | 5.43 % |
| Investment securities | | | | | | |
| Taxable | 130,528 | 707 | 2.18 | 106,609 | 782 | 2.94 |
| Tax-exempt | 3,771 | 49 | 5.32 | 4,581 | 60 | 5.27 |
| Federal funds sold | 11,200 | 2 | 0.10 | 24,310 | 5 | 0.09 |
| Interest-bearing deposits | 124,171 | 61 | 0.20 | 39,182 | 12 | 0.12 |
| Total earning assets | 1,086,223 | 11,736 | 4.35 % | 1,056,658 | 12,794 | 4.86 % |
| Cash and due from banks | 21,424 | | | 18,327 | | |
| Other assets | 70,458 | | | 68,190 | | |
| Allowance for credit losses | (14,507) | | | (17,962) | | |
| Total assets | \$1,163,598 | | | \$1,125,213 | | |
| Interest-bearing liabilities | | | | | | |
| Demand deposits | \$152,685 | 68 | 0.18 % | \$137,775 | 76 | 0.22 % |
| Money market and savings deposits (4) | 276,527 | 813 | 1.18 | 261,869 | 633 | 0.97 |
| Certificates of deposit \$100,000 or more | 242,662 | 880 | 1.46 | 244,805 | 1,022 | 1.67 |
| Other time deposits | 205,046 | 882 | 1.73 | 206,310 | 1,038 | 2.02 |
| Interest-bearing deposits | 876,920 | 2,643 | 1.21 | 850,759 | 2,769 | 1.31 |
| Short-term borrowings | 13,818 | 11 | 0.31 | 15,020 | 13 | 0.36 |
| Long-term debt | 455 | 5 | 4.63 | 932 | 11 | 4.51 |
| Total interest-bearing liabilities | 891,193 | 2,659 | 1.20 % | 866,711 | 2,793 | 1.29 % |
| Noninterest-bearing deposits | 144,210 | | | 126,081 | | |
| Other liabilities | 9,421 | | | 11,234 | | |
| Stockholders' equity | 118,774 | | | 121,187 | | |
| Total liabilities and stockholders' equity | \$1,163,598 | | | \$1,125,213 | | |
| Net interest spread | | \$ 9,077 | 3.15 % | | \$ 10,001 | 3.57 % |

| | | |
|---------------------------|--------|--------|
| Net interest margin | 3.36 % | 3.80 % |
| Tax-equivalent adjustment | | |
| Loans | \$ 27 | \$ 39 |
| Investment securities | 17 | 20 |
| Total | \$ 44 | \$ 59 |

(1) All amounts are reported on a tax equivalent basis computed using the statutory federal income tax rate of 34.0% for 2012 and 2011 exclusive of the alternative minimum tax rate and nondeductible interest expense.

(2) Average loan balances include nonaccrual loans.

(3) Interest income on loans includes amortized loan fees, net of costs, and all are included in the yield calculations.

Interest on money market and savings deposits includes an adjustment to expense related to interest rate caps and (4) the hedged deposits associated with them. This adjustment increased interest expense \$502 thousand for the second quarter of 2012 and \$299 thousand for the second quarter of 2011.

The following table presents the distribution of the average consolidated balance sheets, interest income/expense, and annualized yields earned and rates paid for the six months ended June 30, 2012 and 2011:

| (Dollars in thousands) | For the Three Months Ended June 30, 2012 | | | For the Three Months Ended June 30, 2011 | | |
|--------------------------------------------|---------------------------------------------|-----------------------|----------------|---------------------------------------------|-----------------------|----------------|
| | Average Balance | Income(1)/ Expense | Yield/ Rate | Average Balance | Income(1)/ Expense | Yield/ Rate |
| Earning assets | | | | | | |
| Loans (2), (3) | \$824,569 | \$ 21,957 | 5.35 % | \$884,738 | \$ 23,975 | 5.46 % |
| Investment securities | | | | | | |
| Taxable | 130,148 | 1,464 | 2.26 | 104,131 | 1,439 | 2.79 |
| Tax-exempt | 4,020 | 106 | 5.34 | 4,596 | 118 | 5.18 |
| Federal funds sold | 10,497 | 4 | 0.08 | 35,499 | 21 | 0.12 |
| Interest-bearing deposits | 117,931 | 109 | 0.19 | 30,432 | 18 | 0.12 |
| Total earning assets | 1,087,165 | 23,640 | 4.37 % | 1,059,396 | 25,571 | 4.87 % |
| Cash and due from banks | 19,799 | | | 18,819 | | |
| Other assets | 69,310 | | | 66,711 | | |
| Allowance for credit losses | (14,692) | | | (16,811) | | |
| Total assets | \$1,161,582 | | | \$1,128,115 | | |
| Interest-bearing liabilities | | | | | | |
| Demand deposits | \$152,988 | 142 | 0.19 % | \$134,719 | 149 | 0.22 % |
| Money market and savings deposits (4) | 277,941 | 1,591 | 1.15 | 261,358 | 1,228 | 0.95 |
| Certificates of deposit \$100,000 or more | 241,591 | 1,751 | 1.46 | 251,953 | 2,108 | 1.69 |
| Other time deposits | 203,394 | 1,800 | 1.78 | 207,300 | 2,117 | 2.06 |
| Interest-bearing deposits | 875,914 | 5,284 | 1.21 | 855,330 | 5,602 | 1.32 |
| Short-term borrowings | 15,720 | 26 | 0.33 | 14,595 | 26 | 0.36 |
| Long-term debt | 455 | 10 | 4.63 | 932 | 21 | 4.53 |
| Total interest-bearing liabilities | 892,089 | 5,320 | 1.20 % | 870,857 | 5,649 | 1.31 % |
| Noninterest-bearing deposits | 140,235 | | | 124,201 | | |
| Other liabilities | 9,042 | | | 11,234 | | |
| Stockholders' equity | 120,216 | | | 121,823 | | |
| Total liabilities and stockholders' equity | \$1,161,582 | | | \$1,128,115 | | |
| Net interest spread | | \$ 18,320 | 3.17 % | | \$ 19,922 | 3.56 % |
| Net interest margin | | | 3.39 % | | | 3.79 % |
| Tax-equivalent adjustment | | | | | | |
| Loans | | \$ 56 | | | \$ 78 | |
| Investment securities | | 36 | | | 40 | |
| Total | | \$ 92 | | | \$ 118 | |

(1) All amounts are reported on a tax equivalent basis computed using the statutory federal income tax rate of 34.0% for 2012 and 2011 exclusive of the alternative minimum tax rate and nondeductible interest expense.

(2) Average loan balances include nonaccrual loans.

- (3) Interest income on loans includes amortized loan fees, net of costs, and all are included in the yield calculations. Interest on money market and savings deposits includes an adjustment to expense related to interest rate caps and
- (4) the hedged deposits associated with them. This adjustment increased interest expense \$962 thousand for the first six months of 2012 and \$559 thousand for the first six months of 2011.

Noninterest Income

Noninterest income for the second quarter of 2012 increased \$196 thousand, or 4.5%, when compared to the second quarter of 2011. The higher amount was primarily the result of an increase in other noninterest income which included a \$217 thousand gain on the sale of a bank branch building. This increase was partially offset by a decline in insurance agency commissions and service charges on deposit accounts which were impacted by a decrease in customer use of overdraft protection programs. Total noninterest income for the second quarter of 2012 remained relatively unchanged when compared to the first quarter of 2012. The slightly higher amount when compared to the first quarter of 2012 was primarily the result of the \$217 thousand gain on the sale of a bank branch building which was mainly offset by a decrease in insurance agency commissions due to the fact that contingency payments are typically received in the first quarter of the year.

Total noninterest income for the six months ended June 30, 2012 increased \$375 thousand, or 4.3%, when compared to the same period in 2011, primarily due to higher insurance agency commissions (\$110 thousand) and other noninterest income (\$449 thousand). Other noninterest income included the \$217 thousand gain on the sale of a bank branch building and a \$96 thousand increase in rental income from other real estate owned properties. Partially offsetting the increase in noninterest income was a decline in service charges on deposit accounts.

Noninterest Expense

Noninterest expense for the second quarter of 2012 increased \$469 thousand, or 5.1%, when compared to the second quarter of 2011, mostly due to higher salaries and wages and other noninterest expenses. Salaries and wages increased \$272 thousand, mainly due to the hiring of a new executive vice president at The Talbot Bank of Easton, Maryland during the second quarter of last year as part of that bank's succession plan, and a new lender at CNB for the Delaware region during the third quarter of last year. Other noninterest expenses increased \$212 thousand, primarily due to higher expenses related to other real estate owned activities. Total noninterest expense for the second quarter of 2012 decreased \$835 thousand, or 8.0%, when compared to the first quarter of 2012, primarily due to lower employee benefits and other noninterest expenses. Other employee benefits decreased \$214 thousand, mainly due to lower payroll taxes. Other noninterest expenses decreased \$539 thousand, mostly due to lower expenses related to other real estate owned activities (\$323 thousand) and employee training (\$96 thousand), primarily on the use of upgraded insurance software during the first quarter of 2012.

Total noninterest expense for the six months ended June 30, 2012 increased \$1.1 million, or 5.6%, when compared to the same period in 2011. The increase was primarily due to higher salaries and wages and other noninterest expenses which included larger expenses relating to other real estate owned activities and employee training. These expenses were partially offset by lower FDIC insurance premiums and data processing charges due to the merger of The Felton Bank into CNB during the first quarter of 2011.

Income Taxes

The Company reported income tax expense of \$129 thousand for the second quarter of 2012 and an income tax benefit of \$33 thousand for the second quarter of 2011. The effective tax rate was a 30.6% expense for the second quarter of 2012 and a 12.4% benefit for the second quarter of 2011. The effective tax rate for the second quarter of 2011 was impacted by a disallowed exclusion for U.S. Government agency securities income. The Company reported an income tax benefit of \$1.9 million and \$974 thousand for the first six months of 2012 and 2011, respectively. The effective tax rate for the six months ended June 30, 2011 was a 41.4% benefit, compared to a 42.5% benefit for the same period of 2011.

ANALYSIS OF FINANCIAL CONDITION

Loans

Loans totaled \$810.0 million at June 30, 2012, a \$31.1 million, or 3.7%, decrease from the \$841.1 million at December 31, 2011. Loans included deferred costs net of deferred fees of \$225 thousand at June 30, 2012 and \$188 thousand at December 31, 2011. Residential real estate loans declined the most (\$15.5 million) followed by construction (\$8.8 million) and commercial loans (\$6.5 million). Commercial real estate loans remained relatively unchanged since the end of 2011 while consumer loans decreased \$489 thousand. Fewer high-quality loan opportunities and our level of loan charge-offs continue to deter loan growth. See Note 4, "Loans and Allowance for Credit Losses", in the Notes to Consolidated Financial Statements and below under the caption "Allowance for Credit Losses" for additional information.

Our loan portfolio has a commercial real estate loan concentration, which is defined as a combination of construction and commercial real estate loans. Construction loans were \$111.1 million, or 13.7% of total loans, at June 30, 2012, compared to \$119.9 million, or 14.3% of total loans, at December 31, 2011. Commercial real estate loans were approximately \$315.6 million, or 39.0% of total loans, at June 30, 2012, compared to \$315.4 million, or 37.5% of total loans, at December 31, 2011. We do not engage in foreign or subprime lending activities.

Because most of our loans are secured by real estate, the lack of a meaningful upturn in real estate related activities in our local real estate market and construction industry and slow improvement in general economic conditions have had a material adverse effect on the performance of our loan portfolio and the value of the collateral securing that portfolio. Factors impeding our loan performance and overall financial performance include our levels of loan charge-offs and provisions for credit losses.

Allowance for Credit Losses

We have established an allowance for credit losses, which is increased by provisions charged against earnings and recoveries of previously charged-off debts and is decreased by current period charge-offs of uncollectible debts. Management evaluates the adequacy of the allowance for credit losses on a quarterly basis and adjusts the provision for credit losses based on this analysis. The evaluation of the adequacy of the allowance for credit losses is based primarily on a risk rating system of individual loans, as well as on a collective evaluation of smaller balance homogenous loans, each grouped by loan type. Each loan type is assigned allowance factors based on criteria such as past credit loss experience, local economic and industry trends, and other measures which may impact collectibility. Please refer to the discussion above under the caption "Critical Accounting Policies" for an overview of the underlying methodology management employs to maintain the allowance.

The provision for credit losses was \$3.5 million for the second quarter of 2012, \$5.4 million for the second quarter of 2011 and \$8.4 million for the first quarter of 2012, respectively. The lower level of provision for credit losses was primarily in response to lower loan charge-offs. The provision for credit losses for the first six months of 2012 and 2011 was \$11.9 million and \$11.8 million, respectively. Because most of our loans are secured by real estate, historically low property values and real estate sales are negatively impacting credit quality. Nevertheless, we continue to emphasize credit quality and believe that our underwriting guidelines are strong. When problem loans are identified, management takes prompt action to quantify and minimize losses in its focused efforts to dispose of existing problem loans. Management also works with borrowers in an effort to reach mutually acceptable resolutions.

Net charge-offs for the second quarter of 2012 and for the second quarter of 2011 were \$4.1 million and \$6.5 million, respectively. Net charge-offs for the first quarter of 2012 were \$9.1 million, mainly from one real estate loan relationship. Most of the loan charge-offs in the second quarter of 2012 and the second quarter of 2011 were residential real estate and commercial loans. During the second quarter of 2011, we also recorded large commercial real estate loan charge-offs. The allowance for credit losses as a percentage of average loans was 1.59% for the second quarter of 2012, compared to 1.85% for the second quarter of 2011. Net charge-offs were \$13.1 million and \$9.7 million for the first six months of 2012 and 2011, respectively. The allowance for credit losses as a percentage of average loans was 1.58% for the first six months of 2012, compared to 1.85% for the same period in 2011. Management believes that the provision for credit losses and the resulting allowance were adequate to provide for probable losses inherent in our loan portfolio at June 30, 2012.

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

| (Dollars in thousands) | For the Three Months Ended June 30, | | For the Six Months Ended June 30, | |
|------------------------------------------------------------------------------------------------|-------------------------------------------|-----------|-----------------------------------------|-----------|
| | 2012 | 2011 | 2012 | 2011 |
| Allowance balance – beginning of period | \$13,544 | \$17,471 | \$14,288 | \$14,227 |
| Charge-offs: | | | | |
| Construction | (714) | (728) | (1,786) | (1,414) |
| Residential real estate | (1,554) | (2,390) | (5,673) | (4,481) |
| Commercial real estate | (745) | (2,265) | (1,435) | (2,493) |
| Commercial | (1,085) | (1,525) | (4,440) | (1,771) |
| Consumer | (162) | (40) | (177) | (115) |
| Totals | (4,260) | (6,948) | (13,511) | (10,274) |
| Recoveries: | | | | |
| Construction | - | - | - | 49 |
| Residential real estate | 43 | 34 | 94 | 68 |
| Commercial real estate | - | 5 | 7 | 5 |
| Commercial | 133 | 380 | 208 | 457 |
| Consumer | 5 | 21 | 9 | 41 |
| Totals | 181 | 440 | 318 | 620 |
| Net charge-offs | (4,079) | (6,508) | (13,193) | (9,654) |
| Provision for credit losses | 3,525 | 5,395 | 11,895 | 11,785 |
| Allowance balance – end of period | \$12,990 | \$16,358 | \$12,990 | \$16,358 |
| Average loans outstanding during the period | \$816,553 | \$881,976 | \$824,569 | \$884,738 |
| Net charge-offs (annualized) as a percentage of average loans outstanding during the period | 2.01 % | 2.96 % | 3.22 % | 2.20 % |
| Allowance for credit losses at period end as a percentage of average loans | 1.59 % | 1.85 % | 1.58 % | 1.85 % |

Nonperforming Assets

Nonperforming assets were \$100.2 million at June 30, 2012, compared to \$88.7 million at December 31, 2011. The change in nonperforming assets included a \$9.4 million increase in nonperforming loans and a \$2.1 million increase in other real estate owned. The increase in nonperforming loans included a \$12.0 million increase in accruing troubled debt restructurings net of a \$3.4 million decline in nonaccrual loans. The change in the components of nonperforming assets reflected our continued effort to either develop concessionary workouts relating to problem loans or remove problem loans from our portfolio. See Note 8, "Fair Value Measurements", in the Notes to Consolidated Financial Statements for additional details on the changes in the balances of nonperforming assets. The ratio of total nonperforming assets to total loans and other real estate owned was 12.20% at June 30, 2012, compared to 10.43% at December 31, 2011. Gross interest income of \$1.5 million for the first six months of 2012, \$2.6 million for fiscal year 2011 and \$1.4 million for the first six months of 2011 would have been recorded if nonaccrual loans had been current and performing in accordance with their original terms. No interest was recorded on such loans for the first six months of 2012 or 2011.

The following table summarizes our nonperforming assets:

| (Dollars in thousands) | June 30, 2012 | December 31, 2011 |
|---------------------------------------------------------|------------------|-------------------------|
| Nonperforming assets | | |
| Nonaccrual loans | | |
| Construction | \$ 14,258 | \$ 15,555 |
| Residential real estate | 20,400 | 20,106 |
| Commercial real estate | 11,636 | 14,012 |
| Commercial | 1,609 | 1,669 |
| Consumer | 55 | 28 |
| Total nonaccrual loans | 47,958 | 51,370 |
| Loans 90 days or more past due and still accruing | | |
| Construction | - | 325 |
| Residential real estate | 1,232 | 2,331 |
| Commercial real estate | 2,041 | - |
| Commercial | 62 | 66 |
| Consumer | 184 | 1 |
| Total loans 90 days or more past due and still accruing | 3,519 | 2,723 |
| Accruing troubled debt restructurings | | |
| Construction | 17,078 | 11,781 |
| Residential real estate | 5,008 | 3,792 |
| Commercial real estate | 15,077 | 9,566 |
| Commercial | 68 | 69 |
| Consumer | - | - |
| Total accruing troubled debt restructurings | 37,231 | 25,208 |

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| | | |
|----------------------------|-----------|-----------|
| Total nonperforming loans | 88,708 | 79,301 |
| Other real estate owned | 11,499 | 9,385 |
| Total nonperforming assets | \$100,207 | \$ 88,686 |

| | | |
|-----------------------------------------------------------------|---------|---------|
| Nonaccrual loans to total loans | 5.92 % | 6.11 % |
| Nonaccrual loans to total assets | 4.08 % | 4.44 % |
| Nonperforming assets to total loans and other real estate owned | 12.20 % | 10.43 % |
| Nonperforming assets to total assets | 8.53 % | 7.66 % |

Investment Securities

The investment portfolio is comprised of securities that are either available for sale or held to maturity. Investment securities available for sale are stated at estimated fair value based on quoted market prices. They represent securities which may be sold as part of the asset/liability management strategy or which may be sold in response to changing interest rates. Net unrealized holding gains and losses on these securities are reported net of related income taxes as accumulated other comprehensive income, a separate component of stockholders' equity. Investment securities in the held to maturity category are stated at cost adjusted for amortization of premiums and accretion of discounts. We have the intent and current ability to hold such securities until maturity. At June 30, 2012, 96% of the portfolio was classified as available for sale and 4% as held to maturity, similar to the 95% and 5%, respectively, at December 31, 2011. With the exception of municipal securities, our general practice is to classify all newly-purchased securities as available for sale. See Note 3, "Investment Securities", in the Notes to Consolidated Financial Statements for additional details on the composition of our investment portfolio.

Investment securities totaled \$138.4 million at June 30, 2012, a \$2.2 million, or 1.6%, increase since December 31, 2011. At the end of June 2012, 25.4% of the securities in the portfolio were U.S. Government agencies and 70.4% were mortgage-backed securities, compared to 30.9% and 63.9% , respectively, at year-end 2011, reflecting a shift in the composition of the portfolio to higher-yielding mortgage-backed securities. Our investments in mortgage-backed securities are issued or guaranteed by U.S. Government agencies or government-sponsored agencies.

For the second quarter of 2012, the average balance of investment securities increased to \$134.3 million, compared to \$111.2 million for the same period in 2011. For the first six months of 2012, the average balance of investment securities increased to \$134.2 million, compared to \$108.7 million for the same period in 2011. The increase in the 2012 investment securities average balances when compared to the 2011 balances reflected the investment of excess cash from deposits. Investment securities comprised 12.4% of total average earning assets for the second quarter of 2012, higher than the 10.5% for the second quarter of 2011. Similarly, for the first six months of 2012 and 2011, investment securities were 12.3% and 10.3% of total earning assets, respectively. The tax equivalent yields on investment securities were 2.26% and 3.04% for the second quarter of 2012 and 2011, respectively, while the yields were 2.35% and 2.89% for the first six months of 2012 and 2011, respectively. Reinvestment rates on investment securities purchased during 2012 were lower than the yields on the investment securities that matured during the period.

Deposits

Total deposits at June 30, 2012 were \$1.033 billion, a \$22.8 million, or 2.3%, increase when compared to the \$1.010 billion at December 31, 2011. All deposit categories increased from the end of 2011 except for interest-bearing demand deposits which decreased \$14.8 million, or 9.2%, as deposits shifted to money market and savings which increased \$11.8 million, or 4.4%. Total time deposits increased \$10.1 million, or 2.3%, primarily due to liquidity in the market and the recent closure of a local competitor bank. Noninterest-bearing deposits increased \$15.7 million, or 11.7%, which reflected continuing growth from our customer base.

Short-Term Borrowings

Short-term borrowings at June 30, 2012 and December 31, 2011 were \$13.8 million and \$17.8 million, respectively. Short-term borrowings generally consist of securities sold under agreements to repurchase which are issued in conjunction with cash management services for commercial depositors, overnight borrowings from correspondent banks and short-term advances from the Federal Home Loan Bank (the "FHLB"). Short-term advances are defined as those with original maturities of one year or less. At June 30, 2012 and December 31, 2011, short-term borrowings included only repurchase agreements.

Long-Term Debt

At June 30, 2012 and December 31, 2011, the Company had \$455 thousand in long-term debt. This debt was acquisition-related, incurred as part of the purchase price of TSGIA, Inc. and is payable to the seller thereof, who remains the President of that subsidiary. The interest rate on the debt is 4.08% and principal and interest are payable in annual installments for five years, with the final payment due on October 1, 2012.

Liquidity and Capital Resources

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

To the extent that deposits are not adequate to fund customer loan demand, liquidity needs can be met in the short-term funds markets through arrangements with correspondent banks. The Banks had \$15.5 million in unsecured federal funds lines of credit and a reverse repurchase agreement available on a short-term basis from correspondent banks at June 30, 2012 and December 31, 2011. The Banks are also members of the FHLB, which provides another source of liquidity. Through the FHLB, the Banks had credit availability of approximately \$49.7 million and \$31.6 million at June 30, 2012 and December 31, 2011, respectively. The Banks have pledged, under a blanket lien, all qualifying residential loans under borrowing agreements with the FHLB. Management is not aware of any demands, commitments, events or uncertainties that are likely to materially affect our future ability to maintain liquidity at satisfactory levels.

Total stockholders' equity was \$119.5 million at June 30, 2012, compared to \$121.2 million at December 31, 2011. The net loss and dividends paid contributed to the decrease in stockholders' equity since the end of 2011. The decrease was partially offset by unrealized gains on available-for-sale securities (\$546 thousand) and cash flow hedging activities (\$465 thousand) relating to the interest rate caps. To sustain capital and enhance capital ratios, the board of directors of Shore Bancshares, Inc. decreased the quarterly cash dividend on the common stock from \$.06 per share to \$.01 per share beginning with the dividend that was paid on May 31, 2011. On May 3, 2012, the board of directors voted to suspend quarterly cash dividends until further notice. If the dividend suspension is continued, the Company will retain approximately \$254 thousand in common equity for 2012. We remain well-capitalized which enables us to fund the costs to resolve our problem loans.

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

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

The table below presents a comparison of the Company's capital ratios to the minimum regulatory requirements as of June 30, 2012 and December 31, 2011.

| | June 30, 2012 | December 31, 2011 | Minimum Regulatory Requirements |
|---------------------------------|------------------|----------------------|---------------------------------------|
| Tier 1 risk-based capital ratio | 12.61% | 12.55% | 4.00% |
| Total risk-based capital ratio | 13.87% | 13.80% | 8.00% |

| | | | |
|----------------|-------|-------|-------|
| Leverage ratio | 9.04% | 9.29% | 4.00% |
|----------------|-------|-------|-------|

Item 3. Quantitative and Qualitative Disclosures about Market Risk.

Our primary market risk is to interest rate fluctuation and management has procedures in place to evaluate and mitigate this risk. This risk and these procedures are discussed in Item 7 of Part II of the Annual Report of Shore Bancshares, Inc. on Form 10-K for the year ended December 31, 2011 under the caption “Market Risk Management”. Management believes that there have been no material changes in our market risks, the procedures used to evaluate and mitigate these risks, or our actual and simulated sensitivity positions since December 31, 2011.

Item 4. Controls and Procedures.

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

An evaluation of the effectiveness of these disclosure controls as of June 30, 2012 was carried out under the supervision and with the participation of management, including the CEO and the PAO. Based on that evaluation, the Company's management, including the CEO and the PAO, has concluded that our disclosure controls and procedures are, in fact, effective at the reasonable assurance level.

There was no change in our internal control over financial reporting during the second quarter of 2012 that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

PART II – OTHER INFORMATION

Item 1A. Risk Factors.

The risks and uncertainties to which our financial condition and operations are subject are discussed in detail in Item 1A of Part I of the Annual Report of Shore Bancshares, Inc. on Form 10-K for the year ended December 31, 2011. Management does not believe that any material changes in our risk factors have occurred since they were last disclosed.

Item 6. Exhibits.

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

SIGNATURES

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

SHORE BANCSHARES, INC.

Date: August 9, 2012 By: /s/ W. Moorhead Vermilye
W. Moorhead Vermilye

Chief Executive Officer

(Principal Executive Officer)

Date: August 9, 2012 By: /s/ Susan E. Leaverton
Susan E. Leaverton, CPA

Treasurer/Principal Accounting Officer

EXHIBIT INDEX

| Exhibit Number | Description |
|----------------|---------------------------------------------------------------------------------------------------------------------------|
| 31.1 | Certifications of the Principal Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act (filed herewith). |
| 31.2 | Certifications of the Principal Accounting Officer pursuant to Section 302 of the Sarbanes-Oxley Act (filed herewith). |
| 32 | Certification pursuant to Section 906 of the Sarbanes-Oxley Act (furnished herewith). |
| 101.INS | XBRL Instance File (furnished herewith). |
| 101.SCH | XBRL Label File (furnished herewith). |
| 101.CAL | XBRL Calculation File (furnished herewith). |
| 101.DEF | XBRL Definition File (furnished herewith). |
| 101.LAB | XBRL Label File (furnished herewith). |
| 101.PRE | XBRL Presentation File (furnished herewith). |