MERCANTILE BANKSHARES CORP
Form 10-K
March 01, 2007

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-K

(Mark One)

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

For the fiscal year ended December 31, 2006

or

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

For the transition period from to

Commission file number: 0-5127

MERCANTILE BANKSHARES CORPORATION

(Exact name of registrant as specified in its charter)

Maryland	**52-0898572**
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)

Two Hopkins Plaza

Baltimore, Maryland 21201

(Address of principal executive offices) (Zip Code)

(410) 237-5900

(Registrant s telephone number, including area code)

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

Title of each class	Name of each exchange on which registered
Common Stock ($2 par value per share)	The Nasdaq Stock Market, Inc.

Stock Purchase Rights

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

None

(Title of class)

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

Yes x No o

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

Yes o No x

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

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

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

Large accelerated filer x Accelerated filer o Non-accelerated filer o

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes o No x

At June 30, 2006, the last business day of registrant s most recently completed second fiscal quarter, the aggregate market value of shares of common stock held by non-affiliates of registrant (1) (including fiduciary accounts administered by affiliates) was approximately $4.3 billion based on the last sale price on the Nasdaq National Market on June 30, 2006.

As of February 16, 2007, there were 125,730,716 shares of common stock outstanding.

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(1) Excludes 2,119,115 shares of common stock held by directors, executive officers, and shares held in fiduciary accounts by the Registrant and subsidiaries of the registrant with discretionary power to vote or dispose of such shares as of June 30, 2006. Exclusion of shares held by any person should not be construed to indicate that such person possesses the power, direct or indirect, to direct or cause the direction of the management or policies of the registrant, or that such person is controlled by or under common control with the registrant.

2006 ANNUAL REPORT ON FORM 10-K

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PART I

ITEM 1. BUSINESS.

General

Mercantile Bankshares Corporation, with $17.7 billion in assets at year-end December 31, 2006, is a regional multibank holding company with headquarters in Baltimore, Maryland. It is comprised of 11 banks (the Banks) and a mortgage banking company. Eight banks are headquartered in Maryland, two are in Virginia and one is in Delaware. At December 31, 2006, Bankshares largest bank, Mercantile-Safe Deposit and Trust Company (MSD&T), represented approximately 46% of total assets and operated 36 offices in Maryland, 21 in Virginia, 2 in Washington, D.C. and one in Pennsylvania. MSD&T provides nearly all of Bankshares substantial wealth management operations and specialized corporate banking services. Mercantile Bankshares Corporation was incorporated under the laws of Maryland on May 27, 1969. Mercantile Bankshares Corporation along with its consolidated subsidiaries is referred to in this report as Bankshares, we or Registrant.

On October 8, 2006, Bankshares entered into an Agreement and Plan of Merger with The PNC Financial Services Group, Inc. (PNC) pursuant to which Bankshares will merge with and into PNC, with PNC as the surviving corporation in the merger. When the merger is completed, Bankshares stockholders will receive a combination of PNC common stock and cash in exchange for their Bankshares common stock. Each share of Bankshares common stock will be converted into the right to receive 0.4184 of a share of PNC common stock (including the related preferred stock purchase rights under PNC s May 2000 Rights Agreement) and $16.45 in cash, without interest. Under the formula set forth in the merger agreement, an aggregate of up to approximately 54.2 million shares of PNC common stock (and an equal number of related rights) may be issued and $2.13 billion paid in the merger. This merger was approved by Bankshares stockholders on February 27, 2007 and received substantially all of the required regulatory approvals. The merger is currently expected to close in March of 2007. Pending the merger, Bankshares must comply with the covenants contained in the merger agreement, but is generally continuing to operate in the ordinary course of business.

Bankshares emphasizes long-term customer relationships founded on value-added service and focuses on those traditional services it performs well. This emphasis on relationship banking makes moderate-sized and family-owned businesses a particularly important market for Bankshares affiliate banks. Relationship-oriented banking is carried out through all our community banks, each of which has its own name, management, board of directors and historical ties to the families, businesses and institutions that make up its community. At the same time, community banks, through their association with Bankshares, are able to offer the more sophisticated services and financial strength of a major banking organization, as well as the conveniences of online banking and a large network of banking offices and ATMs.

As a matter of policy, Bankshares affiliates lend almost exclusively within their market areas. Primary corporate objectives are to maintain capital strength, to achieve superior profitability and strong asset quality and to avoid undue risk. We believe that growth is a by-product of meeting these objectives.

On July 17, 2006, Bankshares completed its acquisition of James Monroe Bancorp, Inc. (James Monroe), a bank headquartered in Arlington, Virginia. Subsequent to its acquisition, James Monroe was merged into MSD&T. James Monroe operated six full-service branches and one loan production office in Northern Virginia and suburban Washington, D.C. at the time of the acquisition. The total consideration paid to James Monroe shareholders in connection with the acquisition was $71.4 million in cash and 1.8 million shares of Bankshares common stock. The results of James Monroe s operations have been included in Bankshares results subsequent to July 17, 2006. The assets and liabilities of James Monroe were recorded on the consolidated balance sheet at their respective fair values. The transaction resulted in an increase in total assets of $552 million, including $414 million in gross loans, and liabilities assumed of $507 million, including $434 million of total deposits.

Affiliate Bank Network

Bankshares directly owns all of the outstanding stock of the Banks and directly or indirectly owns all of the outstanding stock of certain other affiliates. The principal components of our banking and nonbanking network are listed below.

Lead Bank and Affiliates

Mercantile-Safe Deposit and Trust Company

Mercantile Mortgage Corporation (MMC)

Mercantile Mortgage, LLC (49.9% owned by MMC)

West River LLC

HarborPoint Capital, GP LLC

HarborPoint Capital LP (74% owned by MMC)

Mercantile Brokerage Services Holdings, LLC

Mercantile Brokerage Services, Inc.

Mercantile Capital Advisors, Inc.

Mercantile/Cleveland, LLC

Boyd Watterson Asset Management, LLC

MBC Agency, Inc.

Mercantile Life Insurance Company

Mercantile Real Estate Advisors, Inc.

Community Banks

The Annapolis Banking and Trust Company	Annapolis, Maryland
The Citizens National Bank	Laurel, Maryland
Farmers & Mechanics Bank	Frederick, Maryland
Keller Stonebraker Insurance, Inc.	Hagerstown, Maryland
Potomac Basin Group Associates, Inc.	Beltsville, Maryland
Marshall National Bank and Trust Company	Marshall, Virginia
Mercantile County Bank	Elkton, Maryland
Mercantile Eastern Shore Bank	Chestertown, Maryland
Mercantile Peninsula Bank	Selbyville, Delaware
Mercantile Southern Maryland Bank	Leonardtown, Maryland
The National Bank of Fredericksburg	Fredericksburg, Virginia
Westminster Union Bank	Westminster, Maryland

For purposes of segment reporting, two operating components have been identified: Banking Services and Investment & Wealth Management. For segment reporting information, see Note No. 16 - Segment Reporting in the Notes to the Consolidated Financial Statements in Item 8 of this Annual Report. Also, see information under the heading Segment Reporting in the sections captioned Analysis of Operating Results for 2006 to 2005 and Review of Earnings and Balance Sheet for 2005 to 2004, in Item 7 of this Annual Report.

Banking Services

Retail Banking

The Banks offer numerous services to meet the checking, savings, invest–ment and credit needs of individuals in their communities. Retail banking services include checking, savings and money market accounts, Individual Retirement Accounts and time deposits. The Banks offer home equity loans and lines of credit, installment loans and lines of credit, and equipment and transportation (auto, marine, recreational vehicles, aircraft) loans to meet a variety of borrowing needs.

Through the affiliate bank network, customers have no-fee access to their accounts at 255 Mercantile BANKING TWENTY-FOURSM ATMs, and they can perform many routine transactions at any of the 240 affiliate-banking offices. For added convenience, substantially all of Bankshares affiliates provide customers with toll-free telephone access to a centralized Customer Service Center and a voice-response account information system. BANKING TWENTY-FOUR ONLINE® enables customers to access their personal accounts online to pay bills, verify account balances, track recent account activity and perform selected transactions. BANKING TWENTY-FOUR ONLINE offers sole proprietors similar capabilities specifically tailored to meet small business needs.

Small Business Banking

The Banks offer numerous services to meet the deposit, credit and service needs of businesses with annual revenues up to $3.0 million or credit needs up to $750 thousand. Each Bank works closely with customers to provide cash management services and extend credit for such purposes as receivables and inventory financing, equipment leases and real estate financing. Where appropriate, the Banks employ government guarantee programs, such as those available from the Small Business Administration.

Commercial Banking

Commercial banking services include commercial deposit, lending and commercial real estate solutions provided to businesses with annual revenues between $4 million and $50 million.

Cash management services help business customers collect, transfer and invest their cash. Through a variety of electronic payment and account management tools, customers are able to monitor and manage cash flows conveniently and efficiently.

With their local knowledge and focus, our Banks are well suited to meet the traditional credit needs of businesses in their market areas. Each Bank works closely with customers to extend credit for general business pur–poses, such as working capital, plant expansion or equipment purchases, and for financing industrial and commercial real estate. When local commercial customers do not qualify for traditional financing, we can help them convert the value of their accounts receivable, inventory and equipment into cash for operations. Additionally, we can arrange more sophisticated financing in the areas of acquisitions and management buyouts. We provide land acquisition and development, construction and interim financing to commercial real estate investors and developers.

In addition to extending credit to businesses in its own market area, MSD&T works in collaboration with other bank affiliates when their customers credit needs exceed the affiliate bank s lending limit or when there is a more specialized commercial banking need. To supplement traditional credit products, the Banks offer capital market products such as municipal bond underwriting, interest rate risk management and financial advisory services through the MSD&T Capital Markets Group.

These services include underwriting and remarketing tax-exempt and taxable municipal variable-rate demand bonds for nonprofit organizations such as senior living and health care providers, private schools, health and social welfare organizations and cultural institutions. By working directly with borrowers, we can evaluate and recommend financing and interest rate risk- management strategies, which include interest rate swaps, caps and collars.

Mortgage Banking

Residential mortgages are provided through Mercantile Mortgage, LLC, a joint venture between Mercantile Mortgage Corporation (Mercantile Mortgage), a sub–sidiary of MSD&T, and Wells Fargo Ventures, LLC. Through Mercantile Mortgage a wide variety of competitively priced fixed and variable-rate products are available, including jumbo loans. Residential mortgage loans also are available through the Banks. Mercantile Mortgage also makes loans for land acquisition, development and construction of single-family and multifamily housing.

Risks associated with residential mortgage lending include interest rate risk, which is mitigated through the sale of the majority of all conforming fixed-rate loans, and default risk by the borrower, which is mitigated through underwriting procedures and credit quality standards, among other things.

Permanent financing for multifamily projects nationwide is provided through HarborPoint Capital, LP, a joint venture, the majority of which is owned by Mercantile Mortgage. HarborPoint Capital, LP, headquartered in Dallas, Texas, is one of the nation s few Fannie Mae DUS (Delegated Underwriting and Servicing) lenders.

Insurance Products

Keller Stonebraker Insurance, Inc., an independent, wholly owned subsidiary of Farmers & Mechanics Bank, arranges a full line of consumer insurance products through offices in Hagerstown and Cumberland, Maryland, and Keyser, West Virginia. Consumer insurance products include annuities, homeowners, automobile, life and personal umbrellas.

Potomac Basin Group Associates, Inc. operates as an independent, wholly owned subsidiary of Farmers & Mechanics Bank. It is an independent insurance agency specializing in corporate employee benefit plans through its offices in Beltsville and Ellicott City, Maryland. Potomac Basin provides commercial products that include property and casualty packages, workers compensation, professional liability and umbrella coverage, bonds and 401(k) and other benefit plans.

MBC Agency, Inc. provides as agent, under group policies, credit life insurance in connection with extensions of credit by the Banks. Mercantile Life Insurance Company reinsures the insurance provided by MBC Agency, Inc.

Investment and Wealth Management Services

Bankshares offers investment and wealth management services through the Investment & Wealth Management division (IWM) of MSD&T. IWM continues to build on a more than 140-year tradition of providing investment and wealth management services to private individuals, families and institutions.

Today, Bankshares provides a range of wealth management services. IWM has risk management and asset allocation analyses to complement the investment advice we offer. An open architecture platform enables Bankshares to offer an array of proprietary investment products and carefully selected outside managers in a range of asset classes, including equity, fixed-income and alternative investment products. Bankshares investment platform provides a range of investment vehicles, from separate account management to mutual funds. Investment and wealth management services are available through professional advisors at MSD&T, through the affiliate bank network and through Baltimore-based Mercantile Brokerage Services, Inc. (MBSI). Asset allocation and risk management capabilities, coupled with a range of proprietary and nonproprietary investment alternatives and investment vehicles, enable Bankshares to provide high quality, advice-driven, risk-managed solutions to meet clients investment objectives. At December 31, 2006, Bankshares had $21.1 billion of discretionary assets under management and $43.3 billion in assets under administration.

Retail Brokerage Services

Mercantile Brokerage Services, Inc., a general securities broker-dealer, offers full-service, discount and online brokerage capabilities and account services. Our customers can choose from investments in stocks, bonds, proprietary and nonproprietary mutual funds, and fixed or variable annuities.

Private Wealth Management Services

When managing a client s assets as part of an investment management or trustee relationship, Bankshares focuses on consistent investment performance and an asset allocation that is individually designed to meet each client s risk/return parameters and investment objectives. Professional advisors, working in partnership with our clients, provide access to proprietary and third-party separate account management, the family of Mercantile Funds, nonproprietary mutual funds and a variety of alternative investments. In addition, IWM provides a range of sophisticated fiduciary and client administrative services, including trust administration, protection and continuity of trust structures, estate settlement, estate advice and planning, tax advice and planning and charitable giving programs. IWM also acts in a custodial capacity for its clients, providing safekeeping of assets, transaction execution, income collection, preparation of tax returns and recordkeeping.

IWM also specializes in services designed to meet the unique needs of families with substantial wealth. We provide a full range of services required to manage seamlessly our client s complex, multigenerational financial circumstances. We also provide guidance in more sophisticated investment strategies, incorporating nontraditional asset classes such as private equity, real estate and hedge funds.

Private Banking Services

The Private Banking Group provides one point of contact for its clients deposit, investment and credit needs, ensuring that these services are delivered within an overall asset management plan. Private bankers can coordinate cash flows; arrange investment of short- and long-term funds; and structure credit arrangements to meet short- to long-term needs.

Institutional Investment Management

Bankshares, through IWM and Boyd Watterson Asset Management, LLC, works to provide businesses and charitable organizations with investment management and administrative services for their employee retirement plans, profit sharing plans and endowments. Clients include state and local government entities, unions, charitable organizations and military institutions. IWM also can help nonprofit organizations, such as charitable and philanthropic groups, with annual giving and capital campaigns, pooled income funds, gift annuities and charitable remainder trusts. Bankshares offers corporations 401(k) programs tailored to their specific needs.

Mercantile Funds

We offer a full spectrum of mutual funds - from equity funds designed to grow clients money over time, to taxable and tax-exempt bond funds designed to offer regular income payments, to money market funds designed to help clients build a cash reserve. The Mercantile Funds help clients create well-rounded portfolios around their goals - with the level of risk and potential for return that makes the most sense for them.

Managed by Mercantile Capital Advisors, Inc., an affiliate of MSD&T, Mercantile Funds utilize an investment foundation based on risk management, in-depth fundamental research and a product line designed to meet clients needs.

Real Estate

IWM founded Mercantile Real Estate Advisors, Inc. in 2006 to expand its longstanding commercial real estate investment and management services to Taft-Hartley pension funds. On behalf of its clients, Mercantile directly invests in properties across the country.

Private Equity

Bankshares, in partnership with MSD&T, began a focused private equity investment initiative in 2000 with two objectives: (1) provide an alternative method of funding to develop additional long-term client relationships with emerging companies in Bankshares market area and (2) provide an alternative use of capital to generate long-term returns. The primary investments are private equity limited partnerships located, or seeking investment opportunities, within Bankshares geographic trade area and, to a lesser extent, direct investments in privately held companies within the region. The private equity funds include small- and middle-market buyout funds, mezzanine funds and late-stage venture funds in which the target investments of the funds are or have the potential to become Bankshares customers. For more information on private equity investments, see Notes No. 1, 6 and 10 in Notes to Consolidated Financial Statements.

Statistical Information

The statistical information required in this Item 1 is set forth in Items 6, 7 and 8 of this Annual Report on Form 10-K, as follows.

	Disclosure Required by Guide 3	Reference to Caption in Item 6 or 7, or Note in Item 8
(I)	Distribution of Assets, Liabilities and Stockholders Equity; Interest Rates and Interest Differentials	Analysis of Interest Rates and Interest Differentials (Item 7) Rate/Volume Analysis (Item 7) Nonperforming Assets (Item 7)
(II)	Investment Portfolio	Bond Investment Portfolio (Item 7) Notes to Consolidated Financial Statements, Note No. 3 - Investment Securities
(III)	Loan Portfolio	Year-End Loan Data (Item 6) Loan Maturity Schedule (Item 7) Interest Rate Risk (Item 7) Nonperforming Assets (Item 7)
(IV)	Summary of Loan Loss Experience	Allowance for Loan Losses (Item 7) Credit Risk Analysis (Item 7) Allocation of Allowance for Loan Losses (Item 7)
(V)	Deposits	Analysis of Interest Rates and Interest Differentials (Item 7) Notes to Consolidated Financial Statements, Note No. 7 - Deposits
(VI)	Return on Equity and Assets	Return on Equity and Assets (Item 6)
(VII)	Short-Term Borrowings	Notes to Consolidated Financial Statements, Note No. 8 - Short-Term Borrowings

Employees

At February 16, 2007, Bankshares and its affiliates had approximately 3,519 employees.

Competition

The banking business is highly competitive. Within their service areas, the Banks compete with commercial banks (including local banks and branches or affiliates of other larger banks), savings and loan associations and credit unions for loans and deposits, and with insurance companies and other financial institutions for various types of loans. There is also competition for commercial and retail banking business from banks and financial institutions located outside our service areas. Interstate banking is an established part of the competitive environment. Bankshares is a financial holding company and is the largest independent bank holding company headquartered in Maryland. Measured in terms of assets under management and administration, MSD&T believes it is one of the larger trust institutions in the mid-Atlantic region of the United States. MSD&T and its subsidiaries (i.e., Boyd Watterson & Mercantile Capital Advisors, Inc.) compete for various classes of fiduciary and investment advisory business with other banks and trust companies, insurance companies, investment counseling firms, mutual funds and others. Mercantile Mortgage is one of many competitors in its area of activity. MBC Agency, Inc. is limited to providing life, health and accident insurance in connection with credit extended by the Banks.

The Banks ranged in asset size from approximately $200 million to $8 billion, at December 31, 2006. They face competition in their own local service areas as well as from the larger competitors mentioned above.

Supervision and Regulation

Bankshares and the Banks

Bankshares, as a registered bank holding company, is subject to regulation and examination by the Board of Governors of the Federal Reserve System (the Federal Reserve Board) under the Bank Holding Company Act of 1956, as amended (the BHC Act) and is required to file with the Federal Reserve Board quarterly and annual reports and such additional information as the Federal Reserve Board may require pursuant to the BHC Act. Among other provisions, the BHC Act and regulations promulgated thereunder require prior approval of the Federal Reserve Board of the acquisition by Bankshares of more than five percent of any class of the voting shares of any bank holding company, bank or savings association.

Capital Adequacy. The Banks include seven banks chartered by the state of Maryland (two of which are members of the Federal Reserve System), a Delaware-chartered bank, and three national banks (additional information about the chartering of the Banks is contained in *The Banks,* below). The Federal Reserve Board, regulator of bank holding companies and state-chartered banks that are members of the Federal Reserve System; the Office of the Comptroller of the Currency (the OCC), the federal regulator of national banks; and the Federal Deposit Insurance Corporation (the FDIC), federal regulator of state-chartered banks that are not members of the Federal Reserve System and insurer of the deposits of all U.S. commercial banks, have issued substantially similar risk-based and leverage capital guidelines applicable to United States banking organizations. In addition, these regulatory agencies may from time to time require that a banking organization maintain capital above the minimum levels, whether because of its financial condition or actual or anticipated growth.

The Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA), among other things, identifies five capital categories for insured depository institutions (well capitalized, adequately capitalized, undercapitalized, significantly undercapitalized and critically undercapitalized) and requires the respective federal regulatory agencies to implement systems for prompt corrective action for insured depository institutions that do not meet minimum capital requirements within such categories. FDICIA imposes progressively more restrictive constraints on operations, management and capital distributions, depending on the category in which an institution is classified. Failure to meet the capital guidelines could also subject a banking institution to requirements to raise capital.

The various regulatory agencies have adopted substantially similar regulations that define the five capital categories identified by FDICIA, using the total risk-based capital, Tier 1 risk-based capital and leverage capital ratios as the relevant capital measures. Such regulations establish various degrees of corrective action to be taken when an institution is considered undercapitalized. Under the regulations, a well capitalized institution must have a Tier 1 risk-based capital ratio of at least six percent, a total risk-based capital ratio of at least ten percent and a leverage ratio of at least five percent and not be subject to a capital directive order. As of December 31, 2006, the most recent notification from the primary regulators for each of Bankshares subsidiary banks categorized them as well capitalized under the prompt corrective action regulations.

Changes to the risk-based capital regime for banking organizations are proposed or implemented from time to time. The minimum risk-based capital requirements that are currently in effect for U.S. banking organizations follow the Capital Accord issued in 1988 by the Basel Committee on Banking Supervision, which is comprised of bank supervisors and central banks from the major industrialized countries, including the United States. The Basel Committee issued a proposed replacement for the 1988 Capital Accord in 2001 (Basel II), and work has continued on the details of Basel II and the timing of its implementation since that time. In the United States, the Basel II framework will only apply to the largest financial institutions. Following the approval of the Accord, non-Basel II institutions expressed concern that the larger banking organizations would gain unfair advantage through the potentially reduced capital requirements that could be possible under the new framework. In addition, the regulators recognized that the existing capital system applicable to smaller banks could be improved to better differentiate risk within asset classes. Therefore, in December 2006, the four federal banking agencies designed a proposal known as Basel I-A to address both of these concerns. The final form of Basel I-A, the timing of its implementation and the impact it might have on Bankshares and its subsidiaries cannot be determined at this time. Additional information regarding capital requirements for bank holding companies and tables reflecting Bankshares regulatory capital position at December 31, 2006 is in Note No. 11 - Shareholders Equity of Notes to the Consolidated Financial Statements in Item 8 of this Annual Report.

The Gramm-Leach-Bliley Act. The Gramm-Leach-Bliley Act of 1999 (the GLB Act) was adopted on November 12, 1999 and amended several of the federal banking laws, including the BHC Act and the Banking Act of 1933 (generally known as Glass-Steagall), that affect Bankshares and its subsidiaries. Prior to the adoption of the GLB Act, the activities of bank holding companies and their subsidiaries were restricted to banking, the business of managing and controlling banks, and other activities that the Federal Reserve Board had determined were so closely related to banking or managing or controlling banks as to be a proper incident thereto. In particular, Glass-Steagall and the BHC Act imposed important restrictions on the ability of bank holding companies or their subsidiaries to engage in the securities or insurance business.

The GLB Act repealed the provisions of Glass-Steagall and restrictions in the BHC Act that limited affiliations among, and overlapping business activities between the banking business and, respectively, the securities and insurance industries. With the adoption of the GLB Act, a bank holding company that makes an effective election to become a financial holding company may, within a holding company system, (a) engage in banking, or managing or controlling banks; (b) perform certain servicing activities for subsidiaries; and (c) engage in any activity, or acquire and retain the shares of any company engaged in any activity that is either (i) financial in nature or incidental to such financial activity, as determined by the Federal Reserve Board in consultation with the Secretary of the Treasury or (ii) complementary to a financial activity and that does not pose a substantial risk to the safety and soundness of depository institutions or the financial system generally, as determined by the Federal Reserve Board. Activities that are financial in nature include activities specified in the GLB Act and those activities that the Federal Reserve Board had determined, by order or regulation in effect prior to enactment of the GLB Act, to be so closely related to banking or managing or controlling banks as to be a proper incident thereto. Thus, a financial holding company may engage in a full range of banking, securities and insurance activities, including securities and insurance underwriting, as well as, subject to certain restrictions, merchant banking activities. The election to become a financial holding company is only available to bank holding companies whose bank and thrift subsidiaries are well capitalized, well managed, and have satisfactory Community Reinvestment Act ratings.

With exceptions for insurance underwriting, merchant banking and real estate investment and development, the GLB Act also permits comparable expansion of national bank activities by banks meeting similar criteria, together with certain additional firewalls and other requirements, through financial subsidiaries of national banks. Similarly, as a matter of Federal law, but still subject to State law, the GLB Act expands the potential financial activities of subsidiaries of State banks. Bankshares filed an election and, on December 20, 2002, became a financial holding company.

The GLB Act also imposed a general scheme of functional regulation with respect to the activities of bank holding companies and their bank and nonbank subsidiaries to ensure that banking activities are regulated by bank regulators, securities activities are regulated by securities regulators, and insurance activities are regulated by insurance regulators, although the Federal Reserve Board retains its role as the umbrella supervisor for bank holding companies. Consequently, various securities activities of bank subsidiaries of Bankshares are now subject to regulation by the Securities and Exchange Commission and the National Association of Securities Dealers, Inc.

As a result of the functional regulation imposed by the GLB Act, the Banks have moved certain securities activities that have become subject to Securities and Exchange Commission regulation into separate securities subsidiaries or affiliates. For example, MSD&T has two subsidiaries that engage in securities activities: Mercantile Capital Advisors, Inc., a registered investment adviser that advises the Mercantile family of mutual funds and certain other institutional accounts; and Mercantile Brokerage Services, Inc., a registered broker-dealer that facilitates the purchase of shares of mutual funds by bank customers and may engage in certain other activities in the future.

The GLB Act also implements a number of requirements designed to protect the privacy of customer information. A financial institution must inform its customers at the outset of the customer relationship, and at least annually thereafter, of the institution s privacy policies and procedures with respect to the customer s nonpublic personal financial information. With certain exceptions, an institution may not provide any nonpublic personal information to unaffiliated third parties unless the customer has been informed that such information may be so provided and the customer has been given the opportunity to opt out. Furthermore, the GLB Act limits a financial institution s use of a customer s account information for marketing purposes and imposes criminal penalties for the use of fraudulent or deceptive means to obtain personal customer financial information. The GLB Act permits states to adopt more rigorous laws with respect to privacy of customer information.

The Fair Credit Reporting Act and the Fair and Accurate Transactions Act of 2003. The Fair Credit Reporting Act (FCRA), among other provisions, restricts any bank from sharing with its affiliates certain information relating to its individual customers creditworthiness and certain other matters with various exceptions. FCRA preempts state laws that purport to restrict further such information sharing among affiliated institutions. The Fair and Accurate Transactions Act of 2003 (the FACT Act), which was signed into law on December 4, 2003, amended FCRA in various respects, including to enhance the ability of consumers to combat identity theft, increase the accuracy of consumer credit reports, and allow consumers to exercise greater control over the type and amount of marketing solicitations that they receive. The new marketing restrictions, with some exceptions, would prevent banks from using certain information received from an affiliate for marketing to a consumer unless the consumer was given notice and an opportunity to opt out. The FACT Act also restricts the sharing of certain types of consumer medical information among affiliates. These new restrictions on sharing or using information shared among affiliates must be implemented by regulations, which were issued for public comment. Certain provisions are currently effective while other provisions have been issued, but have not yet been finalized. More generally, the Federal Reserve Board and the Federal Trade Commission issued joint final rules establishing December 1, 2004 as the effective date for many of the provisions of the FACT.

In December 2004, implementing section 216 of the FACT Act, the federal bank regulatory agencies announced interagency final rules to require financial institutions to adopt measures for properly disposing of consumer information derived from credit reports. Federal banking law requires financial institutions to protect customer information by implementing information security programs. The rules adopted by the banking agencies require institutions to make certain adjustments to their information security programs to include measures for the proper disposal of consumer information. The rules define consumer information to mean any record about an individual, whether in paper, electronic, or other form, that is a consumer report or is derived from a consumer report and that is maintained or otherwise possessed by or on behalf of the [institution] for a business purpose, and include a compilation of such records, but exclude any record that does not identify an individual. The rules took effect on July 1, 2005. Federal regulators have pursued enforcement action against U.S. banks and other entities for failing to properly safeguard customers information.

The USA PATRIOT ACT. Congress adopted the USA PATRIOT ACT (the Patriot Act) on October 26, 2001 in response to the terrorist attacks that occurred on September 11, 2001. Under the Patriot Act, banks are required to maintain and prepare additional records and reports that are designed to assist the government s efforts to combat terrorism. The Patriot Act includes sweeping anti-money laundering and financial transparency laws and required additional regulations, including, among other things, standards for verifying client identification when opening an account and rules to promote cooperation among financial institutions, regulators and law enforcement entities in identifying parties that may be involved in terrorism or money laundering. Specifically, the customer identification program (CIP) regulation issued under the Patriot Act requires each bank to implement a written CIP appropriate for its size and type of business that includes certain minimum requirements. The CIP must be incorporated into the bank s anti-money laundering compliance program, which is subject to approval by the bank s board of directors. The regulation applies to all federally regulated banks and savings associations, credit unions, and non-federally regulated private banks, trust companies, and credit unions. All banks were required to comply with the CIP regulation for all accounts established on or after October 1, 2003.

Interstate Banking. Pursuant to the Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994 (the Interstate Banking and Branching Act), a bank holding company may acquire banks located in states other than its home state without regard to the permissibility of such acquisitions under state law, but subject to any state requirement that the bank has been organized and operating for a minimum period of time, not to exceed five years, and the requirement that the bank holding company, after the proposed acquisition, controls no more than 10% of the total amount of deposits of insured depository institutions in the United States and no more than 30% or such lesser or greater amount set by state law of such deposits in that state.

Subject to certain restrictions, the Interstate Banking and Branching Act also authorizes banks to merge across state lines to create interstate banks. The Interstate Banking and Branching Act also permits a bank to open new branches in a state in which it does not already have banking operations if such state enacts a law permitting de novo branching.

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Other Regulatory Matters. Bankshares is a separate and distinct legal entity from its subsidiaries. It receives substantially all of its revenue from dividends from its subsidiaries and interest payments from the Banks on subordinated debt. These dividends are the principal source of funds to pay dividends on Bankshares common stock and interest on its debt. The payment of dividends by a bank is subject to federal law restrictions as well as to the laws of its state of incorporation in the case of a state-chartered bank. Also, a parent company s right to participate in a distribution of assets upon a subsidiary s liquidation or reorganization is subject to the prior claims of the subsidiary s creditors. It is Federal Reserve Board policy that a bank holding company should serve as a source of financial and managerial strength for, and commit resources to support each, of its subsidiary banks even in circumstances in which it might not do so (or may not legally be required or financially able to do so) absent such a policy.

In addition to the specific laws and regulations discussed above, there are numerous federal and state laws and regulations which regulate the activities of Bankshares and the Banks, including requirements and limitations relating to reserves, permissible investments and lines of business, transactions with officers, directors and affiliates, loan limits, consumer protection laws, privacy of financial information, predatory lending, fair lending, mergers and acquisitions, issuances of securities, dividend payments, inter-affiliate liabilities, extensions of credit and branch banking. The BHC Act and the Federal Reserve Board s regulations limit the ability of bank subsidiaries of bank holding companies to engage in certain tie-in arrangements with bank holding companies and their nonbank subsidiaries in connection with any extension of credit or provision of any property or services, subject to various exceptions.

The laws and regulations to which Bankshares is subject are constantly under review by Congress, regulatory agencies and state legislatures. The likelihood and timing of any bank-related proposals or legislation and the impact they might have on Bankshares and its subsidiaries cannot be determined at this time.

As a general matter, the recent regulatory environment for banking organizations has included significant enforcement actions by banking regulators and other federal and state agencies, involving such matters as alleged shortcomings in anti-money laundering policies and procedures, inadequate protection of confidential customer information, and violations of securities or other laws. As a result of this regulatory environment, banking organizations may experience increases in compliance requirements and associated costs.

Changes in control of Bankshares and the Banks are regulated under the BHC Act, the Change in Bank Control Act of 1978 and various state laws.

The Banks

All the Banks, with the exception of The Citizens National Bank, The National Bank of Fredericksburg, Marshall National Bank and Trust Company and Mercantile Peninsula Bank are Maryland banks, subject to the banking laws of Maryland and to regulations issued by the Commissioner of Financial Regulation of the Maryland, Department of Labor Licensing and Regulation who is required by statute to make at least one examination in each calendar year (or at 18-month intervals if the Commissioner determines that an examination is unnecessary in a particular calendar year). Their deposits are insured by, and they are subject to certain provisions of federal law and regulations and examination by, the FDIC.

In addition, The Annapolis Banking and Trust Company and Farmers & Mechanics Bank are members of the Federal Reserve System and are thereby subject to regulation by the Federal Reserve Board.

The Citizens National Bank, The National Bank of Fredericksburg and Marshall National Bank and Trust Company are national banks subject to regulation and regular examination by the OCC in addition to regulation and examination by the FDIC, which insures their deposits.

Mercantile Peninsula Bank is a Delaware bank, subject to the banking laws of Delaware and to regulation by the Delaware State Bank Commissioner, who is required by statute to make periodic examinations. Its deposits are insured by, and it is subject to certain provisions of federal law and regulation and examination by, the FDIC.

Bankshares and its affiliates are subject to the provisions of Section 23A and Section 23B of the Federal Reserve Act and the Federal Reserve Board s Regulation W, which implements Sections 23A and 23B. Section 23A, among other things, limits the amount of loans or extensions of credit by the Banks to, and their investments in, Bankshares and the nonbank affiliates of the Banks, while Section 23B generally requires that transactions between the Banks and Bankshares and its nonbank affiliates be on terms and under circumstances that are substantially the same as with non-affiliates. Under the cross-guarantee provisions of the Federal Deposit Insurance Act, in the event of a loss suffered or anticipated by the FDIC either as a result of default of a bank subsidiary or related to FDIC assistance provided to a bank subsidiary in danger of default the Banks may be assessed for the FDIC s loss, subject to certain exceptions.

Other Affiliates

As affiliates of Bankshares, the nonbank affiliates are subject to examination by the Federal Reserve Board and, as affiliates of the Banks, they are subject to examination by the FDIC, the Commissioner of Financial Regulation of Maryland and the OCC, as the case may be. In addition, MBC Agency, Inc. and Mercantile Life Insurance Company are subject to licensing and regulation by state insurance authorities. Mercantile Capital Advisors, Inc., Boyd Watterson and Mercantile Brokerage Services, Inc. are subject to regulation by the Securities and Exchange Commission and state securities law authorities, and Mercantile Brokerage Services, Inc. is also subject to regulation by the National Association of Securities Dealers, Inc. Retail sales of insurance and securities products by Mercantile Brokerage Services, Inc. are also subject to the requirements of the Interagency Statement on Retail Sales of Nondeposit Investment Products promulgated in 1994 by the FDIC, the Federal Reserve Board, the Comptroller of the Currency and the Office of Thrift Supervision.

Effects of Monetary Policy

All commercial banking operations are affected by the Federal Reserve System s conduct of monetary policy and its policies change from time to time based on changing circumstances. The Federal Reserve Board effectively controls the supply of bank credit in order to achieve economic results it deems appropriate, including efforts to combat unemployment, recession or inflationary pressures. Among the instruments of monetary policy used to advance these objectives are open market operations in the purchase and sale of U.S. Government securities, changes in the discount rate charged on bank borrowings and changes in reserve requirements against bank deposits. These means are used in varying combinations to influence the general level of interest rates and the general availability of credit. More specifically, actions by the Federal Reserve Board influence the levels of interest rates paid on deposits and other bank funding sources and charged on bank loans as well as the availability of bank funds with which loans and investments can be made.

Cautionary Statement

This Annual Report on Form 10-K contains forward-looking statements, within the meaning of and pursuant to the safe harbor provisions of the Private Securities Litigation Reform Act of 1995. A forward-looking statement encompasses any estimate, prediction, opinion or statement of belief contained in this report and the underlying management assumptions. These forward-looking statements include such words as believes, expects, anticipates, intends, outlook, estimate, forecast, project and similar expressions. Examples of forward-looking statements in t Report on Form 10-K are statements concerning competitive conditions, effects of monetary policy, the potential impact of legislation, identification of trends, loan growth, customer borrowing trends, anticipated levels of interest rates, business strategies and services, continuation or development of specified lending and other activities, credit quality, predictions or assessments related to the determination and adequacy of loan loss allowances, monitored loans, internal controls, tax accounting, importance and effects of capital levels, effects of asset sensitivity and interest rates, earnings simulation model projections, efforts to mitigate market and liquidity risks, dividend payments and impact of Financial Accounting Standards Board (FASB) pronouncements. These statements are based on current expectations and assessments of potential developments affecting market conditions, interest rates and other economic conditions, and results may ultimately vary from the statements made in this report. The following factors, among others, could cause actual results to differ materially from the anticipated results or other expectations expressed in the forward-looking statements: (1) the interest rate environment may further compress margins and adversely affect net interest income; (2) results may be adversely affected by continued diversification of assets and adverse changes in credit quality; (3) economic slowdown could adversely affect credit quality and loan originations; (4) loan growth may not improve to a degree that would help offset continuing pressure on net interest margin; (5) adverse governmental or regulatory policies may be enacted; (6) declines in equity and bond markets may adversely affect IWM revenues; (7) the inability to manage adequately the spread between yields on earning assets and cost of funds could adversely affect results; (8) the merger may be more expensive to complete than anticipated, including as a result of unexpected factors or events; and (9) the integration of Bankshares business and operations with those of PNC may take longer than anticipated, may be more costly than anticipated and may have unanticipated adverse results relating to Bankshares or PNC s existing businesses.

Website Access to Information

Bankshares annual reports on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K and all amendments to those reports may be accessed through Bankshares website as soon as reasonably practicable after such material is electronically filed with, or furnished to, the Securities and Exchange Commission. Bankshares website is www.mercantile.com.

ITEM 1A. RISK FACTORS

The following is a summary of the risk factors that we believe are most relevant to our business. These are factors that, individually or in the aggregate, we think could cause our actual results to differ significantly from anticipated or historical results. You should understand that it is not possible to predict or identify all such factors. Consequently, you should not consider the following to be a complete discussion of all potential risks or uncertainties. We undertake no obligation to publicly update forward-looking statements, whether as a result of new information, future events, or otherwise. You are advised, however, to consult any further disclosure we make on related subjects in our reports on forms 10-Q and 8-K filed with the SEC.

Bankshares is Subject to Interest Rate Risk

Our earnings depend largely on the relationship between the yield on our interest-earning assets and our cost of funds. This relationship, known as the interest rate spread, is subject to fluctuation and is affected by economic and competitive factors which influence market interest rates, the volume and mix of interest-earning assets and interest-bearing liabilities, and the level of non-performing assets. Fluctuations in market interest rates also affect our customers demand for our products and services. See the sections entitled Net Interest Income and Net Interest Margin and Interest Rate Risk in Item 7 Management s Discussion and Analysis of Financial Condition and Results of Operations located elsewhere in this report for further discussion related to Bankshares management of interest rate risk.

Bankshares is Subject to Lending Risk

There are inherent risks associated with Bankshares lending activities. These risks include, among other things, the impact of changes in interest rates and changes in the economic conditions in the markets in which Bankshares operates. Increases in interest rates and/or weakening economic conditions could adversely affect the ability of borrowers to repay outstanding loans or the value of the collateral securing these loans. Commercial loans, including commercial real estate loans are typically subject to a higher credit risk than other types of loans, including residential real estate or consumer loans, because they usually involve larger loan balances to a single borrower and are more susceptible to a risk of default during an economic downturn. Because Bankshares loan portfolio contains a significant number of commercial and industrial, construction and commercial real estate loans with relatively large balances, the deterioration of one or a few of these loans could cause a significant increase in nonperforming loans. These types of loans are also typically larger than residential real estate loans and consumer loans. An increase in nonperforming loans could result in a net loss of earnings from these loans, an increase in the provision for possible loan losses and an increase in loan charge offs, all of which could have a material adverse effect on Bankshares financial condition and results of operations. See the section captioned Loans in Item 7. Management s Discussion and Analysis of Financial Condition and Results of Operations located elsewhere in this report for further discussion related to commercial and industrial, construction and commercial real estate loans.

Bankshares Allowance for Possible Loan Losses and Reserve for Unfunded Commitments May Be Insufficient

In an attempt to provide for losses inherent in the loan portfolio, we estimate an allowance for loan and lease losses and reserve for unfunded commitments based on, among other things, national and regional economic conditions, historical loss experience and delinquency trends. However, we cannot predict loan and lease losses with certainty, and we cannot assure you that charge-offs in future periods will not exceed the allowance for loan and lease losses and reserve for unfunded commitments. If our allowance for loan and lease losses and reserve for unfunded commitments were not sufficient to cover actual loan and lease losses, our earnings would decrease. In addition, regulatory agencies, as an integral part of their examination process, review our allowance for loan and lease losses and reserve for unfunded commitments and may require additions to the allowance and/or the reserve based on their judgment about information available to them at the time of their examination. Factors that require an increase in our allowance for loan and lease losses and reserve for unfunded commitments could reduce our earnings.

Bankshares Operates in a Highly Competitive Industry and Market Area

Bankshares faces substantial competition in all areas of its operations from a variety of competitors, many of which are larger and may have more financial resources. Such competitors primarily include national, regional, and community banks within the various markets in which Bankshares operates. Bankshares also faces competition from many other types of financial institutions, including, without limitation, savings and loans, credit unions, finance companies, brokerage firms, insurance companies, factoring companies and other financial intermediaries. The financial services industry could become even more competitive resulting from legislative, regulatory and technological changes and continued consolidation. Banks, securities firms and insurance companies can merge under the umbrella of a financial holding company, which can offer virtually any type of financial service, including banking, securities underwriting, insurance (both agency and underwriting) and merchant banking. Additionally, technology has lowered barriers to entry and made it possible for nonbanks to offer products and services traditionally provided by banks, such as automatic funds transfer and automatic payment systems. Many of Bankshares competitors have fewer regulatory constraints and may have lower cost structures. Additionally, due to their size, many competitors may be able to achieve economies of scale and, as a result, may offer a broader range of products and services as well as better pricing for those products and services than Bankshares can. Bankshares ability to compete successfully depends on a number of factors, including, among other things:

- The ability to develop, maintain and build upon long-term customer relationships based on top quality service, high ethical standards and safe, sound assets.
- The ability to expand Bankshares market position.
- The scope, relevance and pricing of products and services offered to meet customer needs and demands.
- The rate at which Bankshares introduces new products and services relative to its competitors.
- Customer satisfaction with Bankshares level of service.
- Industry and general economic trends.

Failure to perform in any of these areas could significantly weaken Bankshares competitive position, which could adversely affect Bankshares growth and profitability, which, in turn, could have a material adverse effect on Bankshares financial condition and results of operations.

Bankshares is Subject to Extensive Government Regulation and Supervision

Financial institution regulation has been the subject of significant legislation in recent years and may be the subject of further significant legislation in the future, none of which is within our control. Significant new laws or changes in, or repeals of, existing laws, including with respect to federal and state taxation, may cause our results of operations to differ materially. Further, federal monetary policy, particularly as implemented through the Federal Reserve, significantly affects credit conditions for our affiliated banks, primarily through open market operations in U.S. government securities and the discount rate for bank borrowings and reserve requirements. A material change in any of these conditions would have a material impact on our results of operations. Furthermore, failure to comply with laws, regulations or policies could result in sanctions by regulatory agencies, civil money penalties and/or reputation damage, which could have a material adverse effect on Bankshares business, financial condition and results of operations. While Bankshares has policies and procedures designed to prevent any such violations, there can be no assurance that such violations will not occur. See the section captioned Supervision and Regulation in Item 1 Business located elsewhere in this report.

Bankshares Controls and Procedures May Fail or Be Circumvented

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

Bankshares May Not Be Able To Attract and Retain Skilled People

Bankshares success depends, in large part, on its ability to attract and retain key people. Competition for the best people in the business conducted by Bankshares can be intense and Bankshares may not be able to hire people or to retain them. The unexpected loss of services of one or more of Bankshares key personnel could have a material adverse impact on Bankshares business because of their skills, knowledge of Bankshares market, years of industry experience and the difficulty of promptly finding qualified replacement personnel.

Bankshares Information Systems May Experience an Interruption or Breach in Security

Bankshares relies heavily on communications and information systems to conduct its business. Any failure, interruption or breach in security of these systems could result in failures or disruptions in Bankshares customer relationship management, general ledger, deposit, loan and other systems. While Bankshares has policies and procedures designed to prevent or limit the effect of the failure, interruption or security breach of its information systems, there can be no assurance that any such failures, interruptions or security breaches will not occur or, if they do occur, that they will be adequately addressed. The occurrence of any failures, interruptions or security breaches of Bankshares information systems could damage Bankshares reputation, result in a loss of business, subject Bankshares to additional regulatory scrutiny, or expose Bankshares to civil litigation and possible financial liability, any of which could have a material adverse effect on Bankshares financial condition and results of operations.

Bankshares Continually Encounters Technological Change

The financial services industry is continually undergoing rapid technological change with frequent introductions of new technology driven products and services. The effective use of technology increases efficiency and enables financial institutions to serve customers better and to reduce costs. Bankshares future success depends, in part, upon its ability to address the needs of its customers by using technology to provide products and services that will satisfy customer demands, as well as to create additional efficiencies in Bankshares operations. Many of Bankshares competitors have substantially greater resources to invest in technological improvements. Bankshares may not be able to effectively implement new technology driven products and services or be successful in marketing these products and services to its customers. Failure to keep pace successfully with technological change affecting the financial services industry could have a material adverse impact on Bankshares business and, in turn, Bankshares financial condition and results of operations.

Bankshares is Subject to Claims and Litigation Pertaining to Fiduciary Responsibility

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

Bankshares Relies on Dividends from Its Subsidiaries for Most of Its Revenue

We are a financial holding company and a bank holding company and as a result, much of our income consists of dividends received from our affiliated banks. This means we rely primarily upon dividends from our affiliated banks to pay dividends to Bankshares common stockholders. Federal and state bank regulations restrict the amounts when our affiliated banks pay dividends directly or indirectly to us, when making any extensions of credit to us, when transferring assets to us and when investing in our stock or securities. These regulations also prevent us from borrowing from our affiliated banks unless the loans are secured by collateral. In addition, we cannot assure that our affiliated banks will be able to continue to pay dividends to us at past levels, if at all. If we do not receive sufficient cash dividends or borrowings from our affiliate banks, we may not have sufficient funds to pay dividends on common stock.

Bankshares May Not Be Able to Retain Skilled Personnel in Anticipation of the Planned Merger with PNC

Individual employees may experience uncertainty about their post-merger roles with PNC. Issues relating to the uncertainty and difficulty of integration or a desire not to remain with PNC after the merger may cause them to voluntarily leave Bankshares for other career opportunities. Loss of significant numbers of employees, or employees in key positions, could have a detrimental impact on Bankshares ability to carry on certain routine business activities. There are no assurances that Bankshares will be able to find adequate replacements if they do depart.

ITEM 1B. UNRESOLVED STAFF COMMENTS.

There were no unresolved staff comments as of December 31, 2006.

ITEM 2. PROPERTIES.

The main offices of Bankshares and MSD&T are located in a 21-story building at Two Hopkins Plaza in Baltimore, Maryland. Pursuant to a lease agreement, effective as of December 13, 2004, MSD&T agreed to lease up to approximately 179,000 square feet of prime office space and approximately 27,000 square feet of back-office and storage space at Two Hopkins Plaza, for a term of ten years. At December 31, 2006, MSD&T and Bankshares occupied approximately 206,000 square feet. The lease agreement contains two five-year renewal options. The lease agreement requires aggregate annual rent of approximately $4.0 million in 2006. At December 31, 2006, Bankshares also occupied approximately 132,000 square feet of space in a building located in Linthicum, Maryland, in which its operations and certain other departments are located, and a 7,000 square foot call center facility in Federalsburg, Maryland. The Linthicum and Federalsburg properties are owned by Bankshares. Of the 240 banking offices, 110 are owned in fee, 33 are owned subject to ground leases and 97 are leased, with aggregate annual rentals, not including the branch located at Two Hopkins Plaza, of approximately $13.9 million as of December 31, 2006.

ITEM 3. LEGAL PROCEEDINGS.

Between 2001 and 2003, on behalf of either individual plaintiffs or a putative class of plaintiffs, eight separate actions were filed in state and federal court against Community Bank of Northern Virginia (CBNV) and other defendants challenging the validity of second mortgage loans the defendants made to the plaintiffs. All of the cases were either filed in, or removed to, the federal district court for the Western District of Pennsylvania. In June 2003, the parties to the various actions informed the court that they had reached an agreement in principle to settle the various actions. On July 17, 2003, the court conditionally certified a class for settlement purposes, preliminarily approved the class settlement, and directed the issuance of notice to the class.

Thereafter, certain plaintiffs who had initially opted out of the proposed settlement and other objectors challenged the validity of the settlement in the district court. The district court denied their arguments and approved the settlement. These opt out plaintiffs and other objectors appealed the district court s approval of the settlement to the Third Circuit Court of Appeals.

In August 2005, the Third Circuit reversed the district court s approval of the settlement and remanded the case to the district court with instructions to consider and address certain specific issues when re-evaluating the settlement. In July 2006, the settling parties modified the original settlement agreement and submitted the modified settlement agreement to the District Court. See Note No. 10 - Commitments and Contingencies in Notes to the Consolidated Financial Statements. Certain individuals who were excluded from the settlement class have filed two actions on behalf of a putative class of plaintiffs alleging claims similar to those raised in the initial filing. These actions were later consolidated in the Western District of Pennsylvania.

ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS.

No matter was submitted during the fourth quarter of the fiscal year covered by this Report to a vote of security holders, which is required to be disclosed pursuant to the instructions contained in the form for this Report.

PART II

ITEM 5. MARKET FOR REGISTRANT S COMMON EQUITY, RELATED STOCKHOLDER MATTERS AND ISSUER PURCHASES OF EQUITY SECURITIES.

For information regarding market prices, dividends on Bankshares common stock, and the number of Bankshares stockholders, see the information set forth under the captions Dividends and Recent Common Stock Prices in Item 7 of this Annual Report.

Comparison of Five-Year Cumulative Total Return

The following line graph compares cumulative total stockholder return on our common stock with the Standard & Poor s 500 Index and the Standard & Poor s Banks Composite Index for the period December 31, 2001 through December 31, 2006. The graph assumes $100 invested at the closing price on December 31, 2001 and the reinvestment of all dividends.

	2001	2002	2003	2004	2005	2006
Bankshares	$ 100.00	$ 92.37	$ 112.68	$ 132.91	$ 147.78	$ 188.94
S&P 500	100.00	77.90	100.25	111.15	116.61	135.03
S&P Banks Composite Index	100.00	98.97	129.45	148.81	151.11	174.74

	2002	2003	2004	2005	2006
Bankshares	-7.63 %	21.99 %	17.95 %	11.19 %	27.85 %
S&P 500	-22.10 %	28.68 %	10.88 %	4.91 %	15.79 %
S&P Banks Composite Index*	-1.03 %	30.80 %	14.95 %	1.55 %	15.64 %

*S5CBNK Index TRA on Bloomberg

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ITEM 6. SELECTED FINANCIAL DATA.

The following selected financial data for 2006, 2005, 2004, 2003 and 2002 is qualified in its entirety by, and should be read in conjunction with the more detailed information contained in, the Consolidated Financial Statements and Notes thereto and Management s Discussion and Analysis of Financial Condition and Results of Operations included elsewhere in this Annual Report on Form 10-K.

Five-Year Selected Financial Data

Years Ended December 31, (Dollars in thousands, except per share data)	**2006**		**2005**		**2004**		**2003**		**2002**	
OPERATING RESULTS										
Net interest income	**$ 655,787**		$ 617,126		$ 545,781		$ 472,349		$ 441,035	
Net interest income - taxable equivalent	**663,158**		623,973		552,525		479,109		447,228	
Provision for credit losses			1,576		7,221		12,105		16,378	
Noninterest income	**254,734**		243,120		213,929		183,572		144,519	
Noninterest expense	**457,389**		420,821		391,958		337,447		272,608	
Net income	**288,286**		276,319		229,407		196,814		190,238	
PER COMMON SHARE DATA (1)										
Basic net income	**$ 2.32**		$ 2.28		$ 1.93		$ 1.80		$ 1.82	
Diluted net income	**2.30**		2.26		1.92		1.79		1.81	
Dividends paid	**1.10**		0.99		0.92		0.86		0.79	
Book value at period end	**19.25**		17.81		16.12		15.39		12.83	
Market value at period end	**46.79**		37.63		34.80		30.39		25.73	
Market range:										
High	**47.39**		40.09		35.39		30.63		30.24	
Low	**34.29**		32.27		26.87		20.11		21.38	
BALANCE SHEET DATA AT PERIOD END										
Total loans	**$ 12,792,733**		$ 11,607,845		$ 10,228,433		$ 9,272,160		$ 7,312,027	
Total investment securities	**3,123,552**		3,106,287		2,928,870		3,070,645		2,550,491	
Total assets	**17,716,025**		16,421,729		14,425,690		13,695,472		10,790,376	
Total deposits	**12,773,891**		12,077,350		10,799,199		10,262,553		8,260,940	
Shareholders equity	**2,417,166**		2,194,722		1,917,683		1,841,441		1,324,358	
PROFITABILITY RATIOS										
Return on average assets	**1.69**	%	1.78	%	1.64	%	1.64	%	1.88	%
Return on average equity	**12.31**		13.18		12.26		13.15		15.12	
Return on average tangible equity	**18.40**		19.54		18.00		16.55		16.69	
Net interest rate spread - taxable equivalent	**3.48**		3.88		3.99		3.92		4.05	
Net interest margin on earning assets - taxable equivalent	**4.31**		4.44		4.35		4.32		4.65	
Efficiency ratio	**49.83**		48.53		51.14		50.92		46.07	
Cash operating efficiency ratio	**47.32**		47.61		49.63		49.52		45.80	
CAPITAL RATIOS										
Average equity to average assets	**13.75**	%	13.51	%	13.38	%	12.51	%	12.43	%
Average tangible equity to average tangible assets	**9.82**		9.70		9.70		10.34		11.45	
Dividend payout ratio (1)	**47.41**		43.42		47.67		47.78		43.41	
Risk-based capital:										
Tier 1 capital ratio	**12.02**		11.82		12.33		12.46		15.00	
Total capital ratio	**15.31**		15.37		16.23		16.63		16.29	
Leverage ratio	**10.04**		9.81		10.02		9.60		11.20	
Bank offices	**240**		240		226		227		185	
Employees	**3,544**		3,606		3,479		3,565		2,885	
CREDIT QUALITY DATA AT PERIOD END										
Net charge-offs	**$ 815**		$ 991		$ 13,556		$ 8,574		$ 19,240	
Nonaccrual loans	**30,960**		22,565		30,898		50,352		33,371	
Other real estate owned, net	**1,405**		667		212		191		132	
Total nonperforming assets	**32,365**		23,232		31,110		50,543		33,503	
CREDIT QUALITY RATIOS										
Net charge-offs as a percent of period-end loans	**0.01**	%	0.01	%	0.13	%	0.09	%	0.26	%
Allowance for loan losses as a percent of period-end loans	**1.12**		1.35		1.46		1.68		1.90	

Allowance for loan losses as a percent of nonperforming loans	**461.98**	694.32	482.24	308.50	415.33
Nonperforming assets as a percent of period-end loans and other real estate owned	**0.25**	0.20	0.30	0.55	0.46

(1) On January 10, 2006, Bankshares announced a three-for-two stock split on its common stock. Per share amounts and other applicable information have been adjusted to give effect to the split.

Five-Year Summary of Consolidated Income

Years Ended December 31, (Dollars in thousands)	**2006**	**2005**	**2004**	**2003**	**2002**
INTEREST INCOME					
Interest and fees on loans	**$ 863,563**	$ 700,832	$ 546,531	$ 472,943	$ 468,678
Interest on securities	**132,115**	112,769	111,003	113,254	112,091
Other interest income	**3,044**	2,436	1,503	3,397	4,848
Total interest income	**998,722**	816,037	659,037	589,594	585,617
INTEREST EXPENSE					
Interest on deposits	**251,118**	139,917	83,403	93,190	122,569
Interest on short-term borrowings	**55,100**	26,266	7,844	5,604	11,259
Interest on long-term debt	**36,717**	32,728	22,009	18,451	10,754
Total interest expense	**342,935**	198,911	113,256	117,245	144,582
NET INTEREST INCOME	**655,787**	617,126	545,781	472,349	441,035
Provision for credit losses		1,576	7,221	12,105	16,378
NET INTEREST INCOME AFTER PROVISION FOR CREDIT LOSSES	**655,787**	615,550	538,560	460,244	424,657
NONINTEREST INCOME					
Investment and wealth management	**110,879**	95,756	90,050	78,933	68,435
Service charges on deposit accounts	**46,339**	43,885	44,263	39,194	33,539
Other income	**97,516**	103,479	79,616	65,445	42,545
Total noninterest income	**254,734**	243,120	213,929	183,572	144,519
NONINTEREST EXPENSES					
Salaries and employee benefits	**261,926**	246,397	232,297	198,043	165,371
Net occupancy and equipment expenses	**66,228**	60,255	55,746	52,366	40,368
Other expenses	**129,235**	114,169	103,915	87,038	66,869
Total noninterest expenses	**457,389**	420,821	391,958	337,447	272,608
Income before income taxes	**453,132**	437,849	360,531	306,369	296,568
Provision for income taxes	**164,846**	161,530	131,124	109,555	106,330
NET INCOME	**$ 288,286**	$ 276,319	$ 229,407	$ 196,814	$ 190,238

ITEM 7. MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS.

I. OVERVIEW

Mercantile Bankshares Corporation (Bankshares) is a regional multibank holding company headquartered in Baltimore, Maryland. At December 31, 2006, Bankshares had $17.7 billion in assets, $12.8 billion in loans and $12.8 billion in deposits. It is the largest bank holding company headquartered in the state of Maryland. The two principal lines of business are Banking and Investment & Wealth Management (IWM), delivered through the lead bank, Mercantile-Safe Deposit and Trust Company (MSD&T), and 10 affiliated banks. See Segment Reporting in II. ANALYSIS OF OPERATING RESULTS FOR 2006 TO 2005 in this Item 7 for more information.

On October 8, 2006, Bankshares entered into an Agreement and Plan of Merger with The PNC Financial Services Group, Inc. (PNC) pursuant to which Bankshares will merge with and into PNC, with PNC as the surviving corporation in the merger. When the merger is completed, Bankshares stockholders will receive a combination of PNC common stock and cash in exchange for their Bankshares common stock. Each share of Bankshares common stock will be converted into the right to receive 0.4184 of a share of PNC common stock (including the related preferred stock purchase rights under PNC s May 2000 Rights Agreement) and $16.45 in cash, without interest. Under the formula set forth in the merger agreement, an aggregate of up to approximately 54.2 million shares of PNC common stock (and an equal number of related rights) may be issued and $2.13 billion paid in the merger. This merger was approved by Bankshares stockholders on February 27, 2007 and received substantially all of the required regulatory approvals. The merger is currently expected to close in March of 2007. Pending the merger, Bankshares must comply with the covenants contained in the merger agreement, but is generally continuing to operate in the ordinary course of business.

During the year ended December 31, 2006, Bankshares expensed $13.1 million, or $9.2 million on an after-tax basis, of costs pursuant to the Merger Agreement with PNC. These expenses were comprised of $6.8 million of investment banker and legal fees and $6.3 million of compensation-related expenses.

On January 10, 2006, Bankshares announced a three-for-two stock split on its common stock, payable in the form of a stock dividend on January 27, 2006 to stockholders of record as of the close of business on January 20, 2006. Certain share, average share and per share amounts have been adjusted to give effect to the split.

Bankshares recorded its 31st consecutive year of increased net income in 2006. Net income for Bankshares was $288.3 million for the year ended December 31, 2006, compared with $276.3 million for the year 2005, representing a 4.3% increase. Diluted net income per common share for 2006 increased by 1.8% to $2.30 compared with $2.26 for 2005.

On July 17, 2006, Bankshares completed its acquisition of James Monroe, a commercial bank headquartered in Arlington, Virginia, which was merged into MSD&T. The consideration paid to James Monroe shareholders in connection with the acquisition was comprised of $71.4 million in cash and 1.8 million shares of Bankshares common stock. James Monroe transactions have been included in Bankshares financial results subsequent to July 17, 2006. The assets and liabilities of James Monroe were recorded on the consolidated balance sheet at their respective fair values. The fair values were determined as of July 17, 2006. The transaction resulted in total assets acquired as of July 17, 2006 of $552 million, including $414 million in loans and liabilities assumed of $507 million, including $434 million in deposits. Bankshares recorded $95.4 million of goodwill and $7.8 million of core deposit intangible (CDI). CDI is subject to amortization and is being amortized on an accelerated basis.

The Board of Governors of the Federal Reserve System (Federal Reserve Board) increased short-term rates by 100 basis points in 2006 and 200 basis points in 2005. The net interest margin declined 13 basis points to 4.31% for 2006 from 4.44% for 2005, which compares unfavorably with the increase of nine basis points experienced during 2005. The net interest margin for 2004 was 4.35%. The 2006 net interest margin decrease was attributable to a 40 basis point decline in the spread between the yield on earnings assets and the cost of interest-bearing liabilities, which was partially offset by a 27 basis point increase in the benefit derived from noninterest-bearing sources of funds. Competition to gather deposits increased throughout the year and resulted in higher rates paid on these funds and a flat to inverted yield curve adversely affected the net interest spread. See Analysis of Interest Rate and Interest Differentials and the discussions of Net Interest Income and Interest Rate Risk found in Item 7 of this report.

At December 31, 2006, loans outstanding were $12.8 billion, an increase of 10.2% over the $11.6 billion outstanding at December 31, 2005. Construction loans at December 31, 2006 were $2.0 billion, an increase of 25.1% from $1.6 billion at December 31, 2005. Commercial real estate loans were $4.2 billion at December 31, 2006, an increase of 14.5% from $3.7 billion at December 31, 2005. Residential real estate loans grew by 11.7%.

Total deposits outstanding were $12.8 billion at December 31, 2006, up 5.8% from $12.1 billion outstanding at December 31, 2005. Average deposit growth was driven primarily by increases in time deposits $100,000 and over, money market and other time deposits, which were up 32.2%, 25.8% and 11.5%, respectively, from the year ended December 31, 2005. The James Monroe acquisition provided approximately 45.2% of the deposit growth from the year ended December 31, 2005.

Nonperforming loans increased from $22.6 million at December 31, 2005 to $31.0 million at December 31, 2006. Nonperforming loans as a percent of year-end loans were 0.24% at December 31, 2006. The allowance for loan losses declined by $13.6 million to $143.0 million for the year ended December 31, 2006 due to the reclassification of a portion of the allowance for loan losses to a reserve for unfunded commitments.

Average shareholders equity to average assets was 13.75% for 2006, an increase from 13.51% for 2005.

Bankshares also reports cash operating earnings, defined as GAAP (Generally Accepted Accounting Principles) earnings excluding the amortization of intangible assets associated with purchase accounting for business combinations; securities gains and losses; and other significant gains, losses or expenses (such as those associated with integrating acquired entities operations into Bankshares and expenses related to the PNC merger) unrelated to Bankshares core operations. We believe these non-GAAP measures provide information useful to investors in understanding our ongoing core business and operational performance trends. These measures should not be viewed as a substitute for GAAP. Management believes presentations of financial measures excluding the impact of certain items provide useful supplemental information and better reflect its core operating activities. In order to arrive at core business operating results, the effects of certain noncore business transactions, such as gains and losses on the sale of securities, amortization of intangibles, restructuring charges and merger-related expenses, have been excluded. Management reviews these same measures internally. For instance, the cash operating efficiency ratio, rather than the GAAP basis efficiency ratio, is used to measure management s success at controlling ongoing, core operating expenses. We believe these measures are consistent with how investors and analysts typically evaluate our industry and, by providing these measures, we facilitate their analysis. Cash operating earnings totaled $302.9 million for 2006, an increase of 8.3% over $279.6 million for 2005.

Additionally, management believes that reporting several key measures based on tangible assets (total assets less intangible assets) and tangible equity (total equity less intangible assets) is important, as this more closely approximates the basis for measuring the adequacy of capital for regulatory purposes. For the year 2006, the return on average tangible assets was 1.81% compared with 1.89% for 2005. The ratio of average tangible equity to average tangible assets was 9.82% for 2006 and 9.70% for 2005. See Reconciliation of Non-GAAP Measures for the reconciliation of GAAP measures to non-GAAP measures in the section captioned II. ANALYSIS OF OPERATING RESULTS FOR 2006 TO 2005 in this Item 7.

The remaining sections of Management s Discussion and Analysis of Financial Condition and Results of Operations will provide a more detailed explanation of the important trends and material changes in components of our consolidated financial statements. The discussion suggests that sustaining future earnings growth comparable to our experience in past years will require, among other things, efficient generation of loan growth in a competitive market, while maintaining an adequate spread between yields on earning assets and the cost of funds. Our degree of success in meeting these goals depends on unpredictable factors such as possible changes in prevailing interest rates, the mix of deposits, credit quality and general economic conditions and the impact of the merger with PNC during 2007. This discussion and analysis should be read in conjunction with the consolidated financial statements and other financial information presented in this Report.

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NET INCOME
(Dollars in millions)
Five Year Compound Growth Rate: 9.7%

DILUTED EARNINGS PER SHARE
(In dollars)
Five-Year Compound Growth Rate: 6.2%

TOTAL ASSETS
(Dollars in millions) December 31,
Five-Year Compound Growth Rate: 12.3%

INTEREST YIELDS AND RATES
(Tax-equivalent basis)

Critical Accounting Policies

Set forth below is a discussion of the accounting policies and related estimates that management believes are the most critical to understanding Bankshares consolidated financial statements, financial condition and results of operations, and which require complex management judgments, uncertainties and/or estimates. Information regarding Bankshares other accounting policies is included in Note No. 1 - Significant Accounting Policies in Notes to Consolidated Financial Statements.

Investment Securities

Investment securities classified as held-to-maturity are acquired with the intent and ability to hold until maturity and are carried at amortized cost. Investment securities classified as available-for-sale are acquired to be held for indefinite periods and may be sold in response to changes in interest rates and/or prepayment risk or for liquidity management purposes. These securities are carried at fair value. Securities may become impaired on an other-than-temporary basis, which involves a degree of judgment. Therefore, an assessment is made at the end of each quarter to determine whether there have been any events or economic circumstances to indicate that a security is impaired on an other-than-temporary basis. An other-than-temporary impairment may develop if, based on all available evidence, the carrying amount of the investment is not recoverable within a reasonable period. Factors considered in making this assessment include among others, the intent and ability to hold the investment for a period sufficient for a recovery in value, external credit ratings and recent downgrades, market price fluctuations due to factors other than interest rates, and the probability of collection of contractual cash flows. Securities on which there is an unrealized loss deemed to be other-than-temporary are written down to fair value, and the adjustment is recorded as a realized loss.

Allowance for Loan Losses and Reserve for Unfunded Commitments

Arriving at an appropriate level of allowance for loan losses and reserve for unfunded commitments involves a high degree of judgment. Bankshares allowance for loan losses and reserve for unfunded commitments provide for probable losses based on evaluations of inherent risks in the loan portfolio. The allowance for loan losses and reserve for unfunded commitments are maintained at a level considered by management to be adequate to absorb losses inherent in the loan portfolio as of the date of the consolidated financial statements. We have developed appropriate policies and procedures for assessing the adequacy of the allowance for loan losses that reflect management s careful evaluation of credit risk considering all available information. Management uses historical quantitative information to assess the adequacy of the allowance for loan losses and reserve for unfunded commitments as well as qualitative information about the prevailing economic and business environment, among other things. In developing this assessment, management must rely on estimates and exercise judgment in assigning credit risk. Depending on changing circumstances, future assessments of credit risk may yield materially different results from the estimates, which may require an increase or decrease in the allowance for loan losses and reserve for unfunded commitments.

We employ modeling and estimation tools in developing the appropriate allowance and reserve for unfunded commitments. Bankshares allowance consists of formula-based components for business and retail loans, an allowance for impaired loans and an unallocated component. The following provides a description of each of these components of the allowance, the techniques used and the estimates and judgments inherent in each. In the first quarter of 2006, management refined the methodologies for the formula-based components to align more appropriately the allowance methodology with our current framework for analyzing credit losses. Formula-based allowance calculations for business and retail components permit us to address specifically the current trends and events affecting the credit risk in the loan portfolio. The reserve for unfunded commitments is estimated using the same methodology.

Business loans are comprised of commercial, commercial real estate and construction loans, which are evaluated separately for impairment. For business loans, the formula-based component of the allowance for loan losses is based on statistical migration estimates of the average losses observed for business loans classified by credit grade. Average losses for each credit grade are computed using the annualized historical rate at which loans in each credit grade have defaulted (probability of default rates or PD) and the historical average losses realized for defaulted loans (loss-given-default or LGD). We have developed default rates by analyzing four years of our default experience and more than 14 years of comparable external data. Default rates, which are validated annually, are estimates derived from long-term averages and are not based on short-term economic or environmental factors. LGD rates have been developed using industry benchmarks.

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Retail loans are comprised of consumer installment and residential mortgage loans. For retail loans, the formula-based component of the allowance for loan losses is primarily based on the probability of default rates and LGD rates for specific groups of similar loans by product category. The probability of default rates are based on four years of our default experience and between 14 and 19 years of comparable industry data. LGD rates were developed using industry benchmarks.

For both business and retail loans, the formula-based components include additional qualitative amounts to establish reasonable ranges that consider observed historical variability in losses. Factors we may consider in setting these amounts include, but are not limited to, industry-specific data, portfolio specific risks or concentration and macroeconomic conditions. Including these variability components in the model enables us to capture probable incurred losses that are not yet evident in current default grades, delinquencies and other credit-risk measurement tools.

The specific allowance allocation is based on an analysis of the loan portfolio. Each loan with an outstanding balance in excess of a specified threshold that is either in nonaccrual status or on the Watchlist is evaluated. The Watchlist includes loans identified and closely followed by management. These loans possess certain qualities or characteristics that may lead to collection and loss issues. The identified loans are evaluated for potential loss by analyzing current collateral values or present value of cash flows, as well as the capacity of the guarantor, as applicable. This is in accordance with Financial Accounting Standards Board Statement (SFAS) No. 114, Accounting for Creditors for Impairment of a Loan, and SFAS No. 118, Accounting for Creditors for Impairment of a Loan Income Recognition and Disclosure.

The allowance for loan losses also contains an unallocated component. The unallocated allowance recognizes the imprecision inherent in estimating and measuring inherent loss when allocating the allowance to individual, or pools of, loans. It also takes into consideration the allowance level deemed appropriate by each affiliate based on its local knowledge and input from bank regulators and their view from the standpoint of safety and soundness, among other factors. The amount of this component and its relationship to the total allowance for loan losses may change from one period to another.

In the first quarter of 2006, we reclassified a portion of the allowance for loan losses to a reserve for unfunded commitments, which is included in the other liabilities section of the consolidated balance sheet. The modeling process used in the first quarter of 2006 for the determination of the reserve for unfunded lending commitments is consistent with the process described above for the formula-based component of the allowance for loan losses, also including as a key factor a benchmark average rate at which unfunded exposures have been funded at the time of default. The development of this modeling in 2006 enabled Bankshares to evaluate specifically the risk inherent in unfunded commitments and make the reclassification discussed above. As no model data existed in previous years, prior period data has not been reclassified for comparability. During the year ended December 31, 2006, Bankshares reclassified $15.8 million of the allowance for loan losses to the reserve for unfunded commitments.

For a full discussion of Bankshares methodology for assessing the adequacy of the allowance for loan losses, see Allowance for Loan Losses found elsewhere in Item 7 and Note No. 1 - Significant Accounting Policies in Notes to Consolidated Financial Statements and Note No. 4 Loans and Allowance for Loan Losses and Reserve for Unfunded Commitments.

Loans in Nonaccrual Status or Deemed to Be Impaired

A loan is placed into nonaccrual status when the principal or interest payments on any loan (e.g., commercial, mortgage and construction loans) are past due 90 days or more at the end of a calendar quarter or the payment in full of principal or interest is not expected. Any accrued but uncollected interest is reversed at that time. Consumer installment loans are charged off when they become 90 days past due at the end of the quarter. Additionally, a loan may be put on nonaccrual status sooner than 90 days, if in management s judgment, the loan or portion thereof is deemed uncollectible. Bankshares ceases to accrue interest income on such loans. Subsequent receipts on nonaccrual loans are recorded as a reduction of principal, and interest income is recorded only once principal recovery is reasonably assured. Generally, a loan may be restored to accrual status when all past due principal, interest and late charges have been paid and the Bank expects repayment of the remaining contractual principal and interest.

A loan is considered impaired, based on current information and events, if it is probable that Bankshares will not collect all principal and interest payments according to the contractual terms of the loan agreement. Impaired loans do not include large groups of smaller balance homogeneous loans that are evaluated collectively for impairment (e.g., residential mortgages and consumer installment loans). The impairment of a loan is measured based on the present value of expected future cash flows discounted at the loan s effective interest rate, or the fair value of the collateral if the repayment is expected to be provided predominantly by the underlying collateral. A majority of Bankshares impaired loans are measured by reference to the fair value of the collateral.

Income Taxes

Bankshares recognizes deferred income tax assets and liabilities for the future tax effects of temporary differences, net operating loss carryovers and tax credits. Deferred tax assets are subject to management s judgment, based on available evidence, that future realization is more likely than not. If management determines that Bankshares may be unable to realize all or part of net deferred tax assets in the future, then Bankshares would be required to record a valuation allowance against such deferred tax asset. In such an event, a direct charge to income tax expense may be required to reduce the recorded value of the net deferred tax asset to the expected realizable amount. For more information regarding Bankshares accounting for income taxes, see Note No. 12 - Income Taxes in Notes to Consolidated Financial Statements.

Valuation of Goodwill/Intangible Assets and Analysis for Impairment

Bankshares has increased its market share, in part, through the acquisition of entire financial institutions accounted for under the purchase method of accounting, as well as from the purchase of other financial institutions branches (not the entire institution). Bankshares is required to record assets acquired and liabilities assumed at their fair value, which involves an estimate determined by the use of internal or other valuation techniques. See Note No. 19 - Goodwill and Intangible Assets in Notes to Consolidated Financial Statements for further information on the accounting for goodwill and other intangible assets.

II. ANALYSIS OF OPERATING RESULTS FOR 2006 TO 2005

Segment Reporting

Bankshares reports two distinct business segments, Banking Services and Investment & Wealth Management (IWM), for which financial information is segregated for use in assessing performance and allocating resources when reporting to the Board of Directors. The Banking Services segment consists of the group of 11 affiliate banks and mortgage-banking activities. A schedule disclosing the details of these operating segments can be found in Note No. 16 - Segment Reporting in Notes to the Consolidated Financial Statements. Segment financial information is subjective and, unlike financial accounting, is not necessarily based on GAAP. As a result, financial information of the reporting segments is not necessarily comparable with similar information reported by others and may not be comparable with Bankshares consolidated results. Certain expense amounts, such as operations overhead, have been reclassified from internal financial reporting in order to provide for proper allocation of costs in the reported data.

In the fourth quarter of 2005, the Private Banking Group of MSD&T was consolidated into the Private Banking Group of IWM which is reflected in the segment results below. For loans and deposits included in the IWM segment, a funds transfer-pricing model was utilized to match the duration of the funding and investment of the IWM segment s assets and liabilities.

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Banking Services

The Banking Services segment includes the Retail, Small Business, Commercial and Mortgage Banking lines of business. Banking products include:

- *Retail Banking*: Checking, savings and money market accounts, time deposits and IRAs, insurance, equity lines and loans, lines of credit, and equipment and transportation (auto, recreational vehicle and marine) loans.

- *Small Business Banking*: Deposit and credit products and services to businesses with annual revenues up to $3.0 million or credit needs up to $750.0 thousand, including receivables and inventory financing, equipment leases, and real estate financing.

- *Commercial Banking*: Commercial deposit, lending and commercial real estate solutions to businesses typically with annual revenues between $4.0 million and $50.0 million, and including commercial loans and lines of credit, letters of credit, asset-based lending, commercial real estate, construction loans, capital market products and insurance.

- *Mortgage Banking*: Commercial, multifamily and residential mortgage loan origination and servicing.

The following table presents selected Banking segment information for the three years ended December 31, 2006.

(Dollars in thousands)	**2006**	2005	2004
Net interest income	**$ 642,835**	$ 609,758	$ 534,468
Provision for loan losses		(1,576)	(7,221)
Noninterest income	**120,017**	132,154	114,477
Noninterest expenses	**(352,092)**	(341,543)	(318,706)
Adjustments	**25,683**	17,610	18,098
Income before income taxes	**436,443**	416,403	341,116
Income tax expense	**(152,899)**	(145,044)	(120,253)
Net income	**$ 283,544**	$ 271,359	$ 220,863
Average loans	**$ 11,975,089**	$ 10,876,592	$ 9,591,510
Average earning assets	**15,309,149**	13,917,161	12,576,465
Average assets	**16,785,770**	15,235,634	13,413,992
Average deposits	**12,391,585**	11,444,361	10,323,349
Average equity	**2,072,102**	1,891,834	1,449,355

The Banking Services segment consists of 11 affiliate banks. Mortgage banking activities are not viewed as a separate business line due to their insignificant impact on the core business of Bankshares and, accordingly, are included in the Banking segment.

In the third quarter of 2006, Bankshares acquired James Monroe and merged it into the Mercantile Potomac Division of MSD&T. This acquisition increased our presence in the northern Virginia and Washington, D.C. markets.

The Banking Services segment, which contributed 83.8% of total revenue, continued to experience strong loan and deposit growth. The Banking Services segment was the primary beneficiary of the James Monroe acquisition. Net income for Banking Services for 2006 increased 4.5% to $283.5 million from $271.4 million for 2005.

The Banking Services segment operating results improved over 2005, with revenue growth of 2.8% and an expense growth of 0.8%. Net interest income for Banking Services increased 5.4% to $642.8 million for 2006 from $609.8 million for 2005. The growth in net interest income in 2006 was largely attributable to a 10.1% increase in average loans outstanding. See the analysis of net interest income included in the section captioned Net Interest Income and Net Interest Margin included elsewhere in this document.

The allowance as a percentage of loans was 1.12% at year-end 2006 compared with 1.35% at year-end 2005. During 2006, we reclassified $15.8 million of the allowance for loan losses to a reserve for unfunded commitments, which is included in the other liabilities section of the consolidated balance sheet. The development of this modeling in 2006 enabled Bankshares to evaluate specifically the risk inherent in unfunded commitments and make this reclassification discussed above.

Average loans outstanding increased $1.1 billion, or 10.1%, to $12.0 billion for 2006. The James Monroe acquisition accounted for 36.6% of the increase in average loans outstanding. Construction loans increased 25.7% as compared with the 2005 average, while commercial real estate increased 13.9% and residential real estate loans increased 8.9%.

Average deposits for Banking increased 8.3% to $12.4 billion in 2006. The James Monroe acquisition provided 45.2% of the deposit growth. Year-over-year average deposit growth was driven primarily by increases in money market, time deposits $100,000 and over and other time deposits, which were up 25.8%, 32.2% and 11.5%, respectively.

Noninterest income decreased $12.1 million to $120.0 million from 2005. Mortgage banking fees were $8.2 million lower than the prior year due principally to the sale of Columbia National Real Estate Finance, LLC. Furthermore, gains on sales of bank-owned premises declined $2.6 million from the year ended December 31, 2005.

Noninterest expenses increased $10.5 million over 2005 due primarily to operating expenses of $6.2 million from James Monroe and $9.0 million related to a full year of operating expenses from CBNV. These increases were partially offset by a reduction of $3.3 million in operating expenses resulting from the sale of Columbia National Real Estate Finance, LLC in the third quarter of 2006.

Investment & Wealth Management

IWM includes Retail Brokerage Services, Private Wealth Management, Institutional Investment Management, Private Banking and Mercantile Funds. IWM provides a full line of investment products and retirement, tax and estate planning services. IWM products include:

- *Retail Brokerage Services*: Stocks, bonds, proprietary and nonproprietary mutual funds, fixed and variable annuities.

- *Private Wealth Management Services*: Proprietary and nonproprietary mutual funds, proprietary and nonproprietary separate account management, customized wealth advisory services, defined benefit and defined contribution retirement services, family office services, individual and institutional trust services and custody services.

- *Institutional Investment Management*: Sophisticated investment management and administrative services for employee retirement plans, profit-sharing plans and endowments.

- *Private Banking Services*: Deposits, loans, and mortgages.

- *Mercantile Funds*: Proprietary stock, taxable and nontaxable fixed income, money market mutual funds and registered hedge funds-of-funds.

The following table presents selected IWM segment information for the three years ended December 31, 2006.

(Dollars in thousands)	**2006**	**2005**	**2004**
Net interest income	**$ 13,394**	$ 7,819	$ 10,172
Provision for loan losses			
Noninterest income	**111,412**	95,958	90,516
Noninterest expenses	**(88,567)**	(72,929)	(69,575)
Adjustments	**(3,616)**	(3,885)	(3,603)
Income before income taxes	**32,623**	26,963	27,510
Income tax expense	**(13,049)**	(10,785)	(11,004)
Net income	**$ 19,574**	$ 16,178	$ 16,506
Average loans	**$ 185,642**	$ 152,572	$ 127,739
Average earning assets	**185,642**	152,572	127,739
Average assets	**186,226**	152,941	127,949
Average deposits	**316,367**	199,159	175,096
Average equity	**38,997**	34,354	31,219

In the fourth quarter of 2005, the Private Banking Group of MSD&T was consolidated into the Private Banking Group of IWM which is reflected in the segment results above. Additionally, as loans and deposits are now included in the IWM segment, a funds transfer-pricing model was utilized to match the duration of the funding and investment of the IWM s segment assets and liabilities.

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During the second quarter of 2006, Bankshares IWM Real Estate Advisory Unit restructured both its Real Estate Advisory Unit and a major advisory relationship within the unit. As part of the restructuring, a new registered investment advisor (RIA) was formed and IWM s direct real estate management activities were placed in the RIA.

Net income in IWM increased to $19.6 million in 2006 from $16.2 million in 2005 and pre-tax income increased to $32.6 million in 2006 from $27.0 million in 2005. The increase was due primarily to the restructuring of a major pension advisory relationship in the IWM Real Estate Advisory Unit and growth in average deposits of $117.2 million. Pre-tax income from the Real Estate Advisory Unit increased $3.0 million over 2005 and net interest income from Private Banking increased $5.6 million over 2005. Pretax profit margins, prior to corporate overhead allocation, were 29.0% and 29.7% for 2006 and 2005, respectively.

While equity markets rose during 2006, a slump in the second quarter was followed by a strong recovery in the second half of 2006. The S&P 500 Index ended 2006 at 1,418, up 13.6% from 1,248 at the end of 2005. Between December 31, 2005 and December 31, 2006, the Dow Jones Industrial Average increased 16.3% to 12,463 and the NASDAQ rose 9.5% to 2,415. The fixed income markets, as measured by the Lehman Brothers US Aggregate Bond Index, were down 1.0% in 2006. Bankshares investment asset base is relatively balanced between equities (including real estate) and fixed income, cash and other securities. As of December 31, 2006, 43.3% of IWM managed assets were invested in equities, including real estate. Approximately 37.2% were invested in fixed income securities and 19.5% were invested in cash and other.

	As of December 31,		
Market Indices	**2006**	**2005**	**2004**
Dow Jones Industrial Average	12,463	10,717	10,783
Year-over-Year % Change	16.3	-0.6	3.1
S&P 500 Index-period-end	1,418	1,248	1,214
Year-over-Year % Change	13.6	2.8	9.0
Nasdaq	2,415	2,205	2,175
Year-over-Year % Change	9.5	1.4	8.6
Lehman Brothers U.S. Aggregate Bond Index	101.0	101.9	104.6
Year-over-Year % Change	-1.0	-2.5	-1.3

IWM total revenues increased $21.0 million, or 20.3%, to $124.8 million in 2006 from $103.8 million in 2005. Year-over-year revenue growth exceeded 10.0% in Institutional Management (driven by the restructuring of a major advisory relationship in Bankshares IWM Real Estate Advisory Unit), the Private Bank, in Hedge Funds and in Brokerage.

Private Wealth Management benefited from the rise in equity markets during 2006 and a fee increase on some accounts at the beginning of 2006. Net new business was down from 2005 driven by higher terminations on small accounts due partly to the fee increase.

Institutional Investment Management benefited principally from the restructuring of a major real estate pension advisory relationship. The impact of this change was to increase revenues $10.2 million year-over-year. Revenue declined in our Boyd Watterson Asset Management subsidiary primarily due to lower equity assets under management. Higher terminations in our institutional business continued to impede non-real-estate institutional revenue growth in 2006, evidenced by the loss of a $6.5 billion institutional custody account in the third quarter of 2006.

The Mercantile Funds benefited from higher asset flows into the funds, improved equity markets, and strong performance in the hedge funds-of-funds. The Mercantile Funds assets increased $305 million, or 7.7 %, to $4.3 billion, driven by an 8.7% increase in personal trust assets at December 31, 2006 compared with December 31, 2005.

Brokerage commissions and income benefited from growth in the number of accounts and assets held in accounts. Brokerage assets increased $227 million, or 24%, to $1.2 billion at December 31, 2006 compared with December 31, 2005. In the table on the following page, Mutual Fund assets and Brokerage assets have been allocated to Personal and Institutional.

Private Banking revenues benefited from $33.1 million in loan growth and $117.2 million in deposit growth during 2006.

In 2006, noninterest expenses increased 21.4%, or $15.6 million, to $88.6 million, compared with $72.9 million in 2005. The restructuring of a major real estate pension advisory relationship increased expenses by $6.1 million over 2005.

	Year ended December 31,		
(Dollars in billions)	**2006**	**2005**	**2004**
Personal			
Assets with Investment Responsibility	**$ 9.4**	$ 8.7	$ 8.7
Assets with No Investment Responsibility	**4.4**	3.8	3.6
Total Personal	**13.8**	12.5	12.3
Institutional			
Assets with Investment Responsibility	**11.4**	11.6	12.2
Assets with No Investment Responsibility	**17.8**	22.1	23.1
Total Institutional	**29.2**	33.7	35.3
Mutual Funds Not included Above	**0.3**	0.3	0.2
Total			
Assets with Investment Responsibility	**21.1**	20.6	21.1
Assets with No Investment Responsibility	**22.2**	25.9	26.7
Total Assets Under Administration	**$ 43.3**	$ 46.5	$ 47.8

At December 31, 2006, assets under administration by IWM were $43.3 billion, a decrease of $3.2 billion, or 6.9%, from the prior year due to the loss of a $6.5 billion institutional custody account in the third quarter of 2006. Bankshares had investment responsibility for $21.1 billion, an increase of $0.5 billion, or 2.4%, compared with the prior year.

Bankshares Earnings Performance

ANALYSIS OF INTEREST RATES AND INTEREST DIFFERENTIALS

The following table presents the distribution of the average consolidated balance sheets, interest income/expense and yields earned and rates paid.

(Dollars in thousands)	2006 Average Balance	Income (1) / Expense	Yield (1) / Rate	2005 Average Balance	Income (1) / Expense	Yield (1) / Rate
Earning assets						
Loans: (2),(4)						
Commercial	**$ 2,948,882**	**$ 221,592**	**7.51** %	$ 2,900,598	$ 186,462	6.43 %
Commercial real estate	**3,922,356**	**277,957**	**7.09**	3,444,921	226,356	6.57
Construction	**1,851,632**	**152,667**	**8.24**	1,473,353	102,484	6.96
Residential real estate	**1,918,257**	**119,146**	**6.21**	1,761,955	105,312	5.98
Home equity lines	**480,747**	**37,349**	**7.77**	507,153	30,692	6.05
Consumer	**1,039,138**	**60,254**	**5.80**	941,571	54,283	5.77
Total loans	**12,161,012**	**868,965**	**7.15**	11,029,551	705,589	6.40
Federal funds sold, et al	**54,274**	**3,041**	**5.60**	51,826	2,434	4.70
Securities: (3)						
Taxable securities						
U.S. Treasury securities	**418,560**	**16,718**	**3.99**	494,763	17,906	3.62
U.S. Government agencies securities	**963,618**	**36,777**	**3.82**	922,597	30,143	3.27
Mortgage-backed securities	**1,659,106**	**72,997**	**4.40**	1,418,144	59,084	4.17
Other investments	**63,024**	**2,682**	**4.26**	63,067	2,497	3.96
Tax-exempt securities						
States and political subdivisions	**78,727**	**4,910**	**6.24**	87,992	5,229	5.94
Total securities	**3,183,035**	**134,084**	**4.21**	2,986,563	114,859	3.85
Interest-bearing deposits in other banks	**200**	**3**	**1.53**	197	2	1.21
Total earning assets	**15,398,521**	**1,006,093**	**6.53**	14,068,137	822,884	5.85
Cash and due from banks	**310,843**			309,646		
Bank premises and equipment, net	**140,659**			143,177		
Other assets	**1,329,592**			1,154,561		
Less: allowance for loan losses	**(147,352)**			(154,502)		
Total assets	**$ 17,032,263**			$ 15,521,019		
Interest-bearing liabilities						
Deposits:						
Savings	**$ 1,246,877**	**6,339**	**0.51**	$ 1,428,445	5,545	0.39
Checking plus interest accounts	**1,272,953**	**2,655**	**0.21**	1,399,215	2,367	0.17
Money market	**2,077,613**	**56,967**	**2.74**	1,651,513	23,036	1.39
Time deposits $100,000 and over	**2,150,857**	**97,801**	**4.55**	1,627,194	51,714	3.18
Other time deposits	**2,388,767**	**87,356**	**3.66**	2,142,068	57,255	2.67
Total interest-bearing deposits	**9,137,067**	**251,118**	**2.75**	8,248,435	139,917	1.70
Short-term borrowings	**1,435,082**	**55,100**	**3.84**	1,105,988	26,266	2.37
Long-term debt	**682,324**	**36,717**	**5.38**	749,196	32,728	4.37
Total interest-bearing funds	**11,254,473**	**342,935**	**3.05**	10,103,619	198,911	1.97
Noninterest-bearing deposits	**3,236,404**			3,165,320		
Other liabilities and accrued expenses	**199,289**			155,663		
Total liabilities	**14,690,166**			13,424,602		
Shareholders equity	**2,342,097**			2,096,417		
Total liabilities & shareholders equity	**$ 17,032,263**			$ 15,521,019		
Net interest rate spread		**$ 663,158**	**3.48** %		$ 623,973	3.88 %
Effect of noninterest-bearing funds			**0.83**			0.56

Net interest margin on earning assets		**4.31 %**		4.44 %
Tax-equivalent adjustment included in:				
Loan income	**$ 5,402**		$ 4,757	
Investment securities income	**1,969**		2,090	
Total	**$ 7,371**		$ 6,847	

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(Dollars in thousands)	2004 Average Balance	Income (1) / Expense	Yield (1) / Rate	2003 Average Balance	Income (1) / Expense	Yield (1) / Rate
Earning assets						
Loans: (2),(4)						
Commercial	$ 2,725,452	$ 145,170	5.33 %	$ 2,478,707	$ 135,186	5.45 %
Commercial real estate	2,927,968	173,626	5.93	2,316,627	142,166	6.14
Construction	1,144,044	62,508	5.46	929,939	50,324	5.41
Residential real estate	1,643,504	98,596	6.00	1,350,034	88,292	6.54
Home equity lines	450,244	20,222	4.49	311,037	13,899	4.47
Consumer	828,197	50,940	6.15	702,638	47,973	6.83
Total loans	9,719,409	551,062	5.67	8,088,982	477,840	5.91
Federal funds sold, et al	59,848	1,501	2.51	250,462	3,337	1.33
Securities: (3)						
Taxable securities						
U.S. Treasury securities	741,127	28,710	3.87	1,021,513	41,233	4.04
U.S. Government agencies securities	810,014	28,554	3.53	709,519	32,399	4.57
Mortgage-backed securities	1,250,947	48,159	3.85	927,235	36,135	3.90
Other investments	57,193	2,389	4.18	20,804	807	3.88
Tax-exempt securities						
States and political subdivisions	94,308	5,404	5.73	69,888	4,543	6.50
Total securities	2,953,589	113,216	3.83	2,748,959	115,117	4.19
Interest-bearing deposits in other banks	158	2	1.17	9,085	60	0.66
Total earning assets	12,733,004	665,781	5.23	11,097,488	596,354	5.37
Cash and due from banks	291,540			266,173		
Bank premises and equipment, net	141,368			118,071		
Other assets	985,222			637,461		
Less: allowance for loan losses	(158,163)			(147,612)		
Total assets	$ 13,992,971			$ 11,971,581		
Interest-bearing liabilities						
Deposits:						
Savings	$ 1,425,423	4,197	0.29	$ 1,168,074	4,702	0.40
Checking plus interest accounts	1,289,295	1,899	0.15	1,071,877	2,061	0.19
Money market	1,571,462	9,584	0.61	1,357,234	9,757	0.72
Time deposits $100,000 and over	1,314,423	26,101	1.99	1,272,327	29,464	2.32
Other time deposits	1,933,799	41,622	2.15	1,852,622	47,206	2.55
Total interest-bearing deposits	7,534,402	83,403	1.11	6,722,134	93,190	1.39
Short-term borrowings	932,493	7,844	0.84	851,348	5,604	0.66
Long-term debt	645,375	22,009	3.41	517,386	18,451	3.57
Total interest-bearing funds	9,112,270	113,256	1.24	8,090,868	117,245	1.45
Noninterest-bearing deposits	2,879,290			2,269,720		
Other liabilities and accrued expenses	129,741			113,848		
Total liabilities	12,121,301			10,474,436		
Shareholders equity	1,871,670			1,497,145		
Total liabilities & shareholders equity	$ 13,992,971			$ 11,971,581		
Net interest rate spread		$ 552,525	3.99 %		$ 479,109	3.92 %
Effect of noninterest-bearing funds			0.36			0.40
Net interest margin on earning assets			4.35 %			4.32 %
Tax-equivalent adjustment included in:						
Loan income		$ 4,531			$ 4,897	
Investment securities income		2,213			1,863	
Total		$ 6,744			$ 6,760	

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(Dollars in thousands)	2002 Average Balance	Income (1) / Expense	Yield (1) / Rate	
Earning assets				
Loans: (2),(4)				
Commercial	$ 2,367,328	$ 148,380	6.27	%
Commercial real estate	1,915,994	130,995	6.84	
Construction	733,237	44,667	6.09	
Residential real estate	1,247,859	91,592	7.34	
Home equity lines	215,411	11,122	5.16	
Consumer	609,015	46,744	7.68	
Total loans	7,088,844	473,500	6.68	
Federal funds sold, et al	178,624	4,833	2.71	
Securities: (3)				
Taxable securities				
U.S. Treasury securities	1,478,387	67,531	4.57	
U.S. Government agencies securities	610,617	30,072	4.92	
Mortgage-backed securities	216,391	12,096	5.59	
Other investments	9,131	628	6.88	
Tax-exempt securities				
States and political subdivisions	38,799	3,135	8.08	
Total securities	2,353,325	113,462	4.82	
Interest-bearing deposits in other banks	358	15	4.12	
Total earning assets	9,621,151	591,810	6.15	
Cash and due from banks	227,034			
Bank premises and equipment, net	101,660			
Other assets	314,511			
Less: allowance for loan losses	(140,899)			
Total assets	$ 10,123,457			
Interest-bearing liabilities				
Deposits:				
Savings	$ 966,283	8,405	0.87	
Checking plus interest accounts	873,497	2,908	0.33	
Money market	1,096,417	14,223	1.30	
Time deposits $100,000 and over	1,080,347	34,671	3.21	
Other time deposits	1,759,160	62,362	3.54	
Total interest-bearing deposits	5,775,704	122,569	2.12	
Short-term borrowings	845,938	11,259	1.33	
Long-term debt	279,471	10,754	3.85	
Total interest-bearing funds	6,901,113	144,582	2.10	
Noninterest-bearing deposits	1,856,706			
Other liabilities and accrued expenses	107,671			
Total liabilities	8,865,490			
Shareholders equity	1,257,967			
Total liabilities & shareholders equity	$ 10,123,457			
Net interest rate spread		$ 447,228	4.05	%
Effect of noninterest-bearing funds			0.60	
Net interest margin on earning assets			4.65	%
Tax-equivalent adjustment included in:				
Loan income		$ 4,822		
Investment securities income		1,371		
Total		$ 6,193		

(1) Presented on a tax-equivalent basis using the statutory federal corporate income tax rate of 35%. See Reconciliation of Non-GAAP Measures.

(2) Nonaccrual loans are included in the respective average loan balances.

(3) Average investment securities are reported at amortized cost and exclude unrealized gains (losses) on securities available-for-sale.

(4) Loan fees of $1.5 million, $12.4 million, $11.1 million, $9.3 million and $9.7 million for 2006, 2005, 2004, 2003 and 2002, respectively, are included for rate calculation purposes. Loan fees decreased in 2006 due primarily to increased amortization of deferred loan origination costs.

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Net Interest Income and Net Interest Margin

Net interest income represents the largest source of Bankshares revenue. Changes in both the level of interest rates and the amount and composition of interest-earning assets and interest-bearing liabilities affect it. Interest rate risk represents one of the more significant risks facing financial institutions like Bankshares. See additional discussion under the caption Interest Rate Risk in section III. ANALYSIS OF FINANCIAL CONDITION. It is measured in terms of the effect changes in market interest rates have on net interest income. Bankshares is slightly asset sensitive, with assets repricing more quickly than liabilities in response to changes in interest rates. In a rising rate environment, Bankshares net interest margin (net interest income expressed as a percent of average earning assets) generally expands, causing the growth in net interest income to accelerate. Net interest income, on a fully tax-equivalent basis, was $663.2 million for 2006. This represents an increase of 6.3%, or $39.2 million, over the prior year s $624.0 million. In 2005, fully tax-equivalent net interest income increased by $71.4 million, or 12.9%, over 2004. As previously noted, net interest income is affected by changes in the volume of earning assets and the net interest margin earned thereon. The Rate/Volume Analysis table presents further details supporting this discussion.

The net interest margin decreased 13 basis points in 2006 to 4.31% from 4.44% in 2005. The decrease was attributable to a 40 basis point decline in the net interest spread, which was partially offset by a 27 basis point increase in the benefit derived from noninterest bearing sources of funds. The decline was due primarily to growth in premium money market accounts and certificates of deposit as customers shifted to these higher rate products; increased competition affecting yields on new loans and the overall yield on interest earning assets lagging the increase in funding costs. Bankshares paid an average rate of 2.75% on interest-bearing deposits during 2006, an increase of 105 basis points over 2005. By contrast, the yield on average loans and investments increased by 75 basis points and 36 basis points, respectively, from 2005.

Average earning assets increased by $1.3 billion, or 9.5%, in 2006, due primarily to the acquisition of James Monroe. Average total loans grew $1.1 billion, or 10.3%, during 2006, compared with an increase of $1.3 billion, or 13.5%, in 2005. Average securities, the other major component of earning assets, increased by $196.5 million, or 6.6%, in 2006 compared with an increase of $33.0 million, or 1.1%, in the prior year. See the following section III. ANALYSIS OF FINANCIAL CONDITION for a more in-depth discussion of balance sheet trends. The overall growth in average earning assets added $51.9 million to net interest income in 2006.

During 2006, the Federal Reserve Board raised rates four times, for a total increase of 100 basis points and the yield curve flattened dramatically. As of December 31, 2006, it is unclear what the direction of interest rates will be in 2007. The Federal Reserve has left rates unchanged since June 2006 and has stated a bias toward further rate increases in the future if growth is stronger than expected. Given the current rate environment, the inversion of the yield curve and the competitive pressure on both loan and deposit pricing, we anticipate that the net interest margin will remain under pressure well into next year. Management believes that Bankshares balance sheet is relatively well positioned with respect to Federal Reserve Board interest rate changes; however, competition for loans and deposits is expected to remain intense. For additional information regarding interest rate sensitivity, see the discussion in the Interest Rate Risk section in III. ANALYSIS OF FINANCIAL CONDITION.

SOURCES OF INCOME
(Dollars in millions)

SOURCES OF INCOME

(Dollars in millions)

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RATE/VOLUME ANALYSIS

A rate/volume analysis, which demonstrates changes in tax-equivalent interest income and expense for significant assets and liabilities, appears below. The calculation of rate and volume variances is based on a procedure established for banks by the Securities and Exchange Commission.

	For the year ended December 31, 2006 vs. 2005 Due to variances in			2005 vs. 2004 Due to variances in		
(Dollars in thousands)	**Total**	**Rates (5),(6)**	**Volumes (5),(6)**	**Total**	**Rates (5),(6)**	**Volumes (5),(6)**
Interest earned on:						
Loans:						
Commercial (1)	$ 35,130	$ 31,502	$ 3,628	$ 41,292	$ 30,033	$ 11,259
Commercial real estate (2)	51,601	17,768	33,833	52,730	18,762	33,968
Construction (3)	50,183	18,994	31,189	39,976	17,070	22,906
Residential real estate	13,834	4,126	9,708	6,716	(364)	7,080
Home equity lines	6,657	8,708	(2,051)	10,470	7,026	3,444
Consumer	5,971	314	5,657	3,343	(3,193)	6,536
Taxable securities	19,544	11,047	8,497	1,818	332	1,486
Tax-exempt securities (4)	(319)	259	(578)	(175)	200	(375)
Federal funds sold, et al	607	470	137	933	1,310	(377)
Interest-bearing deposits in other banks	1	1				
Total interest income	183,209	96,286	86,923	157,103	79,007	78,096
Interest paid on:						
Savings deposits	794	1,717	(923)	1,348	1,336	12
Checking plus interest deposits	288	551	(263)	468	282	186
Money market accounts	33,931	22,248	11,683	13,452	12,335	1,117
Time deposits $100,000 and over	46,087	22,276	23,811	25,613	15,673	9,940
Other time deposits	30,101	21,079	9,022	15,633	10,066	5,567
Short-term borrowings	28,834	16,198	12,636	18,422	14,302	4,120
Long-term debt	3,989	7,587	(3,598)	10,719	6,184	4,535
Total interest expense	144,024	108,956	35,068	85,655	66,138	19,517
Net interest earned	$ 39,185	$ (12,670)	$ 51,855	$ 71,448	$ 12,869	$ 58,579

(1) Tax-equivalent adjustments of $3.2 million for 2006 and $3.1 million for 2005 and 2004 are included in the calculation of commercial loan rate variances.

(2) Tax-equivalent adjustments of $0.9 million for 2006, $0.6 million for 2005 and $0.5 million for 2004 are included in the calculation of commercial real estate loan rate variances.

(3) Tax-equivalent adjustments of $1.3 million for 2006, $1.0 million for 2005 and $0.9 million for 2004 are included in the calculation of construction loan rate variances.

(4) Tax-equivalent adjustments of $1.9 million for 2006, $2.1 million for 2005 and $2.2 million for 2004 are included in the calculation of investment securities rate variances.

(5) Changes attributable to mix (rate and volume) are included in the volume variance.

(6) Categories do not add due to the effect of changes in product mix.

Interest Income

Fully tax-equivalent interest income amounted to $1.0 billion in 2006, an increase of $183.2 million, or 22.3%, from $822.9 million in 2005. This compares favorably with the $157.1 million, or 19.1%, increase in 2005 from 2004. The increase in 2006 was due to a 68 basis point improvement in the yield on interest earning assets and $1.3 billion in additional loans and securities outstanding, which contributed $163.4 million and $19.2 million, respectively, in additional interest income. During 2005, the increase was due to growth in average loans and securities that contributed $85.9 million, and an increase in market interest rates, that resulted in a $71.2 million increase from the higher yield on interest-earning assets.

At December 31, 2006, the prime rate was 8.25%, compared with 7.25% and 5.25% at year-end 2005 and 2004, respectively. The average prime rate was 7.96% for 2006, compared with 6.19% for 2005, an increase of 177 basis points. The yield on average total loans in 2006 was 7.15%, a 75 basis point increase from 6.40% in 2005. The commercial, construction and home-equity loan portfolios are the most sensitive to changes in short-term interest rates. The average yield on the construction and home-equity loan portfolios increased 128 basis points and 172 basis points, respectively, while the commercial loan portfolio yield increased 108 basis points over 2005.

The commercial real estate loan portfolio includes both fixed and variable-rate loans and the average portfolio yield increased 52 basis points. The residential real estate and consumer loan portfolios are affected mostly by intermediate and long-term rates and do not move with the prime rate. The yields on the consumer loan portfolio and the residential real estate portfolios increased by 3 basis points and 23 basis points, respectively.

The yield on investment securities increased 36 basis points to 4.21% in 2006 from 3.85% in 2005. The yield on the portfolio increased two basis points in 2005 from 3.83% in 2004. The investment portfolio was particularly affected by the flat yield curve. Securities are typically purchased in two-year to five-year maturities. Market rates for two-year to five-year terms only increased 22 to 30 basis points at December 31, 2006 compared to the previous year. During 2006, Bankshares continued to follow a strategy to diversify the portfolio to a mix of U.S. Treasury, U.S. Government agencies and mortgage-backed securities. This has resulted in a mix of 13.2%, 30.3% and 52.1% of Treasury, agency and mortgage-backed securities, respectively, in 2006. The other 4.4% of the investment securities was comprised of 2.4% municipals and 2.0% other investments for 2006.

Interest Expense

Total interest expense in 2006 was $342.9 million, an increase of $144.0 million, or 72.4%, from $198.9 million in 2005. The increase in interest expense for 2006 was attributable to an increase in the rate paid on total interest-bearing funds of 108 basis points and an 11.4% growth in average balances. Total interest expense in 2005 was $85.7 million greater than the $113.3 million reported in 2004. With the expectation that the yield curve will remain flat to inverted in 2007, we anticipate deposit customers will continue to migrate to short-term, high-yielding deposit products. See management s discussion under Interest Rate Risk in III. ANALYSIS OF FINANCIAL CONDITION for further information regarding Bankshares exposure to changes in interest rates.

The rate paid on total average interest-bearing deposits was 2.75% in 2006, an increase of 105 basis points from 1.70% in 2005. The rate paid on savings, checking plus interest and money market accounts increased 12 basis points, 4 basis points and 135 basis points, respectively. Time deposits of $100,000 and over increased 137 basis points, while the rate paid on other time deposits increased 99 basis points in 2006.

The most interest rate sensitive source of funds is short-term borrowings. This category is comprised of federal funds purchased, securities sold under agreements to repurchase and commercial paper. The duration of these funds is very short, with most repricing daily. Reflecting the rate environment, the rate paid on short-term borrowings increased 147 basis points to 3.84% in 2006, after having increased by 153 basis points in 2005 to 2.37%. The rate paid on long-term debt increased 101 basis points in 2006, following an increase of 96 basis points in the prior year. The increase is related primarily to the increase in interest rate swap costs on Bankshares long-term debt. The $200.0 million of 10-year debt issued by MSD&T in the fourth quarter of 2001, issued at a fixed rate of 5.70%, was converted to a floating rate through an interest rate swap. The notes reprice quarterly and carried an effective cost of 6.02% during 2006 versus 4.24% in 2005. Additionally, Bankshares issued $300.0 million of subordinated debt in April 2003. The notes were issued at a fixed rate of 4.63%. Subsequently, $150.0 million of this debt was converted to a floating rate through interest rate swaps. The effect of the swaps increased the cost on the $300.0 million debt to 5.30% during 2006 versus 4.37% in 2005. Additionally, approximately $17.6 million in Trust Preferred Securities were acquired as part of the James Monroe acquisition at an average rate of 6.34%, which contributed to the increase.

NONINTEREST INCOME

A schedule of noninterest income over the past three years is presented below:

(Dollars in thousands)	Year ended December 31, 2006	2005	2004	% Change 2006/2005	2005/2004
Investment and wealth management	**$ 110,879**	$ 95,756	$ 90,050	15.8 %	6.3 %
Service charges on deposit accounts	**46,339**	43,885	44,263	5.6	(0.9)
Mortgage banking-related fees	**6,786**	15,019	11,495	(54.8)	30.7
Net investment securities gains	**212**	405	1,239	(47.7)	(67.3)
Nonmarketable investments:					
Private equity and other investments	**10,404**	10,379	2,569	0.2	304.0
Hedge funds	**6,241**	4,720	5,529	32.2	(14.6)
Bank-owned life insurance	**6,875**	4,783	3,324	43.7	43.9
Total nonmarketable investments	**23,520**	19,882	11,422	18.3	74.1
Other income:					
Electronic banking fees	**25,696**	23,969	21,766	7.2	10.1
Charges and fees on loans	**11,988**	12,664	10,833	(5.3)	16.9
Insurance	**16,039**	15,017	13,358	6.8	12.4
All other income	**13,275**	16,523	9,503	(19.7)	73.9
Total other income	**66,998**	68,173	55,460	(1.7)	22.9
Total	**$ 254,734**	$ 243,120	$ 213,929	4.8	13.6

Noninterest Income

Noninterest income for 2006 increased by $11.6 million, or 4.8%, to $254.7 million from $243.1 million for 2005. The table above shows the major components of noninterest income. IWM revenue includes personal and institutional fee income related primarily to trust, brokerage and custody services. IWM revenue represented the largest source of noninterest income at 43.5%. Revenues increased 15.8% to $110.9 million in 2006. Growth in IWM revenue was due principally to stronger equity markets, growth in Private Banking, increased brokerage activity, stronger performance in the hedge funds-of-funds (hedge funds) and the restructuring of a major advisory relationship resulting in the formation of Mercantile Real Estate Advisors, Inc. The restructuring of this relationship resulted in increased real estate pension fees of $10.7 million in 2006 over 2005. See the preceding discussion in Segment Reporting for additional information relating to IWM.

Service charges on deposit accounts increased $2.5 million over 2005 due primarily to increases in business overdraft fees. Mortgage banking-related fees were $8.2 million lower than the prior year due principally to the sale of Columbia National Real Estate Finance, LLC.

Nonmarketable investment income represents revenues derived from investing in private equities, hedge funds, Federal Reserve Bank and Federal Home Loan Bank securities acquired to meet various regulatory requirements and bank-owned life insurance (BOLI). In 2006, nonmarketable investment income increased $3.6 million, or 18.3%, over 2005 as a result of a $1.5 million increase in hedge funds revenue and higher income from bank-owned life insurance. The increase in BOLI revenue was due to a full year of earnings from an investment of an additional $50 million made in the third quarter of 2005.

Other income includes several categories. Electronic banking fees consist of merchant card processing fees, foreign ATM fees and check card fees. These fees increased by $1.7 million, or 7.2%, from 2005 due to higher volumes. Insurance revenues increased $1.0 million and are derived from fee income related to the sale and servicing of insurance products. All other income decreased $3.2 million from the prior year due primarily to gains on sales of bank-owned premises of $1.7 million for 2006, compared with $4.3 million for the year 2005.

NONINTEREST EXPENSES

A schedule of noninterest expenses over the past three years is presented below.

(Dollars in thousands)	Year ended December 31, 2006	2005	2004	% Change 2006/2005	2005/2004
Salaries	**$ 205,826**	$ 200,222	$ 187,621	2.8 %	6.7 %
Employee benefits	**56,100**	46,175	44,676	21.5	3.4
Net occupancy expense of bank premises	**32,783**	28,596	24,307	14.6	17.6
Furniture and equipment expenses	**33,445**	31,659	31,439	5.6	0.7
Communications and supplies	**16,034**	16,406	16,904	(2.3)	(2.9)
Professional services	**31,483**	21,914	25,302	43.7	(13.4)
Advertising and promotional expenses	**11,663**	9,103	8,418	28.1	8.1
Other expenses:					
Electronic banking expenses	**14,073**	13,946	11,509	0.9	21.2
Amortization of intangible assets	**9,901**	8,773	8,142	12.9	7.7
Outsourcing expenses	**11,062**	11,231	5,342	(1.5)	110.2
All other expenses	**35,019**	32,796	28,298	6.8	15.9
Total other expenses	**70,055**	66,746	53,291	5.0	25.2
Total	**$ 457,389**	$ 420,822	$ 391,958	8.7	7.4

Noninterest Expenses

Noninterest expenses increased $36.6 million, or 8.7%, from 2005. The table above shows the major components of noninterest expenses. The principal reasons for the year-over-year increase were expenses of $13.4 million related to the James Monroe acquisition and the pending merger with PNC. Excluding the $13.4 million of PNC and James Monroe merger-related expenses, noninterest expenses increased $23.2 million from the prior year. This increase was comprised of $15.3 million in merit and staffing expenses; $6.1 million in stock-based compensation; $0.6 million in directors fees; and $9.9 million in employee benefits, due primarily to increased pension costs of $5.7 million and higher health insurance expenses of $2.6 million. Net occupancy expenses of bank premises increased $4.2 million due primarily to increased rent expenses and furniture and equipment expenses increased $1.8 million. Also contributing to the overall increase in noninterest expenses were $2.8 million in professional fees, $2.6 million in promotional fees and a $2.1 million increase in tax and licensing fees related to the restructuring of a real estate pension advisory relationship. These increases were partially offset by a reduction of $15.9 million in salaries expense due to an increase in the amount of loan origination costs deferred and an $8.7 million decrease in incentive compensation. Included in the $23.2 million increase in noninterest expenses was $6.2 million of operating expenses from James Monroe, which was acquired during the third quarter of 2006.

Controlling costs and maintaining operational efficiencies remains a primary objective for Bankshares. A closely monitored key measure is Bankshares overall efficiency ratio. It is computed by dividing noninterest expenses by the sum of net interest income on a tax-equivalent basis and noninterest income. Bankshares efficiency ratio was 49.83% for 2006 compared with 48.53% for 2005. The cash operating efficiency ratio excludes amortization expense for intangibles and nonoperating income and expenses, such as securities gains and losses and other significant gains, losses or expenses (such as those associated with integrating acquired entities operations into Bankshares or the merger with PNC) unrelated to Bankshares core operations. When calculating certain performance ratios, Bankshares believes that excluding these costs and income helps the investor to evaluate and compare the results of our core, ongoing business operations. Bankshares cash operating efficiency ratio was 47.32% and 47.61% for 2006 and 2005, respectively. See Reconciliation of Non-GAAP Measures found in Item 7.

Salaries, which include base compensation, commissions, incentive compensation and stock-based compensation, are the largest component of noninterest expenses at 45.0%. Salaries increased $5.6 million, or 2.8%, over 2005. This increase was comprised of $15.3 million in merit and staffing expenses; $6.1 million in stock-based compensation; $6.3 million in compensation related to the merger with PNC and $1.6 million in directors fees; and $0.5 million in deferred compensation. These increases were partially offset by a reduction of $15.9 million in salaries expense due to an increase in the amount of loan origination costs deferred and an $8.7 million decrease in incentive compensation.

Noninterest Income Noninterest income for 2006 increased by $11.6 million, or 4.8%, to $254.7 million from $243.1

Employee benefit expenses increased $9.9 million, due primarily to increased pension costs of $5.7 million, higher insurance expenses of $2.6 million and a $1.3 million increase in payroll taxes related to increased salary expenses.

Net occupancy expense, which includes premises depreciation, rents, maintenance and utilities increased $4.2 million due primarily to increased rent expenses and higher utility costs. Furniture and equipment expenses, which include depreciation, rental and maintenance expense associated with the upkeep and improvement of hardware and computer software, increased $1.8 million.

Other expenses consist of professional services, advertising and promotion, electronic banking, intangible amortization, outsourcing and all other expenses. Other expenses increased $15.4 million, or 15.8%, in 2006. Professional services increased $9.6 million of which $6.8 million was related to the PNC merger. Amortization of intangibles increased $1.1 million, from $8.8 million in 2005 to $9.9 million in 2006, the majority of which resulted from the James Monroe merger. The remaining increase in other expenses was due primarily to an increase in promotional fees of $2.6 million and an increase of $2.1 million in tax and licensing fees, which was primarily related to the restructuring of a real estate pension advisory relationship.

III. ANALYSIS OF FINANCIAL CONDITION

Investment Securities

Bankshares investment securities portfolio is structured to manage liquidity, interest rate risk and regulatory capital and to take advantage of market conditions that create more economically attractive returns on investments. The total investment securities portfolio was $3.1 billion at December 31, 2006 and 2005, with net unrealized losses of $39.2 million and $51.7 million for the years ended December 31, 2006 and 2005, respectively. The portfolio consists of short-term and intermediate-term U.S. Treasury and U.S. Government agency obligations, adjustable-rate mortgage-backed securities (ARMs) and intermediate average-life agency collateralized mortgage obligations (CMOs). More than 99.5% of the total investment portfolio is classified as available-for-sale.

At December 31, 2006, the weighted-average maturity of the debt securities available-for-sale portfolio was 2.0 years compared with 2.3 years at December 31, 2005. Since 58.6% of this portfolio was mortgage-backed securities, the expected remaining maturity may differ from contractual maturity because borrowers may have the right to prepay obligations before the underlying mortgages mature. The fair value of the debt securities available-for-sale portfolio at December 31, 2006 was 98.7% of amortized cost compared with 98.2% at December 31, 2005. The fair value and unrealized loss on securities as of December 31, 2006, segregated by those securities that have been in an unrealized loss position for a year or more, was $1.8 billion and $39.8 million, respectively. Because the declines in fair value were due to changes in interest rates, not in estimated cash flows or credit quality, no charge for an other-than-temporary impairment was required at December 31, 2006. The reference point for determining those securities in an unrealized loss position is quarter-end. As such, it is possible that a security had a market value that exceeded its amortized cost on other days during 2006.

The estimated effects of a 200 basis point increase or decrease in interest rates on the fair value and the expected remaining maturity of the mortgage-backed securities available-for-sale portfolio are provided in the table below.

(Dollars in millions)	**Fair Value**	**Net Unrealized Gain (Loss)**	**Remaining Maturity in Years**
At December 31, 2006	$ 1,821.7	$ (31.3)	2.6
Assuming a 200 basis point:			
Increase in interest rates	1,674.9	(146.8)	4.2
Decrease in interest rates	1,838.3	16.6	1.1

More information on the investment portfolio is provided in the following table and in Note No. 3 - Investment Securities in Notes to Consolidated Financial Statements.

DEBT INVESTMENT PORTFOLIO

The following summary shows the maturity distribution and average tax-equivalent yields for the bond investment portfolio at December 31, 2006.

(Dollars in thousands)	Within 1 Year	1-5 Years	5-10 Years	After 10 Years	Total
Securities available-for-sale (1)					
U.S. Treasuries					
Fair Value	$ 140,764	$ 195,753	$	$	$ 336,517
Yield	3.81 %	4.50 %	%	%	4.21 %
U.S. Government agencies					
Fair Value	$ 510,795	$ 326,930	$ 12	$	$ 837,737
Yield	3.86 %	4.46 %	7.54 %	%	4.10 %
States and political subdivisions					
Fair Value	$ 2,080	$ 27,551	$ 27,068	$	$ 56,699
Yield	5.39 %	5.45 %	5.93 %	%	5.68 %
Mortgage-backed securities (2)					
Fair Value	$ 99,742	$ 1,610,457	$ 111,531	$	$ 1,821,730
Yield	4.04 %	4.71 %	4.58 %	%	4.67 %
Other bonds, notes and debentures					
Fair Value	$ 3,984	$ 1,952	$	$	$ 5,936
Yield	2.72 %	4.28 %	%	%	3.23 %
Total securities available-for-sale					
Fair Value	$ 757,365	$ 2,162,643	$ 138,611	$	$ 3,058,619
Yield	3.87 %	4.66 %	4.85 %	%	4.48 %
Securities held-to-maturity					
States and political subdivisions					
Amortized Cost	$ 1,990	$ 5,574	$ 5,535	$	$ 13,099
Yield	5.47 %	6.85 %	7.85 %	%	7.07 %

(1) Investment securities available-for-sale are presented at estimated fair value. Yields on such securities are based on amortized cost.

(2) Maturities are reflected based on projected maturities at time of purchase. Actual maturities will vary as a result of the level of loan prepayments in the underlying mortgage pools.

LOAN COMPOSITION AND GROWTH

Average Loans (Dollars in millions)

Five-Year Compound Growth Rate: 12.2%

Loan Portfolio

A comparative chart of average loan balances is included below; year-end balances are in Note No. 4 - Loans and Allowance for Loan Losses and Reserve for Unfunded Commitments in Notes to Consolidated Financial Statements.

Loans totaled $12.8 billion for the year ended December 31, 2006, an increase of 10.2% over the $11.6 billion for the year ended December 31, 2005. Loans averaged $12.2 billion in 2006 compared with $11.0 billion in 2005, an increase of 10.3%. On average in 2006, commercial real estate grew 13.9%; construction grew 25.7%; residential real estate loans grew 8.9%; and consumer loans increased 10.4% over 2005. The increases in the various loan categories resulted from both organic growth and the acquisition of James Monroe, which added $414 million in loans. On an average basis, the percentage of commercial real estate loans to total loans increased to 32.3% in 2006 from 31.2% in 2005. The shift in the loan portfolio from commercial loans to commercial real estate loans reflected economic activity in our local market.

COMPOSITION OF LOANS

	Average Balances									
(Dollars in thousands	**2006**		**2005**		**2004**		**2003**		**2002**	
Commercial	**$ 2,948,882**	**24.2 %**	$ 2,900,598	26.3 %	$ 2,725,452	28.1 %	$ 2,478,707	30.6 %	$ 2,367,328	33.4 %
Commercial real estate	**3,922,356**	**32.3**	3,444,921	31.2	2,927,968	30.1	2,316,627	28.6	1,915,994	27.0
Construction	**1,851,632**	**15.2**	1,473,353	13.4	1,144,044	11.8	929,939	11.5	733,237	10.3
Residential real estate	**1,918,257**	**15.8**	1,761,955	16.0	1,643,504	16.9	1,350,034	16.7	1,247,859	17.6
Home equity lines	**480,747**	**4.0**	507,153	4.6	450,244	4.6	311,037	3.9	215,411	3.0
Consumer	**1,039,138**	**8.5**	941,571	8.5	828,197	8.5	702,638	8.7	609,015	8.7
Total	**$ 12,161,012**	**100.0 %**	$ 11,029,551	100.0 %	$ 9,719,409	100.0 %	$ 8,088,982	100.0 %	$ 7,088,844	100.0 %

Noninterest Income Noninterest income for 2006 increased by $11.6 million, or 4.8%, to $254.7 million from $243.1

Deposits

Bankshares primary source of funding for its investing and lending activities is deposits gathered by the 240 branches of its banking affiliates. Average total deposits in 2006 were $12.4 billion, representing an increase of $959.7 million, or 8.4%, over the prior year average of $11.4 billion. For the year ended December 31, 2006, 80.4% of the funding for average earning assets was derived from deposits compared with 81.1% for the year ended December 31, 2005. The affiliate-banking model positions Bankshares to compete not only with the large national and regional banking companies in the gathering of these funds, but also with local community banks. Based on historical experience, management

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believes Bankshares is well-positioned to retain this core customer base, although pricing pressure is expected to be intense. Bankshares continues to promote its cash management services to its commercial customers in order to maintain and expand this key source of funding. However, should there be an outflow of deposits the investment portfolio should provide adequate liquidity.

In 2006, interest-bearing deposits represented 73.8% of average total deposits and totaled $9.1 billion, reflecting growth of 10.8% from 2005. Growth in savings accounts slowed as customers demonstrated a stronger preference for higher yielding money market and certificates of deposit accounts. Checking plus interest accounts decreased 9.0% from 2005 to $1.3 billion. Time deposits $100,000 and over and other time deposits increased 20.4% on average in 2006 over 2005.

DEPOSIT MIX

	Average Balances									
(Dollars in thousands	**2006**		**2005**		**2004**		**2003**		**2002**	
Noninterest-bearing deposits	**$ 3,236,404**	**26.2 %**	$ 3,165,320	27.7 %	$ 2,879,290	27.6 %	$ 2,269,720	25.2 %	$ 1,856,706	24.3 %
Interest-bearing deposits:										
Savings	**1,246,877**	**10.1**	1,428,445	12.5	1,425,423	13.7	1,168,074	13.0	966,283	12.7
Checking plus interest	**1,272,953**	**10.2**	1,399,215	12.2	1,289,295	12.4	1,071,877	11.9	873,497	11.4
Money market	**2,077,613**	**16.8**	1,651,513	14.5	1,571,462	15.1	1,357,234	15.1	1,096,417	14.4
Time deposits $100,000 and over	**2,150,857**	**17.4**	1,627,194	14.3	1,314,423	12.6	1,272,327	14.2	1,080,347	14.2
Other time deposits	**2,388,767**	**19.3**	2,142,068	18.8	1,933,799	18.6	1,852,622	20.6	1,759,160	23.0
Total	**$ 12,373,471**	**100.0 %**	$ 11,413,755	100.0 %	$ 10,413,692	100.0 %	$ 8,991,854	100.0 %	$ 7,632,410	100.0 %

Risk Management

Bankshares has established an integrated risk management structure in which senior management regularly identifies, measures and manages risks. The Chief Risk Officer coordinates and directs the work of several standing management committees charged with managing the risks Bankshares faces and provides regular reports to the Audit Committee. These committees are listed below.

Credit Quality Committee

The Credit Quality Committee oversees the establishment of consistent credit quality policies and, among other responsibilities, works with management in determining important financial reporting information, including the allowance for loan and lease loss reserve. A centralized loan review function is charged with analyzing the risks and quality of the lending portfolios. Among other things, Loan Review reaffirms or modifies individual loan-risk ratings in accordance with Bankshares Loan Policy. The Committee reports quarterly to the Audit Committee. The members of the Committee include the senior vice presidents of Loan Review, Chief Financial Officer, Chief Administrative/Risk Officer, Vice Chairman/Chief Operating Officer and Chief Executive Officer of Bankshares, the senior vice president of Credit Policy at MSD&T, the executive vice president of Affiliate Administration and Bankshares Treasurer.

Asset and Liability Committee

The Asset and Liability Committee (ALCO) manages interest rate risk, market risk and liquidity risk. These risks are described in more detail in this Item 7.

Compliance Committee

The Compliance Committee establishes compliance guidelines and ensures strict compliance with all relevant regulatory and statutory requirements for Bankshares and its affiliates. In creating the Compliance Committee, management intended to foster a strong compliance function, which would establish global compliance guidelines and ensure strict compliance for Bankshares and its affiliates with relevant banking statutes and regulations, including the Bank Secrecy Act, anti-money laundering statutes and fair lending statutes. A chief compliance officer oversees compliance with existing regulatory requirements and is responsible for developing a comprehensive training program.

Noninterest Income Noninterest income for 2006 increased by $11.6 million, or 4.8%, to $254.7 million from $243.1

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Compliance deficiencies are reported to senior management through the General Counsel and the Compliance Committee. As part of its mission, the Committee regularly assesses Bankshares compliance efforts and maintains a high level of awareness about compliance and its effect on daily activities. The chief compliance officer prepares a report, at least quarterly, that includes (1) the results of compliance monitoring activities and any compliance concerns identified with recommended corrective action, (2) regulatory developments related to new and revised regulations and proposed regulations, (3) compliance training activities, (4) compliance initiatives, (5) regulatory exams, and (6) customer complaints. The Committee s meetings are chaired by the General Counsel and are held quarterly. In addition, the chief compliance officer presents the compliance report to the Audit Committee quarterly.

Disclosure Committee

The Disclosure Committee is comprised of senior representatives of all of Bankshares business lines and is responsible for reviewing Bankshares periodic filings and disclosures in order to ensure compliance with the requirements of U.S. securities laws. In conjunction with the Chief Executive Officer and the Chief Financial Officer, the Disclosure Committee is charged with the design and oversight of internal controls over financial reporting.

The Committee conducts a systematic analysis of Bankshares annual and quarterly filings and reports filed on Form 8-K. It has established and evaluates the disclosure policies and procedures relating to the various certification requirements of the Chief Executive Officer and the Chief Financial Officer, as required by sections 302, 404, and 906 of The Sarbanes-Oxley Act of 2002.

The Committee, at least annually, performs an analysis of the primary business processes/cycles that support financial reporting. The Committee reviews important changes in the law related to disclosure requirements with Bankshares external and internal legal counsel. The Chief Financial Officer and his subordinates monitor important changes in accounting standards and evaluate changes in the organization that may affect internal controls over financial reporting or that may require disclosure, and regularly report to the Committee on such developments. The Committee regularly reports to the Audit Committee.

Technology and Operations Committee

The Technology and Operations Committee evaluates operational risk on an ongoing basis. The Committee has developed an Operational and IT Risk framework, including the evaluation of key risk indicators and the integration with existing Bankshares internal control and risk-assessment efforts. Specifically, the Committee ensures that risk management is a responsibility of all layers of management, and it monitors the implementation of the various operational and information technology risk policies of Bankshares. The Committee ensures that a structure and process exist for the continuous identification and evaluation, and subsequent remediation, of operational risk. Membership includes eight individuals from the Operations & Technology Division. Ad hoc members include representatives from executive management, business units, Internal Audit, Financial Services and Compliance. The President of MSD&T and the Chief Risk Officer/Chief Administrative Officer are kept apprised of the Committee s activities. The Chair of the Committee, the executive vice president of Operations & Technology Services, reports to the Audit Committee at least annually.

Credit Risk Analysis

Bankshares loans and commitments are substantially to borrowers located in its immediate region. Bankshares has restricted its participation in multibank credits where Bankshares is not the managing or agent bank. Central to the operation of a sound and successful financial institution is the balanced management of asset growth and credit quality. Responsibility for loan underwriting and monitoring is clearly fixed on key management personnel in each of our affiliates and, ultimately, on the boards of directors of each affiliate. These responsibilities are supported at the holding company level by appropriate underwriting guidelines and effective ongoing loan review. In addition, Bankshares has set an internal limit for each affiliate bank that is well below the regulatory limit on the maximum amount of credit that may be extended to a single borrower.

Bankshares loan review function examines each affiliate bank at least once every five quarters. These examinations provide Bankshares management with an independent perspective as to overall loan portfolio quality, risk profile, risk trends and credit administration processes at each affiliate. The Audit Committee receives quarterly reports on the findings.

ALLOWANCE AS A PERCENT OF PERIOD-END LOANS; NONPERFORMING LOANS AS A PERCENT OF PERIOD-END LOANS

ALLOWANCE FOR LOAN LOSSES and RESERVE FOR UNFUNDED COMMITMENTS

Allowance for loan losses (Dollars in thousands)	**Year Ended December 31,** **2006**	**2005**	**2004**	**2003**	**2002**
Allowance for loan losses, beginning of period	**$ 156,673**	$ 149,002	$ 155,337	$ 138,601	$ 141,463
Allowance of acquired bank	**3,985**	7,086		13,205	
Charge-offs:					
Commercial	**(2,459)**	(3,692)	(13,433)	(6,916)	(18,193)
Commercial real estate	**(447)**	(32)	(67)	(625)	(471)
Construction				(170)	
Residential real estate	**(54)**	(202)	(427)	(246)	(251)
Home equity lines	**(35)**	(91)	(7)	(29)	(74)
Consumer	**(3,292)**	(3,585)	(4,446)	(4,338)	(3,232)
Total	**(6,287)**	(7,602)	(18,380)	(12,324)	(22,221)
Recoveries:					
Commercial	**3,067**	3,545	1,768	1,345	896
Commercial real estate	**129**	158	118	174	161
Construction	**2**	446	5	136	226
Residential real estate	**73**	238	442	125	128
Home equity lines	**24**		38	44	83
Consumer	**2,177**	2,224	2,453	1,926	1,487
Total	**5,472**	6,611	4,824	3,750	2,981
Net charge-offs	**(815)**	(991)	(13,556)	(8,574)	(19,240)
Provision for credit losses	**(990)**	1,576	7,221	12,105	16,378
Transfer to reserve for unfunded commitments	**(15,824)**				
Allowance for loan losses, end of period	**$ 143,029**	$ 156,673	$ 149,002	$ 155,337	$ 138,601
Average loans	**$ 12,161,012**	$ 11,029,551	$ 9,719,409	$ 8,088,982	$ 7,088,844
Period-end loans	**$ 12,792,733**	$ 11,607,845	$ 10,228,433	$ 9,272,160	$ 7,312,027
Percent of net charge-offs to average loans	**0.01 %**	0.01 %	0.14 %	0.11 %	0.27 %
Percent of allowance for loan losses to period-end loans	**1.12 %**	1.35 %	1.46 %	1.68 %	1.90 %

Reserve for unfunded commitments (Dollars in thousands)	**Year Ended December 31,** **2006**	**2005**	**2004**	**2003**	**2002**
Reserve for unfunded lending commitments, beginning of period	**$**	$	$	$	$
Provision for credit losses	**990**				
Transfer from allowance for loan losses	**15,824**				
Reserve for unfunded lending commitments, end of period	**$ 16,814**	$	$	$	$

Bankshares maintains an allowance for loan losses at a level considered by management to be adequate to absorb potential losses inherent in the loan portfolio. Each Bankshares affiliate is required to maintain an allowance for loan losses adequate to absorb losses inherent in its individual loan portfolio. Each affiliate s reserve is dedicated to that affiliate only and is not available to absorb losses from another affiliate. The allowance for loan losses is comprised of specific allocations to impaired loans and general allocations to pools of loans not deemed impaired. It may also include an unallocated amount. The portfolio review and the calculation of the allowance for loan losses are performed on a quarterly basis by Bankshares management. The calculation is reviewed by the Bankshares Credit Quality Committee and each affiliate bank as to its allowance. Final approval rests with the Credit Quality Committee. The final evaluation is reviewed with the Bankshares Audit Committee. All loan loss reserves are subject to annual bank regulatory examinations and determinations as to their methodology and adequacy. Overall, the determinations of the allowance for loan losses incorporate SFAS No. 114, Accounting by Creditors for Impairment of a Loan - an amendment of FASB Statements No. 5 and 15, and SFAS No. 118, Accounting by Creditors for Impairment of a Loan - Income Recognition and Disclosure. Also incorporated in determination of the allowance is SFAS No. 5, Accounting for Contingencies ; guidance contained in the Securities and Exchange Commission s Staff Accounting Bulletin (SAB) No. 102, Loan Loss Allowance Methodology and Documentation ; and the Federal Financial Institutions Examination Council s Policy Statement on Allowance for Loan and Lease Losses Methodologies and Documentation for Banks and Savings Institutions.

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ALLOCATION OF ALLOWANCE FOR LOAN LOSSES

The following table presents the amount of allowance for loan losses and the percentage distribution of loan amounts in each category, at the date shown.

	Allowance amount allocated as of December 31,									
	2006		**2005**		**2004**		**2003**		**2002**	
(Dollars in thousands)	**Amount**	**% of Total Loans**	**Amount**	**% of Total Loans**	**Amount**	**% of Total Loans**	**Amount**	**% of Total Loans**	**Amount**	**% of Total Loans**
Allowance amount allocated to:										
Commercial	**$ 37,290**	**23.9 %**	$ 55,421	25.5 %	$ 58,915	28.0 %	$ 94,584	28.5 %	$ 97,472	32.8 %
Commercial real estate	**47,612**	**33.1**	39,790	31.9	32,770	30.5	28,237	29.6	21,275	27.6
Construction	**35,980**	**15.7**	16,163	13.8	11,080	12.4	10,806	11.5	9,644	11.1
Residential real estate	**7,221**	**15.7**	12,371	15.5	10,303	16.4	7,263	16.6	3,645	16.9
Home equity lines	**1,634**	**3.6**	3,342	4.4	5,460	4.9	4,710	4.5	1,860	3.3
Consumer	**4,541**	**8.0**	10,808	8.9	8,787	7.8	9,737	9.3	4,705	8.3
Allowance amount not allocated	**8,751**		18,778		21,687					
Total	**$ 143,029**	**100.0 %**	$ 156,673	100.0 %	$ 149,002	100.0 %	$ 155,337	100.0 %	$ 138,601	100.0 %

Allowance for Loan Losses

The allowance for loan losses has been established through provisions for loan losses against income. Loans deemed uncollectible are charged against the allowance for loan losses and any subsequent recoveries are credited to the allowance. The total allowance for loan losses decreased $13.6 million from year-end 2005 to $143.0 million at December 31, 2006, which reflected the addition of $4.0 million of James Monroe s allowance at consummation under SOP 03-3, Accounting for Certain Loans or Debt Securities Acquired in a Transfer. The allowance for loan losses as a percent of loans declined to 1.12% at December 31, 2006 compared with 1.35% at December 31, 2005. This reflects the establishment of the reserve for unfunded commitments, the overall improving credit quality trends. During 2006, there was no provision for loan loss expense compared with $1.6 million in 2005. Net charge-offs decreased to $815 thousand during 2006 compared with $991 thousand during 2005. The consumer portfolio represented the largest net charge-off amount for 2006 at $1.1 million. Net charge-offs as a percent of average loans were 0.01%, 0.01% and 0.14% for the years ended December 31, 2006, 2005 and 2004, respectively. Intensive collection efforts continue after a loan is charged off in order to maximize the recovery of amounts previously charged off. Recoveries as a percent of loans charged off were 87.0% in 2006, 86.9% in 2005 and 26.3% in 2004. Recoveries in a given year may not relate to loans charged off in that year. Further details related to the allowance for loan losses are shown in the tables above and in Note No. 4 - Loans and Allowance for Loan Losses and Reserve for Unfunded Commitments in Notes to Consolidated Financial Statements.

The allowance for loan losses is comprised of specific allocations to impaired loans, general allocations to pools of loans not deemed impaired and an unallocated amount. Current trends and economic conditions that affect the collectibility of the loan portfolio are incorporated into the general allocation. These can include, but are not limited to, exposure to an industry experiencing problems, changes in the nature or volume of the portfolio, delinquency and nonaccrual trends.

The specific allowance allocation is based on an analysis of the loan portfolio by each affiliate bank and Loan Review. Each loan with an outstanding balance in excess of a specified threshold that is either on nonaccrual status or on the Watchlist is evaluated. The Watchlist represents loans identified and closely followed by management. They possess certain qualities or characteristics that may lead to collection and loss issues. Monitored loans, which are included in the Watchlist, display additional risk characteristics suggesting that they may be classified as nonperforming loans in the near future. The identified loans are evaluated for potential loss in accordance with SFAS No. 114 and SFAS No. 118 by analyzing current collateral values or present values of cash flows, as well as the capacity of the guarantor, as applicable. The specific allocation resulting from this review increased to $6.6 million at December 31, 2006 from $4.2 million at December 31, 2005 and was related to specific loan balances of $14.7 million and $12.0 million at December 31, 2006 and 2005, respectively. See Nonperforming Assets in the following section for more detail.

Noninterest Income Noninterest income for 2006 increased by $11.6 million, or 4.8%, to $254.7 million from $243.1

We employ modeling and estimation tools in developing the appropriate allowance and reserve for unfunded commitments. Bankshares allowance consists of formula-based components for business and retail loans, an allowance for impaired loans and an unallocated component. The following provides a description of each of these components of the allowance, the techniques used and the estimates and judgments inherent in each. In the first quarter of 2006, management refined the methodologies for the formula-based components to align more appropriately the allowance methodology with our current framework for analyzing credit losses. Formula-based allowance calculations for business and retail components permit us to address specifically the current trends and events affecting the credit risk in the loan portfolio. The reserve for unfunded commitments is estimated using the same methodology.

Business loans are comprised of commercial, commercial real estate and construction loans, which are evaluated separately for impairment. For business loans, the formula-based component of the allowance for loan losses is based on statistical migration estimates of the average losses observed for business loans classified by credit grade. Average losses for each credit grade are computed using the annualized historical rate at which loans in each credit grade have defaulted (probability of default rates or PD) and the historical average losses realized for defaulted loans (loss-given-default or LGD). We have developed default rates by analyzing four years of our default experience and more than 14 years of comparable external data. Default rates, which are validated annually, are estimates derived from long-term averages and are not based on short-term economic or environmental factors. LGD rates have been developed using industry benchmarks.

Retail loans are comprised of consumer installment and residential mortgage loans. For retail loans, the formula-based component of the allowance for loan losses is primarily based on the probability of default rates and LGD rates for specific groups of similar loans by product category. The probability of default rates are based on four years of our default experience and between 14 and 19 years of comparable industry data. LGD rates were developed using industry benchmarks.

For both business and retail loans, the formula-based components include additional qualitative amounts to establish reasonable ranges that consider observed historical variability in losses. Factors we may consider in setting these amounts include, but are not limited to, industry-specific data, portfolio specific risks or concentrations, and macroeconomic conditions. Including these variability components in the model enables us to capture probable incurred losses that are not yet evident in current default grades, delinquencies and other credit-risk measurement tools.

The general allowance was $127.7 million and $133.7 million at December 31, 2006 and 2005, respectively.

The combination of specific and general allowance calculations resulted in $134.3 million being allocated to loan portfolio segments at December 31, 2006 compared with $137.9 million at December 31, 2005. The decrease in the allocated allowance is primarily attributable to improving credit quality over the past several years.

The unallocated allowance represents the difference between the combined specific and general allocations and the actual allowance. The unallocated allowance recognizes the imprecision inherent in estimating and measuring loss when allocating the allowance to individual, or pools of, loans. It is designed to capture fully inherent losses in the loan portfolio after taking into consideration these perspectives. It takes into consideration the allowance level deemed appropriate by each affiliate based on its local knowledge and input from their regulators, including their view from the standpoint of safety and soundness, among other factors. The amount of this component and its relationship to the total allowance for loan losses may change from one period to another. At December 31, 2006, the unallocated component of the allowance for loan losses was $8.8 million, or 6.1%, of the allowance for loan losses.

NONPERFORMING ASSETS

A five-year comparison of nonperforming assets is presented below.

	As of December 31,				
(Dollars in thousands)	**2006**	**2005**	**2004**	**2003**	**2002**
Nonaccrual loans (1)					
Commercial	**$ 5,336**	$ 15,771	$ 25,510	$ 37,393	$ 19,944
Commercial real estate	**4,777**	4,451	1,959	7,363	9,322
Construction	**15,690**	376	9	651	1,365
Residential real estate	**4,583**	1,505	2,748	3,721	2,479
Home equity lines	**123**	88	300	78	105
Consumer	**451**	374	372	1,146	156
Total	**30,960**	22,565	30,898	50,352	33,371
Renegotiated loans (1)					
Loans contractually past due 90 days or more and still accruing interest					
Total nonperforming loans	**30,960**	22,565	30,898	50,352	33,371
Other real estate owned	**1,405**	667	212	191	132
Total nonperforming assets	**$ 32,365**	$ 23,232	$ 31,110	$ 50,543	$ 33,503
Nonperforming loans as a percent of period-end loans	**0.24 %**	0.19 %	0.30 %	0.54 %	0.46 %
Nonperforming assets as a percent of period-end loans and other real estate owned	**0.25 %**	0.20 %	0.30 %	0.55 %	0.46 %

(1) Aggregate gross interest income of $2.7 million and $2.1 million in 2006 and 2005, respectively, on nonaccrual and renegotiated loans would have been recorded if these loans had been accruing on their original terms throughout the period or since origination if held for part of the period. The amount of interest income on the nonaccrual and renegotiated loans that was recorded totaled $0.7 million and $0.5 million in 2006 and 2005, respectively.

Nonperforming Assets

Nonperforming assets consist of nonaccrual loans, renegotiated loans and other real estate owned (i.e., real estate acquired in foreclosure or in lieu of foreclosure). With respect to nonaccrual loans, our policy is that, regardless of the value of the underlying collateral and/or guarantees, no interest is accrued on the entire balance once either principal or interest payments on any loan are 90 days past due at the end of a calendar quarter. All accrued and uncollected interest on such loans is reversed out of interest income and is recognized only as it is collected. If a loan is impaired and has a specific loss allocation based on an analysis under SFAS No. 114, Accounting by Creditors for Impairment of a Loan an amendment of FASB Statements No. 5 and 15, all payments are applied against the loan s principal. A loan may be placed on nonaccrual status sooner than this standard if, in management s judgment, such action is warranted.

Nonperforming assets as a percentage of period-end loans and other real estate owned were 0.25% at December 31, 2006 compared with 0.20% in the preceding year. At year-end 2006, nonperforming assets were $32.4 million compared with $23.2 million at year-end 2005. Nonperforming loans totaled $31.0 million at December 31, 2006 compared with $22.6 million at December 31, 2005. This increase was primarily due to one construction relationship.

The level of monitored loans, or loans with characteristics suggesting that they may be classified as nonperforming in the near future were $2.3 million at December 31, 2006 compared with $2.2 million a year before. The amount of loans past due 30-89 days increased from $65.2 million at December 31, 2005 to $78.6 million at December 31, 2006. The increase was primarily reflected in the categories: commercial, commercial real estate and residential real estate. In general, the increase was in loans past due 30 days; however, Bankshares has seen a growing delinquency trend in residential real estate loans during the second half of 2006.

Noninterest Income Noninterest income for 2006 increased by $11.6 million, or 4.8%, to $254.7 million from $243.1

Other real estate owned was $1.4 million at December 31, 2006 compared with $667 thousand at December 31, 2005. These properties generally are sold within a short period; therefore, regardless of the amount, the properties generally will have changed from year to year. Other real estate owned is carried at the lower of cost or fair market value. Refer to the data in the Nonperforming Assets table on the preceding page, which shows the changes in the amounts of various categories of nonperforming assets over the last five years and sets forth the relationship between nonperforming loans and total loans.

LOAN MATURITY SCHEDULE

The following table illustrates loan diversity by maturity distribution for commercial (including commercial real estate and lease financing) and construction loans as of December 31, 2006.

	Maturing			
(Dollars in thousands)	**1 year or less**	**Over 1 through 5 years**	**Over 5 years**	**Total**
Commercial	$ 2,371,038	$ 3,799,876	$ 1,123,221	$ 7,294,135
Construction	888,250	999,706	121,881	2,009,837
Total	$ 3,259,288	$ 4,799,582	$ 1,245,102	$ 9,303,972

Of the $6.0 billion in loans maturing after one year, $3.0 billion, or 50.1%, have fixed interest rates, and $3.0 billion, or 49.9%, have variable interest rates.

Asset/Liability and Market Risk Management

Asset/liability management involves the evaluation, monitoring and management of interest rate risk, market risk, liquidity and funding. The Asset/Liability Management Committee (ALCO) oversees policy guidelines and reports periodically to the Board of Directors. This Committee consists of senior financial and business executives. Treasury division management and other finance personnel monitor the day-to-day exposure to interest rates in response to loan and deposit flows.

Interest Rate Risk

Interest rate risk, which potentially can have a significant earnings impact, is an integral part of being a financial intermediary. Bankshares is subject to interest rate risk due to a variety of factors including:

- Assets and liabilities may mature or reprice at different times (for example, currently our assets reprice slightly faster than our liabilities and if interest rates fall, earnings will initially decline);

- Assets and liabilities may reprice at the same time but by different amounts (for example, when the market level of interest rates is falling, we may reduce rates paid on checking and savings deposit accounts by an amount that is less than the general decline in market interest rates);

- Short-term and long-term market interest rates may change by different amounts (i.e., the shape of the yield curve may affect new loan and investment yields and funding costs differently); or

- The remaining maturity of various assets or liabilities may shorten or lengthen as interest rates change (for example, if long-term mortgage rates fall, mortgage-backed securities may prepay significantly earlier than anticipated, which could reduce portfolio income). In addition, interest rate changes have an indirect impact on loan demand, credit losses, mortgage originations, the value of mortgage servicing rights and other sources of earnings.

A balance sheet is considered asset-sensitive when its assets (loans and securities) reprice faster or to a greater extent than liabilities (deposits and borrowings). An asset-sensitive balance sheet will produce more net interest income when rates rise and less net interest income when rates fall. A balance sheet is described as liability-sensitive when its liabilities (deposits or borrowings) reprice more frequently or to a greater degree than its assets (loans and securities). A liability-sensitive balance sheet will produce a lower level of net interest income when interest rates rise and more net interest income when rates fall. Bankshares large noninterest-bearing deposit and equity base funds a loan portfolio with a large

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Noninterest Income Noninterest income for 2006 increased by $11.6 million, or 4.8%, to $254.7 million from $243.1

percentage of floating-rate commercial and consumer loans, which creates a bias towards asset sensitivity.

To manage this asset sensitivity in our balance sheet, we maintain a large portfolio of fixed-rate, although short-duration, investments. Periodically, we elect to use derivatives to protect assets and liabilities from changes in interest rates. When deciding whether to use derivatives instead of cash market instruments to achieve the same goal, we consider a number of factors, such as cost, efficiency, the effect on our liquidity and capital and our overall strategy. The derivatives we use for interest rate risk management purposes are primarily interest rate swaps. We fully incorporate the market risk associated with interest rate risk management derivatives into our earnings simulation model in the same manner as other on-balance-sheet financial instruments. The credit risk amount and estimated net fair value of these derivatives as of December 31, 2006 and 2005 are presented in Note No. 18 - Derivative Instruments and Hedging Activities in Notes to the Consolidated Financial Statements. Derivatives are used for asset/liability management in three ways: (1) to convert long-term fixed-rate debt to floating-rate payments by entering into receive-fixed swaps at issuance; (2) to convert the cash flows from selected asset and/or liability instruments/portfolios from fixed to floating payments or vice versa; and (3) to hedge the mortgage origination pipeline by utilizing forward commitments for loans held-for-sale.

We assess interest rate risk by comparing projected net interest income in the current rate environment with various interest rate scenarios that differ in the direction of interest rate changes, the degree of change over time, the speed of the change and the projected shape of the yield curve. This analysis incorporated substantially all of Bankshares assets and liabilities and off-balance sheet instruments as of December 31, 2006. Through these simulations, management estimates the impact on net interest income of a 200 basis point upward and a 200 basis point downward change in interest rates. In analyzing interest rate sensitivity for policy measurement, we compare our forecasted net interest income in both high rate and low rate scenarios to our most likely earnings estimate utilizing a flat rate scenario. The policy measurement period is 12 months in length, beginning with the first month of the forecast. Our objective is to manage prudently the interest-bearing assets and liabilities on our balance sheet in ways that minimize our exposure to changes in interest rates. Our high rate and low rate scenarios assume gradual 100 and 200 basis point increases or decreases in the federal funds rate relative to the flat rate scenario. Our standard approach evaluates expected net interest income in a 200 basis point range both above and below the flat rate scenario. To capture the impact of yield curve-related risk, we simultaneously measure the impact of nonparallel shifts in rates. A parallel shift would move all points on the yield curve by the same increments. A nonparallel shift would consist of a 100 basis point increase in short-term rates, while long-term rates would increase by a different amount. A rate shift in which short-term rates rise to a greater extent than long-term rates is referred to as a flattening of the yield curve. Conversely, long-term rates rising to a greater extent than short-term rates leads to a steepening of the yield curve.

EARNINGS SENSITIVITY

The following table summarizes the effect a positive 100 and 200 basis point change and a negative 100 and 200 basis point change in interest rates would have on Bankshares net interest income over the next 12 months.

	Calculated increase / (decrease) in projected net interest income As of December 31,			
Change in interest rates (basis points)	**2006**		**2005**	
+200	0.1	%	2.3	%
+100	0.1	%	1.3	%
-100	(0.5	)%	(1.8	)%
-200	(2.0	)%	(4.6	)%

As seen in the Earnings Sensitivity table above, within a one-year horizon, the earnings sensitivity model forecasts that, compared with the net interest income projection under stable rates, net interest income remains basically unchanged if interest rates increased by 100 and 200 basis points, respectively. Conversely, if interest rates decreased by 100 and 200 basis points, net interest income would decrease by 0.5% and 2.0%, respectively. Bankshares manages the interest rate risk profile within policy limits of +/- 5.0% change in net interest income on a +/- 200 basis point change in interest rates and at December 31, 2006 was within the risk limits established. These results are not necessarily indicative of future actual results, nor do they take into account certain actions that management may undertake in response to future changes in interest rates.

MARKET VALUE OF EQUITY MODELING

Bankshares also utilizes the market value of equity as a measurement tool in managing interest rate sensitivity. The market value of equity measures the degree to which the market values of Bankshares   assets and liabilities and off-balance sheet instruments will change given a change in interest rates. ALCO guidelines limit the change in market value of equity in a 200 basis point parallel rate shock to 12.5% of the market value of equity assuming interest rates at December 31, 2006. The up 200 basis point scenario resulted in a 4.6% decrease at December 31, 2006 and a 2.9% decrease at December 31, 2005. The down 200 basis point scenario resulted in a 1.7% decrease at December 31, 2006 and a 3.9% decrease at December 31, 2005. At December 31, 2006 and 2005, Bankshares was within its policy guidelines.

The valuation analysis is dependent upon certain key assumptions about the nature of indeterminate maturities of assets and liabilities. Management estimates the average life and rate characteristics of asset and liability accounts based on historical analysis and management s expectation of rate behavior. These assumptions are periodically validated and updated.

Market Risk

Market risk is defined as the constraint imposed by lower market values of assets and liabilities as interest rates and equity markets fluctuate. Changes in market values also affect the fee income earned by IWM, where a significant portion of the fee schedule is tied to current values of assets under management or administration. Bankshares has designated substantially all of its investment portfolio as available-for-sale, and in accordance with financial reporting standards, this portfolio is reported at fair value. Changes in fair value, net of tax, are reflected as a component of shareholders   equity.

Trading Activities

Bankshares provides capital market products to its customers. From a market risk perspective, Bankshares   net income is exposed to changes in interest rates, credit spreads, and equities and their implied volatilities. The primary purpose of Bankshares   trading business is to accommodate customers in the management of their market price risks. Derivative transactions executed with customers are simultaneously hedged in the capital markets. All derivatives transacted with customers used to hedge capital market transactions with customers are carried at fair value. The ALCO establishes and monitors counterparty risk limits. The notional amount, exposure amount and estimated net fair value of all customer accommodation derivatives at December 31, 2006 are included in Note No. 18 - Derivative Instruments and Hedging Activities in Notes to the Consolidated Financial Statements.

Equity Markets

Bankshares is directly and indirectly affected by changes in the equity markets. Bankshares has made investments in private equities and hedge funds. These private equity investments are made within capital allocations approved by Bankshares   management. Management reviews these investments at least quarterly and assesses them for possible other-than-temporary impairment. For nonmarketable investments, the analysis is based on the facts and circumstances of each individual investment and the expectations for that investment s cash flows and capital needs, the viability of the business model and an appropriate exit strategy. Private equity investments totaled $25.4 million at December 31, 2006 and $20.7 million at December 31, 2005. Hedge fund investments totaled $68.8 million at December 31, 2006 and $62.8 million at December 31, 2005.

Changes in equity market prices may also indirectly affect Bankshares   net income (1) by affecting the value of third-party assets under management or administration within IWM and, hence, fee income; (2) by affecting particular borrowers, whose ability to repay principal and/or interest may be affected by the stock market; or (3) by affecting brokerage activity, related commission income and other business activities.

Bankshares   maintenance of capital ratios well above regulatory requirements (see   Capital Resources and Adequacy) provides management with the flexibility to utilize the available-for-sale portfolio for liquidity and interest rate risk management needs, even during a period when valuations are depressed. Maintaining a fairly short duration in the portfolio also mitigates market risk.

Liquidity Risk

Liquidity risk is the possibility that Bankshares will not be able to fund present and future financial obligations. The objective of liquidity management is to maintain the ability to meet commitments to fund loans, purchase securities and repay deposits and other liabilities in accordance with their terms. To achieve this objective, the ALCO establishes and monitors liquidity guidelines that require sufficient asset-based liquidity to cover potential funding requirements and to avoid over-reliance on volatile, less reliable funding markets. Debt securities in the available-for-sale portfolio provide liquidity, in addition to the immediately liquid resources of cash and due from banks and federal funds sold and securities purchased under resale agreements. By limiting the maturity of securities and maintaining a conservative investment posture, management can rely on the investment portfolio to help meet any short-term funding needs. U.S. Treasury and agency securities, which provide the greatest liquidity, averaged $1.4 billion in 2006 and 2005.

Core customer deposits historically have provided a substantial source of relatively stable, low-cost funds. During 2006, core deposits (total deposits less time deposits of $100,000 and over), averaged $10.2 billion compared with $9.8 billion during 2005. Although not viewed as core deposits, a substantial portion of short-term borrowings comprised of securities sold under agreements to repurchase and commercial paper originate from core deposit relationships tied to the overnight cash management program offered to customers. Short-term borrowings averaged $1.4 billion during 2006, a 29.8% increase from 2005.

In addition to these sources, Bankshares has access to national markets for certificates of deposit, commercial paper and debt financing. Should Bankshares need to supplement its liquidity, it also has $3.2 billion in lines with the Federal Home Loan Banks of Atlanta and Pittsburgh (FHLB) and back-up commercial paper lines of $40.0 million with commercial banks. Bankshares is required to obtain approval from holders of Bankshares 6.80% unsecured senior notes if Bankshares incrementally borrows in excess of 4% of Average Total Assets under the FHLB lines.

Long-term debt decreased to $659.0 million at December 31, 2006 from $742.2 million at December 31, 2005. Approximately $17.6 million in Trust Preferred Securities were acquired as part of the James Monroe acquisition. During 2006, $95.8 million was repaid on long-term debt. Bankshares can access the capital markets for long-term funding by issuing registered debt and private placements. In October 2006, Moody s Investors Service affirmed Mercantile Bankshares Corporation s commercial paper rating of P-1 and Bankshares subordinated debt rating of A2. Also in October 2006, Standard & Poor s Ratings Service revised Bankshares rating to A+/Watch Negative/A-1 and counterparty rating of A+/Watch Negative/A-1. Rating agencies base their ratings on many quantitative and qualitative factors, including capital adequacy, liquidity, asset quality, quality of the management team, business mix and the level and quality of earnings.

TIER I CAPITAL RATIO*

Regulatory Tier I Minimum: 4.0%

*Tier I equity as percentages of risk-adjusted total assets at December 31,

DIVIDENDS PER SHARE

Five-Year Compound Growth Rate: 8.5%

Market Risk Market risk is defined as the constraint imposed by lower market values of assets and liabilities as inter

Capital Resources and Adequacy

Bankshares has consistently maintained a capital to asset ratio higher than its peers as reported in data furnished by its regulators. Shareholders equity averaged $2.3 billion during 2006, which represented an increase of $245.7 million, or 11.7%, over the prior year s average. A significant portion of the increase was caused by the shares issued in the James Monroe acquisition that were valued at $63.1 million, plus net earnings retention.

Maintenance of capital strength has long been a guiding principle of Bankshares. Ample capital is necessary to sustain growth, to provide a measure of protection against unanticipated declines in asset values and to safeguard the funds of depositors. Capital also provides a source of funds to meet loan demand and enables Bankshares to manage its assets and liabilities effectively.

Shareholders equity increased 10.1% to $2.4 billion at year-end 2006 from $2.2 billion at year-end 2005. The increase was attributable primarily to earnings growth and the shares issued in connection with the James Monroe acquisition partially offset by increased cash dividend payments. In addition, at December 31, 2006, Bankshares implemented SFAS No. 158, Employers Accounting for Defined Benefit Pension and Other Postretirement Plans-an amendment of FASB Statements No. 87, 88, 106, and 132(R). The initial application of SFAS 158 did not affect Bankshares results of operations; however, shareholders equity was reduced by $23.1 million. See Note No. 14 Pension and Other Postretirement Benefit Plans in Notes to Consolidated Financial Statements.

Book value per share was $19.25 at December 31, 2006 compared with $17.81 at December 31, 2005. The ratio of average equity to average assets was 13.75% in 2006 and 13.51% in 2005, ranking Bankshares among the most strongly capitalized banks in the industry. Excluding intangible assets average tangible equity to average tangible assets was 9.82% and 9.70% in 2006 and 2005, respectively. Bankshares believes that excluding intangible assets helps the investor understand the effects of acquisition activities on its results and more closely approximates the basis for measuring the adequacy of capital for regulatory purposes.

While maintaining exceptional capital strength Bankshares also has a share repurchase program. On June 13, 2006, Bankshares Board of Directors authorized the repurchase of two million shares of common stock, in addition to the remaining shares authorized by the Board of Directors in 2001. At December 31, 2006, there remained 2.7 million shares of common stock authorized for repurchase. The share repurchase program has supported management s strategy to enhance shareholder value. Management has repurchased shares in open market and privately negotiated transactions during periods when capital accumulates at a rate in excess of that required to support the growth of earning assets. See Note No. 11 - Shareholders Equity in Notes to Consolidated Financial Statements and the Statements of Changes in Consolidated Shareholders Equity found elsewhere in this document for details related to the share repurchase program. The repurchase programs have been suspended as a condition of the merger agreement with PNC.

Various bank regulatory agencies have implemented capital guidelines, which are directly related to a bank s risk-based capital ratios. By regulatory definition, a well capitalized institution, such as Bankshares, faces fewer regulatory constraints on its operations than institutions classified as undercapitalized. For example, only well capitalized banks can accept brokered deposits without advance regulatory approval. In addition, FDIC deposit insurance premium rates are significantly lower for banks with higher capital levels. The Tier I Capital Ratio graph above shows that Bankshares has maintained capital levels well in excess of the regulatory minimum over each of the last five years. For a further discussion of the regulatory capital requirements that apply to Bankshares, see Note No. 11 - Shareholders Equity in Notes to Consolidated Financial Statements. Bank regulatory agencies also impose certain restrictions on transactions among and between subsidiaries of bank holding companies, including extensions of credit, transfers of assets and payments of dividends. Historically, the dividend restrictions have not limited dividend payments at Bankshares and it is not anticipated that they will have a constraining effect in the future. In addition to dividend restrictions, Capital requirements also are affected by off-balance sheet risks. These include such items as letters of credit and commitments to extend credit. Refer to Note No. 10 - Commitments and Contingencies in Notes to Consolidated Financial Statements for information regarding Bankshares commitments.

DIVIDENDS

	2006				2005			
Quarter	**4th**	**3rd**	**2nd**	**1st**	**4th**	**3rd**	**2nd**	**1st**
Common dividends	**$ 0.28**	**$ 0.28**	**$ 0.28**	**$ 0.26**	$ 0.25	$ 0.25	$ 0.25	$ 0.23

Bankshares has paid quarterly cash dividends on its common stock since September 1970 when such stock was first issued. Bankshares intends to consider quarterly payment of dividends on its common stock, but such payment is necessarily dependent on many factors, including the future earnings and financial requirements of Bankshares and its affiliates.

On January 10, 2006, Bankshares Board of Directors announced a three-for-two stock split on its common stock. In addition, the Board stated its intention to raise the indicated quarterly per share dividend rate, adjusted for the stock split, to $0.26 per share.

For the 30th consecutive year, the annual dividend paid on common stock exceeded the prior year s level. Effective with the June 2006 dividend, the quarterly cash dividend was increased 7.7% to $0.28 from $0.26 per share. Over the last five years, dividends have increased at a compound growth rate of 8.5%. Management periodically will evaluate the dividend rate in light of Bankshares capital strength, profitability and conditions prevailing in the economy in general and the banking industry in particular. The annual dividends paid per common share were $1.10 in 2006 and $0.99 in 2005. Total cash dividends paid were $136.7 million in 2006 and $120.2 million in 2005. The Dividends table above presents quarterly dividends paid over the last two years.

On February 6, 2007, Bankshares Board of Directors declared a quarterly dividend of $0.28 per share on the common stock, payable February 28, 2007, to stockholders of record as of February 21, 2007.

RECENT COMMON STOCK PRICES
Market Prices (1)

	2006				2005			
Quarter	**4th**	**3rd**	**2nd**	**1st**	**4th**	**3rd**	**2nd**	**1st**
High	**$ 47.39**	**$ 37.96**	**$ 39.53**	**$ 39.82**	$ 40.09	$ 37.46	$ 35.20	$ 34.90
Low	**36.04**	**34.29**	**35.00**	**36.88**	34.11	34.13	32.39	32.27

(1) The stock of Mercantile Bankshares Corporation is traded on the Nasdaq Global Select Market under the symbol MRBK. The quotations represent actual transactions.

As of February 16, 2007, there were 10,811 shareholders of record.

Off-Balance Sheet Arrangements and Contractual Obligations

Off-Balance Sheet Arrangements

Bankshares consolidates majority-owned subsidiaries that it controls. Other affiliates, including certain joint ventures in which there is less than 20% ownership, generally are carried at the lower of cost or fair market value. Bankshares does not dispose of troubled loans or problem assets by means of unconsolidated special purpose entities.

Bankshares mortgage banking subsidiary, as a Fannie Mae Delegated Underwriting and Servicing lender, has a loss sharing arrangement for loans originated on behalf of and sold to Fannie Mae. In the ordinary course of business, Bankshares routinely originates and sells mortgage loans in the secondary market. Typically, these loans are sold under forward commitments. Refer to Note No. 10 - Commitments and Contingencies in Notes to Consolidated Financial Statements for additional information regarding commitments relating to mortgage banking.

Contractual Obligations and Other Commitments

Through the normal course of business, Bankshares enters into certain contractual obligations and other commitments. Such obligations generally relate to funding operations through debt arrangements as well as leases of premises and equipment. For further information on commitments, see Notes No. 5, 9 and 10 in Notes to Consolidated Financial Statements.

As a financial services provider, Bankshares routinely enters into commitments to extend credit, including loan commitments, standby letters of credit and financial guarantees. Guarantees are contracts that contingently require us to make payments to a guaranteed party based on an event or changes in an underlying asset, liability, rate or index. While contractual obligations represent future cash requirements of Bankshares, a significant portion of commitments to extend credit are likely to expire without being drawn upon. Such commitments are subject to the same credit policies and approval processes accorded to loans made by Bankshares.

Additionally, Bankshares has committed to invest funds in third-party private equity investments.

The table below summarizes significant contractual obligations and other commitments.

(Dollars in thousands)	**1 Year or less**	**1-3 years**	**3-5 years**	**After 5 years**	**Total**
Contractual obligations					
Long-term debt (1)	$ 18,999	$ 50,950	$ 237,585	$ 351,486	$ 659,020
Operating leases	18,594	27,316	17,070	46,814	109,794
Purchase obligations	5,000	10,000	10,000		25,000
Total contractual obligations by period	$ 42,593	$ 88,266	$ 264,655	$ 398,300	$ 793,814
Other commitments					
Commitments to extend credit					$ 5,024,880
Standby letters of credit and financial guarantees					596,879
Unfunded third-party private equity investments					30,552
Total other commitments					$ 5,652,311

(1) Includes $47.2 million in financing resulting from the sale of the Hopkins Plaza Building. Includes principal payments only.

REVIEW OF EARNINGS AND BALANCE SHEET FOR 2005 TO 2004

Performance & Operating Analysis

On May 18, 2005, Bankshares completed its acquisition of Community Bank of Northern Virginia (CBNV), a bank headquartered in Sterling, Virginia, which was merged into MSD&T and became part of MSD&T s Mercantile Potomac Bank. CBNV operated 14 branch offices in the Northern Virginia metropolitan market at the time of the acquisition. The primary reason for the merger with CBNV was to expand Bankshares distribution network in Northern Virginia, a higher growth market. The total consideration paid to CBNV shareholders in connection with the acquisition was $82.9 million in cash and 3.7 million shares of Bankshares common stock, which reflects the adjustment for the three-for-two stock split announced by Bankshares on January 10, 2006. CBNV transactions have been included in Bankshares financial results subsequent to May 18, 2005. The assets and liabilities of CBNV were recorded on the Consolidated Balance Sheet at their respective fair values. The fair values were determined as of May 18, 2005. The transaction resulted in total assets acquired as of May 18, 2005 of $888.2 million, including $671.0 million of loans and leases; liabilities assumed were $842.3 million, including $626.9 million of deposits. Bankshares recorded $162.1 million of goodwill and $4.6 million of core deposit intangible.

(1) Includes $47.2 million in financing resulting from the sale of the Hopkins Plaza Building. Includes principal paym

Net income in 2005 was $276.3 million compared with $229.4 million in 2004, a 20.4% increase. Diluted net income per common share was $2.26 in 2005 compared with $1.92 in 2004, an increase of 17.7%. Return on average assets was 1.78% and return on average equity was 13.18% in 2005 compared with 1.64% and 12.26%, respectively, in 2004. Average assets increased 10.9% to $15.5 billion; average deposits increased 9.6% to $11.4 billion; and average loans increased 13.5% to $11.0 billion for the year ended December 31, 2005 compared with the prior year.

Net interest income, on a fully tax-equivalent basis, was $624.0 million in 2005 compared with $552.5 million in 2004. Both changes in the level of interest rates and changes in the amount and composition of interest-earning assets and interest-bearing liabilities affected net interest income. The net interest margin improved nine basis points to 4.44% for 2005 from 4.35% for 2004.

Noninterest income for 2005 increased by $29.2 million, or 13.6%, to $243.1 million compared with $213.9 million for 2004. IWM revenues increased 6.3% to $95.8 million in 2005, which was due principally to stronger equity markets, increased new sales in Private Wealth Management and increased brokerage activity. Mortgage banking fees increased $3.5 million, or 30.7%, over 2004 due to strong performance in the commercial sector. Residential mortgage banking fees for 2005 were nearly flat when compared with 2004. Nonmarketable investment income increased $8.5 million, or 74.1%, over 2004 resulting from better private equity investment performance and higher income from bank-owned life insurance (BOLI) of which Bankshares purchased an additional $50.0 million in the third quarter of 2005.

Noninterest expenses for 2005 increased $28.9 million, or 7.4%, from 2004. Year-over-year expenses increased due to approximately $8.0 million related to the acquisition of CBNV; $8.3 million in higher incentive compensation due to improved operating performance; and $6.3 million in merit and staffing increases. Partially offsetting these increases was a reduction in salaries expense by $2.5 million based on the deferral of loan origination costs. Professional fees decreased $3.4 million due to reduction in fees for the implementation of compliance with The Sarbanes-Oxley Act of 2002 and for a litigation matter in 2004. Outsourcing fees increased $5.9 million in 2005 over 2004 due to the outsourcing of IWM back-office functions.

Net occupancy expense increased by $4.3 million, or 17.6%, during 2005 due to 14 net additional branch locations and the loss of outside tenant income from the December 2004 sale of Bankshares headquarters building.

Segment Reporting

In the fourth quarter of 2005, the Private Banking Group of MSD&T was consolidated into the Private Banking Group of IWM. The segment results were reclassified to conform to current presentation for comparability. Additionally, as loans and deposits were reflected in the IWM segment, a funds transfer-pricing model was utilized to match the duration of the funding and investment of the IWM segment s assets and liabilities.

Banking

Net income in 2005 was $271.4 million compared with $220.9 million in 2004, a 22.9% increase. For the year ended December 31, 2005, average assets increased 13.6% to $15.2 billion; average deposits increased 10.9% to $11.4 billion; and average loans increased 13.4% to $10.9 billion.

Net interest income increased 14.1% to $609.8 million in 2005 over $534.5 million in 2004. The growth in net interest income was largely attributable to a 13.4% increase in average loans outstanding with CBNV contributing approximately 32.1%. Average loans outstanding increased 13.4% to $10.9 billion for 2005 with the majority of growth in commercial real estate (19.0%), construction loans (28.7%) and consumer loans (13.0%) in 2005 over 2004.

Average deposits for Banking were $11.4 billion in 2005, an increase of 10.9% over 2004. The strongest year-over-year growth was in certificates of deposit (19.9%), noninterest-bearing deposits (9.3%) and money market deposit accounts(8.5%). The CBNV acquisition contributed approximately 34.8% of this deposit growth.

The year-over-year increases in noninterest income and noninterest expenses from 2004 were attributable primarily to the CBNV acquisition, increased deposit activity and branch expansion. Noninterest income increased to $132.2 million in 2005 from $114.5 million in 2004 with gains on sales of bank premises increasing $2.7 million, mortgage-banking fees increasing $3.5 million, nonmarketable investments increasing $2.6 million, insurance fees increasing $1.8 million and

(1) Includes $47.2 million in financing resulting from the sale of the Hopkins Plaza Building. Includes principal paym

(1) Includes $47.2 million in financing resulting from the sale of the Hopkins Plaza Building. Includes principal paym

electronic banking fees increasing by $2.2 million. Partially offsetting these gains was a decrease of $0.6 million in deposit service charges. Noninterest expenses increased to $341.5 million in 2005 from $318.7 million in 2004. The increase was partially attributable to $8.2 million in additional operating expenses related to the CBNV acquisition and $11.2 million, in salaries and benefits. Incentive compensation linked to improved operating performance increased $7.7 million and pension expense increased $1.3 million. Occupancy expense increased by $3.6 million and electronic banking costs increased $2.4 million.

IWM

Net income in 2005 was $16.2 million compared with $16.5 million in 2004. Excluding the Private Banking Group, IWM net income increased $1.3 million, or 11.5%, in 2005 compared with 2004. Pretax profit margins, prior to corporate overhead allocations, were 29.9% and 31.1% for 2005 and 2004, respectively. At December 31, 2005, assets under administration by IWM were $46.5 billion, a decrease of $1.3 billion from the prior year. Bankshares had investment management responsibility for $20.6 billion and $21.1 billion at December 31, 2005 and 2004, respectively.

The decrease in net income resulted primarily from a reduction in net interest income in the Private Banking Group. This decline was due to lower earnings attributed to noninterest-bearing demand deposit accounts due to greater volatility in customer balances during 2005.

Revenues increased $3.1 million, or 3.1%, to $103.8 million in 2005 from $100.7 million in 2004. Revenue increases were achieved in Private Wealth Management, Institutional Investment Management, Mercantile Funds and Brokerage. Revenues declined in Private Banking despite strong loan and deposit growth. IWM revenues increased principally due to stronger equity and real estate markets during 2005 compared with 2004, increased new sales in Private Wealth Management and increased brokerage activity.

Expenses increased 4.8% to $72.9 million in 2005 compared with $69.6 million in 2004. Increases in personnel-related, technology and occupancy expenses were offset by decreases in professional services, travel and marketing expense.

Credit Quality Measures

Provision for loan losses was $1.6 million in 2005 compared with $7.2 million in 2004. Net charge-offs in 2005 were $1.0 million, or 0.01% of average total loans compared with $13.6 million, or 0.14%, in 2004. The allowance for loan losses was $156.7 million, or 1.35% of total loans, at December 31, 2005 compared with $149.0 million, or 1.46%, at December 31, 2004.

At December 31, 2005, total nonperforming assets were $23.2 million, or 0.20% of period-end loans and other real estate owned, compared with $31.1 million, or 0.30%, at December 31, 2004. The decrease in nonperforming loans was due primarily to an improvement in credit quality at MSD&T, the lead bank.

Capital Ratios

The ratio of average shareholders equity to average total assets was 13.51% for 2005 and 13.38% for 2004. Bankshares total risk-based capital ratio at December 31, 2005 was 15.37%, and Tier I capital ratio was 11.82%, exceeding the minimum regulatory guidelines of 8.0% and 4.0%, respectively. Bankshares leverage ratios were 9.81% and 10.02% at December 31, 2005 and 2004, respectively, exceeding the minimum regulatory guideline of 4.0%. As of December 31, 2005, all of Bankshares bank affiliates exceeded all capital adequacy requirements necessary to be considered well capitalized. For additional information on Bankshares risk-based capital ratios, see Note No. 11 - Shareholders Equity in Notes to Consolidated Financial Statements.

(1) Includes $47.2 million in financing resulting from the sale of the Hopkins Plaza Building. Includes principal paym

QUARTERLY RESULTS OF OPERATIONS (unaudited)

The following is a summary of the quarterly results of operations.

	Three months ended			
2006 (Dollars in thousands, except per share data)	**Dec. 31**	**Sept. 30**	**June 30**	**March 31**
Interest income	**$ 270,160**	**$ 258,856**	**$ 241,793**	**$ 227,913**
Interest expense	**100,165**	**92,787**	**80,383**	**69,600**
Net interest income	**169,995**	**166,069**	**161,410**	**158,313**
Provision for loan losses				
Investment securities gains (losses)	**7**	**218**		**(13)**
Net income	**72,862**	**71,573**	**73,092**	**70,759**
Per share of common stock:				
Basic	**0.58**	**0.57**	**0.59**	**0.58**
Diluted	**0.57**	**0.57**	**0.59**	**0.57**

	Three months ended			
2005 (Dollars in thousands, except per share data)	**Dec. 31**	**Sept. 30**	**June 30**	**March 31**
Interest income	$ 225,203	$ 214,525	$ 197,064	$ 179,245
Interest expense	62,769	55,283	44,697	36,162
Net interest income	162,434	159,242	152,367	143,083
Provision for loan losses		820		756
Investment securities gains (losses)	(53)	(32)	76	414
Net income	74,863	70,956	67,873	62,627
Per share of common stock:				
Basic	0.61	0.58	0.56	0.53
Diluted	0.60	0.57	0.56	0.52

(1) Includes $47.2 million in financing resulting from the sale of the Hopkins Plaza Building. Includes principal paym

RECONCILIATION OF NON-GAAP MEASURES

We believe the non-GAAP measures we use provide information useful to investors in understanding our ongoing core business and operational performance trends. These measures should not be viewed as a substitute for GAAP. Management believes presentations of financial measures excluding the impact of certain items provide useful supplemental information and better reflect its core operating activities. In order to arrive at core business operating results, the effects of certain non-core business transactions such as gains and losses on the sales of securities, amortization of intangibles, restructuring charges and merger-related expenses, have been excluded. Management reviews these same measures internally. For instance, the cash operating efficiency ratio, rather than the GAAP basis efficiency ratio, is used to measure management s success at controlling ongoing, core operating expenses. Additionally, management believes that reporting several key measures based on tangible assets (total assets less intangible assets) and tangible equity (total equity less intangible assets) is important as this more closely approximates the basis for measuring the adequacy of capital for regulatory purposes.

	For the twelve months ended December 31,		**For the three months December 31,**	
	2006	2005	**2006**	2005

(1)The net interest margin and efficiency ratios are presented on a fully taxable-equivalent (FTE) and annualized basis. The FTE basis adjusts for the tax-favored status of income from certain loans and investments. Management believes this measure to be the preferred industry measurement of net interest income and provides a relevant comparison between taxable and nontaxable investments.

Net interest income (GAAP basis)	**$ 655,787**	$ 617,126	**$ 169,995**	$ 162,434
Taxable-equivalent adjustment	**7,371**	6,847	**1,847**	1,833
Net interest income - taxable equivalent	**$ 663,158**	$ 623,973	**$ 171,842**	$ 164,267

(2) Management excludes the balance of intangible assets and their related amortization expense from its calculation of return on average tangible equity and average tangible equity to average tangible assets. This adjustment allows management to review the core operating results and core capital position of Bankshares. This is consistent with the treatment by the bank regulatory agencies that excludes goodwill and other intangible assets from their calculation of risk-based capital ratios.

Return on average equity (GAAP basis)	**12.31**	**%**	13.18	%	**11.78**	**%**	13.44	%
Impact of excluding average intangible assets and amortization	**6.09**		6.36		**6.23**		6.82	
Return on average tangible equity	**18.40**	**%**	19.54	%	**18.01**	**%**	20.26	%
Average equity to average assets (GAAP basis)	**13.75**	**%**	13.51	%	**13.95**	**%**	13.59	%
Impact of excluding average intangible assets and amortization	**(3.93**	**)**	(3.81	)	**(4.15**	**)**	(3.98	)
Average tangible equity to average tangible assets	**9.82**	**%**	9.70	%	**9.80**	**%**	9.61	%

(3) The efficiency ratio is measured by dividing noninterest expenses by the sum of net interest income on an FTE basis and noninterest income. When computing the cash operating efficiency ratio and cash operating earnings, management excludes the amortization of intangible assets, restructuring charges, merger-related expenses, and gains and losses on sales of premises and from the sales of investment securities in order to assess the core operating results of Bankshares and because of the uncertainty as to timing and amount of gain or loss to be recognized.

Efficiency ratio (GAAP basis)	**49.83**	**%**	48.53	%	**53.29**	**%**	47.87	%
Impact of excluding:								
Securities gains and (losses)	**0.01**		0.03				(0.01	)
Gains on sales of premises	**0.10**		0.24		**0.37**			

(1) Includes $47.2 million in financing resulting from the sale of the Hopkins Plaza Building. Includes principal paym

Amortization of deposit intangibles	**(0.75)**	(0.67)	**(0.91)**	(0.66)
Amortization of other intangibles	**(0.33)**	(0.35)	**(0.26)**	(0.35)
Restructuring charges				
Merger-related expenses	**(1.54)**	(0.17)	**(5.58)**	(0.16)
Cash operating efficiency ratio	**47.32 %**	47.61 %	**46.91 %**	46.69 %

(4) Bankshares presents cash operating earnings in order to assess its core operating results.

Net income (GAAP basis)	**$ 288,286**	$ 276,319	**$ 72,862**	$ 74,863
Less:				
Securities (gains) and losses, net of tax	**(128)**	(245)	**(4)**	32
Gains on sales of premises, net of tax	**(1,054)**	(2,624)	**(992)**	
Plus:				
Amortization of deposit intangibles, net of tax	**4,140**	3,492	**1,327**	899
Amortization of other intangibles, net of tax	**1,845**	1,812	**388**	486
Restructuring charges, net of tax				
Merger-related expenses, net of tax	**9,797**	877	**9,386**	216
Cash operating earnings	**$ 302,886**	$ 279,631	**$ 82,967**	$ 76,496

(1) Includes $47.2 million in financing resulting from the sale of the Hopkins Plaza Building. Includes principal paym

RECENT ACCOUNTING PRONOUNCEMENTS

On February 16, 2006, the Financial Accounting Standards Board (FASB) issued Statement No. 155, Accounting for Certain Hybrid Instruments. This standard amends the guidance in FASB Statements (SFAS) No. 133, Accounting for Derivative Instruments and Hedging Activities, and SFAS No. 140, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities. SFAS No. 155 allows financial instruments that have embedded derivatives to be accounted for as a whole (eliminating the need to bifurcate the derivative from its host) if the holder elects to account for the instrument on a fair value basis. SFAS No. 155 is effective for all financial instruments acquired or issued after the beginning of an entity s first fiscal year that begins after September 15, 2006. Bankshares does not anticipate this statement will have a material effect on its results of operations or financial condition.

In March 2006, the FASB issued SFAS No. 156, Accounting for Servicing of Financial Assets-An Amendment of FASB Statement No. 140. This standard amends the guidance in SFAS No.140, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities. Among other requirements, SFAS No. 156 requires an entity to recognize a servicing asset or servicing liability each time it undertakes an obligation to service a financial asset by entering into a servicing contract. The standard requires initial measurement of all newly purchased or issued separately recognized servicing assets and servicing liabilities at fair value, if practicable. Subsequent measurements may be made using either the fair value or amortization method. SFAS No. 156 is effective as of the beginning of an entity s first fiscal year that begins after September 15, 2006 with early adoption permitted in the quarter-ended March 31, 2006. Bankshares does not anticipate this statement will have a material effect on its results of operations or financial condition.

On July 13, 2006, the FASB issued FASB Interpretation No. 48 (FIN 48). FIN 48 clarifies the accounting for uncertainty in income taxes recognized in an enterprise s financial statements in accordance with SFAS No. 109, Accounting for Income Taxes . FIN 48 prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. FIN 48 also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure and transition. FIN 48 is effective for fiscal years beginning after December 15, 2006. An enterprise shall disclose the cumulative effect of the change on retained earnings in the statement of financial position as of the date of adoption and such disclosure is required only in the year of adoption. Bankshares expects that the effect of adopting FIN 48 will result in an immaterial adjustment to 2007 opening retained earnings.

On September 15, 2006, the FASB issued SFAS No. 157, Fair Value Measurements, which provides for enhanced guidance for using the fair value to measure assets and liabilities. SFAS No. 157 defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles (GAAP), and expands disclosures about fair value measurements. SFAS No. 157 is applicable under other accounting pronouncements that either require or permit fair value measurements and does not require any new fair value measurements. SFAS No. 157 is effective for financial statements issued for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. Bankshares is in the process of analyzing the implications of SFAS No. 157.

On September 20, 2006, the FASB ratified EITF 06-4, Accounting for Deferred Compensation and Postretirement Benefit Aspects of Endorsement Split-Dollar Life Insurance Arrangements. EITF 06-4 addresses accounting for split-dollar life insurance arrangements after the employer purchases a life insurance policy on the covered employee. This EITF states that an obligation arises as a result of a substantive agreement with an employee to provide future postretirement benefits. Under EITF 06-4, the obligation is not settled upon entering into an insurance arrangement. Since the obligation is not settled, a liability should be recognized in accordance with applicable authoritative guidance. EITF 06-4 is effective for fiscal years beginning after December 15, 2007. Bankshares is in the process of analyzing the implications of EITF 06-4.

On September 20, 2006, the FASB ratified EITF 06-5, Accounting for Purchases of Life Insurance Determining the Amount That Could Be Realized in Accordance with FASB Technical Bulletin No. 85-4, *Accounting for Purchases of Life Insurance*. This issue addresses how an entity should determine the amount that could be realized under the insurance contract at the balance sheet date in applying FTB 85-4 and if the determination should be on an individual or group policy basis. EITF 06-5 is effective for fiscal years beginning after December 15, 2006. The adoption of EITF 06-5 is not expected to have a material effect on Bankshares financial statements.

ITEM 7A. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Market risk refers to the risk of loss arising from adverse changes in interest rates, foreign currency exchange rates, commodity prices, and other relevant market rates and prices, such as equity prices. The risk of loss can be assessed from the perspective of adverse changes in fair values, cash flows, and future earnings. Due to the nature of its operations, Bankshares is primarily exposed to interest rate risk and, to a lesser extent, liquidity risk.

Refer to Item 1A. Risk Factors and Item 7. Management s Discussion and Analysis of Financial Condition and Results of Operations, of this report, along with the cautionary statements set forth elsewhere in this report for additional information.

ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA.

On July 13, 2006, the FASB issued FASB Interpretation No. 48 (FIN 48). FIN 48 clarifies the accounting for unce

Report of Independent Registered Public Accounting Firm

The Board of Directors and Shareholders of Mercantile Bankshares Corporation:

We have audited the accompanying consolidated balance sheet of Mercantile Bankshares Corporation as of December 31, 2006, and the related consolidated statements of income, shareholders equity, and cash flows for the year then ended. These financial statements are the responsibility of the Company s management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the consolidated financial position of Mercantile Bankshares Corporation at December 31, 2006, and the consolidated results of their operations and their cash flows for the year then ended, in conformity of U.S. generally accepted accounting principles.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the effectiveness of Mercantile Bankshares Corporation s internal control over financial reporting as of December 31, 2006, based on the criteria established in Internal Control-Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission and our report dated February 27, 2007, expressed an unqualified opinion thereon.

/s/ Ernst & Young LLP
McLean, Virginia
February 27, 2007

Management s Report on Internal Control over Financial Reporting

Management of Mercantile Bankshares Corporation, (together with its consolidated subsidiaries, we, us or Bankshares), is responsible for establishing and maintaining adequate internal control over financial reporting as defined in Rules 13a-15(f) and 15d-15(f) under the Securities Exchange Act of 1934. Our internal control over financial reporting is designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. Our internal control over financial reporting includes those policies and procedures that:

(i) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of Bankshares;

(ii) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of Bankshares are being made only in accordance with authorization of management and directors of Bankshares; and

(iii) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition of our assets that could have a material effect on the financial statements.

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

Management assessed the effectiveness of our internal control over financial reporting as of December 31, 2006. In making this assessment, management used the criteria described in the Internal Control-Integrated Framework set forth by the Committee of Sponsoring Organizations of the Treadway Commission (COSO).

Based on our assessment and those criteria, management has concluded that, as of December 31, 2006, Bankshares internal control over financial reporting was effective. Our independently registered public accounting firm has audited management s assessment of the effectiveness of Bankshares internal control over financial reporting as of December 31, 2006 as stated in their report that appears on the following page.

/s/ Edward J. Kelly, III
Edward J. Kelly, III
Chairman, President and Chief Executive Officer

/s/ Terry L. Troupe
Terry L. Troupe
Executive Vice President and Chief Financial Officer

Mercantile Bankshares Corporation
March 1, 2007

Report of Independent Registered Public Accounting Firm

The Board of Directors and Shareholders of Mercantile Bankshares Corporation:

We have audited management s assessment, included in the accompanying Management s Report on Internal Control over Financial Reporting, that Mercantile Bankshares Corporation maintained effective internal control over financial reporting as of December 31, 2006, based on criteria established in Internal Control Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (the COSO criteria). Mercantile Bankshares Corporation s management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting. Our responsibility is to express an opinion on management s assessment and an opinion on the effectiveness of the company s internal control over financial reporting based on our audit.

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

A company s internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company s internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company s assets that could have a material effect on the financial statements.

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

In our opinion, management s assessment that Mercantile Bankshares Corporation maintained effective internal control over financial reporting as of December 31, 2006, is fairly stated, in all material respects, based on the COSO criteria. Also, in our opinion, Mercantile Bankshares Corporation maintained, in all material respects, effective internal control over financial reporting as of December 31, 2006, based on the COSO criteria.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheet of Mercantile Bankshares Corporation as of December 31, 2006 and the related consolidated statements of income, shareholders equity, and cash flows for the year then ended and our report dated February 27, 2007, expressed an unqualified opinion thereon.

/s/ Ernst & Young LLP
McLean, Virginia
February 27, 2007

Report of Independent Registered Public Accounting Firm

To the Board of Directors and Shareholders of Mercantile Bankshares Corporation:

In our opinion, the consolidated balance sheet as of December 31, 2005 and the related consolidated statements of income, changes in shareholders equity and cash flows for each of two years in the period ended December 31, 2005 present fairly, in all material respects, the financial position of Mercantile Bankshares Corporation and its subsidiaries at December 31, 2005, and the results of their operations and their cash flows for each of the two years in the period ended December 31, 2005, in conformity with accounting principles generally accepted in the United States of America. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits. We conducted our audits of these statements in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

/s/ PricewaterhouseCoopers LLP
Baltimore, MD
March 10, 2006

Consolidated Balance Sheets

DECEMBER 31, (Dollars in thousands, except per share data)	2006	2005
ASSETS		
Cash and due from banks	**$ 347,246**	$ 369,536
Interest-bearing deposits in other banks	**200**	200
Federal funds sold	**2,609**	25,104
Total cash and cash equivalents	**350,055**	394,840
Trading account securities at fair value	**3,605**	
Investment securities available-for-sale amortized cost of $3,148,953 (2006) and $3,141,858 (2005)	**3,110,453**	3,089,628
Investment securities held-to-maturity fair value of $13,462 (2006) and $17,181 (2005)	**13,099**	16,659
Loans held-for-sale		26,263
Loans	**12,792,733**	11,607,845
Less: allowance for loan losses	**(143,029)**	(156,673)
Loans, net	**12,649,704**	11,451,172
Bank premises and equipment, net	**141,464**	137,419
Other real estate owned, net	**1,405**	667
Goodwill, net	**768,686**	670,028
Other intangible assets, net	**45,736**	46,653
Other assets	**631,818**	588,400
Total assets	**$ 17,716,025**	$ 16,421,729
LIABILITIES		
Deposits:		
Noninterest-bearing deposits	**$ 3,271,286**	$ 3,324,650
Interest-bearing deposits	**9,502,605**	8,752,700
Total deposits	**12,773,891**	12,077,350
Short-term borrowings	**1,652,196**	1,237,714
Accrued expenses and other liabilities	**213,752**	169,780
Long-term debt	**659,020**	742,163
Total liabilities	**15,298,859**	14,227,007
COMMITMENTS AND CONTINGENCIES		
SHAREHOLDERS EQUITY		
Preferred stock, no par value; authorized 2,000,000 shares; issued and outstanding - None		
Common stock, $2 par value; authorized 200,000,000 shares; issued shares - 125,581,400 (2006) and 82,165,414 (2005)	**251,163**	164,331
Capital surplus	**672,698**	676,830
Retained earnings	**1,540,836**	1,386,405
Accumulated other comprehensive loss	**(47,531)**	(32,844)
Total shareholders equity	**2,417,166**	2,194,722
Total liabilities and shareholders equity	**$ 17,716,025**	$ 16,421,729

See Notes to Consolidated Financial Statements.

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Statements of Consolidated Income

For the years ended December 31, **(Dollars in thousands, except per share data)**	**2006**	2005	2004
INTEREST INCOME			
Interest and fees on loans	**$ 863,563**	$ 700,832	$ 546,531
Interest and dividends on investment securities:			
Taxable interest income	**126,492**	107,133	105,423
Tax-exempt interest income	**2,968**	3,161	3,266
Other investment income	**2,655**	2,475	2,314
Total interest and dividends on investment securities	**132,115**	112,769	111,003
Other interest income	**3,044**	2,436	1,503
Total interest income	**998,722**	816,037	659,037
INTEREST EXPENSE			
Interest on deposits	**251,118**	139,917	83,403
Interest on short-term borrowings	**55,100**	26,266	7,844
Interest on long-term debt	**36,717**	32,728	22,009
Total interest expense	**342,935**	198,911	113,256
NET INTEREST INCOME	**655,787**	617,126	545,781
Provision for credit losses		1,576	7,221
NET INTEREST INCOME AFTER PROVISION FOR CREDIT LOSSES	**655,787**	615,550	538,560
NONINTEREST INCOME			
Investment and wealth management	**110,879**	95,756	90,050
Service charges on deposit accounts	**46,339**	43,885	44,263
Mortgage banking related fees	**6,786**	15,019	11,495
Investment securities gains	**212**	405	1,239
Nonmarketable investments	**23,520**	19,882	11,422
Other income	**66,998**	68,173	55,460
Total noninterest income	**254,734**	243,120	213,929
NONINTEREST EXPENSES			
Salaries	**205,826**	200,222	187,621
Employee benefits	**56,100**	46,175	44,676
Net occupancy expense of bank premises	**32,783**	28,596	24,307
Furniture and equipment expenses	**33,445**	31,659	31,439
Communications and supplies	**16,034**	16,406	16,904
Professional services	**31,483**	21,914	25,302
Advertising and promotional	**11,663**	9,103	8,418
Other expenses	**70,055**	66,746	53,291
Total noninterest expenses	**457,389**	420,821	391,958
Income before income taxes	**453,132**	437,849	360,531
Provision for income taxes	**164,846**	161,530	131,124
NET INCOME	**$ 288,286**	$ 276,319	$ 229,407
NET INCOME PER SHARE OF COMMON STOCK			
Basic	**$ 2.32**	$ 2.28	$ 1.93
Diluted	**$ 2.30**	$ 2.26	$ 1.92
DIVIDENDS PAID PER COMMON SHARE	**$ 1.10**	$ 0.99	$ 0.92

See Notes to Consolidated Financial Statements.

Statements of Changes in Consolidated Shareholders Equity

FOR YEARS ENDED DECEMBER 31, 2006, 2005 AND 2004

(Dollars in thousands, except per share data)	**Total**	**Common Stock**	**Capital Surplus**	**Retained Earnings**	**Accumulated Other Comprehensive Income (Loss)**
BALANCE, DECEMBER 31, 2003	$ 1,841,441	$ 159,545	$ 548,664	$ 1,110,748	$ 22,484
Net income	229,407			229,407	
Unrealized losses on securities available-for-sale, net of reclassification adjustment, net of taxes	(25,209)				(25,209)
Comprehensive income	204,198				
Cash dividends paid:					
Common stock ($0.92 per share)	(109,295)			(109,295)	
Issuance of 117,126 shares for dividend reinvestment and stock purchase plan	5,281	234	5,047		
Issuance of 24,583 shares for employee stock purchase dividend reinvestment plan	1,130	50	1,080		
Stock options					
Issuance of 350,110 shares	7,911	700	7,211		
Expense	1,892		1,892		
Stock awards					
Issuance of 35,982 shares	1,632	72	1,560		
Deferred compensation	(1,632)			(1,632)	
Expense	2,042			2,042	
Directors deferred compensation plan					
Transfer opening balance	6,406		6,406		
Contribution	787		787		
Dividend			168	(168)	
Purchase of 1,000,000 shares under stock repurchase plan	(44,110)	(2,000)	(42,110)		
BALANCE, DECEMBER 31, 2004	1,917,683	158,601	530,705	1,231,102	(2,725)
Net income	276,319			276,319	
Unrealized losses on securities available-for-sale, net of reclassification adjustment, net of taxes	(30,119)				(30,119)
Comprehensive income	246,200				
Cash dividends paid:					
Common stock ($0.99 per share)	(120,167)			(120,167)	
Issuance of 2,460,995 shares for acquisitions	125,351	4,922	120,429		
Fair value of 138,764 converted options related to employee stock option plan of acquired bank	5,182		5,182		
Issuance of 108,693 shares for dividend reinvestment and stock purchase plan	5,506	217	5,289		
Issuance of 22,803 shares for employee stock purchase dividend reinvestment plan	1,195	46	1,149		
Stock options					
Issuance of 203,695 shares	4,504	407	4,097		
Expense	5,196		5,196		
Stock awards					
Issuance of 57,728 shares	3,055	116	2,939		
Deferred compensation	(3,222)			(3,222)	
Expense	2,637			2,637	
Directors deferred compensation plan					
Issuance of 10,994 shares	470	22	448		
Contribution	1,132		1,132		
Dividend			264	(264)	
BALANCE, DECEMBER 31, 2005	2,194,722	164,331	676,830	1,386,405	(32,844)

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FOR YEARS ENDED DECEMBER 31, 2006, 2005 and 2004

(Dollars in thousands, except per share data)	Total	Common Stock	Capital Surplus	Retained Earnings	Accumulated Other Comprehensive Income (Loss)
Net income	288,286			288,286	
Unrealized gains on securities available-for-sale, net of reclassification adjustment, net of taxes	8,457				8,457
Comprehensive income	296,743				
Adjustment to initially apply SFAS No. 158, net of taxes	(23,144)				
Cash dividends paid:					(23,144)
Common stock ($1.10 per share)	(136,714)			(136,714)	
Issuance of 1,833,757 shares for bank acquisition	63,140	3,668	59,472		
Fair value of 138,066 converted options related to employee stock option plan of acquired bank	1,605		1,605		
Issuance of 134,274 shares for dividend reinvestment and stock purchase plan	4,706	268	4,438		
Issuance of 28,613 shares for employee stock purchase dividend reinvestment plan	1,073	57	1,016		
Stock options					
Issuance of 195,724 shares	4,178	392	3,786		
Expense	3,020		3,020		
Stock awards and units					
Issuance of 177,480 shares	368	355	13		
Repurchase of 44,409 shares for tax settlement	(1,755)	(89)	(1,666)		
Expense	8,133		8,133		
Directors deferred compensation plan					
Issuance of 5,721 shares	192	11	181		
Contribution	981		981		
Dividend			347	(347)	
Adoption of SFAS No. 123(R)			(3,206)	3,206	
Issuance of 41,084,826 shares for a 3-for-2 stock split	(82)	82,170	(82,252)		
BALANCE, DECEMBER 31, 2006	**$ 2,417,166**	**$ 251,163**	**$ 672,698**	**$ 1,540,836**	**$ (47,531)**

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Statements of Consolidated Cash Flows

FOR YEARS ENDED DECEMBER 31, (Dollars in thousands)	2006	2005	2004
CASH FLOWS FROM OPERATING ACTIVITIES:			
Net income	**$ 288,286**	$ 276,319	$ 229,407
Adjustments to reconcile net income to net cash provided by operating activities:			
Provision for credit losses		1,576	7,221
Depreciation	**15,780**	15,558	15,645
Amortization of other intangible assets	**9,901**	8,773	8,142
Provision for deferred tax benefits	**(9,678)**	(9,263)	(23,749)
Tax benefit from the issuance of stock-based awards	**168**		
Write-downs of other real estate owned		1	14
Gains on sales of other real estate owned	**(7)**	(198)	(204)
Gains on sales of investments securities	**(212)**	(405)	(1,239)
Gains on sales of premises	**(1,744)**	(4,341)	(1,664)
Net (increase) decrease in assets:			
Loans held-for-sale	**27,468**	(14,974)	3,925
Interest receivable	**(11,595)**	(9,052)	2,486
Nonmarketable investments	**(11,972)**	13,100	(11,297)
Trading account assets, net	**(3,605)**		
Other assets	**(15,024)**	7,360	14,349
Net increase (decrease) in liabilities:			
Interest payable	**19,286**	8,373	(1,113)
Other liabilities	**7,329**	(1,205)	7,307
Net cash provided by operating activities	**314,381**	291,622	249,230
CASH FLOWS FROM INVESTING ACTIVITIES:			
Proceeds from maturities of investment securities held-to-maturity	**3,560**	3,517	8,037
Proceeds from maturities of investment securities available-for-sale	**1,006,738**	898,334	917,216
Proceeds from sales of investment securities available-for-sale	**108,184**	121,634	49,314
Purchases of investment securities available-for-sale	**(1,005,380)**	(1,078,446)	(871,948)
Net increase in customer loans	**(777,196)**	(713,794)	(973,155)
Proceeds from sales of other real estate owned	**2,241**	485	533
Capital expenditures	**(23,831)**	(10,214)	(10,474)
Proceeds from sales of premises	**2,969**	7,981	3,872
Proceeds from sale of interest in Ltd Partnership	**6,705**		
Business acquisitions (net of cash received)	**(61,251)**	(78,655)	
Business acquisition contingent consideration	**(8,806)**		
Purchase of nonmarketable investments	**(14,619)**	(58,581)	(9,799)
Net cash used in investing activities	**(760,686)**	(907,739)	(886,404)
CASH FLOWS FROM FINANCING ACTIVITIES:			
Net increase (decrease) in noninterest-bearing deposits	**(149,080)**	167,769	298,310
Net increase in interest-bearing deposits	**412,602**	485,400	238,338
Net increase in short-term borrowings	**360,323**	340,151	78,836
Proceeds from issuance of long-term debt			51,250
Repayment of long-term debt	**(95,837)**	(118,535)	(8,044)
Tax benefit from the issuance of stock-based awards	**1,164**		
Excess tax benefit related to stock-based awards	**860**		
Proceeds from issuance of shares	**9,957**	11,205	14,322
Repurchase of common shares	**(1,755)**		(44,110)
Dividends paid	**(136,714)**	(120,167)	(109,295)
Net cash provided by financing activities	**401,520**	765,823	519,607
Net increase (decrease) in cash and cash equivalents	**(44,785)**	149,706	(117,567)
Cash and cash equivalents at beginning of period	**394,840**	245,134	362,701
Cash and cash equivalents at end of period	**$ 350,055**	$ 394,840	$ 245,134
SUPPLEMENTAL INFORMATION			
Cash payments for interest	**$ 322,475**	$ 189,186	$ 114,370
Cash payments for income taxes	**175,987**	173,306	138,832

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Notes to Consolidated Financial Statements

1. SIGNIFICANT ACCOUNTING POLICIES

A. Basis of Presentation

Mercantile Bankshares Corporation (Bankshares) is a regional multibank holding company headquartered in Baltimore, Maryland. At December 31, 2006, Bankshares had $17.7 billion in assets, $12.8 billion in loans and $12.8 billion in deposits. It is the largest bank holding company headquartered in the state of Maryland. The two principal lines of business are Banking Services and Investment & Wealth Management (IWM), delivered through the lead bank Mercantile-Safe Deposit and Trust Company (MSD&T) and 10 affiliated banks. The consolidated financial statements, which include the accounts of Mercantile Bankshares Corporation (Bankshares) (Nasdaq: MRBK) and all of its affiliates, are prepared in conformity with accounting principles generally accepted in the United States of America and follow general practice within the banking industry. All significant intercompany transactions have been eliminated. For purposes of comparability, certain prior period amounts have been reclassified to conform to current period presentation.

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and contingent assets and liabilities at the date of the financial statements and the disclosure of revenues and expenses during the reporting period. These estimates and assumptions, such as the accounting for loan losses and reserve for unfunded commitments, depreciation and pension obligations, are based on information available as of the date of the financial statements and could differ from actual results.

Assets (other than cash deposits) held for others under fiduciary and agency relationships are not included in the accompanying balance sheets since they are not assets of Bankshares or its affiliates. Acquisitions accounted for as purchases are included in the financial statements from the respective dates of affiliation.

On January 10, 2006, Bankshares announced a three-for-two stock split on its common stock. Certain share, average share and per share amounts have been adjusted to give effect to the split.

B. Investment Securities

Investments are classified as either held-to-maturity or available-for-sale or trading at the date of commitment of purchase. The fair value of securities is based on pricing services that rely on quoted market prices, or if quoted market prices are not available, then the fair value is estimated using quoted market prices for similar securities, pricing models or discounted cash flow analysis. Interest and dividends declared on securities are recognized in interest and dividend income on an accrual basis. Premiums and discounts on debt securities are amortized/accreted by the level yield methods adjusted for the effects of prepayments on the underlying investments. Realized gains and losses are recognized on a specific identification trade date basis. Amortized cost is used to compute gains or losses on the sales of securities, which are reported in the Statement of Consolidated Income.

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Investment securities classified as held-to-maturity are acquired with the intent and ability to hold until maturity and are carried at cost, adjusted for amortization of premiums and accretion of discounts. Investment securities classified as available-for-sale are acquired to be held for indefinite periods of time and may be sold in response to changes in interest rates and/or prepayment risk or for liquidity management purposes. These securities are carried at fair value, and any unrealized gain or loss in the market value of available-for-sale securities is reported as accumulated other comprehensive income, a separate component of shareholders equity, net of applicable taxes. Trading securities are acquired with the intent to be held for a short period with a subsequent resale. These securities are carried at fair value with realized and unrealized gains and losses recorded in trading account profit and losses in the results of operations.

An assessment is made at the end of each quarter to determine whether there have been any events or economic circumstances to indicate that a security is impaired on an other-than-temporary basis. An other-than-temporary impairment may develop if, based on all available evidence, the carrying amount of the investment is not recoverable within a reasonable period of time. Factors considered in making this assessment include, among others, the intent and ability to hold the investment for a period of time sufficient for a recovery in value; external credit ratings and recent downgrades; market price fluctuations due to factors other than interest rates; and the probability of collection of contractual cash flows. Securities on which there is an unrealized loss that is deemed to be other-than-temporary are written down to fair value, and the adjustment is recorded as a realized loss in securities gains (losses).

C. Loans

Interest income on loans is accrued at the contractual rate on the principal amount outstanding. Beginning in 2005, loan origination and commitment fees, direct loan acquisition and origination costs, when significant, are deferred and accreted to interest income over the life of the loan or over the commitment period. Loans held-for-sale in conjunction with the mortgage banking business are carried at the lower of aggregate cost or fair value. Fees related to loans held-for-sale are recognized as a component of mortgage banking income upon the sale of the loan. Valuation allowances on these impaired loans reflect only losses incurred after the acquisition (meaning the present value of all cash flows expected at acquisition that are ultimately not received) with the estimated cash flows reevaluated on a quarterly basis. When scheduled principal or interest payments are past due 90 days or more at quarter-end on any loan, the accrual of interest income is discontinued. Subsequent receipts on these loans are recorded as a reduction of principal, and interest income is recorded only once principal recovery is reasonably assured. Previously accrued but uncollected interest on these loans is charged against interest income. Generally, a loan may be restored to accruing status when all past due principal, interest and late charges have been paid and Bankshares expects repayment of the remaining contractual principal and interest.

In accordance with Statements of Financial Accounting Standards (SFAS) Nos. 114 and 118, Accounting by Creditors for Impairment of a Loan - an amendment of FASB Statements Nos. 5 and 15 a loan is considered impaired when, based on current information and events, if it is probable that Bankshares will not collect all principal and interest payments according to the contractual terms of the loan agreement. The impairment of a loan is measured based on the present value of expected future cash flows discounted at the loan s effective interest rate, or the fair value of the collateral if the repayment is expected to be provided predominantly by the underlying collateral. Impaired loans do not include large groups of smaller balance homogeneous loans that are evaluated collectively for impairment (e.g., residential mortgages and consumer installment loans). The allowance for loan losses related to these loans is included in the allowance for loan losses applicable to other than impaired loans. A majority of Bankshares impaired loans are measured by reference to the fair value of the collateral.

D. Allowance for Loan Losses and Reserve for Unfunded Commitments

The allowance for loan losses and reserve for unfunded commitments are estimated at a level considered by management to be adequate to absorb losses inherent in the loan portfolio. Management s assessment includes the systematic evaluation of several factors: current economic conditions and their impact on specific borrowers and industry groups; the level of classified and nonperforming loans; the historical loss probability of default and loss given default by loan type; the results of regulatory examinations; and, in specific cases, the estimated value of underlying collateral. The assessments of economic conditions, results of regulatory examinations and other risk elements are primarily determined by management at each affiliate and reviewed by Bankshares. In developing this assessment, management must rely on estimates and exercise judgment in assigning credit risk. Depending on changing circumstances, future assessments of credit risk may yield materially different results from the estimates, which may require an increase or a decrease in the allowance for loan losses and reserve for unfunded commitments.

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The allowance is increased or reduced by the loan loss provision charged or credited to operating expenses and reduced by loan charge-offs, net of recoveries. The provision for loan losses is based on a continuing review of the loan portfolios, past loss experience and current economic conditions that may affect borrowers ability to pay. A loan is charged-off when, in management s judgment, the collection of the remaining balance carried is remote. Consumer loans that are 90 days past due at quarter end, unless well secured and in the process of collection, are charged off immediately.

We employ modeling and estimation tools in developing the appropriate allowance and reserve for unfunded commitments. Bankshares allowance consists of formula-based components for business and retail loans, an allowance for impaired loans and an unallocated component. The following provides a description of each of these components of the allowance, the techniques used and the estimates and judgments inherent in each. In the first quarter of 2006, management refined the methodologies for the formula-based components to align more appropriately the allowance methodology with our current framework for analyzing credit losses. Formula-based allowance calculations for business and retail components permit us to address specifically the current trends and events affecting the credit risk in the loan portfolio. The reserve for unfunded commitments is estimated using the same methodology.

Business loans are comprised of commercial, commercial real estate and construction loans, which are evaluated separately for impairment. For business loans, the formula-based component of the allowance for loan losses is based on statistical migration estimates of the average losses observed for business loans classified by credit grade. Average losses for each credit grade are computed using the annualized historical rate at which loans in each credit grade have defaulted (probability of default rates or PD) and the historical average losses realized for defaulted loans (loss-given-default or LGD). We have developed default rates by analyzing four years of our default experience and more than 14 years of comparable external data. Default rates, which are validated annually, are estimates derived from long-term averages and are not based on short-term economic or environmental factors. LGD rates have been developed using industry benchmarks.

Retail loans are comprised of consumer installment and residential mortgage loans. For retail loans, the formula-based component of the allowance for loan losses is primarily based on the probability of default rates and LGD rates for specific groups of similar loans by product category. The probability of default rates are based on four years of our default experience and between 14 and 19 years of comparable industry data. LGD rates were developed using industry benchmarks.

For both business and retail loans, the formula-based components include additional qualitative amounts to establish reasonable ranges that consider observed historical variability in losses. Factors we may consider in setting these amounts include, but are not limited to, industry-specific data, portfolio specific risks or concentrations, and macroeconomic conditions. Including these variability components in the model enables us to capture probable incurred losses that are not yet evident in current default grades, delinquencies and other credit-risk measurement tools.

The modeling process used in for the determination of the reserve for unfunded lending commitments is consistent with the process for the formula-based component of the allowance for loan losses, also including as a key factor a benchmark average rate at which unfunded exposures have been funded at the time of default. The development of this modeling in 2006 enabled Bankshares to evaluate specifically the risk inherent in unfunded commitments. As no model data existed in previous years, prior period data has not been reclassified for comparability.

E. Loans Held-for-Sale

Bankshares enters into commitments to sell loans that it has originated. Generally, these loans are held for a short term. Mortgage loans held for sale are recorded at the principal amount less deferred fee income, with fee income subsequently reflected in earnings when the loan is sold. The carrying amounts of loans held-for-sale are reported at the lower of cost or fair market value, with the original principal amount adjusted to reflect changes in the loans fair value as applicable through fair value hedge accounting. Pursuant to SFAS No. 133, loans held-for-sale, commitments to sell the loans and any commitments to originate loans are recorded on the balance sheet at estimated fair market value. The determination of any write-down to market value on loans held-for -sale includes consideration of all open positions and outstanding commitments from investors. Declines in the market value of loans held-for-sale are recorded as a charge in mortgage banking-related fees. Subsequent declines or recoveries of previous declines in the market value of loans held for sale are recorded in mortgage banking-related fees. Sales of loans are recorded when the proceeds are received, and any difference between the proceeds and the carrying amount is recorded as a gain or loss in mortgage banking-related fees.

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F. Bank Premises and Equipment

Bank premises and equipment are stated at cost less accumulated depreciation and amortization. Depreciation and amortization are computed using both the straight-line and accelerated methods over the estimated useful lives of the properties. Expenditures for repairs and maintenance are charged to operating expenses as incurred. Expenditures for improvements that extend the life of an asset are capitalized and depreciated over the asset s remaining useful life. Gains or losses realized on the disposition of properties are reflected in consolidated income.

G. Other Real Estate Owned

Other real estate owned consists primarily of real estate obtained through foreclosure or acceptance of deeds in lieu of foreclosure. Other real estate owned is held for sale and is stated at the lower of cost or fair value.

H. Goodwill and Intangible Assets

Goodwill is the excess of the cost of Bankshares investment over the equity in the net assets of purchased businesses. Goodwill and identified intangible assets with indefinite useful lives are not subject to amortization. Rather they are subject to impairment testing on an annual basis, or more often if events or circumstances indicate there may be impairment.

Separately identified intangible assets that have a finite useful life are amortized over that life in a manner that reflects the estimated decline in the economic value of the identified intangible asset. Identified intangible assets that have a finite useful life are periodically reviewed to determine whether there have been any events or circumstances to indicate the recorded amount is not recoverable from projected undiscounted net operating cash flows. If the projected undiscounted net operating cash flows are less than the carrying amount, a loss is recognized to reduce the carrying amount to fair value, or when appropriate, the amortization period is reduced.

Bankshares impairment evaluations for the year ended December 31, 2006, indicated that none of Bankshares goodwill or identified intangible assets was impaired with the exception of one small customer relationship intangible.

Bankshares recognizes as assets the right to service mortgage loans for others. Market quotes are used to determine the fair value of the mortgage servicing rights at the date of the sale. The capitalized mortgage servicing rights are amortized over the estimated period of net servicing income. Bankshares analyzes the capitalized mortgage servicing rights for impairment using a discounted cash flow analysis. A valuation allowance is established through a charge to earnings if the amount of unamortized mortgage servicing rights exceeds fair value.

I. Stock-Based Compensation

Bankshares stock-based compensation plans are accounted for in accordance with the provisions of SFAS No. 123(R), Share-Based Payment. Under this standard, awards granted to retirement-eligible employees are expensed immediately; compensation cost for options is determined based on the fair value of each option and the number of options that are granted and expected to vest; and forfeitures are estimated upon the grant of awards and the amount to be charged to expense is reduced by the forfeiture amount. Bankshares stock options have an exercise price equal to the fair value of the stock on the date of grant, and vest based on continued service for a specified period, generally over three to five years. The fair value of the option is measured on the date of grant using the Black-Scholes option-pricing model with market assumptions. This amount is amortized on a straight-line basis over the vesting period. Option pricing models require the use of highly subjective assumptions, including expected stock price volatility, which if changed can materially affect fair value estimates. Compensation expense for restricted stock awards and restricted stock units are based on the closing market value of Bankshares stock on the date an award is granted and is amortized as salaries expense in the results of operations in accordance with the applicable vesting schedule, generally on a straight-line over one to three years.

J. Pension and Postretirement Benefit Obligations

Bankshares offers various pension plans and postretirement benefit plans to employees. The calculation of the obligations and related expenses under these plans requires the use of actuarial valuation methods and assumptions. Actuarial valuations and assumptions used in the determination of future values of plan assets and liabilities are subject to management judgment and may differ significantly if different assumptions are used. At December 31, 2006, Bankshares implemented SFAS No.158, Employers Accounting for Defined Benefit Pension and Other

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Postretirement Plans an amendment of FASB Statements No. 87, 88, 106, and 132(R). Therefore, starting in 2006, Bankshares recognizes the funded status of its benefits plans, measured as the difference between the fair value of plan assets and the benefit

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obligations in its consolidated statement of financial position. Gains or losses and prior service costs or credits that arise during the period but are recognized as components of net periodic benefit costs of the period pursuant to SFAS No. 87 and 106 are recognized as a component of other comprehensive income. Previously, Bankshares recognized corresponding adjustments in other comprehensive income when gains or losses, prior service costs or credits, and transition assets or obligations remaining from the initial application of SFAS 87 and 106 are subsequently recognized as components of net periodic benefits costs pursuant to the recognition and amortization provisions of SFAS No. 87, 88, and 106. These adjustments are recorded on a tax effected basis.

K. Income Taxes

Income taxes are recorded in accordance with SFAS No. 109, Accounting for Income Taxes. The asset and liability approach underlying SFAS No. 109 requires the recognition of deferred tax liabilities and assets for the expected future tax consequences of temporary differences between the carrying amounts and tax bases of Bankshares assets and liabilities. Deferred taxes are determined using enacted tax rates in effect for the year in which the temporary difference is expected to reverse. To the extent tax rates or laws change, deferred tax assets and liabilities are adjusted in the period that the tax change is enacted. Income tax expense includes deferred tax expense, which represents the net change in the deferred tax asset or liability balance during the year plus any change in a valuation allowance; and current tax expense, which represents the aggregate amount of tax currently payable to or receivable from tax authorities.

L. Earnings Per Share

Basic and diluted earnings per share (EPS) amounts are computed in accordance with the provisions of SFAS No. 128, Earnings Per Share. Basic EPS is computed by dividing income available to common shareholders by weighted average common shares outstanding during the period. Diluted EPS is computed using the same components as in basic EPS with the denominator adjusted for the dilutive effect of stock options and restricted stock awards.

M. Cash Flows

For purposes of reporting cash flows, cash and cash equivalents include cash and due from banks, interest-bearing deposits in other banks, federal funds sold and securities purchased under resale agreements. Generally, federal funds are purchased and sold for one-day periods; securities purchased/sold under resale agreements are purchased/sold for periods of one to sixty days.

N. Derivatives and Hedging Activities

Derivatives are accounted for in accordance with SFAS No. 133, Accounting for Derivative Instruments and Hedging Activities as subsequently amended by SFAS No. 137, SFAS No. 138 and SFAS No. 149, which establishes accounting and reporting standards for derivatives and hedging activities. Under SFAS No. 133, Bankshares may designate a derivative as either a hedge of the fair value of a recognized fixed-rate asset or liability or an unrecognized firm commitment (fair value hedge), a hedge of a forecasted transaction or of the variability of future cash flows of a floating-rate asset or liability (cash flow hedge), or a foreign currency fair value or cash flow hedge (foreign currency hedge). All derivatives are recorded as other assets or other liabilities on the balance sheet at their respective fair values with unrealized gains and losses recorded either in other comprehensive income or in the results of operations, depending on the purpose for which the derivative is held. Derivatives that do not meet the criteria for designation as a hedge under SFAS No. 133 at inception, or fail to meet the criteria thereafter, are included in trading account assets or liabilities.

Changes in the fair value of a derivative that is designated and qualifies as a fair value hedge, along with the gain or loss on the hedged asset or liability that is attributable to the hedged risk are recorded as other noninterest income in the results of operations. To the extent of the effectiveness of a hedge, changes in the fair value of a derivative that is designated and qualifies as a cash flow hedge are recorded in other comprehensive income. For all hedge relationships, ineffectiveness resulting from differences between the changes in fair values or cash flows of the hedged item and changes in fair value of the derivative are recognized as other noninterest income in the results of operations. The net interest settlement on derivatives designated as fair value or cash flow hedges is treated as an adjustment of the interest income or interest expense of the hedged assets or liabilities.

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At inception of a hedge transaction, Bankshares formally documents the hedge, as well as the risk management objective and strategy for undertaking the hedge transactions. This process includes identification of the hedging instrument, hedged item, risk being hedged and the methodology for measuring ineffectiveness. Both at inception and on an ongoing basis, an assessment is made as to whether the derivatives used in hedging transactions have been highly effective in offsetting changes in the fair value of hedged items and whether those derivatives may be expected to remain highly effective in future periods.

Bankshares discontinues hedge accounting prospectively when either it is determined that the derivative is no longer highly effective in offsetting changes in the fair value or cash flows of a hedged item; the derivative expires or is sold, terminated or exercised; the derivative is de-designated because it is unlikely that a forecasted transaction will occur; or management determines that designation of the derivative as a hedging instrument is no longer appropriate.

When hedge accounting is discontinued, the derivative is reclassified as a trading account asset or liability. When a fair value hedge is discontinued, the hedged asset or liability is no longer adjusted for changes in fair value, and the existing basis adjustment is amortized or accreted as an adjustment to yield over the remaining life of the asset or liability. When a cash flow hedge is discontinued but the hedged cash flows or forecasted transaction are still expected to occur, unrealized gains and losses that were accumulated in other comprehensive income are included in the results of operations in the same period when the results of operations are also affected by the hedged cash flow. They are recognized in the results of operations immediately if the cash flow hedge was discontinued because a forecasted transaction is not expected to occur.

Under SFAS No. 133, as amended, commitments to purchase loans and certain commitments to sell loans are derivatives. These commitments can be designated as a hedge; otherwise, they are recorded as a freestanding derivative and classified as a trading account asset or liability.

Bankshares occasionally may enter into a contract (host contract) that contains a derivative that is embedded in the financial instrument. If applicable, an embedded derivative is separated from the host contract and can be designated as a hedge; otherwise, the derivative is recorded as a freestanding derivative and classified as a trading account asset or liability.

O. Nonmarketable Investments

Nonmarketable investments include private equity investments that are not publicly traded, securities acquired to meet various regulatory requirements (for example, Federal Reserve Bank Stock), bank-owned life insurance and hedge fund investments. Bankshares reviews typically include an analysis of the facts and circumstances of each investment for fair value determination, the expectations for the investments cash flows and capital needs, the viability of its business model and our exit strategy. Since these private equity investments have no readily ascertainable fair value, they are reported at amounts that we have estimated to be fair value. In estimating the fair value of each investment, we must apply judgment using certain assumptions. Bankshares believes that an investment s cost is the best indication of its fair value initially, provided that there have been no significant positive or negative developments subsequent to its acquisition that indicate the necessity of an adjustment to a fair value estimate. Private equity investments are reviewed at least quarterly for possible other-than-temporary impairment. If, and when, such an event takes place, Bankshares adjusts the investment s fair value by an amount that Bankshares believes reflects the nature of the event. Bankshares recognizes any adjustment to fair value as other noninterest income. Bank-owned life insurance is carried at cash surrender value, which approximates fair value. Investments in hedge funds are recorded at fair value. Changes in fair values are reported as noninterest income.

P. Recent Accounting Pronouncements

On February 16, 2006, the Financial Accounting Standards Board (FASB) issued SFAS No. 155, Accounting for Certain Hybrid Instruments. This standard amends the guidance in SFAS No. 133, Accounting for Derivative Instruments and Hedging Activities, and SFAS No. 140, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities. SFAS No. 155 allows financial instruments that have embedded derivatives to be accounted for as a whole (eliminating the need to bifurcate the derivative from its host) if the holder elects to account for the instrument on a fair value basis. SFAS No. 155 is effective for all financial instruments acquired or issued after the beginning of an entity s first fiscal year that begins after September 15, 2006. Bankshares does not anticipate this statement will have a material effect on its results of operations or financial condition.

In March 2006, the FASB issued SFAS No. 156, Accounting for Servicing of Financial Assets-An Amendment of FASB Statement No. 140. This standard amends the guidance in SFAS No.140, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities. Among other requirements, SFAS No. 156 requires an entity to recognize a servicing asset or servicing liability each time it undertakes an obligation to service a financial asset by entering into a servicing contract. The standard requires initial measurement of all newly purchased or issued separately recognized servicing assets and servicing liabilities at fair value, if practicable. Subsequent measurements may be made using either the fair value or amortization method. SFAS No. 156 is effective as of the beginning of an entity s first fiscal year that begins after September 15, 2006 with early adoption permitted in the quarter-ended March 31, 2006. Bankshares does not anticipate this statement will have a material effect on its results of operations or financial condition.

On July 13, 2006, the FASB issued FASB Interpretation No. 48 (FIN 48). FIN 48 clarifies the accounting for uncertainty in income taxes recognized in an enterprise s financial statements in accordance with SFAS No. 109, Accounting for Income Taxes. FIN 48 prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. FIN 48 also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure and transition. FIN 48 is effective for fiscal years beginning after December 15, 2006. An enterprise shall disclose the cumulative effect of the change on retained earnings in the statement of financial position as of the date of adoption and such disclosure is required only in the year of adoption. Bankshares expects that the effect of adopting FIN 48 will result in an immaterial adjustment to 2007 opening retained earnings.

On September 15, 2006, the FASB issued SFAS No. 157, Fair Value Measurements, which provides for enhanced guidance for using the fair value to measure assets and liabilities. SFAS No. 157 defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles (GAAP), and expands disclosures about fair value measurements. SFAS No. 157 is applicable under other accounting pronouncements that either require or permit fair value measurements and does not require any new fair value measurements. SFAS No. 157 is effective for financial statements issued for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. Bankshares is in the process of analyzing the implications of SFAS No. 157.

On September 20, 2006, the FASB ratified EITF 06-4, Accounting for Deferred Compensation and Postretirement Benefit Aspects of Endorsement Split-Dollar Life Insurance Arrangements. EITF 06-4 addresses accounting for split-dollar life insurance arrangements after the employer purchases a life insurance policy on the covered employee. This EITF states that an obligation arises as a result of a substantive agreement with an employee to provide future postretirement benefits. Under EITF 06-4, the obligation is not settled upon entering into an insurance arrangement. Since the obligation is not settled, a liability should be recognized in accordance with applicable authoritative guidance. EITF 06-4 is effective for fiscal years beginning after December 15, 2007. Bankshares is in the process of analyzing the implications of EITF 06-4.

On September 20, 2006, the FASB ratified EITF 06-5, Accounting for Purchases of Life Insurance Determining the Amount That Could Be Realized in Accordance with FASB Technical Bulletin No. 85-4, *Accounting for Purchases of Life Insurance*. This issue addresses how an entity should determine the amount that could be realized under the insurance contract at the balance sheet date in applying FTB 85-4 and if the determination should be on an individual or group policy basis. EITF 06-5 is effective for fiscal years beginning after December 15, 2006. The adoption of EITF 06-5 is not expected to have a material effect on Bankshares financial statements.

2. BUSINESS COMBINATIONS

The following provides information concerning mergers, acquisitions and restructurings completed during the two years ended December 31, 2006. These acquisitions were accounted for as purchases. The numbers of shares issued in the purchases have been adjusted for the three-for-two stock split. The results of operations of these acquisitions subsequent to the acquisition dates are included in Bankshares Statements of Consolidated Income. Individually, the results of operations of these acquisitions prior to the acquisition dates were not material to Bankshares results of operations.

On July 17, 2006, Bankshares completed its acquisition of James Monroe Bancorp, Inc. (James Monroe), an Arlington, Virginia-based commercial bank. James Monroe was merged into Mercantile-Safe Deposit & Trust Company (MSD&T). At the time of the acquisition, James Monroe operated six full-service branches and a loan production office located in Northern Virginia and suburban Washington, D.C. The total consideration paid to James Monroe shareholders in connection with the acquisition was $71.4 million in cash and 1.8 million shares of Bankshares common stock. The results of James Monroe s operations have been included in Bankshares financial results subsequent to July 17, 2006. The assets and liabilities of James Monroe were recorded on the consolidated balance sheet at their respective fair values. The fair values were determined as of July 17, 2006. The transaction resulted in total assets acquired of $552 million, including $414 million in gross loans; and liabilities assumed of $507 million, including $434 million in total deposits. Additionally, Bankshares preliminarily recorded $95.4 million of goodwill and $7.8 million of core deposit intangible (CDI). Intangible assets subject to amortization are being amortized on an accelerated basis.

As part of the acquisition, Bankshares considered SFAS No. 146 and, as such, Bankshares exit costs, referred to herein as merger-related costs, are defined to include costs for branch closings and related severance, combining operations such as systems conversions, and printing/mailing costs incurred by Bankshares prior to and after the merger date and are included in Bankshares results of operations. Bankshares expensed merger-related costs totaling $1.0 million for 2006. The costs associated with these activities are included in noninterest expense. Merger-related expenses incurred to date consisted largely of expenses for systems conversion and branch closing costs**.**

On May 18, 2005, Bankshares completed its acquisition of CBNV, a bank headquartered in Sterling, Virginia, which was merged into MSD&T. CBNV operated 14 branch offices in the Northern Virginia metropolitan market at the time of the acquisition. The primary reason for the merger with CBNV was to expand Bankshares distribution network in Northern Virginia, a higher growth market. The total consideration paid to CBNV shareholders in connection with the acquisition was $82.9 million in cash and 3.7 million shares of Bankshares common stock. CBNV transactions have been included in Bankshares financial results subsequent to May 18, 2005. The assets and liabilities of CBNV were recorded on the consolidated balance sheet at their respective fair values. The transaction resulted in total assets acquired as of May 18, 2005 of $888.2 million, including $671.0 million of loans and leases; liabilities assumed were $842.3 million, including $626.9 million of deposits. Additionally, Bankshares recorded $162.9 million of goodwill and $4.6 million of CDI. CDI are subject to amortization and are being amortized on an accelerated basis.

Bankshares expensed merger-related costs totaling $1.3 million for the year ended December 31, 2005. The costs associated with these activities are included in noninterest expenses. Merger-related expenses incurred consisted largely of expenses for systems conversion costs, branch closings and integrations of operations. Prior to the merger, CBNV recorded exit costs of $9.7 million relating to severance, system conversions, branch consolidations and costs associated with terminating contracts.

3. INVESTMENT SECURITIES

The amortized cost and fair value of investment securities at December 31, 2006 and 2005 were as follows:

	2006				2005			
(Dollars in thousands)	**Amortized Cost**	**Gross Unrealized Gains**	**Gross Unrealized Losses**	**Fair Value**	**Amortized Cost**	**Gross Unrealized Gains**	**Gross Unrealized Losses**	**Fair Value**
Securities held-to-maturity								
States and political subdivisions	**$ 13,099**	**$ 372**	**$ 9**	**$ 13,462**	$ 16,659	$ 541	$ 19	$ 17,181
Securities available-for-sale								
U.S. Treasury	**$ 338,283**	**$ 227**	**$ 1,993**	**$ 336,517**	$ 434,893	$ 223	$ 3,080	$ 432,036
U.S. Government agencies	**843,634**	**109**	**6,006**	**837,737**	992,040	29	12,761	979,308
Mortgage-backed securities (1)	**1,853,028**	**2,289**	**33,587**	**1,821,730**	1,581,845	685	38,269	1,544,261
States and political subdivisions	**56,709**	**163**	**173**	**56,699**	70,017	306	188	70,135
Other bonds, notes and debentures	**6,028**		**92**	**5,936**	19,083		215	18,868
Total bonds	**3,097,682**	**2,788**	**41,851**	**3,058,619**	3,097,878	1,243	54,513	3,044,608
Other investments	**51,271**	**1,099**	**536**	**51,834**	43,980	1,236	196	45,020
Total	**$ 3,148,953**	**$ 3,887**	**$ 42,387**	**$ 3,110,453**	$ 3,141,858	$ 2,479	$ 54,709	$ 3,089,628

(1) Maturities are reflected based on projected maturities at time of purchase. Actual maturities will vary as a result of the level of loan prepayments in the underlying mortgage pools.

The amortized cost and fair value of the bond investment portfolio by contractual maturity at December 31, 2006 and 2005 are shown below.

	2006		2005	
(Dollars in thousands)	**Amortized Cost**	**Fair Value**	**Amortized Cost**	**Fair Value**
Securities held-to-maturity				
Within 1 year	**$ 1,990**	**$ 1,989**	$ 2,347	$ 2,349
1-5 years	**5,574**	**5,664**	7,353	7,492
5-10 years	**5,535**	**5,809**	6,959	7,340
After 10 years				
Total	**$ 13,099**	**$ 13,462**	$ 16,659	$ 17,181
Securities available-for-sale				
Within 1 year	**$ 761,878**	**$ 757,365**	$ 621,979	$ 617,587
1-5 years	**2,196,139**	**2,162,643**	2,292,959	2,244,736
5-10 years	**139,665**	**138,611**	182,940	182,285
After 10 years				
Total	**$ 3,097,682**	**$ 3,058,619**	$ 3,097,878	$ 3,044,608

At December 31, 2006 and 2005, no single issue of investment securities exceeded 10.0% of shareholders equity. At December 31, 2006 and 2005, securities with an amortized cost of $1.6 billion and $1.3 billion, respectively, were pledged as collateral for certain deposits as required.

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The following table shows the gross unrealized losses and fair value of Bankshares investments with unrealized losses that are not deemed to be other-than-temporarily impaired (in thousands), aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position at December 31, 2006 and 2005.

	Less than 12 Months		12 months or more		Total	
At December 31, 2006 (Dollars in thousands)	**Gross Unrealized Losses**	**Fair Value**	**Gross Unrealized Losses**	**Fair Value**	**Gross Unrealized Losses**	**Fair Value**
U.S. Treasury	**$ 382**	**$ 181,456**	**$ 1,611**	**$ 155,061**	**$ 1,993**	**$ 336,517**
U.S. Government agencies	**328**	**293,051**	**5,678**	**544,686**	**6,006**	**837,737**
Mortgage-backed securities	**1,364**	**713,866**	**32,223**	**1,107,864**	**33,587**	**1,821,730**
States and political subdivisions	**14**	**38,913**	**159**	**17,785**	**173**	**56,699**
Other bonds, notes and debentures			**92**	**5,936**	**92**	**5,936**
Total bonds	**2,088**	**1,227,286**	**39,763**	**1,831,333**	**41,851**	**3,058,619**
Other investments	**536**	**51,834**			**536**	**51,834**
Total	**$ 2,624**	**$ 1,279,120**	**$ 39,763**	**$ 1,831,333**	**$ 42,387**	**$ 3,110,453**

	Less than 12 Months		12 months or more		Total	
At December 31, 2005 (Dollars in thousands)	**Gross Unrealized Losses**	**Fair Value**	**Gross Unrealized Losses**	**Fair Value**	**Gross Unrealized Losses**	**Fair Value**

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