

SHORE BANCSHARES INC  
Form 10-Q  
August 09, 2010

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

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FORM 10-Q

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

For the Quarterly Period Ended June 30, 2010

OR

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

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

Commission file number 0-22345

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

Maryland  
(State or Other Jurisdiction of  
Incorporation or Organization)

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

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

21601  
(Zip Code)

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

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

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

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

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

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

(Do not check if a smaller reporting company)

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

APPLICABLE ONLY TO CORPORATE ISSUERS

Indicate the number of shares outstanding of each of the issuer’s classes of common stock, as of the latest practicable date: 8,443,436 shares of common stock outstanding as of July 31, 2010.

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## PART I – FINANCIAL INFORMATION

## Item 1. Financial Statements.

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

	June 30, 2010 (Unaudited)	December 31, 2009
<b>ASSETS</b>		
Cash and due from banks	\$ 16,645	\$ 14,411
Interest-bearing deposits with other banks	15,652	598
Federal funds sold	32,372	60,637
Investment securities:		
Available for sale, at fair value	98,211	97,595
Held to maturity, at amortized cost – fair value of \$8,523 (2010) and \$9,012 (2009)	8,345	8,940
Loans	905,477	916,557
Less: allowance for credit losses	(13,289)	(10,876)
Loans, net	892,188	905,681
Premises and equipment, net	14,924	14,307
Goodwill	15,954	15,954
Other intangible assets, net	5,148	5,406
Other real estate and other assets owned, net	1,428	2,572
Other assets	28,329	30,415
<b>TOTAL ASSETS</b>	<b>\$ 1,129,196</b>	<b>\$ 1,156,516</b>
<b>LIABILITIES</b>		
Deposits:		
Noninterest-bearing demand	\$ 121,410	\$ 122,492
Interest-bearing demand	136,041	133,946
Money market and savings	256,975	249,793
Certificates of deposit \$100,000 or more	244,048	262,663
Other time	213,134	222,043
Total deposits	971,608	990,937
Short-term borrowings	17,864	20,404
Accrued expenses and other liabilities	13,629	15,936
Long-term debt	1,429	1,429
<b>TOTAL LIABILITIES</b>	<b>1,004,530</b>	<b>1,028,706</b>
<b>STOCKHOLDERS' EQUITY</b>		
Common stock, par value \$.01 per share; shares authorized – 35,000,000; shares issued and outstanding – 8,443,436 (2010) and 8,418,963 (2009)	84	84
Warrant	1,543	1,543
Additional paid in capital	30,081	29,872
Retained earnings	94,021	96,151
Accumulated other comprehensive (loss) income	(1,063)	160

TOTAL STOCKHOLDERS' EQUITY	124,666	127,810
TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY	\$ 1,129,196	\$ 1,156,516

See accompanying notes to Consolidated Financial Statements.

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

	For the Three Months Ended June 30,		For the Six Months Ended June 30,	
	2010	2009	2010	2009
<b>INTEREST INCOME</b>				
Interest and fees on loans	\$ 13,047	\$ 13,754	\$ 25,921	\$ 27,371
Interest and dividends on investment securities:				
Taxable	846	768	1,728	1,524
Tax-exempt	56	79	115	164
Interest on federal funds sold	14	23	26	30
Interest on deposits with other banks	4	6	5	7
Total interest income	13,967	14,630	27,795	29,096
<b>INTEREST EXPENSE</b>				
Interest on deposits	3,242	4,441	6,627	8,726
Interest on short-term borrowings	19	28	51	77
Interest on long-term debt	15	75	31	149
Total interest expense	3,276	4,544	6,709	8,952
NET INTEREST INCOME	10,691	10,086	21,086	20,144
Provision for credit losses	4,917	1,681	12,534	3,616
NET INTEREST INCOME AFTER PROVISION FOR CREDIT LOSSES	5,774	8,405	8,552	16,528
<b>NONINTEREST INCOME</b>				
Service charges on deposit accounts	831	888	1,617	1,697
Trust and investment fee income	372	258	788	476
Investment securities gains	-	-	-	49
Insurance agency commissions	2,595	2,893	5,484	6,228
Other noninterest income	770	1,308	1,561	2,247
Total noninterest income	4,568	5,347	9,450	10,697
<b>NONINTEREST EXPENSE</b>				
Salaries and wages	4,363	4,759	8,853	9,299
Employee benefits	758	1,200	2,039	2,580
Occupancy expense	597	587	1,219	1,136
Furniture and equipment expense	313	302	613	616
Data processing	660	580	1,291	1,190
Directors' fees	105	117	226	285
Amortization of other intangible assets	129	129	258	258
Insurance agency commissions expense	464	537	892	1,087
FDIC insurance premium expense	460	919	941	1,163
Other noninterest expenses	1,839	1,563	3,677	2,962
Total noninterest expense	9,688	10,693	20,009	20,576

INCOME (LOSS) BEFORE INCOME TAXES	654	3,059	(2,007)	6,649	
Income tax expense (benefit)	209	1,166	(890)	2,543	
NET INCOME (LOSS)	445	1,893	(1,117)	4,106	
Preferred stock dividends and discount accretion	-	1,539	-	1,876	
Net income (loss) available to common shareholders	\$ 445	\$ 354	\$ (1,117)	\$ 2,230	
Basic net earnings (loss) per common share	\$ 0.05	\$ 0.04	\$ (0.13)	\$ 0.27	
Diluted net earnings (loss) per common share	\$ 0.05	\$ 0.04	\$ (0.13)	\$ 0.27	
Dividends paid per common share	\$ 0.06	\$ 0.16	\$ 0.12	\$ 0.32	

See accompanying notes to Consolidated Financial Statements.

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

	Preferred	Common		Additional	Retained	Accumulated Other Comprehensive Income (Loss)	Total Stockholders' Equity
	Stock	Stock	Warrant	Paid in Capital	Earnings		
Balances, January 1, 2010	\$ -	\$ 84	\$ 1,543	\$ 29,872	\$ 96,151	\$ 160	\$ 127,810
Comprehensive income:							
Net loss	-	-	-	-	(1,117)	-	(1,117)
Unrealized gains on available-for-sale securities, net of taxes	-	-	-	-	-	844	844
Unrealized losses on cash flow hedging activities, net of taxes	-	-	-	-	-	(2,067)	(2,067)
Total comprehensive income							(2,340)
Stock-based compensation expense	-	-	-	209	-	-	209
Cash dividends paid (\$0.12 per share)	-	-	-	-	(1,013)	-	(1,013)
Balances, June 30, 2010	\$ -	\$ 84	\$ 1,543	\$ 30,081	\$ 94,021	\$ (1,063)	\$ 124,666
Balances, January 1, 2009	\$ -	\$ 84	\$ -	\$ 29,768	\$ 96,140	\$ 1,393	\$ 127,385
Comprehensive income:							
Net income	-	-	-	-	4,106	-	4,106
Unrealized losses on available-for-sale securities, net of taxes	-	-	-	-	-	(639)	(639)
Total comprehensive income							3,467
Warrant issued	-	-	1,543	-	-	-	1,543
Preferred shares issued pursuant to TARP	25,000	-	-	-	-	-	25,000
Discount from issuance of preferred stock	(1,543)	-	-	-	-	-	(1,543)
Discount accretion	68	-	-	-	(68)	-	-
Repurchase of preferred stock	(23,525)	-	-	-	-	-	(23,525)



Common shares issued for employee stock-based awards	-	-	-	2	-	-	2							
Stock-based compensation expense	-	-	-	46	-	-	46							
Preferred stock dividends	-	-	-	-	(1,808)	-	(1,808)							
Cash dividends paid (\$0.32 per share)	-	-	-	-	(2,691)	-	(2,691)							
Balances, June 30, 2009	\$	-	\$	84	\$	1,543	\$	29,816	\$	95,679	\$	754	\$	127,876

See accompanying notes to Consolidated Financial Statements.

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

	For the Three Months Ended June 30,		For the Six Months Ended June 30,	
	2010	2009	2010	2009
Net income (loss)	\$ 445	\$ 1,893	\$ (1,117)	\$ 4,106
Other comprehensive (loss) income:				
Securities available for sale:				
Unrealized holding gains (losses) on available-for-sale securities	1,338	(447)	1,412	(1,014)
Tax effect	(538)	178	(568)	404
Reclassification of gains recognized in net income	-	-	-	(49)
Tax effect	-	-	-	20
Net of tax amount	800	(269)	844	(639)
Cash flow hedging activities:				
Unrealized holding losses on cash flow hedging activities	(2,135)	-	(3,466)	-
Tax effect	862	-	1,399	-
Net of tax amount	(1,273)	-	(2,067)	-
Total other comprehensive loss	(473)	(269)	(1,223)	(639)
Comprehensive (loss) income	\$ (28)	\$ 1,624	\$ (2,340)	\$ 3,467

See accompanying notes to Consolidated Financial Statements.

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

	For the Six Months Ended June 30,	
	2010	2009
<b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>		
Net (loss) income	\$ (1,117)	\$ 4,106
Adjustments to reconcile net income to net cash provided by operating activities:		
Provision for credit losses	12,534	3,616
Depreciation and amortization	1,147	890
Discount accretion on debt securities	(63)	(131)
Stock-based compensation expense	209	46
Gains on sales of securities	-	(49)
Losses on sales of other real estate owned	55	-
Write-downs of other real estate owned	522	-
Net changes in:		
Insurance premiums receivable	(42)	(43)
Accrued interest receivable	199	251
Other assets	(681)	(2,384)
Accrued interest payable	(384)	18
Other liabilities	(1,923)	1,973
Net cash provided by operating activities	10,456	8,293
<b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>		
Proceeds from maturities and principal payments of securities available for sale	26,343	30,828
Proceeds from sales of investment securities available for sale	-	2,048
Purchases of securities available for sale	(25,797)	(34,933)
Proceeds from maturities and principal payments of securities held to maturity	585	2,080
Purchases of securities held to maturity	-	(824)
Net decrease (increase) in loans	742	(34,776)
Purchases of premises and equipment	(1,183)	(715)
Proceeds from sales of other real estate owned	784	-
Investment in unconsolidated subsidiary	(25)	-
Net cash provided by (used in) investing activities	1,449	(36,292)
<b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>		
Net increase in demand, money market and savings deposits	8,195	105,291
Net (decrease) increase in certificates of deposit	(27,524)	30,672
Net decrease in short-term borrowings	(2,540)	(24,874)
Proceeds from issuance of preferred stock and warrant	-	25,000
Repurchase of preferred stock	-	(23,525)
Proceeds from issuance of common stock	-	2
Preferred stock dividends paid	-	(1,808)
Common stock dividends paid	(1,013)	(2,691)
Net cash (used in) provided by financing activities	(22,882)	108,067
Net (decrease) increase in cash and cash equivalents	(10,977)	80,068
Cash and cash equivalents at beginning of period	75,646	27,294

Cash and cash equivalents at end of period	\$	64,669	\$	107,362
Supplemental cash flows information:				
Interest paid	\$	7,094	\$	8,934
Income taxes paid	\$	846	\$	3,123
Transfers from loans to other real estate owned	\$	216	\$	2,064

See accompanying notes to Consolidated Financial Statements.

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

Note 1 - Basis of Presentation

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

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

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

Note 2 – Earnings Per Share

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

	For the Three Months Ended		For the Six Months Ended	
	June 30,		June 30,	
(In thousands, except per share data)	2010	2009	2010	2009
Net income (loss) available to common shareholders	\$ 445	\$ 354	\$ (1,117)	\$ 2,230
Weighted average shares outstanding - Basic	8,443	8,413	8,440	8,409
Dilutive effect of stock-based awards	-	4	-	4
Weighted average shares outstanding - Diluted	8,443	8,417	8,440	8,413
Earnings (loss) per common share - Basic	\$ 0.05	\$ 0.04	\$ (0.13)	\$ 0.27
Earnings (loss) per common share - Diluted	\$ 0.05	\$ 0.04	\$ (0.13)	\$ 0.27

The calculations of diluted earnings/(loss) per share for the three and six months ended June 30, 2010 each excluded nine thousand weighted average stock-based awards and that portion of a warrant to purchase 173 thousand weighted average shares of common stock because the effect would have been antidilutive. There were no weighted average stock-based awards excluded from the calculations of diluted earnings per share for the three and six months ended June 30, 2009. The calculations of diluted earnings per share for the three and six months ended June 30, 2009 excluded that portion of a warrant to purchase 173 thousand and 165 thousand weighted average shares of common stock, respectively, because the effect would have been antidilutive.

## Note 3 – Investment Securities

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

(Dollars in thousands)	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
Available-for-sale securities:				
June 30, 2010:				
Obligations of U.S. Treasury	\$ 2,999	\$ -	\$ -	\$ 2,999
Obligations of U.S. Government agencies and corporations	58,760	1,262	39	59,983
Mortgage-backed securities	33,269	1,391	7	34,653
Other equity securities	556	20	-	576
Total	\$ 95,584	\$ 2,673	\$ 46	\$ 98,211
December 31, 2009:				
Obligations of U.S. Treasury	\$ 2,998	\$ -	\$ -	\$ 2,998
Obligations of U.S. Government agencies and corporations	57,258	879	397	57,740
Mortgage-backed securities	35,579	818	90	36,307
Other equity securities	546	4	-	550
Total	\$ 96,381	\$ 1,701	\$ 487	\$ 97,595
Held-to-maturity securities:				
June 30, 2010:				
Obligations of states and political subdivisions	\$ 8,345	\$ 186	\$ 8	\$ 8,523
December 31, 2009:				
Obligations of states and political subdivisions	\$ 8,940	\$ 163	\$ 91	\$ 9,012

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

(Dollars in thousands)	Available-for-sale		Held-to-maturity	
	Amortized Cost	Estimated Fair Value	Amortized Cost	Estimated Fair Value
Due in one year or less	\$ 12,438	\$ 11,578	\$ 2,138	\$ 2,147
Due after one year through five years	39,342	41,289	4,252	4,406
Due after five years through ten years	18,525	19,182	1,450	1,467
Due after ten years	24,723	25,586	505	503
	95,028	97,635	8,345	8,523
Equity securities	556	576	-	-
Total	\$ 95,584	\$ 98,211	\$ 8,345	\$ 8,523

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

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

(Dollars in thousands)	Less than 12 Months		More than 12 Months		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
<b>Available-for-sale securities:</b>						
U.S. Gov't. agencies and corporations	\$ 6,060	\$ 39	\$ -	\$ -	\$ 6,060	\$ 39
Mortgage-backed securities	1,153	7	-	-	1,153	7
Total	\$ 7,213	\$ 46	\$ -	\$ -	\$ 7,213	\$ 46

The available-for-sale securities have a fair value of approximately \$98.2 million. Of these securities, approximately \$7.2 million have unrealized losses when compared to their amortized cost. The securities with the unrealized losses in the available-for-sale portfolio all have modest duration risk, low credit risk, and minimal losses (approximately 0.05%) when compared to amortized cost. The unrealized losses on debt securities that exist are the result of market changes in interest rates since original purchase. Because the Company does not intend to sell these debt securities and it is not more likely than not that the Company will be required to sell these securities before recovery of their amortized cost bases, which may be at maturity, the Company considers the unrealized losses in the available-for-sale portfolio to be temporary.

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

(Dollars in thousands)	Less than 12 Months		More than 12 Months		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
<b>Held-to-maturity securities:</b>						
Obligations of states and political subdivisions	\$ 1,059	\$ 4	\$ 186	\$ 4	\$ 1,245	\$ 8

The held-to-maturity securities have a fair value of approximately \$8.5 million. Approximately \$1.2 million of these securities have unrealized losses when compared to their amortized cost. All of the securities with unrealized losses are municipal securities with modest duration risk, low credit risk, and minimal losses (approximately 0.10%) when compared to amortized cost. The unrealized losses that exist are the result of market changes in interest rates since the original purchase. Because the Company does not intend to sell these securities and it is not more likely than not that the Company will be required to sell these securities before recovery of their amortized cost bases, which may be at maturity, the Company considers that the unrealized losses in the held-to-maturity portfolio are temporary.

#### Note 4 – Impaired Loans

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



payments received.

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

(Dollars in thousands)	June 30, 2010	December 31, 2009	June 30, 2009
Impaired loans with a valuation allowance	\$ 7,254	\$ 2,028	\$ 1,093
Impaired loans with no valuation allowance	30,234	14,274	12,602
Total impaired loans	\$ 37,488	\$ 16,302	\$ 13,695
Allowance for credit losses applicable to impaired loans	\$ 1,362	\$ 468	\$ 454
Allowance for credit losses applicable to other than impaired loans	11,927	10,408	10,330
Total allowance for credit losses	\$ 13,289	\$ 10,876	\$ 10,784
Average recorded investment in impaired loans	\$ 28,082	\$ 12,646	\$ 4,817

Gross interest income of \$1.0 million for the first six months of 2010, \$859 thousand for fiscal year 2009 and \$327 thousand for the first six months of 2009 would have been recorded if nonaccrual loans had been current and performing in accordance with their original terms. Interest actually recorded on such loans was \$0 for the first six months of 2010 and \$4 thousand for both fiscal year 2009 and the first six months of 2009.

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

#### Note 5 – Other Assets and Liabilities

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

(Dollars in thousands)	June 30, 2010	December 31, 2009
Nonmarketable investment securities	\$ 3,149	\$ 3,149
Insurance premiums receivable	1,025	983
Accrued interest receivable	4,605	4,804
Deferred income taxes	5,836	3,337
Interest rate caps (1)	2,602	6,168
Prepaid FDIC premium expense	4,760	5,449
Other assets	6,352	6,525
Total	\$ 28,329	\$ 30,415

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

(Dollars in thousands)	June 30, 2010	December 31, 2009
Accrued interest payable	\$ 1,397	\$ 1,781
Counterparty collateral - interest rate caps (1)	3,098	4,847
Other liabilities	9,134	9,308
Total	\$ 13,629	\$ 15,936

(1) See Note 8 for further discussion.

#### Note 6 - Stock-Based Compensation

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

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

During the three and six months ended June 30, 2010, the Company recognized pre-tax stock-based compensation expense of \$93 thousand and \$209 thousand, respectively, compared to \$25 thousand and \$46 thousand, respectively, for the same periods last year. Stock-based compensation expense is recognized ratably over the requisite service period for all awards and is based on the grant-date fair value. Unrecognized stock-based compensation expense related to nonvested share-based compensation arrangements was \$607 thousand as of June 30, 2010. The weighted-average period over which this unrecognized expense was expected to be recognized was 2.0 years.

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

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

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

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

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

At June 30, 2010, all 8,420 outstanding options were exercisable, had a weighted average exercise price of \$13.17, and had a remaining contract life of 1.8 years.

There was no aggregate intrinsic value in options outstanding and exercisable based on the \$11.91 market value per share of the Company's common stock at June 30, 2010. The total intrinsic value of stock options exercised during the six months ended June 30, 2010 and 2009 was \$0 and less than \$1 thousand, respectively. Cash received upon exercise of options during the first six months of 2010 and 2009 was \$0 and approximately \$1 thousand, respectively.

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

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

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

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

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

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

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

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

#### Investment Securities Available for Sale

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

#### Loans

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

Other Real Estate and Other Assets Owned (Foreclosed Assets)

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

## Derivative Assets and Liabilities

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

## Assets Recorded at Fair Value on a Recurring Basis

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

(Dollars in thousands)	Fair Value	Quoted Prices (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
<b>Securities available for sale:</b>				
U.S. Treasury	\$ 2,999	\$ 2,999	\$ -	\$ -
U.S. Government agencies	59,983	-	59,983	-
Mortgage-backed securities	34,653	-	34,653	-
Other equity securities	576	-	576	-
<b>Total</b>	<b>\$ 98,211</b>	<b>\$ 2,999</b>	<b>\$ 95,212</b>	<b>\$ -</b>
Interest rate caps	\$ 2,602	\$ -	\$ 2,602	\$ -

## Assets Recorded at Fair Value on a Nonrecurring Basis

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

(Dollars in thousands)	Fair Value	Quoted Prices (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
<b>Impaired loans</b>				
Real estate - construction	\$ 19,287	\$ -	\$ -	\$ 19,287
Real estate - residential	8,583	-	-	8,583
Real estate - commercial	4,224	-	-	4,224
Commercial	3,968	-	-	3,968
Consumer	64	-	-	64
<b>Total</b>	<b>\$ 36,126</b>	<b>\$ -</b>	<b>\$ -</b>	<b>\$ 36,126</b>
Other real estate and other assets owned	\$ 1,428	\$ -	\$ -	\$ 1,428

Impaired loans had a carrying amount of \$37.5 million at June 30, 2010 with a valuation allowance of \$1.4 million.



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

Cash and Cash Equivalents

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

Investment Securities

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

### Loans

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

### Financial Liabilities

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

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

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

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

(Dollars in thousands)	June 30, 2010		December 31, 2009	
	Carrying Amount	Estimated Fair Value	Carrying Amount	Estimated Fair Value
<b>Financial assets:</b>				
Cash and cash equivalents	\$ 64,669	\$ 64,669	\$ 75,646	\$ 75,646
Investment securities	106,556	106,734	106,535	106,607
Loans	905,477	919,109	916,557	934,362
Less: allowance for loan losses	(13,289)	-	(10,876)	-
Total	\$ 1,063,413	\$ 1,090,512	\$ 1,087,862	\$ 1,116,615
<b>Financial liabilities:</b>				
Deposits	\$ 971,608	\$ 976,291	\$ 990,937	\$ 999,016
Short-term borrowings	17,864	17,864	20,404	20,404
Long-term debt	1,429	1,502	1,429	1,530
Total	\$ 990,901	\$ 995,657	\$ 1,012,770	\$ 1,020,950

### Note 8 – Derivative Instruments and Hedging Activities

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

purposes.

During the third quarter of 2009, as part of its overall interest rate risk management strategy, the Company purchased interest rate caps to effectively fix the interest rate on \$70 million of the Company's money market deposit accounts at 2.97% for five years. The interest rate caps qualified for hedge accounting. The aggregate fair value of these derivatives was an asset of \$2.6 million at June 30, 2010 and \$6.2 million at December 31, 2009. For the second quarter and first half of 2010, interest expense included a net interest settlement of \$70 thousand and \$100 thousand, respectively.

By entering into derivative instrument contracts, the Company exposes itself, from time to time, to counterparty credit risk. Counterparty credit risk is the risk that the counterparty will fail to perform under the terms of the derivative contract. When the fair value of a derivative contract is in an asset position, the counterparty has a liability to the Company, which creates credit risk for the Company. The Company attempts to minimize this risk by selecting counterparties with investment grade credit ratings, limiting its exposure to any single counterparty and regularly monitoring its market position with each counterparty. Also to minimize risk, the Company obtained counterparty collateral which was recorded in other liabilities. The counterparty collateral was \$3.1 million at June 30, 2010 and \$4.8 million at December 31, 2009.

#### Note 9 – Commitments

In the normal course of business, to meet the financial needs of its customers, the Company's bank subsidiaries enter into financial instruments with off-balance sheet risk. These financial instruments include commitments to extend credit and standby letters of credit. At June 30, 2010, total commitments to extend credit were approximately \$158.9 million. The comparable amount was \$147.3 million at December 31, 2009. Outstanding letters of credit were approximately \$15.7 million at June 30, 2010 and \$19.0 million at December 31, 2009.

#### Note 10 – Segment Reporting

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

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

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

(Dollars in thousands)	Community Banking	Insurance Products and Services	Parent Company	Consolidated Total
<b>2010</b>				
Interest income	\$ 27,708	\$ 87	\$ -	\$ 27,795
Interest expense	(6,665)	-	(44)	(6,709)
Provision for credit losses	(12,534)	-	-	(12,534)
Noninterest income	3,625	5,825	-	9,450
Noninterest expense	(11,820)	(4,983)	(3,206)	(20,009)
Net intersegment income (expense)	(2,828)	(243)	3,071	-
Income (loss) before taxes	(2,514)	686	(179)	(2,007)
Income tax (expense) benefit	1,115	(304)	79	890
Net income (loss)	\$ (1,399)	\$ 382	\$ (100)	\$ (1,117)
<b>2009</b>				
Interest income	\$ 29,063	\$ 33	\$ -	\$ 29,096
Interest expense	(8,912)	-	(40)	(8,952)
Provision for credit losses	(3,616)	-	-	(3,616)
Noninterest income	4,134	6,563	-	10,697
Noninterest expense	(11,837)	(5,666)	(3,073)	(20,576)
Net intersegment income (expense)	(2,799)	(238)	3,037	-
Income (loss) before taxes	6,033	692	(76)	6,649
Income tax (expense) benefit	(2,308)	(264)	29	(2,543)
Net income	\$ 3,725	\$ 428	\$ (47)	\$ 4,106
Total assets	\$ 1,105,944	\$ 20,153	\$ 3,099	\$ 1,129,196
<b>2009</b>				
Total assets	\$ 1,134,421	\$ 20,012	\$ 3,779	\$ 1,158,212

#### Note 11 – New Accounting Pronouncements

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

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

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

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

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

Forward-Looking Information

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

Introduction

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

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

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

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

Critical Accounting Policies

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

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

#### Allowance for Credit Losses

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



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

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

#### Goodwill and Other Intangible Assets

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

Impairment testing requires that the fair value of each of the Company's reporting units be compared to the carrying amount of its net assets, including goodwill. The Company's reporting units were identified based on an analysis of each of its individual operating segments. If the fair value of a reporting unit is less than book value, an expense may be required to write down the related goodwill or purchased intangibles to record an impairment loss. At June 30, 2010, it was determined that there were no circumstances that dictated interim testing for impairment of goodwill or intangible assets.

#### Fair Value

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

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

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

## OVERVIEW

Net income for the second quarter of 2010 was \$445 thousand, or diluted earnings per common share of \$0.05, compared to \$354 thousand, or diluted earnings per common share of \$0.04, for the second quarter of 2009. For the first quarter of 2010, the Company reported a net loss of \$1.6 million, or diluted loss per common share of \$(0.19). The second quarter of 2010 included a provision for credit losses of \$4.9 million, which was \$3.2 million higher than the comparable amount for the second quarter of 2009 but \$2.7 million lower than the comparable amount for the first quarter of 2010. Annualized return on average assets was 0.16% for the three months ended June 30, 2010, compared to 0.13% for the same period in 2009. Annualized return on average stockholders' equity was 1.42% for the second quarter of 2010, compared to 1.07% for the second quarter of 2009. For the first quarter of 2010, annualized return on average assets was (0.55)% and return on average equity was (4.95)%.

For the first six months of 2010, the Company reported a net loss of \$1.1 million, or diluted loss per common share of \$(0.13), compared to net income of \$2.2 million, or diluted earnings per common share of \$0.27, for the first six months of 2009. Annualized return on average assets was (0.20)% for the six months ended June 30, 2010, compared to 0.41% for the same period in 2009. Annualized return on average stockholders' equity was (1.78)% for the first six months of 2010, compared to 3.18% for the first six months of 2009.

During the first six months of 2009, net income available to common stockholders was negatively impacted by dividends and discount accretion associated with the January 9, 2009 sale and April 15, 2009 repurchase of preferred stock under the U.S. Department of the Treasury's Troubled Asset Relief Program Capital Purchase Program. The dividends and accretion for the second quarter of 2009 totaled \$1.5 million. The comparable amount for the first six months of 2009 was \$1.9 million.

## RESULTS OF OPERATIONS

### Net Interest Income

Net interest income for the three months ended June 30, 2010 was \$10.7 million, an increase of 6.0% when compared to the same period last year. Slightly higher average earning assets and lower rates paid on interest-bearing liabilities were sufficient to offset the decline in yields on earning assets. The net interest margin was 4.03% for the second quarter of 2010, an increase of 18 basis points when compared to the second quarter of 2009. The net interest margin has benefited from the Company's effort to reduce deposit pricing structures. Net interest income increased 2.8% from the first quarter of 2010, primarily due to slightly higher rates on average earning assets and a decrease in the balances and rates paid on interest-bearing liabilities offsetting the small decline in average earning assets. The net interest margin increased 8 basis points from 3.95% for the first quarter of 2010.

Interest income was \$14.0 million for the second quarter of 2010, a decrease of 4.5% from the second quarter of 2009. Average earning assets increased 1.0% during the second quarter of 2010 when compared to the same period in 2009, while yields earned decreased 30 basis points to 5.26%. Average loans decreased slightly and the yield earned on loans decreased 29 basis points. Loans comprised 84.9% of total average earning assets for the second quarter of 2010, a decrease from the 86.1% for the second quarter of 2009. Interest income increased 1.0% when compared to the first quarter of 2010. Average earning assets declined slightly during the second quarter of 2010 when compared to the first quarter of 2010, while yields earned increased 2 basis points.

Interest expense was \$3.3 million for the three months ended June 30, 2010, a decrease of 27.9% when compared to the same period last year. Average interest-bearing liabilities increased 1.2%, while rates paid decreased 60 basis

points to 1.50%. During the second quarter of 2009, the Company began to participate in the Promontory Insured Network Deposits Program ("IND"). The \$36.4 million increase in average money market and savings deposits for the second quarter of 2010 over the same period of 2009 included approximately \$27.6 million from the IND program. The Company incurs the largest amount of interest expense from time deposits. For the three months ended June 30, 2010, the average balance of certificates of deposit \$100,000 or more increased 2.5% when compared to the same period last year, while the average rate paid on these certificates of deposit decreased 111 basis points to 2.09%. Average other time deposits decreased 9.9% and the rate paid on average other time deposits decreased 89 basis points, when comparing the second quarter of 2010 to the second quarter of 2009. Expanded levels of FDIC insurance coverage contributed to the shift from other time deposits to certificates of deposit \$100,000 or more. When comparing the second quarter of 2010 to the first quarter of 2010, interest expense decreased 4.6% because average interest-bearing liabilities decreased slightly and rates paid decreased 8 basis points.

Net interest income for the six months ended June 30, 2010 was \$21.1 million, an increase of 4.7% when compared to the same period last year. An increase in the volume of average earning assets and a reduction in the cost of funds were sufficient to offset the decline in yields on earning assets. The net interest margin increased from 3.96% for the first six months of 2009 to 3.99% for the first six months of 2010.

Interest income was \$27.8 million for the first six months of 2010, a decrease of 4.5% when compared to the first six months of 2009. Average earning assets increased 3.8% during the six months ended June 30, 2010 when compared to the same period in 2009, while yields earned decreased 46 basis points to 5.25%. Average loans increased slightly during the first six months of 2010, while the yield earned on loans decreased 35 basis points when compared to the same period of 2009. Loans comprised 84.8% and 87.6% of total average earning assets for the first six months of 2010 and 2009, respectively.

Interest expense was \$6.7 million for the six months ended June 30, 2010, a decrease of 25.1% when compared to the same period last year. Average interest-bearing liabilities increased 6.1%, while rates paid decreased 64 basis points to 1.54%. The \$70.0 million increase in average money market and savings deposits for the first half of 2010 over the same period of 2009 included approximately \$57.2 million from the IND program. For the six months ended June 30, 2010, the average balance of certificates of deposit \$100,000 or more increased 5.6% when compared to the same period last year, while the average rate paid decreased 113 basis points to 2.17%. Average other time deposits decreased 7.7% and the rate paid on average other time deposits decreased 88 basis points when compared to the first six months of 2009.

## Analysis of Interest Rates and Interest Differentials

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

(Dollars in thousands)	For the Three Months Ended June 30, 2010			For the Three Months Ended June 30, 2009		
	Average Balance	Income(1)/ Expense	Yield/ Rate	Average Balance	Income(1)/ Expense	Yield/ Rate
<b>Earning assets</b>						
Loans (2), (3)	\$ 909,295	\$ 13,083	5.77%	\$ 913,671	\$ 13,795	6.06%
<b>Investment securities</b>						
Taxable	103,284	846	3.29	75,277	768	4.09
Tax-exempt	6,460	85	5.30	8,110	122	6.02
Federal funds sold	38,001	14	0.15	55,699	23	0.16
Interest-bearing deposits	14,075	4	0.12	8,129	6	0.33
Total earning assets	1,071,115	14,032	5.26%	1,060,886	14,714	5.56%
Cash and due from banks	9,997			18,705		
Other assets	67,860			51,595		
Allowance for credit losses	(14,310)			(10,848)		
Total assets	\$ 1,134,662			\$ 1,120,338		
<b>Interest-bearing liabilities</b>						
Demand deposits	\$ 132,563	83	0.25%	\$ 125,076	76	0.24%
Money market and savings deposits	259,273	468	0.72	222,825	351	0.63
Certificates of deposit \$100,000 or more	251,340	1,310	2.09	245,210	1,954	3.20
Other time deposits	215,987	1,381	2.56	239,668	2,060	3.45
Interest-bearing deposits	859,163	3,242	1.51	832,779	4,441	2.14
Short-term borrowings	15,771	19	0.48	25,435	28	0.45
Long-term debt	1,429	15	4.40	7,947	75	3.78
Total interest-bearing liabilities	876,363	3,276	1.50%	866,161	4,544	2.10%
Noninterest-bearing deposits	117,586			109,652		
Other liabilities	15,043			11,918		
Stockholders' equity	125,670			132,607		
Total liabilities and stockholders' equity	\$ 1,134,662			\$ 1,120,338		
Net interest spread		\$ 10,756	3.76%		\$ 10,170	3.46%
Net interest margin			4.03%			3.85%
<b>Tax-equivalent adjustment</b>						
Loans		\$ 36			\$ 41	
Investment securities		29			43	
Total		\$ 65			\$ 84	

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

(Dollars in thousands)	For the Six Months Ended June 30, 2010			For the Six Months Ended June 30, 2009		
	Average Balance	Income(1)/ Expense	Yield/ Rate	Average Balance	Income(1)/ Expense	Yield/ Rate
<b>Earning assets</b>						
Loans (2), (3)	\$ 909,831	\$ 25,993	5.76%	\$ 906,066	\$ 27,455	6.11%
<b>Investment securities</b>						
Taxable	103,385	1,728	3.37	75,067	1,524	4.09
Tax-exempt	6,611	175	5.35	8,605	253	5.92
Federal funds sold	42,253	26	0.13	38,873	30	0.15
Interest-bearing deposits	11,177	5	0.10	5,298	7	0.28
Total earning assets	1,073,257	27,927	5.25%	1,033,909	29,269	5.71%
Cash and due from banks	12,197			15,395		
Other assets	67,889			50,487		
Allowance for credit losses	(13,238)			(10,259)		
Total assets	\$ 1,140,105			\$ 1,089,532		
<b>Interest-bearing liabilities</b>						
Demand deposits	\$ 130,287	163	0.25%	\$ 123,104	148	0.24%
Money market and savings deposits	258,180	895	0.70	188,165	525	0.56
Certificates of deposit \$100,000 or more	255,416	2,744	2.17	241,997	3,966	3.30
Other time deposits	217,849	2,825	2.62	236,077	4,087	3.50
Interest-bearing deposits	861,732	6,627	1.55	789,343	8,726	2.23
Short-term borrowings	16,896	51	0.60	32,469	77	0.48
Long-term debt	1,429	31	4.43	7,947	149	3.78
Total interest-bearing liabilities	880,057	6,709	1.54%	829,759	8,952	2.18%
Noninterest-bearing deposits	117,759			106,968		
Other liabilities	15,420			11,304		
Stockholders' equity	126,869			141,501		
Total liabilities and stockholders' equity	\$ 1,140,105			\$ 1,089,532		
<b>Net interest spread</b>						
		\$ 21,218	3.71%		\$ 20,317	3.53%
<b>Net interest margin</b>						
			3.99%			3.96%
<b>Tax-equivalent adjustment</b>						
Loans		\$ 72			\$ 84	
Investment securities		60			89	
Total		\$ 132			\$ 173	

(1) All amounts are reported on a tax equivalent basis computed using the statutory federal income tax rate of 34.5% for 2010 and 35.0% for 2009 exclusive of the alternative minimum tax rate and nondeductible interest expense.

(2) Average loan balances include nonaccrual loans.

(3)

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

#### Noninterest Income

Noninterest income for the second quarter of 2010 decreased \$779 thousand, or 14.6%, when compared to the second quarter of 2009. The decline in noninterest income during the second quarter of 2010 when compared to the second quarter of 2009 was primarily due to a decline in insurance agency commissions of \$298 thousand and a \$420 thousand mark-to-market gain on interest rate swaps in 2009. The decrease of \$314 thousand, or 6.4%, when compared to the first quarter of 2010 was primarily a result of \$744 thousand in insurance agency contingency income which is typically received in the first quarter of each year and based on the prior year's performance. The decrease in contingency income was partially offset by an increase in commission income.

Noninterest income for the first six months of 2010 decreased \$1.2 million, or 11.7%, when compared to the first six months of 2009. As with the second quarter 2010 results, the decrease was mainly due to a decline in insurance agency commissions and the mark-to-market gain on interest rate swaps in 2009.



#### Noninterest Expense

Noninterest expense for the second quarter of 2010 decreased \$1.0 million, or 9.4%, when compared to the second quarter of 2009. The decrease was primarily attributable to lower expenses accrued for bonus and profit sharing plans and lower FDIC insurance premium expense which were partially offset by higher expenses related to collection and other real estate owned activities. Included in the FDIC insurance premium expense for the second quarter of 2009 was a special one-time assessment of \$513 thousand. Noninterest expense decreased \$633 thousand, or 6.1%, from the first quarter of 2010 primarily due to lower expenses accrued for bonus and profit sharing plans.

Noninterest expense for the first six months of 2010 decreased \$567 thousand, or 2.8%, when compared to the first six months of 2009. Similar to the second quarter 2010 results, the decrease was primarily attributable to lower expenses accrued for bonus and profit sharing plans and lower FDIC insurance premium expense which were partially offset by higher expenses related to collection and other real estate owned activities.

#### Income Taxes

The Company's effective tax rate was 32.0% for the three months ended June 30, 2010, compared to 38.1% for the same period last year. For the six months ended June 30, 2010, the effective tax rate was a 44.3% benefit compared to a 38.2% expense for the same period last year. Management believes that currently there are no additional changes in tax laws or to our tax structure that are likely to have a material impact on our future effective tax rate.

### ANALYSIS OF FINANCIAL CONDITION

#### Loans

Loans, net of unearned income, totaled \$905.5 million at June 30, 2010, a 1.2% decrease since December 31, 2009. Average loans were \$909.3 million for the three months ended June 30, 2010, which was slightly lower than the comparable amount for the same period last year. For the six months ended June 30, 2010, average loans were \$909.8 million, which was slightly higher than the comparable amount for the same period in 2009. Loan growth slowed when compared to the prior year as the weakened economy created fewer loan opportunities to originate high-quality credits. At the same time we are experiencing slowing loan growth, net loan charge-offs increased \$2.8 million and \$8.0 million for the second quarter and first half of 2010, respectively, when compared to the same periods last year.

Our loan portfolio has a concentration of commercial real estate loans. Commercial real estate loans, excluding construction and land development loans, were approximately \$316.4 million, or 34.9% of total loans, at June 30, 2010, compared to \$315.9 million, or 34.5% of total loans, at December 31, 2009. Construction and land development loans were \$155.2 million, or 17.1% of total loans, at June 30, 2010, compared to \$161.4 million, or 17.6% of total loans, at December 31, 2009. We do not engage in foreign or subprime lending activities.

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

#### Allowance for Credit Losses

We have established an allowance for credit losses, which is increased by provisions charged against earnings and recoveries of previously charged-off debts and is decreased by current period charge-offs of uncollectible debts. Management evaluates the adequacy of the allowance for credit losses on a quarterly basis and adjusts the provision for credit losses based upon this analysis. The evaluation of the adequacy of the allowance for credit losses is based on a risk rating system of individual loans, as well as on a collective evaluation of smaller balance

homogenous loans based on factors such as past credit loss experience, local economic trends, nonperforming and problem loans, and other factors which may impact collectibility. A loan is placed on nonaccrual when it is specifically determined to be impaired and principal and interest is delinquent for 90 days or more. Please refer to the discussion above under the caption "Critical Accounting Policies" for an overview of the underlying methodology management employs on a quarterly basis to maintain the allowance.

The provision for credit losses for the three months ended June 30, 2010 and 2009 was \$4.9 million and \$1.7 million, respectively. The provision for credit losses for the first quarter of 2010 was \$7.6 million. The provision for credit losses for the first six months of 2010 and 2009 was \$12.5 million and \$3.6 million, respectively. The continued historically large level of provision expense was the result of the overall increase in nonperforming assets and loan charge-offs, and management's assessment of the worsening in general economic conditions. We continue to emphasize credit quality and believe that our underwriting guidelines are strong. However, the prolonging or deepening of the current economic recession will likely cause us to continue to experience higher levels of provision expense, nonperforming assets and charge-offs. As problem loans are identified, management takes prompt action to quantify and minimize losses and also works with the borrowers in an effort to reach mutually acceptable resolutions.

Net charge-offs were \$4.4 million for the three months ended June 30, 2010, compared to \$1.6 million for the same period last year and \$5.7 million for the first quarter of 2010. Most of the charge offs in the second quarter of 2010 were residential real estate and commercial loans whereas most of the charge-offs in the first quarter of 2010 were construction loans. The construction loan charge-offs during the first quarter of 2010 consisted principally of one large real estate development loan of \$3.4 million. The allowance for credit losses as a percentage of average loans increased to 1.46% for the second quarter of 2010, compared to 1.18% for the second quarter of 2009 and 1.41% for the first quarter of 2010. Net charge-offs were \$10.1 million for the first six months of 2010, compared to \$2.2 million for the same period in 2009. The allowance for credit losses as a percentage of average loans increased to 1.46% for the first six months of 2010 from 1.19% for the same period last year. Based on management's quarterly evaluation of the adequacy of the allowance for credit losses, it believes that the allowance for credit losses and the related provision were adequate at June 30, 2010 to provide for probable losses inherent in our loan portfolio.

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

(Dollars in thousands)	For the Three Months Ended June 30,		For the Six Months Ended June 30,	
	2010	2009	2010	2009
Allowance balance – beginning of period	\$ 12,791	\$ 10,709	\$ 10,876	\$ 9,320
Charge-offs:				
Real estate – construction	(681)	(128)	(4,190)	(215)
Real estate – residential	(2,525)	(611)	(3,516)	(951)
Real estate – commercial	(46)	(173)	(46)	(173)
Commercial	(1,164)	(629)	(2,388)	(727)
Consumer	(145)	(88)	(311)	(199)
Totals	(4,561)	(1,629)	(10,451)	(2,265)
Recoveries:				
Real estate – construction	13	2	13	2
Real estate – residential	36	1	74	53
Real estate – commercial	1	-	102	-
Commercial	53	-	56	4
Consumer	39	20	85	54
Totals	142	23	330	113
Net charge-offs	(4,419)	(1,606)	(10,121)	(2,152)
Provision for credit losses	4,917	1,681	12,534	3,616
Allowance balance – end of period	\$ 13,289	\$ 10,784	\$ 13,289	\$ 10,784
Average loans outstanding during the period	\$ 909,295	\$ 913,671	\$ 909,831	\$ 906,066
Net charge-offs (annualized) as a percentage of average loans outstanding during the period	1.95%	0.71%	2.24%	0.95%
Allowance for credit losses at period end as a percentage of average loans	1.46%	1.18%	1.46%	1.19%

## Nonperforming Assets

Nonperforming assets were \$38.9 million at June 30, 2010, compared to \$18.9 million at December 31, 2009. The increase in nonaccrual loans during the first half of 2010 was primarily in construction loans and related largely to two borrowing relationships. The Company has a \$5.0 million participation with a regional bank that is matured. Through December 31, 2009, the customer made all interest payments. This loan migrated from 90 days past due to nonaccrual in the first quarter of 2010. Also during the first quarter of 2010, a second significant construction loan relationship totaling approximately \$14.0 million was put on nonaccrual and subsequently \$3.4 million was charged off. Total nonperforming assets to total loans and other real estate and other assets owned increased to 4.29% at June 30, 2010, compared to 2.05% at December 31, 2009. Loans past due 90 days and still accruing at June 30, 2010 decreased to \$4.7 million from \$7.4 million at December 31, 2009 mainly due to the previously-mentioned migration of the \$5.0 million participation from 90 days past due to nonaccrual. The increase in the residential real estate category was due to delinquencies and foreclosures occurring in the second quarter of 2010.

The following table summarizes our nonperforming and past due assets:

(Dollars in thousands)	June 30, 2010	December 31, 2009
<b>Nonperforming assets</b>		
Nonaccrual loans		
Real estate – construction	\$ 20,449	\$ 7,163
Real estate – residential	8,783	4,246
Real estate – commercial	4,224	2,828
Commercial	3,968	2,028
Consumer	64	37
Total nonaccrual loans	37,488	16,302
Other real estate and other assets owned	1,428	2,572
Total nonperforming assets	38,916	18,874
Loans 90 days past due and still accruing		
Real estate – construction	48	5,096
Real estate – residential	4,365	2,274
Real estate – commercial	107	-
Commercial	49	-
Consumer	150	55
Total loans 90 days past due	4,719	7,425
Total nonperforming assets and past due loans	\$ 43,635	\$ 26,299
Nonperforming assets to total loans and other real estate and other assets owned	4.29%	2.05%
Nonperforming assets to total assets	3.45%	1.63%
Nonperforming assets and past due loans, to total loans and other real estate and other assets owned	4.81%	2.86%
Nonperforming assets and past due loans to total assets	3.86%	2.27%

#### Investment Securities

Investment securities totaled \$106.6 million at June 30, 2010, relatively unchanged since December 31, 2009. The average balance of investment securities was \$109.7 million for the three months ended June 30, 2010, compared to \$83.4 million for the same period in 2009. The tax equivalent yields on investment securities were 3.40% and 4.28% for the three months ended June 30, 2010 and 2009, respectively. The average balance of investment securities was \$110.0 million for the six months ended June 30, 2010, compared to \$83.7 million for the same period in 2009. The tax equivalent yields on investment securities were 3.49% and 4.28% for the first six months of 2010 and 2009, respectively. The increases in the 2010 investment securities average balances compared to the 2009 average balances reflected the investment of excess deposits.

#### Deposits

Total deposits at June 30, 2010 were \$971.6 million, a \$19.3 million, or 2.0%, decrease when compared to the \$990.9 million at December 31, 2009. The decrease was primarily in certificates of deposit \$100,000 or more mainly due to municipal deposits which historically decline at this time of the year. The decrease in other time deposits was attributable to management's effort to reduce deposit pricing structures.

#### Short-Term Borrowings

Short-term borrowings at June 30, 2010 and December 31, 2009 were \$17.9 million and \$20.4 million, respectively. Short-term borrowings generally consist of securities sold under agreements to repurchase, overnight borrowings from correspondent banks and short-term advances from the FHLB. Short-term advances are defined as those with original maturities of one year or less. The decline in short-term borrowings since December 31, 2009 was primarily due to the repayment of \$3.4 million drawn on a \$10.0 million line of credit with a commercial bank.

#### Long-Term Debt

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

#### Liquidity and Capital Resources

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

To the extent that deposits are not adequate to fund customer loan demand, liquidity needs can be met in the short-term funds markets through arrangements with correspondent banks. Talbot Bank and CNB are also members of the FHLB of Atlanta and Felton Bank is a member of the FHLB of Pittsburgh, and these banks have pledged collateral sufficient to permit additional borrowings of up to approximately \$24.3 million in the aggregate at June 30, 2010. Management is not aware of any trends or demands, commitments, events or uncertainties that are likely to materially affect our future ability to maintain liquidity at satisfactory levels.

Total stockholders' equity was \$124.7 million at June 30, 2010, compared to \$127.8 million at December 31, 2009. The net loss, unrealized losses on cash flow hedging activities and dividends paid all contributed to the decrease in stockholders' equity since the end of 2009. To increase capital, support the Company's growth, and enhance capital ratios, management has reduced dividends in 2010. The Company reduced the quarterly common stock dividend to \$0.06 from \$0.16 per share beginning with the dividend that was payable on February 26, 2010.

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

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

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

	June 30, 2010	December 31, 2009	Minimum Regulatory Requirements
Tier 1 risk-based capital ratio	11.63%	11.45%	4.00%
Total risk-based capital ratio	12.86%	12.59%	8.00%
Leverage ratio	9.40%	9.27%	4.00%

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

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

### Item 4. Controls and Procedures.

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

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

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

## PART II – OTHER INFORMATION

### Item 1A. Risk Factors.

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

The Dodd-Frank Wall Street Reform and Consumer Protection Act may affect our business activities, financial position and profitability by increasing our regulatory compliance burden and associated costs, placing restrictions on certain products and services, and limiting our future capital raising strategies.



On July 21, 2010, the President signed into law the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Act"), which implements significant changes in the financial regulatory landscape and will impact all financial institutions, including Talbot Bank, CNB and Felton Bank. The Act is likely to increase our regulatory compliance burden. However, it is too early for us to fully assess the full impact of the Act on our business, financial condition or results of operations in part because many of the Act's provisions require subsequent regulatory rulemaking.

Among the Act's significant regulatory changes, it creates a new financial consumer protection agency, known as the Bureau of Consumer Financial Protection (the "Bureau"), that is empowered to promulgate new consumer protection regulations and revise existing regulations in many areas of consumer compliance, which will increase our regulatory compliance burden and costs and may restrict the financial products and services we offer to our customers.

Moreover, the Act permits states to adopt stricter consumer protection laws and states attorney general may enforce consumer protection rules issued by the Bureau. The Act also imposes more stringent capital requirements on bank holding companies by, among other things, imposing leverage ratios on bank holding companies and prohibiting new trust preferred issuances from counting as Tier 1 capital. These restrictions will limit our future capital strategies. The Act also increases regulation of derivatives and hedging transactions, which could limit our ability to enter into, or increase the costs associated with, interest rate and other hedging transactions.

Although certain provisions of the Act, such as direct supervision by the Bureau, will not apply to banking organizations with less than \$10 billion of assets, such as Talbot Bank, CNB and Felton Bank, the changes resulting from the legislation will impact our business. These changes will require us to invest significant management attention and resources to evaluate and make necessary changes.

Recent amendments to the Federal Reserve Board's Regulation E may negatively impact our noninterest income.

On November 12, 2009, the Board of Governors of the Federal Reserve System announced the final rules amending Regulation E that prohibit financial institutions from charging fees to consumers for paying overdrafts on automated teller machine and one-time debit card transactions, unless a consumer consents, or opts-in, to the overdraft service for those types of transactions. Compliance with this regulation is effective July 1, 2010 for new consumer accounts and August 15, 2010 for existing consumer accounts. The impact that these new rules will have on us is unknown at this time, but they do have the potential to reduce our noninterest income and this reduction could be material.

#### Item 6. Exhibits.

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

#### SIGNATURES

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

SHORE BANCSHARES, INC.

Date: August 6, 2010

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

Date: August 6, 2010

By: /s/ Susan E. Leaverton  
Susan E. Leaverton, CPA



EXHIBIT INDEX

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