

MERCANTILE BANKSHARES CORP
Form 10-Q
August 06, 2004

**UNITED STATES
SECURITIES AND EXCHANGE COMMISSION**

WASHINGTON, D.C. 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended June 30, 2004

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 0-5127

MERCANTILE BANKSHARES CORPORATION

(Exact name of registrant as specified in its charter)

Maryland
(State or other jurisdiction of
incorporation or organization)

52-0898572
(I.R.S. Employer
Identification No.)

**2 Hopkins Plaza
Baltimore, Maryland 21201**

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(Address of principal executive offices) (Zip Code)

(410) 237-5900

(Registrant's telephone number, including area code)

NONE

(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 period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes No

Indicate by check mark whether the registrant is an accelerated filer (as defined in Exchange Act Rule 12b-2). Yes No

As of July 31, 2004, 79,092,605 shares of registrant's Common Stock, \$2 par value per share, were outstanding.

PART I FINANCIAL INFORMATION**Item 1. Financial Statements (Unaudited)****MERCANTILE BANKSHARES CORPORATION****CONSOLIDATED BALANCE SHEETS**

| (Dollars in thousands, except per share data) | June 30, 2004 | December 31, 2003 | June 30, 2003 |
|--|------------------|----------------------|------------------|
| ASSETS | | | |
| Cash and due from banks | \$ 296,046 | \$ 321,882 | \$ 350,833 |
| Interest-bearing deposits in other banks | 158 | 14,583 | 258 |
| Federal funds sold | 125,000 | 26,236 | 324,274 |
| Securities purchased under resale agreements | | | 100,000 |
| Total cash and cash equivalents | 421,204 | 362,701 | 775,365 |
| Investment securities available-for-sale (Note 4) | 3,014,862 | 3,123,514 | 2,692,101 |
| Investment securities held-to-maturity (Note 4) | 50,699 | 49,417 | 51,189 |
| Total investment securities | 3,065,561 | 3,172,931 | 2,743,290 |
| Loans held-for-sale | 747 | 14,925 | 85,740 |
| Loans: | | | |
| Commercial | 2,723,066 | 2,577,021 | 2,314,680 |
| Commercial real estate | 2,910,749 | 2,738,832 | 2,145,959 |
| Construction | 1,129,208 | 1,064,021 | 887,237 |
| Residential real estate | 1,468,804 | 1,335,375 | 1,092,785 |
| Consumer | 1,472,300 | 1,482,860 | 1,031,760 |
| Lease financing | 57,983 | 74,051 | 88,510 |
| Total loans | 9,762,110 | 9,272,160 | 7,560,931 |
| Less: allowance for loan losses | (158,431) | (155,337) | (142,261) |
| Loans, net | 9,603,679 | 9,116,823 | 7,418,670 |
| Bank premises and equipment, less accumulated depreciation of \$156,722 (June 2004), \$152,771 (December 2003) and \$124,171 (June 2003) | 141,523 | 140,922 | 104,099 |
| Other real estate owned, net | 402 | 191 | 376 |
| Goodwill, net (Note 7) | 517,615 | 522,173 | 119,730 |
| Other intangible assets, net (Note 7) | 52,478 | 56,223 | 16,107 |
| Other assets | 326,936 | 308,583 | 232,924 |
| Total assets | \$ 14,130,145 | \$ 13,695,472 | \$ 11,496,301 |
| LIABILITIES | | | |
| Deposits: | | | |
| Noninterest-bearing deposits | \$ 3,043,242 | \$ 2,750,721 | \$ 2,276,408 |
| Interest-bearing deposits | 7,600,452 | 7,511,832 | 6,359,166 |
| Total deposits | 10,643,694 | 10,262,553 | 8,635,574 |
| Short-term borrowings | 891,879 | 809,021 | 816,309 |
| Accrued expenses and other liabilities | 115,705 | 134,735 | 90,291 |
| Long-term debt | 637,570 | 647,722 | 578,533 |
| Total liabilities | 12,288,848 | 11,854,031 | 10,120,707 |
| SHAREHOLDERS EQUITY | | | |
| Preferred stock, no par value; authorized 2,000,000 shares; issued and outstanding - None | | | |

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Common stock, \$2 par value; authorized 130,000,000 shares; issued shares - 79,088,986 (June 2004), 79,772,705 (December 2003) and 69,093,254 (June 2003); restricted shares - 137,278 (June 2004), 121,369 (December 2003) and 171,369 (June 2003)

| | | | |
|---|----------------------|---------------|---------------|
| | 158,178 | 159,545 | 138,187 |
| Capital surplus | 522,758 | 548,664 | 128,714 |
| Retained earnings | 1,168,462 | 1,110,748 | 1,063,381 |
| Accumulated other comprehensive income (loss) | (8,101) | 22,484 | 45,312 |
| Total shareholders' equity | 1,841,297 | 1,841,441 | 1,375,594 |
| Total liabilities and shareholders' equity | \$ 14,130,145 | \$ 13,695,472 | \$ 11,496,301 |

See notes to consolidated financial statements

MERCANTILE BANKSHARES CORPORATION

STATEMENTS OF CONSOLIDATED INCOME

| (Dollars in thousands, except per share data) | For the 6 Months Ended June 30, | | For the 3 Months Ended June 30, | |
|--|------------------------------------|------------------|------------------------------------|------------------|
| | 2004 | 2003 | 2004 | 2003 |
| INTEREST INCOME | | | | |
| Interest and fees on loans | \$ 261,176 | \$ 222,954 | \$ 132,116 | \$ 111,962 |
| Interest and dividends on investment securities: | | | | |
| Taxable interest income | 53,566 | 53,822 | 26,165 | 26,638 |
| Tax-exempt interest income | 1,697 | 964 | 820 | 497 |
| Dividends | 561 | 428 | 300 | 199 |
| Other investment income (losses) | 2,969 | 2,882 | (372) | 2,318 |
| Total interest and dividends on investment securities | 58,793 | 58,096 | 26,913 | 29,652 |
| Other interest income | 764 | 2,040 | 589 | 1,314 |
| Total interest income | 320,733 | 283,090 | 159,618 | 142,928 |
| INTEREST EXPENSE | | | | |
| Interest on deposits | 40,640 | 48,579 | 19,873 | 23,450 |
| Interest on short-term borrowings | 2,899 | 3,014 | 1,480 | 1,469 |
| Interest on long-term debt | 10,460 | 7,648 | 5,205 | 5,286 |
| Total interest expense | 53,999 | 59,241 | 26,558 | 30,205 |
| NET INTEREST INCOME | 266,734 | 223,849 | 133,060 | 112,723 |
| Provision for loan losses | 4,779 | 6,067 | 2,353 | 3,051 |
| NET INTEREST INCOME AFTER PROVISION FOR LOAN LOSSES | 261,955 | 217,782 | 130,707 | 109,672 |
| NONINTEREST INCOME | | | | |
| Investment and wealth management | 44,919 | 36,873 | 22,936 | 19,508 |
| Service charges on deposit accounts | 20,470 | 16,371 | 10,351 | 8,311 |
| Mortgage banking related fees | 5,233 | 4,895 | 2,293 | 2,507 |
| Investment securities gains | 535 | 7,351 | 590 | 6,536 |
| Other income | 30,278 | 17,800 | 15,380 | 8,575 |
| Total noninterest income | 101,435 | 83,290 | 51,550 | 45,437 |
| NONINTEREST EXPENSES | | | | |
| Salaries | 89,477 | 70,732 | 44,689 | 36,317 |
| Employee benefits | 23,441 | 18,747 | 10,928 | 9,319 |
| Net occupancy expense of bank premises | 11,879 | 8,315 | 5,819 | 4,219 |
| Furniture and equipment expenses | 14,937 | 13,542 | 7,573 | 6,743 |
| Communications and supplies | 8,499 | 6,617 | 4,195 | 3,181 |
| Other expenses | 38,520 | 28,877 | 20,163 | 17,270 |
| Total noninterest expenses | 186,753 | 146,830 | 93,367 | 77,049 |
| Income before income taxes | 176,637 | 154,242 | 88,890 | 78,060 |
| Applicable income taxes | 64,627 | 55,246 | 32,577 | 28,050 |
| NET INCOME | \$ 112,010 | \$ 98,996 | \$ 56,313 | \$ 50,010 |
| NET INCOME PER SHARE OF COMMON STOCK (Note 3): | | | | |
| Basic | \$ 1.41 | \$ 1.44 | \$ 0.71 | \$ 0.73 |
| Diluted | \$ 1.40 | \$ 1.43 | \$ 0.71 | \$ 0.72 |
| DIVIDENDS PAID PER COMMON SHARE | \$ 0.68 | \$ 0.63 | \$ 0.35 | \$ 0.33 |

See notes to consolidated financial statements

MERCANTILE BANKSHARES CORPORATION

STATEMENTS OF CHANGES IN CONSOLIDATED SHAREHOLDERS EQUITY

For The Six Months Ended June 30, 2004 and 2003

| (Dollars in thousands, except per share data) | Total | Common Stock | Capital Surplus | Retained Earnings | Accumulated Other Comprehensive Income (Loss) |
|--|--------------|-----------------|--------------------|----------------------|--|
| BALANCE, DECEMBER 31, 2002 | \$ 1,324,358 | \$ 137,672 | \$ 120,577 | \$ 1,010,248 | \$ 55,861 |
| Net income | 98,996 | | | 98,996 | |
| Unrealized gains (losses) on securities available-for-sale, net of reclassification adjustment, net of taxes | (10,549) | | | | (10,549) |
| Comprehensive income | 88,447 | | | | |
| Cash dividends paid: | | | | | |
| Common stock (\$.63 per share) | (43,365) | | | (43,365) | |
| Issuance of 60,823 shares for dividend reinvestment and stock purchase plan | 2,119 | 122 | 1,997 | | |
| Issuance of 12,249 shares for employee stock purchase dividend reinvestment plan | 455 | 25 | 430 | | |
| Issuance of 89,053 shares for employee stock option plan | 1,540 | 177 | 1,363 | | |
| Issuance of 100,537 shares for restricted stock awards | 3,561 | 202 | 3,359 | | |
| Deferred compensation restricted stock awards | (2,498) | | | (2,498) | |
| Purchase of 5,500 shares under stock repurchase plan | (212) | (11) | (201) | | |
| Vested stock options | 1,189 | | 1,189 | | |
| BALANCE, JUNE 30, 2003 | \$ 1,375,594 | \$ 138,187 | \$ 128,714 | \$ 1,063,381 | \$ 45,312 |
| BALANCE, DECEMBER 31, 2003 | \$ 1,841,441 | \$ 159,545 | \$ 548,664 | \$ 1,110,748 | \$ 22,484 |
| Net income | 112,010 | | | 112,010 | |
| Unrealized gains (losses) on securities available-for-sale, net of reclassification adjustment, net of taxes | (30,585) | | | | (30,585) |
| Comprehensive income | 81,425 | | | | |
| Cash dividends paid: | | | | | |
| Common stock (\$.68 per share) | (53,957) | | | (53,957) | |
| Issuance of 61,696 shares for dividend reinvestment and stock purchase plan | 2,639 | 123 | 2,516 | | |
| Issuance of 12,660 shares for employee stock purchase dividend reinvestment plan | 557 | 25 | 532 | | |
| Issuance of 215,631 shares for employee stock option plan | 3,894 | 432 | 3,462 | | |
| Issuance of 26,294 shares for restricted stock awards | 1,199 | 53 | 1,146 | | |
| Deferred compensation, net restricted stock awards | (285) | | | (285) | |
| Transfer opening balance related to directors deferred compensation plan | 6,406 | | 6,406 | | |
| | 196 | | 196 | | |

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| | | | | | |
|--|---------------------|-------------------|-------------------|---------------------|----------------|
| Directors deferred compensation plan contribution | | | | | |
| Directors deferred compensation plan dividend | | | | 54 | (54) |
| Purchase of 1,000,000 shares under stock repurchase plan | (44,110) | (2,000) | (42,110) | | |
| Vested stock options | 1,892 | | 1,892 | | |
| BALANCE, JUNE 30, 2004 | \$ 1,841,297 | \$ 158,178 | \$ 522,758 | \$ 1,168,462 | (8,101) |

See notes to consolidated financial statements

MERCANTILE BANKSHARES CORPORATION

STATEMENTS OF CONSOLIDATED CASH FLOW

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For the 6 Months Ended

| Increase (decrease) in cash and cash equivalents (Dollars in thousands) | June 30, | |
|---|------------|------------|
| | 2004 | 2003 |
| CASH FLOWS FROM OPERATING ACTIVITIES: | | |
| Net income | \$ 112,010 | \$ 98,996 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Provision for loan losses | 4,779 | 6,067 |
| Depreciation and amortization | 7,787 | 6,331 |
| Amortization of other intangible assets | 4,088 | 1,409 |
| Investment securities gains | (535) | (7,351) |
| Write-downs (income) of investments in private equity funds | (229) | 188 |
| Gains on sales of other real estate owned | (13) | (268) |
| Gains on sales of buildings | (963) | (228) |
| Net (increase) decrease in assets: | | |
| Interest receivable | 3,954 | 5,036 |
| Other receivables | 3,751 | (7,564) |
| Bank-owned life insurance | (1,579) | (868) |
| Other assets | (4,864) | 1,104 |
| Loans held-for-sale | 14,178 | (85,740) |
| Net increase (decrease) in liabilities: | | |
| Interest payable | (1,125) | 921 |
| Accrued expenses | (9,788) | (2,182) |
| Taxes payable | (5,278) | (4,094) |
| Net cash provided by operating activities | 126,173 | 11,757 |
| CASH FLOWS FROM INVESTING ACTIVITIES: | | |
| Proceeds from maturities of investment securities held-to-maturity | 3,913 | 4,603 |
| Proceeds from maturities of investment securities available-for-sale | 532,465 | 439,129 |
| Proceeds from sales of investment securities available-for-sale | 42,055 | 399,958 |
| Purchases of investment securities held-to-maturity | (5,195) | (2,401) |
| Purchases of investment securities available-for-sale | (514,304) | (954,481) |
| Net increase in customer loans | (493,705) | (251,555) |
| Proceeds from sales of other real estate owned | 75 | 268 |
| Capital expenditures | (5,403) | (8,376) |
| Proceeds from sales of buildings | 2,594 | 602 |
| Business acquisitions (net of cash received) | | (28,530) |
| Other investing activity | (2,956) | (1,085) |
| Net cash used in investing activities | (440,461) | (401,868) |
| CASH FLOWS FROM FINANCING ACTIVITIES: | | |
| Net increase in noninterest-bearing deposits | 292,521 | 189,663 |
| Net increase in checking plus interest and savings accounts | 178,657 | 150,951 |
| Net (decrease) increase in certificates of deposit | (90,037) | 34,020 |
| Net increase (decrease) in short-term borrowings | 82,858 | (7,076) |
| Proceeds from issuance of long-term debt | | 300,000 |
| Repayment of long-term debt | (231) | (8,400) |
| Proceeds from issuance of shares | 7,090 | 4,114 |
| Repurchase of common shares | (44,110) | (212) |
| Dividends paid | (53,957) | (43,365) |
| Net cash provided by financing activities | 372,791 | 619,695 |
| Net increase in cash and cash equivalents | 58,503 | 229,584 |
| Cash and cash equivalents at beginning of period | 362,701 | 545,781 |
| Cash and cash equivalents at end of period | \$ 421,204 | \$ 775,365 |
| SUPPLEMENTAL INFORMATION | | |
| Cash payments for interest | \$ 55,125 | \$ 58,321 |
| Cash payments for income taxes | 62,571 | 50,199 |

See notes to consolidated financial statements

MERCANTILE BANKSHARES CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

1. Basis of Presentation

The consolidated financial statements, which include the accounts of Mercantile Bankshares Corporation (Bankshares) (Nasdaq: MRBK) and all of its affiliates, are prepared in conformity with accounting principles generally accepted in the United States of America and follow general practice within the banking industry. In the opinion of management, the consolidated financial statements include all adjustments necessary for a fair presentation of the interim period. These adjustments are of a normal nature and include adjustments to eliminate all significant intercompany transactions. In view of the changing conditions in the national economy, the effect of actions taken by regulatory authorities and normal seasonal factors, the results for the interim period are not necessarily indicative of annual performance. For comparability, certain prior period amounts have been reclassified to conform with current period presentation.

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and contingent assets and liabilities in the financial statements, and the disclosure of revenue and expenses during the reporting period. These assumptions are based on information available as of the date of the financial statements and could differ from actual results. See Annual Report on Form 10-K for more detail.

2. Business Combinations

The following provides information concerning acquisitions. These acquisitions were accounted for as purchases. The results of operations of these acquisitions subsequent to the acquisition dates are included in Bankshares' Statements of Consolidated Income. Individually, the results of operations of these acquisitions prior to the acquisition dates were not material to Bankshares' results of operations.

In March and April 2003, Bankshares acquired in separate transactions, Boyd Watterson Asset Management LLC (BW), an investment management firm, and Peremel & Company, Inc. (Peremel), a directed and discount brokerage company. In the aggregate, the companies were purchased for approximately \$29 million in cash. The BW acquisition has a potential additional contingent payment of up to \$8.6 million which, if paid, will be recorded as goodwill. The contingent payment will be recorded assuming certain metrics are met and becomes payable three years from the acquisition date. Bankshares finalized and recorded approximately \$10.1 million of identified intangibles, mostly client relationships, as a result of these acquisitions. These intangibles are being amortized on a straight-line basis over a range of three to eight years. Goodwill recorded on these transactions totaled approximately \$18.0 million at June 30, 2004.

On August 12, 2003, Bankshares completed its acquisition of F&M Bancorp (F&M), a bank holding company headquartered in Frederick, Maryland. The total consideration paid to F&M shareholders in connection with the acquisition was \$124.1 million in cash and 10.4 million shares of Bankshares' common stock. F&M transactions have been included in Bankshares' financial results since August 13, 2003. Acquired assets on August 12, 2003 totaled \$2.2 billion, including \$1.4 billion of loans and leases; liabilities assumed were \$2.0 billion, including \$1.7 billion of deposits. As of June 30, 2004, Bankshares had recorded \$395.8 million of goodwill, \$36.0 million of core deposit intangible, \$5.8 million of mostly client relationship intangibles (relating to the two insurance subsidiaries) and \$1.1 million in a trademark intangible. The weighted average amortization period for the newly-acquired core deposit intangible is nine years, and the client-relationship identified

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intangible ranges from three to fifteen years. On October 24, 2003, certain assets and liabilities of F&M were transferred to other Bankshares affiliates in order to align customers' accounts with the Bankshares' affiliate serving the geographic area where those customers reside.

3. Earnings Per Share

Basic earnings per share (EPS) are computed by dividing income available to common shareholders by weighted average common shares outstanding. Diluted EPS are computed using the same components as basic EPS with the denominator adjusted for the dilutive effect of stock awards. The following tables provide reconciliation between the computation of basic EPS and diluted EPS for the six months and quarters ended June 30, 2004 and 2003, respectively.

| (In thousands, except per share data) | For the 6 Months Ended June 30, | | | | | |
|--|---------------------------------|-------------------------------------|---------|------------|-------------------------------------|---------|
| | Net Income | 2004 Weighted Average Common Shares | EPS | Net Income | 2003 Weighted Average Common Shares | EPS |
| Basic EPS | \$ 112,010 | 79,422 | \$ 1.41 | \$ 98,996 | 68,815 | \$ 1.44 |
| Dilutive effect of stock options and restricted stock awards | | 510 | | | 438 | |
| Vested directors deferred compensation plan shares | | 75 | | | | |
| Diluted EPS | \$ 112,010 | 80,007 | \$ 1.40 | \$ 98,996 | 69,253 | \$ 1.43 |

| (In thousands, except per share data) | For the 3 Months Ended June 30, | | | | | |
|--|---------------------------------|-------------------------------------|---------|------------|-------------------------------------|---------|
| | Net Income | 2004 Weighted Average Common Shares | EPS | Net Income | 2003 Weighted Average Common Shares | EPS |
| Basic EPS | \$ 56,313 | 79,119 | \$ 0.71 | \$ 50,010 | 68,860 | \$ 0.73 |
| Dilutive effect of stock options and restricted stock awards | | 483 | | | 458 | |
| Vested directors deferred compensation plan shares | | 149 | | | | |
| Diluted EPS | \$ 56,313 | 79,751 | \$ 0.71 | \$ 50,010 | 69,318 | \$ 0.72 |

Antidilutive options and awards excluded from the computation of diluted earnings per share were 445,909 and 238,838 for the six months ended June 30, 2004 and 2003, respectively, and 593,500 and 249,978 for the second quarter of 2004 and 2003, respectively.

4. Investment Securities

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The amortized cost and fair value of investment securities at June 30, 2004, December 31, 2003 and June 30, 2003 are shown below:

| (Dollars in thousands) | June 30, 2004 | | December 31, 2003 | | June 30, 2003 | |
|--------------------------------------|---------------------|---------------------|---------------------|---------------------|---------------------|---------------------|
| | Amortized Cost | Fair Value | Amortized Cost | Fair Value | Amortized Cost | Fair Value |
| Securities available-for-sale | | | | | | |
| U.S. Treasury | \$ 761,492 | \$ 770,566 | \$ 823,356 | \$ 845,754 | \$ 950,507 | \$ 988,831 |
| U.S. Government agencies | 805,462 | 806,149 | 778,916 | 793,611 | 657,177 | 685,061 |
| Mortgage-backed securities | 1,246,021 | 1,221,506 | 1,288,109 | 1,283,630 | 927,625 | 933,508 |
| States and political subdivisions | 69,019 | 69,284 | 77,897 | 79,870 | 449 | 477 |
| Other investments | 145,375 | 147,357 | 118,948 | 120,649 | 83,694 | 84,224 |
| Total | \$ 3,027,369 | \$ 3,014,862 | \$ 3,087,226 | \$ 3,123,514 | \$ 2,619,452 | \$ 2,692,101 |
| Securities held-to-maturity | | | | | | |
| States and political subdivisions | \$ 25,663 | \$ 26,590 | \$ 28,213 | \$ 30,115 | \$ 36,224 | \$ 39,239 |
| Other investments | 25,036 | 25,036 | 21,204 | 21,204 | 14,965 | 14,965 |
| Total | \$ 50,699 | \$ 51,626 | \$ 49,417 | \$ 51,319 | \$ 51,189 | \$ 54,204 |

5. Impaired Loans

When scheduled principal or interest payments are past due 90 days or more at quarter-end on any loan, the accrual of interest income is discontinued and subsequent receipts on these loans are recorded as a reduction of principal, and interest income is recorded only once principal recovery is reasonably assured. Previously accrued but uncollected interest on these loans is charged against interest income. Generally a loan may be restored to accruing status when all past due principal, interest and late charges have been paid and the bank expects repayment of the remaining contractual principal and interest.

Under Statements of Financial Accounting Standards (SFAS) Nos. 114 and 118, Accounting by Creditors for Impairment of a Loan-an amendment of FASB Statements No. 5 and 15, a loan is considered impaired, based on current information and events, if it is probable that Bankshares will not collect all principal and interest payments according to the contractual terms of the loan agreement. The impairment of a loan is measured based on the present value of expected future cash flows discounted at the loan's effective interest rate, or the fair value of the collateral if the repayment is expected to be provided predominantly by the underlying collateral. A majority of Bankshares' impaired loans are measured by reference to the fair value of the collateral. Information with respect to impaired loans and the related valuation allowance (if the measure of the impaired loan is less than the recorded investment) at June 30, 2004, December 31, 2003 and June 30, 2003 is shown below. See Annual Report on Form 10-K for more detail.

| (Dollars in thousands) | June 30, 2004 | December 31, 2003 | June 30, 2003 |
|---|------------------|----------------------|------------------|
| Impaired loans with a specific valuation allowance | \$ 24,864 | \$ 26,715 | \$ 18,523 |
| All other impaired loans | 12,160 | 18,692 | 15,066 |
| Total impaired loans | \$ 37,024 | \$ 45,407 | \$ 33,589 |
| Specific allowance for loan losses applicable to impaired loans | \$ 14,497 | \$ 14,925 | \$ 8,840 |
| General allowance for loan losses applicable to other than impaired loans | 143,934 | 140,412 | 133,421 |
| Total allowance for loan losses | \$ 158,431 | \$ 155,337 | \$ 142,261 |
| Year-to-date interest income on impaired loans recorded on the cash basis | \$ 212 | \$ 443 | \$ 155 |
| Year-to-date average recorded investment in impaired loans during the period | \$ 41,116 | \$ 31,241 | \$ 26,438 |
| Quarter-to-date interest income on impaired loans recorded on the cash basis | \$ 109 | \$ 223 | \$ 58 |
| Quarter-to-date average recorded investment in impaired loans during the period | \$ 39,752 | \$ 37,382 | \$ 28,822 |

Note: Impaired loans do not include large groups of smaller balance homogeneous loans that are evaluated collectively for impairment (e.g., residential mortgages and consumer installment loans). The allowance for loan losses related to these loans is included in the general allowance for loan losses applicable to other than impaired loans.

6. Commitments

Bankshares is a party to financial instruments that are not reflected in the balance sheet, which include commitments to extend credit and standby letters of credit. Various commitments to extend credit (lines of credit) are made in the normal course of banking business. Letters of credit are issued for the benefit of customers by affiliated banks. These commitments are subject to loan underwriting standards and geographic boundaries consistent with Bankshares' loans outstanding. Bankshares' lending activities are concentrated in Maryland, Delaware and Virginia.

Commitments to extend credit are agreements to lend to a customer as long as there is no violation of any condition established in the contract. Commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. Since many of the commitments are expected to expire without being drawn upon, the total commitment amounts do not necessarily represent future cash requirements. Total commitments to extend credit were \$3.9 billion at June 30, 2004, \$3.6 billion at December 31, 2003, and \$2.8 billion at June 30, 2003.

Letters of credit are commitments issued to guarantee the performance of a customer to a third party. Outstanding letters of credit were \$320.9 million at June 30, 2004, \$281.4 million at December 31, 2003 and \$245.2 million at June 30, 2003. Fees received for issuing letters of credit are deferred and amortized over the life of the commitment. The fees on letters of credit at June 30, 2004, December 31, 2003, and June 30, 2003 had a carrying value of \$1.2 million, \$1.0 million and \$0.4 million, respectively, representing unamortized fees.

Bankshares mortgage banking subsidiary is a Fannie Mae Delegated Underwriting and Servicing lender, and has a loss sharing arrangement for loans originated on behalf of and sold to Fannie Mae. The unamortized principal balance of the underlying loans totaled \$183.9 million, \$149.4 million and \$123.6 million at June 30, 2004, December 31, 2003 and June 30, 2003, respectively. No loss reserve has been established for possible losses on loans originated and sold in the secondary market since there have been no losses recognized during the history of this arrangement and no losses were incurred at June 30, 2004. The mortgage subsidiary also has originated and sold loans with recourse in the event of foreclosure on the underlying real estate. The unamortized amount of principal balance of loans sold with recourse totaled \$2.0 million at June 30, 2004, \$2.3 million at December 31, 2003 and \$2.8 million at June 30, 2003. These mortgages are generally in good standing, are well-collateralized and no loss has ensued and no future loss is expected.

Bankshares has committed to invest funds in third-party private equity investments. At June 30, 2004, December 31, 2003 and June 30, 2003, \$18.7 million, \$16.1 million and \$18.0 million, respectively, remained unfunded.

7. Goodwill and Other Intangible Assets

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Goodwill decreased by \$4.6 million during the second quarter of 2004. This decrease was related to finalizing F&M's purchase accounting adjustments.

The following table discloses the gross carrying amount and accumulated amortization of intangible assets subject to amortization at June 30, 2004 and December 31, 2003:

| (Dollars in thousands) | Gross carrying amount | June 30, 2004 Accumulated amortization | Net amount | Gross carrying amount | December 31, 2003 Accumulated amortization | Net amount |
|---------------------------|-----------------------|---|------------|-----------------------|---|------------|
| Deposit intangibles | \$ 49,881 | \$ (12,280) | \$ 37,601 | \$ 49,881 | \$ (9,546) | \$ 40,335 |
| Mortgage servicing rights | 2,670 | (1,957) | 713 | 2,351 | (1,790) | 561 |
| Customer lists and other | 17,010 | (2,846) | 14,164 | 17,010 | (1,683) | 15,327 |
| Total | \$ 69,561 | \$ (17,083) | \$ 52,478 | \$ 69,242 | \$ (13,019) | \$ 56,223 |

The projections of amortization expense shown for mortgage servicing rights are based on asset balances and the interest rate environment as of June 30, 2004. Future amortization expense may be significantly different depending upon changes in the mortgage servicing portfolio, mortgage interest rates and market conditions.

The following table shows the current period and estimated future amortization expense for amortized intangible assets. Identifiable intangible assets are amortized based on estimated lives of up to 15 years. Bankshares recorded \$36.0 million of core deposit intangibles and \$6.9 million in customer list and other intangibles in conjunction with the F&M acquisition. Management reviews other intangible assets for impairment yearly, or whenever events or changes in circumstances indicate that their carrying amounts may not be recoverable. For those intangible assets subject to amortization, impairment is indicated if the sum of undiscounted estimated future net cash flow is less than the carrying amount of the asset. Impairment is recognized by writing down the carrying value of the asset. Any impairment recognized in a valuation account is reflected in the income statement in the corresponding period. Bankshares recorded a \$124 thousand impairment in the second quarter of 2004 for mortgage servicing rights. The mortgage servicing impairment valuation increased to \$293 thousand at June 30, 2004 compared to \$169 thousand at December 31, 2003.

The following table shows the current period and estimated future amortization expense for amortized intangible assets.

| (Dollars in thousands) | Core deposit intangibles | Mortgage servicing intangibles | Customer lists and other intangibles | Total | |
|---|--------------------------|--------------------------------|--------------------------------------|----------|-------|
| Six months ended June 30, 2004 (actual) | \$ 2,734 | \$ 182 | \$ 1,172 | \$ 4,088 | |
| Six months ended December 31, 2004 (estimated) | 2,734 | 152 | 1,163 | 4,049 | |
| Twelve months ended December 31, 2004 (estimated) | 5,468 | 334 | 2,335 | 8,137 | |
| Estimate for year ended December 31, | | | | | |
| | 2005 | 5,467 | 342 | 2,326 | 8,135 |
| | 2006 | 5,467 | 219 | 2,083 | 7,769 |
| | 2007 | 5,209 | | 1,890 | 7,099 |
| | 2008 | 4,344 | | 1,708 | 6,052 |
| | 2009 | 4,120 | | 985 | 5,105 |

8. Comprehensive Income

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The following table summarizes the market value change and related tax effect of unrealized gains (losses) on securities available-for-sale for the six months ended June 30, 2004 and 2003. The net amount is included in accumulated other comprehensive income (loss) in the Statements of Changes in Consolidated Shareholders' Equity.

| (Dollars in thousands) | For the 6 Months Ended June 30, | | | | | |
|---|---------------------------------|----------------------------|-------------|---------------|----------------------------|-------------|
| | Pretax Amount | 2004 Tax (Expense) Benefit | Net Amount | Pretax Amount | 2003 Tax (Expense) Benefit | Net Amount |
| Unrealized gains (losses) on securities available-for-sale: | | | | | | |
| Unrealized holding gains (losses) arising during the period | \$ (48,260) | \$ 17,998 | \$ (30,262) | \$ (9,484) | \$ 3,379 | \$ (6,105) |
| Reclassification adjustment for (gains) losses included in net income | (535) | 212 | (323) | (7,351) | 2,907 | (4,444) |
| Total | \$ (48,795) | \$ 18,210 | \$ (30,585) | \$ (16,835) | \$ 6,286 | \$ (10,549) |

9. Capital Adequacy

Bankshares and its bank affiliates are subject to various regulatory capital adequacy requirements administered by federal and state banking agencies. These requirements include maintaining certain capital ratios above minimum levels. These capital ratios include tier I capital and total risk-based capital as percentages of net risk-weighted assets and tier I capital as a percentage of adjusted average total assets (leverage ratio). The minimum ratios for capital adequacy purposes are 4.00%, 8.00% and 4.00%, for the tier I capital, total capital and leverage ratios, respectively. To be categorized as *well capitalized*, a bank must maintain minimum ratios of 6.00%, 10.00% and 5.00%, for its tier I capital, total capital and leverage ratios, respectively. As of June 30, 2004, Bankshares and all of its bank affiliates exceeded all capital adequacy requirements to be considered well capitalized.

Capital ratios and the amounts used to calculate them are presented in the following table for Bankshares and Mercantile-Safe Deposit & Trust Company (MSD&T), the lead bank, as of June 30, 2004 and December 31, 2003.

| (Dollars in thousands) | June 30, 2004 | | December 31, 2003 | |
|-------------------------------|---------------|------------|-------------------|------------|
| | Bankshares | MSD&T | Bankshares | MSD&T |
| Tier I capital | \$ 1,286,355 | \$ 401,076 | \$ 1,248,492 | \$ 396,186 |
| Total risk-based capital | 1,707,056 | 446,391 | 1,666,064 | 440,479 |
| Net risk-weighted assets | 10,552,378 | 3,607,148 | 10,020,487 | 3,529,223 |
| Adjusted average total assets | 13,290,852 | 4,433,480 | 13,011,399 | 4,353,713 |
| Tier I capital ratio | 12.19% | 11.12% | 12.46% | 11.23% |
| Total capital ratio | 16.18% | 12.38% | 16.63% | 12.48% |
| Leverage ratio | 9.68% | 9.05% | 9.60% | 9.10% |

Bankshares has an ongoing share repurchase program. At June 30, 2004 there were 476,327 shares remaining for repurchase of the 2,000,000 shares previously authorized by the Board of Directors on December 11, 2001. For the six months ended June 30, 2004 and the twelve months ended December 31, 2003, 1,000,000 and 5,500 shares, respectively, were repurchased by Bankshares. In April 2004, Bankshares entered into a privately negotiated agreement for the accelerated repurchase of the one million shares. Shares repurchased in 2003 were acquired in open market transactions.

10. Segment Reporting

Operating segments as defined by SFAS No. 131 *Disclosures about Segments of an Enterprise and Related Information* are components of an enterprise with separate financial information. The component engages in business activities from which it derives revenues and incurs expenses and whose operating results management relies on for decision-making and performance assessment. Bankshares has three reportable segments its 19 Community Banks, MSD&T Banking and Investment and Wealth Management (IWM).

The following tables present selected segment information for the six months ended June 30, 2004 and 2003. The components in the Other column consist of amounts for the nonbanking affiliates and intercompany eliminations. Certain expense amounts such as operations overhead have been reclassified from internal financial reporting in order to provide for full cost absorption. These reclassifications are shown in the Adjustments line. F&M is included in the column Community Banking whereas BW and Peremel are included in the column IWM.

| For the 6 Months Ended June 30, 2004 | | | | | | |
|--------------------------------------|--------------|------------------|--------------|----------|------------|--------------|
| (Dollars in thousands) | Community | Banking MSD&T | Total (1) | IWM | Other | Total |
| Net interest income | \$ 193,063 | \$ 71,218 | \$ 264,281 | \$ | \$ 2,453 | \$ 266,734 |
| Provision for loan losses | 256 | (5,035) | (4,779) | | | (4,779) |
| Noninterest income | 42,474 | 22,087 | 55,613 | 45,229 | 593 | 101,435 |
| Noninterest expenses | (111,323) | (50,389) | (152,764) | (33,809) | (180) | (186,753) |
| Adjustments | (3,486) | 11,872 | 8,386 | (1,926) | (6,460) | |
| Income (loss) before income taxes | 120,984 | 49,753 | 170,737 | 9,494 | (3,594) | 176,637 |
| Income tax (expense) benefit | (42,009) | (17,973) | (59,982) | (3,797) | (848) | (64,627) |
| Net income (loss) | \$ 78,975 | \$ 31,780 | \$ 110,755 | \$ 5,697 | \$ (4,442) | \$ 112,010 |
| Average loans | \$ 6,459,844 | \$ 3,021,123 | \$ 9,480,967 | | \$ 192 | \$ 9,481,159 |
| Average earning assets | 8,793,808 | 4,060,059 | 12,518,189 | | 105,293 | 12,623,482 |
| Average assets | 9,269,341 | 4,412,700 | 13,227,398 | | 550,019 | 13,777,417 |
| Average deposits | 7,344,946 | 3,089,790 | 10,299,390 | | (66,939) | 10,232,451 |
| Average equity | 939,744 | 444,236 | 1,383,980 | | 464,858 | 1,848,838 |

| For the 6 Months Ended June 30, 2003 | | | | | | |
|--------------------------------------|--------------|------------------|--------------|----------|------------|--------------|
| (Dollars in thousands) | Community | Banking MSD&T | Total (1) | IWM | Other | Total |
| Net interest income | \$ 153,503 | \$ 71,489 | \$ 224,992 | \$ | \$ (1,143) | \$ 223,849 |
| Provision for loan losses | (3,109) | (2,958) | (6,067) | | | (6,067) |
| Noninterest income | 31,542 | 21,592 | 45,968 | 37,164 | 158 | 83,290 |
| Noninterest expenses | (78,352) | (43,929) | (115,115) | (30,426) | (1,289) | (146,830) |
| Adjustments | (3,220) | 7,763 | 4,543 | (1,559) | (2,984) | |
| Income (loss) before income taxes | 100,364 | 53,957 | 154,321 | 5,179 | (5,258) | 154,242 |
| Income tax (expense) benefit | (34,637) | (19,443) | (54,080) | (2,072) | 906 | (55,246) |
| Net income (loss) | \$ 65,727 | \$ 34,514 | \$ 100,241 | \$ 3,107 | \$ (4,352) | \$ 98,996 |
| Average loans | \$ 4,527,296 | \$ 2,909,487 | \$ 7,436,783 | | \$ 253 | \$ 7,437,036 |
| | 6,304,570 | 4,032,098 | 10,146,223 | | 84,427 | 10,230,650 |

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Average earning
assets

| | | | | | |
|------------------|-----------|-----------|------------|-----------|------------|
| Average assets | 6,624,800 | 4,326,291 | 10,661,253 | 119,121 | 10,780,374 |
| Average deposits | 5,359,878 | 3,118,910 | 8,362,812 | (170,611) | 8,192,201 |
| Average equity | 843,198 | 454,182 | 1,297,380 | 12,517 | 1,309,897 |

(1) Amounts do not necessarily add due to eliminations.

11. Derivative Instruments and Hedging Activities

FASB Statement No. 133 (SFAS No. 133), *Accounting for Derivative Instruments and Hedging Activities*, FASB Statement No. 138 (SFAS No. 138), *Accounting for Certain Derivative Instruments and Certain Hedging Activities – an amendment to FASB Statement No. 133* and FASB Statement No. 149 (SFAS No. 149), *Amendment of Statement No. 133 on Derivative Instruments and Hedging Activities* (collectively referred to as derivatives), establishes accounting and reporting standards for derivative instruments and for hedging activities. Bankshares maintains an overall interest rate risk management strategy that incorporates the use of derivative instruments to minimize significant unplanned fluctuations in earnings that are caused by interest rate volatility. Derivative instruments that are used as part of the interest rate risk management strategy have been restricted to interest rate swaps. Interest rate swaps generally involve the exchange of fixed-rate and variable-rate interest payments between two parties, based on a common notional principal amount and maturity date. As of June 30, 2004, Bankshares has interest rate swaps to convert its nonprepayable fixed-rate debt to floating-rate debt. Bankshares also arranges interest rate swaps for commercial loan customers through its capital markets group. The increase in the number of contracts since December 31, 2003 is related to their activities.

The fair value of derivative instruments recorded in other assets was \$2.4 million (notional \$210.5 million) and \$6.6 million (notional \$203.1 million) at June 30, 2004 and December 31, 2003, respectively. The fair value of derivative instruments recorded in other liabilities was \$13.3 million (notional \$160.5 million) and \$8.0 million (notional \$150.0 million) at June 30, 2004 and December 31, 2003, respectively. For the six months ended June 30, 2004, Bankshares recognized a net gain of \$6 thousand, which represented the ineffective portion of the fair-value hedge of fixed-rate loans made to borrowers. For the year ended December 31, 2003, Bankshares recognized a net gain of \$70 thousand. The impact of the hedge decreased interest income \$61 thousand in the first six months of 2004 and \$167 thousand in 2003. The fair-value hedges of nonprepayable fixed-rate debt were effective for the reported periods. The impact of the hedges decreased interest expense \$5.7 million in the first six months of 2004 and \$8.5 million in 2003.

The following tables summarize the gross position of derivatives at June 30, 2004 and December 31, 2003:

| June 30, 2004 (Dollars in thousands) | Number of Contracts | Notional Amount | Years to Maturity | Weighted Average | | Fair Value |
|--------------------------------------|---------------------|-----------------|-------------------|------------------|---------------|-------------|
| | | | | Fixed Rate | Variable Rate | |
| Gross Position Summary: | | | | | | |
| Pay Fixed/Receive Variable | | | | | | |
| Interest Rate Swaps | 4 | \$ 10,512 | 6.64 | 4.68% | 1.25% | \$ 8 |
| Receive Fixed/Pay Variable | | | | | | |
| Interest Rate Swaps | 7 | 360,512 | 7.95 | 5.21% | 1.99% | (10,862) |
| Total | 11 | \$ 371,024 | 7.91 | | | \$ (10,854) |

| December 31, 2003 (Dollars in thousands) | Number of Contracts | Notional Amount | Years to Maturity | Weighted Average | | Fair Value |
|--|---------------------|-----------------|-------------------|------------------|---------------|------------|
| | | | | Fixed Rate | Variable Rate | |
| Gross Position Summary: | | | | | | |
| Pay Fixed/Receive Variable | | | | | | |
| Interest Rate Swaps | 1 | \$ 3,108 | 0.33 | 9.38% | 4.00% | \$ (64) |
| Receive Fixed/Pay Variable | | | | | | |
| Interest Rate Swaps | 3 | 350,000 | 8.44 | 5.21% | 1.98% | (1,366) |
| Total | 4 | \$ 353,108 | 8.37 | | | \$ (1,430) |

Mortgage loans held-for-sale have inherent forward contract (agreements to sell or purchase loans at a specific rate or yield) characteristics. Risk may arise from the corresponding parties' inability to meet the terms of their contracts and from movement in interest rates. Bankshares had

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forward commitments to sell and fund individual fixed-rate and variable-rate mortgage loans that are reported at fair value. The fair value adjustments were not material at June 30, 2004 and December 31, 2003.

12. Stock-based Compensation Expense

Bankshares has several stock-based compensation programs for its directors, management and employees. Compensation costs for stock options and restricted stock awards are included in salary expense. Another form of stock-based compensation is phantom stock, which is used for a portion of the Bankshares Directors Deferred Compensation Plan. A change in this plan was approved at the annual shareholders meeting, and was effective April 1, 2004. This plan requires all deferred fees to be settled in Bankshares stock. This reduces the expense fluctuations that occurred with phantom stock, which resulted in variances corresponding to the changes in Bankshares stock price. The compensation cost for the phantom stock is included in other expenses. Stock-based compensation amounts for the six months ended and quarter ended June 30, 2004 and 2003, respectively, are summarized in the following table:

| (Dollars in thousands) | For the 6 Months Ended June 30, | | For the 3 Months Ended June 30, | |
|--|------------------------------------|----------|------------------------------------|----------|
| | 2004 | 2003 | 2004 | 2003 |
| Stock options expense | \$ 1,200 | \$ 865 | \$ 794 | \$ 406 |
| Restricted stock awards expense | 1,007 | 922 | 519 | 604 |
| Subtotal included in salaries expense | 2,207 | 1,787 | 1,313 | 1,010 |
| Phantom stock expense | (198) | 314 | 180 | 989 |
| Total stock-based compensation expense | \$ 2,009 | \$ 2,101 | \$ 1,493 | \$ 1,999 |

13. **Pension & Other Postretirement Benefit Plans**

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Bankshares sponsors qualified and nonqualified pension plans and other postretirement benefit plans for its employees. The following table summarizes the components of the net periodic benefit cost for the pension plans for the six months ended and the three months ended June 30, 2004 and 2003, respectively.

| | For the 6 Months Ended June 30, 2004 | | | For the 6 Months Ended June 30, 2003 | | |
|--------------------------------------|--------------------------------------|--------------|----------|--------------------------------------|--------------|----------|
| | Qualified | Nonqualified | Total | Qualified | Nonqualified | Total |
| Service cost | \$ 3,144 | \$ 282 | \$ 3,426 | \$ 2,560 | \$ 230 | \$ 2,790 |
| Interest cost | 5,098 | 202 | 5,300 | 4,996 | 156 | 5,152 |
| Expected return on plan assets | (7,690) | | (7,690) | (6,198) | | (6,198) |
| Amortization of prior service cost | 390 | 12 | 402 | 390 | 12 | 402 |
| Recognized net actuarial (gain) loss | 354 | 58 | 412 | 1,122 | 16 | 1,138 |
| Amortization of transition asset | | 48 | 48 | | 50 | 50 |
| Net periodic benefit cost | \$ 1,296 | \$ 602 | \$ 1,898 | \$ 2,870 | \$ 464 | \$ 3,334 |

| | For the 3 Months Ended June 30, 2004 | | | For the 3 Months Ended June 30, 2003 | | |
|--------------------------------------|--------------------------------------|--------------|----------|--------------------------------------|--------------|----------|
| | Qualified | Nonqualified | Total | Qualified | Nonqualified | Total |
| Service cost | \$ 1,572 | \$ 141 | \$ 1,713 | \$ 1,280 | \$ 115 | \$ 1,395 |
| Interest cost | 2,549 | 101 | 2,650 | 2,498 | 78 | 2,576 |
| Expected return on plan assets | (3,845) | | (3,845) | (3,099) | | (3,099) |
| Amortization of prior service cost | 195 | 6 | 201 | 195 | 6 | 201 |
| Recognized net actuarial (gain) loss | 201 | 29 | 230 | 517 | 8 | 525 |
| Amortization of transition asset | | 24 | 24 | | 25 | 25 |
| Net periodic benefit cost | \$ 672 | \$ 301 | \$ 973 | \$ 1,391 | \$ 232 | \$ 1,623 |

The following table summarizes the components of the net periodic benefit cost for the other postretirement benefit plans for the six months ended and the three months ended June 30, 2004 and 2003, respectively.

| | For the 6 Months Ended June 30, | | For the 3 Months Ended June 30, | |
|--------------------------------------|---------------------------------|--------|---------------------------------|--------|
| | 2004 | 2003 | 2004 | 2003 |
| Service cost | \$ 130 | \$ 88 | \$ 65 | \$ 59 |
| Interest cost | 428 | 367 | 214 | 246 |
| Expected return on plan assets | | | | |
| Amortization of prior service cost | | | | |
| Recognized net actuarial (gain) loss | 81 | 64 | 43 | 43 |
| Amortization of transition asset | | | | |
| Net periodic benefit cost | \$ 639 | \$ 519 | \$ 322 | \$ 348 |

As previously disclosed in its financial statements for the year ended December 31, 2003, Bankshares generally makes cash contributions to the pension plan in amounts permitted by guidelines established under employee benefit and tax laws. Bankshares currently estimates it will be able to contribute up to approximately \$10 million to the pension plan for 2004. Cash contributions are normally made after valuations have been finalized for the plan year and prior to the tax return filing date. As of June 30, 2004, no contributions had been made.

14. Recent Accounting Standards

In December 2003, the American Institute of Certified Public Accountants issued Statement of Position (SOP) 03-3, Accounting for Certain Loans or Debt Securities Acquired in a Transfer, which addresses the accounting for differences between contractual cash flows and expected cash flows for loans acquired in a transfer when those differences are attributable at least in part to credit quality. It includes such loans acquired in purchase business combinations where there is evidence of deterioration in credit quality since origination. This SOP requires the difference between expected cash flows and the purchase price to be accreted as an adjustment to yield over the life of the acquired loans; the difference between contractual cash flows and expected cash flows is not subject to accretion. This SOP would represent a change from current practice where the allowance for loan losses is carried over in purchase accounting. The SOP is effective for loans acquired beginning after December 15, 2004. Bankshares is currently evaluating the impact it will have on operations and financial statements.

On March 9, 2004, the Securities and Exchange Commission (SEC) issued Staff Accounting Bulletin No. 105 (SAB 105), Application of Accounting Principles to Loan Commitments, which summarizes the views of the SEC staff regarding the application of Generally Accepted Accounting Principles to loan commitments accounted for as derivative instruments. SAB 105 states that the value of the servicing asset should not be included in the estimate of fair value of interest rate lock commitments (IRLCs). IRLCs associated with mortgages to be held for sale represent commitments to extend credit at specified interest rates. SAB 105 is applicable for all IRLCs accounted for as derivatives and entered into on or after April 1, 2004. This SAB does not have a material impact on Bankshares financial statements.

15. **Subsequent Event/Contingencies**

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On July 12, 2004, former employee John Pileggi filed suit against Mercantile Bankshares Corporation, Mercantile-Safe Deposit and Trust Company and Edward J. Kelly, III. For additional detail, see Part II Other Information Item 1 Legal Proceedings below.

During the second quarter of 2004, the Maryland Legislature passed two tax bills relating to certain payments among related entities. The first bill requires taxpayers to add back otherwise deductible interest and intangible expenses paid to related entities for tax years beginning after December 31, 2003. Some exceptions apply, including certain interest expenses deducted among related banks, so long as the transactions fall within the legislation's safe harbor provision. In applying the add back and safe harbor provisions, Maryland's Comptroller has been granted discretionary authority to determine whether the transaction giving rise to the payment had as a principal purpose the avoidance of tax and whether it was at arm's length. Additionally, the Comptroller's Office now has the power to reallocate or reapportion income among related entities if it determines that the entities' income is not accurately reflected on their tax returns. The second bill gives taxpayers the right to take advantage of an amnesty period. Bankshares is currently in the process of determining what impact, if any, this legislation will have on its operations and financial results.

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

MERCANTILE BANKSHARES CORPORATION

HIGHLIGHTS

Consolidated Financial Results

In March, April and August of 2003, Bankshares acquired in separate transactions, Boyd Watterson Asset Management, LLC (BW), Peremel & Company (Peremel), and F&M Bancorp (F&M), respectively, which are collectively referred to herein as the Acquisitions . The Acquisitions were accounted for under the purchase method of accounting and have been included in Bankshares' financial results since their respective closings. On October 24, 2003, certain assets and liabilities of F&M were transferred to other Bankshares' affiliates in order to align customers accounts with the Bankshares' affiliate serving the geographic area where those customers reside. (See Footnote No. 2 to the Consolidated Financial Statements included in this report.)

Net income for the quarter ended June 30, 2004 was \$56.3 million, a 13% increase from net income of \$50.0 million for the same period in 2003 and a 1% increase over the \$55.7 million reported for the first quarter of 2004. For the quarter ended June 30, 2004, diluted net income per share was \$.71, a decrease of 1% from the \$.72 reported for the same period of last year and an increase of 3% over the \$.69 reported for the first quarter of this year. Adjusted weighted average shares outstanding increased from 69.3 million for the quarter ended June 30, 2003, to 79.8 million for the quarter ended June 30, 2004 as a result of the F&M acquisition. The results of operations for the Acquisitions are included from their respective merger dates forward.

Factors positively affecting earnings for the second quarter included strong growth in average loans and deposits, up 3.1% and 3.3%, respectively, from the first quarter of 2004, improved noninterest income and expense control. Partially offsetting these factors was a 13 basis point (bp) decline in the net interest margin to 4.24% from 4.37% in the first quarter of 2004. A loss of \$0.7 million from Bankshares' investment in three hedge funds, as compared to a gain of \$3.0 million in the first quarter of 2004, accounted for 12 bp of the margin contraction. These investments are carried in the other investments category within investment securities available-for-sale.

Bankshares also reports cash operating earnings, defined as GAAP (Generally Accepted Accounting Principles) earnings excluding the amortization of intangible assets associated with purchase accounting for business combinations; securities gains and losses; and other significant gains, losses or expenses (such as those associated with integrating acquired entities' operations into Bankshares) unrelated to Bankshares' core operations. Cash operating earnings totaled \$57.3 million for the second quarter of 2004, an increase of 22% over the \$47.0 million for the same period for 2003 and a slight increase over the \$56.8 million for the first quarter of 2004. Diluted cash operating earnings per share for the second quarter of 2004 and 2003 were \$.72, and \$.68, respectively, and \$.71 per share for the first quarter of 2004. A reconciliation of net income (GAAP basis) to cash operating earnings can be found on page 33 of this filing.

Management believes that reporting several key measures based on cash operating earnings and tangible equity (equity less intangible assets and their related amortization expense) is important, as this is the basis for measuring the adequacy of capital for regulatory purposes. For the three months ended June 30, 2004, return on average tangible assets was 1.73%, return on average tangible equity was 18.14% and average tangible

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equity to average tangible assets was 9.55%. Comparable ratios for the three months ended June 30, 2003 were 1.86%, 17.05% and 10.91%, respectively. A reconciliation of these ratios from their respective GAAP basis ratios can be found on page 33 of this filing.

For the first six months of 2004, net income was \$112.0 million, an increase of 13% over the \$99.0 million reported for the comparable period in 2003. Diluted net income per share was \$1.40, a decrease of 2% from the \$1.43 reported for the same period of last year. For the six months ended June 30, 2004, compared to the same period of 2003, cash operating earnings were \$114.1 million and \$95.8 million, respectively. Diluted cash operating earnings per share for these periods were \$1.43 and \$1.38, respectively. The ratios of return on average tangible assets, return on average tangible equity and average tangible equity to average tangible assets for the year-to-date 2004 were 1.74%, 18.10% and 9.64%, respectively. These ratios for the year-to-date 2003 were 1.89%, 17.02% and 11.10%, respectively.

SEGMENT REPORTING

As noted in Footnote No. 10 *Segment Reporting*, Bankshares has historically reported three distinct business segments for which financial information is segregated for use in assessing performance and allocating resources when reporting to the Board of Directors. Segment financial information is subjective and, unlike financial accounting, is not necessarily based on GAAP. As a result, the financial information of the reporting segments is not necessarily comparable with similar information reported by others and may not be comparable with Bankshares consolidated results.

Banking

On a combined basis, Community Banks and MSD&T continue to be the primary contributors to Bankshares' earnings. Historically, Bankshares has distinguished between two operating units, Community and MSD&T, with the former focused on small business and retail banking and the latter on commercial and specialty lending. With the F&M acquisition and the announced plan to consolidate 11 affiliate banks into 4 banks, this distinction is becoming less apparent. Increased house lending authority at the Community Banks has resulted in additional loan growth within their footprint and less referral and overline business to MSD&T.

Community Banking

Net income for the six months ended June 30, 2004, was \$79.0 million. This represented a \$13.2 million, or 20% increase over the same period last year. Community Banking was the primary beneficiary of the F&M acquisition. For the first half of 2004 compared to the same period last year, net interest income increased by \$39.6 million, or 26%, to \$193.1 million. Growth in average earning assets of \$2.5 billion, largely attributable to the F&M acquisition, more than offset the effect of a 51 bp reduction in the net interest margin. Contributing to the net interest margin compression was the capital restructuring of the Community Banks during the third quarter of last year. \$300 million of subordinated debt issued by Bankshares in April 2003, used in part to fund the cash portion of the F&M acquisition, was invested in a like amount of subordinated debt issued by the Community Banks. Excess equity capital was paid to Bankshares in the form of a special cash dividend. The \$6.2 million in interest expense incurred during the first half of 2004 related to this subordinated debt reduced the Community Banks' net interest margin by 15 bp. The Community Banks had a reduction in the provision for loan losses compared to the same period of 2003 as credit quality remained stable.

The year-over-year increases in noninterest income and noninterest expenses for the first half of 2004 compared to the same period of 2003, are attributable to the F&M acquisition and branch / market expansion programs at several Community Banks. Noninterest income increased year-over-year by \$10.9 million, with deposit service charges increasing \$4.1 million, insurance fees increasing \$6.8 million, and electronic banking fees increasing \$2.7 million accounting for the largest gains. These gains were partially offset by a decrease of \$5.7 million in net gains on investment securities. Noninterest expenses increased by \$33.0 million in the first half of 2004 compared to the same period of 2003. Over 50% of this increase is related to salaries and benefits, which grew by \$16.4 million. Staffing levels increased from 1,868 full time equivalent to 2,267 full time equivalent year-over-year mostly due to the acquisition of F&M. Occupancy expense increased by \$3.1 million, furniture and equipment expenses increased by \$1.6 million and amortization of intangible assets increased \$2.4 million.

MSD&T

The net income contribution from MSD&T Banking declined by \$2.7 million for the six months ended June 30, 2004 to \$31.8 million compared to the same period last year. Contributing to the decline were reduced net interest income, a higher provision for loan losses and increased noninterest expenses. Partially offsetting these items was an increase in noninterest income.

The decline in net interest income in the first half of 2004 compared to the same period in 2003 was attributable to a 6 bp decline in the net interest margin from 3.64% to 3.58%. This decline is consistent with the overall decline experienced by Bankshares. The provision for loan losses was \$5.0 million in the first half of 2004 compared to \$3.0 million in the first half of 2003. Nonperforming loans declined during the current quarter due to collections and the return of several loans to performing status. For additional information, see discussion of nonperforming assets under Nonperforming Assets below.

The increase in noninterest income was spread across numerous categories. Noninterest income increased \$0.5 million in the first half of 2004 compared to the first half of 2003. The year-over-year increase was mitigated by decreases in gains on investment securities of \$1.3 million in 2003 and -0- in 2004, and a 5% decrease in mortgage banking related fees as a result of a slow down in refinancing activities. Noninterest expense increased by \$6.5 million from the first half of 2003 to \$50.4 million. This represents a 15% increase over the prior year. Increased personnel costs of \$7.0 million accounted for the increase. Staffing levels increased from 1,143 full time equivalents to 1,216 full time equivalents year-over-year principally due to compliance and other staff functions. Costs for shared services are charged to Investment and Wealth Management (IWM) and Community Banking and are reflected in the noninterest

expense line. Certain other costs not directly charged are allocated to IWM and Community Banking as reflected in the adjustments line.

Investment & Wealth Management

Net income increased \$2.6 million or 83% to \$5.7 million for the six months ended June 30, 2004 as compared to the \$3.1 million reported in the same period last year

Revenues for the first half of 2004 increased \$8.1 million, or 22%, over the same period last year, with \$5.4 million of the increase related to the BW and Peremel acquisitions. The remaining increase was primarily due to strong equity markets and new sales. Total assets under administration increased to \$46.2 billion at June 30, 2004 from \$42.0 billion at June 30, 2003. At June 30, 2004 and June 30, 2003 assets under management were \$21.4 billion and \$19.4 billion, respectively.

Noninterest expenses increased by \$3.4 million or 11% to \$33.8 million for the first half of 2004 from \$30.4 million for the same period last year. The increase in noninterest expense is mostly due to the acquisition of BW and Peremel. Full time equivalent staff levels have increased from 293 at June 30, 2003 to 310 at June 30, 2004. The Peremel acquisition and the assumption of F&M's brokerage operation accounted for the full time equivalent increase. During the first quarter of 2004, Bankshares entered into a 7-year service contract with SunGard Wealth Management Services to provide a new core accounting system and assume management of IWM's back-office operations. Post conversion, which is expected late in 2004, Bankshares expects to achieve net savings in excess of \$1.0 million in 2005. Management expects to incur conversion costs of \$2.5 million. \$1.7 million of the conversion costs will be amortized over the life of the contract. Bankshares also expects to incur exit costs of approximately \$1.2 million in the second half of 2004.

CONSOLIDATED RESULTS

Net Interest Income and Net Interest Margin

Analysis of Interest Rates and Interest Differentials

The following table presents the distribution of the average consolidated balance sheet, interest income/expense and annualized yields earned and rates paid through the six months ended June 30, 2004 and 2003.

| (Dollars in thousands) | For the 6 Months Ended June 30, 2004 | | | For the 6 Months Ended June 30, 2003 | | |
|--|---|---------------------|-----------------|---|---------------------|-----------------|
| | Average Balance | Income*/ Expense | Yield*/ Rate | Average Balance | Income*/ Expense | Yield*/ Rate |
| Earning assets | | | | | | |
| Loans:** | | | | | | |
| Commercial | \$ 2,679,828 | \$ 68,399 | 5.13% | \$ 2,401,370 | \$ 67,224 | 5.65% |
| Commercial real estate | 2,820,197 | 82,304 | 5.87 | 2,087,406 | 65,616 | 6.34 |
| Construction | 1,108,601 | 28,623 | 5.19 | 847,382 | 23,341 | 5.55 |
| Residential real estate | 1,398,153 | 41,608 | 5.98 | 1,083,780 | 36,339 | 6.76 |
| Consumer | 1,474,380 | 42,521 | 5.80 | 1,017,098 | 32,870 | 6.52 |
| Total loans | 9,481,159 | 263,455 | 5.59 | 7,437,036 | 225,390 | 6.11 |
| Federal funds sold, et al | 71,648 | 763 | 2.14 | 185,883 | 2,034 | 2.21 |
| Securities:*** | | | | | | |
| Taxable securities | | | | | | |
| U.S. Treasury and government agencies | 1,550,468 | 29,463 | 3.82 | 1,834,196 | 39,958 | 4.39 |
| Mortgage-backed | 1,266,028 | 24,103 | 3.83 | 636,760 | 13,864 | 4.39 |
| Other investments | 152,850 | 3,541 | 4.66 | 98,328 | 3,365 | 6.90 |
| Tax-exempt securities | | | | | | |
| States and political subdivisions | 101,171 | 2,807 | 5.58 | 38,099 | 1,595 | 8.44 |
| Total securities | 3,070,517 | 59,914 | 3.92 | 2,607,383 | 58,782 | 4.55 |
| Interest-bearing deposits in | | | | | | |
| other banks | 158 | 1 | 1.07 | 348 | 6 | 3.70 |
| Total earning assets | 12,623,482 | 324,133 | 5.16 | 10,230,650 | 286,212 | 5.64 |
| Cash and due from banks | 291,982 | | | 234,901 | | |
| Bank premises and equipment, net | 141,694 | | | 104,268 | | |
| Other assets | 877,515 | | | 351,801 | | |
| Less: allowance for loan losses | (157,256) | | | (141,246) | | |
| Total assets | \$ 13,777,417 | | | \$ 10,780,374 | | |
| Interest-bearing liabilities | | | | | | |
| Deposits: | | | | | | |
| Savings | \$ 1,399,234 | 2,027 | 0.29 | \$ 1,054,033 | 2,743 | 0.52 |
| Checking plus interest | 1,269,432 | 935 | 0.15 | 973,366 | 1,105 | 0.23 |
| Money market | 1,577,378 | 4,457 | 0.57 | 1,193,102 | 5,059 | 0.86 |
| Time deposits \$100,000 and over | 1,301,407 | 12,320 | 1.90 | 1,250,819 | 15,503 | 2.50 |
| Other time deposits | 1,967,533 | 20,901 | 2.14 | 1,712,535 | 24,169 | 2.85 |
| Total interest-bearing deposits | 7,514,984 | 40,640 | 1.09 | 6,183,855 | 48,579 | 1.58 |
| Short-term borrowings | 915,121 | 2,899 | 0.64 | 775,526 | 3,014 | 0.78 |
| Long-term debt | 648,817 | 10,460 | 3.24 | 402,225 | 7,648 | 3.83 |
| Total interest-bearing funds | 9,078,922 | 53,999 | 1.20 | 7,361,606 | 59,241 | 1.62 |
| Noninterest-bearing deposits | 2,717,467 | | | 2,008,346 | | |
| | 132,190 | | | 100,525 | | |

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| | | | | | |
|--|----------------------|-------------------|--------------|----------------------|--------------|
| Other liabilities and accrued expenses | | | | | |
| Total liabilities | 11,928,579 | | | 9,470,477 | |
| Shareholders' equity | 1,848,838 | | | 1,309,897 | |
| Total liabilities & shareholders' equity | \$ 13,777,417 | | | \$ 10,780,374 | |
| Net interest rate spread | | \$ 270,134 | 3.96% | \$ 226,971 | 4.02% |
| Effect of noninterest-bearing funds | | | 0.34 | | 0.45 |
| Net interest margin on earning assets | | | 4.30% | | 4.47% |
| Taxable-equivalent adjustment included in: | | | | | |
| Loan income | | \$ 2,279 | | \$ 2,436 | |
| Investment securities income | | 1,121 | | 686 | |
| Total | | \$ 3,400 | | \$ 3,122 | |

* Presented on a tax-equivalent basis using the statutory federal corporate income tax rate of 35% (see non-GAAP reconciliation on page 33)

** Nonaccrual loans are included in average loans

*** Balances reported at amortized cost; excludes pretax unrealized gains (losses) on securities available-for-sale

Analysis of Interest Rates and Interest Differentials

The following table presents the distribution of the average consolidated balance sheet, interest income/expense and annualized yields earned and rates paid for the second quarter of 2004 and 2003.

| (Dollars in thousands) | For the 3 Months Ended June 30, 2004 | | | For the 3 Months Ended June 30, 2003 | | |
|---------------------------------------|---|---------------------|-----------------|---|---------------------|-----------------|
| | Average Balance | Income*/ Expense | Yield*/ Rate | Average Balance | Income*/ Expense | Yield*/ Rate |
| Earning assets | | | | | | |
| Loans:** | | | | | | |
| Commercial | \$ 2,727,051 | \$ 34,775 | 5.13% | \$ 2,411,227 | \$ 33,464 | 5.57% |
| Commercial real estate | 2,871,615 | 41,648 | 5.83 | 2,116,259 | 33,317 | 6.31 |
| Construction | 1,113,301 | 14,414 | 5.21 | 870,955 | 11,955 | 5.51 |
| Residential real estate | 1,437,331 | 21,120 | 5.91 | 1,089,772 | 18,026 | 6.63 |
| Consumer | 1,474,586 | 21,292 | 5.81 | 1,025,363 | 16,421 | 6.42 |
| Total loans | 9,623,884 | 133,249 | 5.57 | 7,513,576 | 113,183 | 6.04 |
| Federal funds sold, et al | 95,504 | 588 | 2.48 | 313,844 | 1,311 | 1.68 |
| Securities:*** | | | | | | |
| Taxable securities | | | | | | |
| U.S. Treasury and government agencies | 1,543,661 | 14,369 | 3.74 | 1,741,380 | 18,763 | 4.32 |
| Mortgage-backed | 1,254,512 | 11,796 | 3.78 | 760,630 | 7,875 | 4.15 |
| Other investments | 159,282 | (66) | (0.17) | 98,277 | 2,544 | 10.38 |
| Tax-exempt securities | | | | | | |
| States and political subdivisions | 98,182 | 1,356 | 5.55 | 37,412 | 823 | 8.82 |
| Total securities | 3,055,637 | 27,455 | 3.61 | 2,637,699 | 30,005 | 4.56 |
| Interest-bearing deposits | | | | | | |
| in other banks | 158 | 1 | 1.06 | 338 | 3 | 3.50 |
| Total earning assets | 12,775,183 | 161,293 | 5.08 | 10,465,457 | 144,502 | 5.54 |
| Cash and due from banks | 298,440 | | | 243,728 | | |
| Bank premises and equipment, net | 141,757 | | | 104,825 | | |
| Other assets | 881,921 | | | 361,951 | | |
| Less: allowance for loan losses | (158,116) | | | (142,237) | | |
| Total assets | \$ 13,939,185 | | | \$ 11,033,724 | | |
| Interest-bearing liabilities | | | | | | |
| Deposits: | | | | | | |
| Savings | \$ 1,434,288 | 1,043 | 0.29 | \$ 1,078,760 | 1,373 | 0.51 |
| Checking plus interest | 1,302,313 | 474 | 0.15 | 993,268 | 547 | 0.22 |
| Money market | 1,564,295 | 2,095 | 0.54 | 1,201,044 | 2,422 | 0.81 |
| Time deposits \$100,000 and over | 1,315,119 | 5,941 | 1.82 | 1,277,652 | 7,535 | 2.37 |
| Other time deposits | 1,955,632 | 10,320 | 2.12 | 1,708,177 | 11,573 | 2.72 |
| Total interest-bearing deposits | 7,571,647 | 19,873 | 1.06 | 6,258,901 | 23,450 | 1.50 |
| Short-term borrowings | 910,854 | 1,480 | 0.65 | 771,892 | 1,469 | 0.76 |
| Long-term debt | 648,576 | 5,205 | 3.23 | 527,223 | 5,286 | 4.02 |
| Total interest-bearing funds | 9,131,077 | 26,558 | 1.17 | 7,558,016 | 30,205 | 1.60 |
| Noninterest-bearing deposits | 2,826,610 | | | 2,054,813 | | |
| | 129,737 | | | 96,602 | | |

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| | | | | | | | |
|--|----------------------|-------------------|--------------|--|---------------|-------------------|--------------|
| Other liabilities and accrued expenses | | | | | | | |
| Total liabilities | 12,087,424 | | | | 9,709,431 | | |
| Shareholders' equity | 1,851,761 | | | | 1,324,293 | | |
| Total liabilities & shareholders' equity | | | | | | | |
| | \$ 13,939,185 | | | | \$ 11,033,724 | | |
| Net interest rate spread | | \$ 134,735 | 3.91% | | | \$ 114,297 | 3.94% |
| Effect of noninterest-bearing funds | | | 0.33 | | | | 0.44 |
| Net interest margin on earning assets | | | 4.24% | | | | 4.38% |
| Taxable-equivalent adjustment included in: | | | | | | | |
| Loan income | | \$ 1,133 | | | | \$ 1,221 | |
| Investment securities income | | 542 | | | | 353 | |
| Total | | \$ 1,675 | | | | \$ 1,574 | |

* Presented on a tax-equivalent basis using the statutory federal corporate income tax rate of 35% (see non-GAAP reconciliation on page 33)

** Nonaccrual loans are included in average loans

*** Balances reported at amortized cost; excludes pretax unrealized gains (losses) on securities available-for-sale

Rate / Volume Analysis

A rate/volume analysis, which demonstrates changes in interest income and expense for significant assets and liabilities, appears below:

| (Dollars in thousands) | For the 6 Months Ended June 30, 2004 vs. 2003 | | | For the 3 Months Ended June 30, 2004 vs. 2003 | | |
|---|---|---------------|---------------|---|---------------|---------------|
| | Rates | Volumes (5) | Total | Rates | Volumes (5) | Total |
| Interest earned on: | | | | | | |
| Loans: | | | | | | |
| Commercial (1) | \$ (6,620) | \$ 7,795 | \$ 1,175 | \$ (3,072) | \$ 4,383 | \$ 1,311 |
| Commercial real estate (2) | (6,347) | 23,035 | 16,688 | (3,561) | 11,892 | 8,331 |
| Construction (3) | (1,913) | 7,195 | 5,282 | (868) | 3,327 | 2,459 |
| Residential real estate | (5,272) | 10,541 | 5,269 | (2,655) | 5,749 | 3,094 |
| Consumer | (5,127) | 14,778 | 9,651 | (2,323) | 7,194 | 4,871 |
| Total loans | (25,279) | 63,344 | 38,065 | (12,479) | 32,545 | 20,066 |
| Taxable securities (4) | (8,985) | 8,905 | (80) | (7,091) | 4,008 | (3,083) |
| Tax-exempt securities (4) | (1,428) | 2,640 | 1,212 | (804) | 1,337 | 533 |
| Federal funds sold, et al | (21) | (1,250) | (1,271) | 189 | (912) | (723) |
| Interest-bearing deposits in other banks | (2) | (3) | (5) | (2) | (2) | (2) |
| Total interest income | (35,715) | 73,636 | 37,921 | (20,185) | 36,976 | 16,791 |
| Interest paid on: | | | | | | |
| Savings deposits | (1,614) | 898 | (716) | (783) | 453 | (330) |
| Checking plus interest deposits | (506) | 336 | (170) | (243) | 170 | (73) |
| Money market accounts | (2,231) | 1,629 | (602) | (1,060) | 733 | (327) |
| Certificates of deposit | | | | | | |
| \$100,000 and over | (3,810) | 627 | (3,183) | (1,815) | 221 | (1,594) |
| Other time deposits | (6,867) | 3,599 | (3,268) | (2,930) | 1,677 | (1,253) |
| Short-term borrowings | (658) | 543 | (115) | (253) | 264 | 11 |
| Long-term debt | (1,877) | 4,689 | 2,812 | (1,298) | 1,217 | (81) |
| Total interest expense | (17,563) | 12,321 | (5,242) | (8,382) | 4,735 | (3,647) |
| Net interest earned | \$ (18,152) | \$ 61,315 | \$ 43,163 | \$ (11,803) | \$ 32,241 | \$ 20,438 |

(1) Interest year-to-date tax-equivalent adjustment of \$1.6 million for 2004 and 2003, respectively, and quarter-to-date tax-equivalent adjustment of \$759 thousand and \$781 thousand for 2004 and 2003, respectively, are included in the commercial loan rate variances.

(2) Interest year-to-date tax-equivalent adjustment of \$268 thousand and \$185 thousand for 2004 and 2003, respectively, and quarter-to-date tax-equivalent adjustment of \$154 thousand and \$99 thousand for 2004 and 2003, respectively, are included in the commercial real estate loan rate variances.

(3) Interest year-to-date tax-equivalent adjustment of \$458 thousand and \$680 thousand for 2004 and 2003, respectively, and quarter-to-date tax-equivalent adjustment of \$221 thousand and \$341 thousand for 2004 and 2003, respectively, are included in the construction loan rate variances.

(4) Interest year-to-date tax-equivalent adjustment of \$1.1 million and \$0.7 million for 2004 and 2003, respectively, and quarter-to-date tax-equivalent adjustment of \$542 thousand and \$353 thousand for 2004 and 2003,

respectively, are included in the investment securities rate variances.

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

Net Interest Income and Net Interest Margin (continued)

Net interest income for the quarter ended June 30, 2004 increased 18% to \$133.1 million from the second quarter last year primarily as a result of the F&M acquisition. Net interest income is affected by both changes in the amount and composition of interest-earning assets and interest-bearing liabilities and by changes in the level of interest rates. The growth in net interest income was attributable to the growth of 22% in average earning assets that more than offset a decline in the net interest margin. Average loan growth from March 31, 2004 to June 30, 2004 was \$285.5 million or 3% (12% annualized).

The positive effect on interest income of year-over-year growth in average earning assets was partially offset by a 14 bp decline in the net interest margin from 4.38% for the second quarter of 2003 to 4.24% for the current quarter. This was driven principally by the performance of Bankshares' previously disclosed investments in hedge funds-of-funds related to the investment and wealth management business, which are designated as assets held for sale. Changes in their fair value are reflected in the income statement as a component of other investment income. After four successive quarters of strong performance, these investments generated a loss of \$0.7 million in the second quarter.

of 2004 versus a gain of \$3.0 million in the first quarter. This led to a linked-quarter decline in the net interest margin from 4.37% to 4.24%, with the performance of the hedge fund investments accounting for 12 bp of the decline. In the first quarter of 2004, the hedge fund investments contributed 7 bps to the net interest margin. In the second quarter these investments adversely affected the margin by 5 bps. Bankshares has begun to redeem these investments and will continue to do so gradually over time. MSD&T Banking segment's net interest margin increased 3 bp to 3.58% for the second quarter of 2004 from 3.55% in the first quarter while the Community Banking's net interest margin decreased 1 bp to 4.46% for the current quarter from 4.47% in the first quarter of 2004. Helping to offset the decline in the net interest margin was linked-quarter growth in average loans of 3.1%. Loans grew in all categories, with commercial loans and lease receivables up 3.6%; commercial real estate up 3.7%; construction up 0.9%; residential real estate up 5.8%; and consumer up slightly. The average balance in the securities portfolio was down 1.1% from the first to the second quarter of 2004. Lower reinvestment yields on maturing investment securities and prepayments of mortgage-related securities reduced yields in the investment portfolio. Average deposits were up 3.3% on a linked-quarter basis, with increases in noninterest-bearing deposits (8.4%), savings (5.1%), checking plus interest (5.3%), and time deposits \$100,000 and over (2.1%), more than offsetting declines in money market (down 1.6%) and other time deposits (down 1.2%). Based on current market conditions, which include a recent slowing of mortgage refinancing activity and increase in the prime rate at June 30, 2004, management expects the net interest margin to improve during the second half of 2004.

Net interest income for the first six months of 2004 increased to \$266.7 million or 19% over the \$223.8 million for the first six months of last year principally due to F&M. The growth in net interest income was attributable to 27% growth in average loans and 18% growth in average securities. The positive impact of asset growth on interest income was partially offset by a 17 bp decline in the net interest margin from 4.47% to 4.30%. Nearly two-thirds of the decline in the net interest margin was attributable to the reduced benefit derived from the investment of noninterest-bearing funds. This benefit fell from 45 bp in 2003 to 34 bp in 2004.

Noninterest Income

| (Dollars in thousands) | For the 6 Months Ended | | | For the 3 Months Ended | | |
|-------------------------------------|------------------------|------------------|-----------------------|------------------------|------------------|-----------------------|
| | 2004 | June 30, 2003 | % Change 2004/2003 | 2004 | June 30, 2003 | % Change 2004/2003 |
| Investment and wealth management | \$ 44,919 | \$ 36,873 | 21.8% | \$ 22,936 | \$ 19,508 | 17.6% |
| Service charges on deposit accounts | 20,470 | 16,371 | 25.0 | 10,351 | 8,311 | 24.5 |
| Mortgage banking related fees: | | | | | | |
| Commercial | 3,483 | 3,319 | 4.9 | 1,563 | 1,693 | (7.7) |
| Residential | 1,750 | 1,576 | 11.0 | 730 | 814 | (10.3) |
| Total mortgage banking related fees | 5,233 | 4,895 | 6.9 | 2,293 | 2,507 | (8.5) |
| Investment securities gains | 535 | 7,351 | (92.7) | 590 | 6,536 | (91.0) |
| Other income: | | | | | | |
| Electronic banking fees | 10,351 | 7,598 | 36.2 | 5,951 | 4,145 | 43.6 |
| Charges and fees on loans | 5,293 | 4,518 | 17.2 | 2,835 | 2,069 | 37.0 |
| Insurance | 7,095 | 332 | | 3,267 | 175 | |
| Bank-owned life insurance | 1,579 | 868 | 81.9 | 785 | 439 | 78.8 |
| All other income | 5,960 | 4,484 | 32.9 | 2,542 | 1,747 | 45.5 |
| Total other income | 30,278 | 17,800 | 70.1 | 15,380 | 8,575 | 79.4 |
| Total | \$ 101,435 | \$ 83,290 | 21.8% | \$ 51,550 | \$ 45,437 | 13.5% |

Noninterest income for the quarter ended June 30, 2004 increased by \$6 million, or 13%, to \$51.6 million compared to \$45.4 million for the same period in 2003. Noninterest income increased 3% from the first quarter of 2004. The table above shows the major components of noninterest income. Investment and wealth management revenue represents the largest source of noninterest income and increased 18% over the

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prior year and 4% over the first quarter of 2004. Factors having a positive impact on IWM revenues were strong equity markets and increased new sales across both mutual funds and separately managed accounts.

Service charges on deposit accounts increased in line with the growth in deposit balances. For the second quarter of 2004 compared to the second quarter of 2003, the \$2.0 million, or 25%, growth in service charge income was largely attributable to the F&M acquisition. Service charges on deposits increased modestly compared to the first quarter of 2004 due to deposit growth.

Mortgage banking-related fees decreased 9% in the second quarter of 2004 compared to the second quarter of 2003 and decreased 22% from the first quarter of 2004 due primarily to normal seasonal fluctuations, a general slowdown in refinancing activities and the integration of F&M's mortgage banking business into Wells Fargo Ventures LLC. Bankshares' mortgage banking revenue is comprised of loan activities of Mercantile Mortgage Corporation's commercial mortgage subsidiary, Columbia National Real Estate Financing LLC, and its residential mortgage joint venture with Wells Fargo Ventures LLC.

Last year \$6.5 million in investment securities gains resulted from sales of equity securities held in the available-for-sale portfolios and the balance related to the continued restructuring of the bond portfolios. The gain in the second quarter of 2003 was generated as part of a repositioning of the balance sheet for interest rate changes that adjusted portfolio yields and duration. The increases in other income for the three months ended June 30, 2004 compared to the three months ended June 30, 2003 include several categories. Electronic banking fees, which consist of merchant card processing fees, foreign ATM fees and check card fees increased \$1.8 million or 44%. These fees are seasonal and also benefited from the F&M acquisition. Charges and fees on loans consisting of letters of credit fees, late fees and other assessed loan fees increased \$0.8 million or 37%. Insurance revenues, which are derived from fee income related to the sale and servicing of insurance products, increased \$3.1 million primarily due to the F&M acquisition. All other income increased \$0.8 million or 46%, which consisted of revenues from various sources, such as safe deposit box rent, travelers checks, money orders and bill collection fees. Included in all other income in the second quarter of 2004 is \$0.3 million in gains from the disposition of bank-owned buildings, which was excluded from cash operating earnings. On a linked-quarter basis a seasonally-related decline in insurance fee income and a decline in all other income was more than offset by increases in electronic banking fees and charges and fees on loans.

For the six months ended June 30, 2004, noninterest income increased by \$18.1 million or 22%, to \$101.4 million compared to \$83.3 million for the same period in 2003. This increase was largely due to the F&M acquisition and a 22% increase in IWM fees, which was partially offset by the \$6.8 million decrease in investment securities gains.

Noninterest Expense

| (Dollars in thousands) | For the 6 Months Ended | | | For the 3 Months Ended | | |
|--|------------------------|------------|-----------------------|------------------------|-----------|-----------------------|
| | 2004 | 2003 | % Change 2004/2003 | 2004 | 2003 | % Change 2004/2003 |
| Salaries | \$ 89,477 | \$ 70,732 | 26.5% | \$ 44,689 | \$ 36,317 | 23.1% |
| Employee benefits | 23,441 | 18,747 | 25.0 | 10,928 | 9,319 | 17.3 |
| Net occupancy expense of bank premises | 11,879 | 8,315 | 42.9 | 5,819 | 4,219 | 37.9 |
| Furniture and equipment expense | 14,937 | 13,542 | 10.3 | 7,573 | 6,743 | 12.3 |
| Communication and supplies | 8,499 | 6,617 | 28.4 | 4,195 | 3,181 | 31.9 |
| Other expenses: | | | | | | |
| Professional services | 8,830 | 7,041 | 25.4 | 4,996 | 4,962 | 0.7 |
| Advertising and promotional expense | 3,838 | 3,711 | 3.4 | 2,135 | 2,247 | (5.0) |
| Electronic banking expense | 4,414 | 3,434 | 28.5 | 2,485 | 1,851 | 34.3 |
| Amortization of intangible assets | 4,088 | 1,409 | 190.1 | 2,056 | 848 | 142.5 |
| Outsourcing expense | 2,686 | 1,959 | 37.1 | 1,227 | 1,010 | 21.5 |
| All other expenses | 14,664 | 11,323 | 29.5 | 7,264 | 6,352 | 14.4 |
| Total other expense | 38,520 | 28,877 | 33.4 | 20,163 | 17,270 | 16.8 |
| Total | \$ 186,753 | \$ 146,830 | 27.2% | \$ 93,367 | \$ 77,049 | 21.2% |

Noninterest expense for the three months ended June 30, 2004 increased by \$16.3 million, or 21%, to \$93.4 million compared to \$77.0 million for the three months ended June 30, 2003. The table above shows the major components of noninterest expense. The principal reason for the year-over-year increase in each noninterest expense category was the acquisitions of F&M. On a linked-quarter basis all major categories of noninterest expense reflected declines except for furniture & equipment expenses and other expenses resulting in a slight decline in total noninterest expenses for the quarter.

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Management continues to focus on expense control and is encouraged by the progress made to date. While total noninterest expenses were down slightly from the first to the second quarter of 2004, certain additional expenses related to directors' deferred compensation (\$0.5 million), the consolidation of bank affiliates (\$0.4 million), and certain employee separation costs (\$0.8 million) offset the stronger underlying trend of reduced expenses. Moreover, volume-driven increases in electronic banking costs accounted for \$0.6 million of additional expense during the second quarter of 2004, which coincides with an increase in electronic banking fee income.

As a result of the higher level of expenses, the efficiency ratio, a key measure of expense management, increased over 2003. The efficiency ratio is computed by dividing noninterest expenses by the sum of net interest income on a tax-equivalent basis and noninterest income. Bankshares' efficiency ratio was 50.12% compared to 48.24% for the three months ended June 30, 2004 and 2003, respectively. A large portion of the increased expenses is due to the acquisition of F&M. On a non-GAAP basis, the cash operating efficiency ratio excludes amortization expense for intangibles and nonoperating income and expenses, such as securities gains and losses and other significant gains, losses or expenses (such as those associated with integrating acquired entities' operations into Bankshares) unrelated to Bankshares' core operations. Bankshares' cash operating efficiency ratio was 49.03%, compared to 49.24%

for the three months ended June 30, 2004 and 2003, respectively. For the reconciliation of GAAP to non-GAAP measures, see page 33 in this filing.

Employee-related expenses, which include salaries, benefits and incentive compensation, were the largest component at 60% of noninterest expenses. F&M accounted for a substantial portion of the \$10.0 million increase in employee-related expenses for the second quarter of 2004 compared to the same period in 2003. Salaries and benefit expenses for the second quarter of 2004 compared to the first quarter of 2004, declined \$1.7 million.

Net occupancy expense, which includes depreciation, rents, maintenance and utilities, increased due to the additional branch and corporate office locations related to the F&M acquisition. On a linked-quarter basis net occupancy expense decreased with a reduction in the number of facilities operated by F&M.

Furniture and equipment expenses include premises depreciation, rental and maintenance expense associated with the upkeep and improvement of hardware and computer software. Furniture and equipment increased due to normal increases in software license and maintenance fees associated with the core banking system.

Communications and supplies increased due to supplies needed for additional branch office locations, including brochures and operational supplies, as well as increased customer information mailings and disclosures related to the F&M acquisition.

Other expenses consist of professional services, marketing, electronic banking and several other categories such as travel and membership, amortization, licensing, insurance and sundry losses. The increases for the three months ended June 30, 2004 compared to the three months ended June 30, 2003 are attributable to the F&M acquisition. Of the \$2.9 million increase in other expenses for the second quarter of 2004 compared to the second quarter of 2003, \$1.2 million is associated with the increased amortization of intangible assets resulting from the acquisition of F&M. Other expenses increased \$1.8 million, over the first quarter of 2004. This increase from the previous quarter is principally due to higher professional fees of \$1.1 million. This included a \$0.5 million increase relating to directors deferred compensation. At the Annual Meeting, shareholders approved a change to the Directors Deferred Compensation Plan that will substantially reduce expense volatility in future periods. Professional fees also included \$0.4 million relating to the consolidation of 11 bank affiliates into four, leaving the organization with 13 bank affiliates. Management expects to incur additional legal fees due to pending legal proceedings. Other expenses also increased as a result of advertising expenses related to planned promotional campaigns; increases in electronic banking transaction costs that were more than offset by increases in electronic banking revenues; and \$0.8 million in certain employee separation costs.

Noninterest expense for the six months ended June 30, 2004 increased to \$186.8 million or 27% over the \$146.8 million for the six months ended June 30, 2003. The increase in each category was largely attributable to the F&M acquisition.

Analysis of Financial Condition

At June 30, 2004 compared to December 31, 2003, total assets increased 3% or \$434.7 million. Total loans increased 5% or \$490.0 million. Loans grew in nearly every category in this period except for the consumer portfolio, which decreased less than 1% and the planned run-off in

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lease receivables. Total investment securities decreased 3% or \$107.4 million.

Total deposits at June 30, 2004, were \$10.6 billion, an increase of 4% or \$381.1 million over December 31, 2003. Interest-bearing deposits, which represent 71% of total deposits increased 1%, while noninterest-bearing deposits increased 11% from the end of last year. A decline in money market and time deposits of \$100,000 and over was more than offset by increases in all of the other deposit categories.

At June 30, 2004 compared to June 30, 2003, total assets increased 23% or \$2.6 billion. Total loans increased 29% or \$2.2 billion and total investment securities increased 12% or \$0.3 billion. These substantial increases are due principally to the acquisition of F&M, which accounted for approximately 80% of the growth in total assets.

At June 30, 2004, total deposits increased 23% or \$2.0 billion compared to one year earlier. F&M added approximately 80% to the total deposit growth. The additional growth in deposits was in core deposits from customers in the local markets. The affiliate banking structure positions Bankshares to compete not only with the large national and regional banking companies in the gathering of these funds, but also with local community banks. Management believes Bankshares is positioned to retain these deposits in a rising interest rate scenario. However, should there be an outflow of deposits, a reversal of recent trends, the investment portfolio should provide adequate liquidity.

Shareholders' equity at June 30, 2004 was \$1.8 billion. Bankshares has authorization enabling it to repurchase up to approximately 0.5 million additional shares. In April, Bankshares repurchased 1.0 million shares at a cost of \$44.1 million by entering into a privately negotiated agreement for the accelerated purchase of these shares. Since the share repurchase program began in the mid-1990's, Management has generally targeted 40% of net income for cash dividends to shareholders and 30% of net income for potential

share repurchases. Effective at the June 2004 Board meeting, the quarterly dividend rate was increased 6% to \$.35 from \$.33 per share. At June 30, 2004 and December 31, 2003, the cash dividend payout ratio was 48.23% and 47.78% respectively. A change to the Directors' Deferred Compensation Plan was approved at the 2004 Annual Shareholders' meeting. Beginning April 1, 2004 all deferred directors' fees are covered by the plan. At April 1, 2004 directors had the option to leave their deferred balance in the old Phantom stock plan, or convert their balance into vested shares under the new plan. All but thirteen directors converted their balances to the new plan. This resulted in adding approximately 149,000 stock equivalents and a \$6.4 million addition to Capital Surplus. These vested shares will be issued after a director retires. For more details, see the Statements of Changes in Consolidated Shareholders' Equity and Footnote No. 12.

RISK MANAGEMENT

Credit Risk Analysis

Bankshares' loans and commitments are substantially to borrowers located in our immediate region. Bankshares has set an internal limit for each affiliate bank, that is well below the regulatory limit, on the maximum amount of credit that may be extended to a single borrower. For more information on credit risk see Risk Management - Credit Risk Analysis in the Mercantile Bankshares Corporation's 2003 Annual Report on Form 10-K.

Nonperforming Assets

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

During the six months ended June 30, 2004, nonperforming assets decreased \$10.2 million to \$40.3 million from \$50.5 million at December 31, 2003. Nonaccrual loans were \$39.9 million at June 30, 2004 and other real estate owned, the other component of nonperforming assets, was \$0.4 million. Nonperforming assets as a percent of period-end loans and other real estate owned was .41% at June 30, 2004 and .55% at December 31, 2003, respectively. The decrease in nonperforming loans was due primarily to improvement in credit quality at MSD&T. Credit quality at the Community Banks also continued to improve.

At June 30, 2004 and December 31, 2003, monitored loans, or loans with characteristics suggesting that they could be classified as nonperforming in the near future, were \$23.9 million and \$28.4 million, respectively. Two loans at MSD&T contributed \$17.2 million and one loan at The Citizens National Bank affiliate contributed \$5.3 million to the current total. The MSD&T loans are secured by two commercial aircraft, which are leased to a regional commercial airline. In light of the prevailing conditions in the commercial airline industry, management has included these loans in the monitored status. The amount of loans past due 30-89 days decreased from \$43.6 million at December 31, 2003 to \$33.1 million at June 30, 2004.

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The table below presents a comparison of nonperforming assets at June 30, 2004, December 31, 2003 and June 30, 2003.

| (Dollars in thousands) | June 30, 2004 | December 31, 2003 | June 30, 2003 |
|---|------------------|----------------------|------------------|
| Nonaccrual loans (1) | | | |
| Commercial | \$ 34,002 | \$ 36,569 | \$ 26,919 |
| Commercial real estate | 2,197 | 7,363 | 3,798 |
| Construction | 155 | 651 | 1,178 |
| Residential real estate | 2,518 | 3,721 | 4,001 |
| Consumer | 346 | 1,224 | 178 |
| Lease financing | 670 | 824 | 1,694 |
| Total | 39,888 | 50,352 | 37,768 |
| Renegotiated loans (1) | | | |
| Loans contractually past due 90 days or more and still accruing interest | | | |
| Total nonperforming loans | 39,888 | 50,352 | 37,768 |
| Other real estate owned | 402 | 191 | 376 |
| Total nonperforming assets | \$ 40,290 | \$ 50,543 | \$ 38,144 |
| Nonperforming loans as a percent of period-end loans | 0.41% | 0.54% | 0.50% |
| Nonperforming assets as a percent of period-end loans and other real estate owned | 0.41% | 0.55% | 0.50% |

(1) Aggregate gross interest income of \$1.4 million, \$4.1 million and \$1.5 million for the first half of 2004, the year 2003 and the first half of 2003, respectively, on nonaccrual and renegotiated loans, would have been recorded if these loans had been accruing on their original terms throughout the period or since origination if held for part of the period. The amount of interest income on the nonaccrual and renegotiated loans that was recorded totaled \$0.5 million, \$2.1 million and \$0.6 million for the first six months of 2004, the year 2003 and the first six months of 2003, respectively.

Note: Bankshares was monitoring loans estimated to aggregate \$23.9 million at June 30, 2004, \$26.6 million at March 31, 2004 and \$28.4 million at December 31, 2003, not classified as nonaccrual or renegotiated loans. These loans had characteristics that indicated they might result in such classification in the future.

Allowance and Provision for Loan Losses

Each Bankshares affiliate is required to maintain an allowance for loan losses adequate to absorb losses inherent in the loan portfolio. Each affiliate's reserve is dedicated to that affiliate only and is not available to absorb losses from another affiliate. Management at each affiliate, along with Bankshares management, conducts a regular review to assure that adequacy. On a periodic basis, significant credit exposures, nonperforming loans, impaired loans, historical losses by loan type and various statistical measurements of asset quality are examined to assure the adequacy of the allowance for loan losses. Management believes that the allowance for loan losses is at an adequate level to absorb losses inherent in the portfolio.

The allowance for loan losses has been established through provisions for loan losses charged against income. Loans deemed uncollectible are charged against the allowance for loan losses and any subsequent recoveries are credited to the allowance. Intensive collection efforts continue after charge-off in order to maximize recovery amounts. The provision for loan losses for the second quarter of 2004 was \$2.4 million, a 23% decrease from the same period last year and a 3% decrease from the first quarter of 2004. The decline in the provision reflects a continued improvement in the economy and stable credit quality within Bankshares' Community Banks. The Community Banks' loan portfolios are more heavily weighted toward consumer and residential real estate loans. Potential losses in these portfolios are more predictable and quantifiable, generally resulting in a lower required allowance. Net charge-offs were \$0.6 million for the second quarter of 2004, \$1.1 million for the first quarter of 2004 and \$3.5 million for the fourth quarter of 2003. The allowance for loan losses as a percent of period-end loans decreased to 1.62% at June 30, 2004 from 1.66% at March 31, 2004 and 1.68% at December 31, 2003.

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The following table presents a summary of the activity in the Allowance for Loan Losses.

| (Dollars in thousands) | For the 6 Months Ended June 30, | | For the 3 Months Ended June 30, | |
|--|---------------------------------|--------------|---------------------------------|--------------|
| | 2004 | 2003 | 2004 | 2003 |
| Allowance balance - beginning | \$ 155,337 | \$ 138,601 | \$ 156,635 | \$ 140,427 |
| Charge-offs: | | | | |
| Commercial | (945) | (719) | (255) | (613) |
| Commercial real estate | (28) | (342) | | (1) |
| Construction | | | | |
| Residential real estate | (129) | (50) | (28) | (50) |
| Consumer | (2,377) | (1,573) | (1,260) | (722) |
| Lease financing | | (1,188) | | (547) |
| Total | (3,479) | (3,872) | (1,543) | (1,933) |
| Recoveries: | | | | |
| Commercial | 337 | 409 | 237 | 205 |
| Commercial real estate | 26 | 117 | 8 | 99 |
| Construction | 4 | 135 | | |
| Residential real estate | 191 | 39 | 139 | 35 |
| Consumer | 1,236 | 765 | 602 | 377 |
| Lease financing | | | | |
| Total | 1,794 | 1,465 | 986 | 716 |
| Net charge-offs | (1,685) | (2,407) | (557) | (1,217) |
| Provision for loan losses | 4,779 | 6,067 | 2,353 | 3,051 |
| Allowance balance - ending | \$ 158,431 | \$ 142,261 | \$ 158,431 | \$ 142,261 |
| Average loans | \$ 9,481,159 | \$ 7,437,036 | \$ 9,623,884 | \$ 7,513,576 |
| Percent of net charge-offs (annualized) to average loans | 0.04% | 0.07% | 0.02% | 0.06% |
| Period-end loans | \$ 9,762,110 | \$ 7,560,931 | | |
| Percent of allowance for loan losses to period-end loans | 1.62% | 1.88% | | |

Interest Rate Risk

The objective of interest rate risk management is to contain the risks associated with interest rate fluctuations. The process involves identification and management of the sensitivity of net interest income to changing interest rates and other market factors. Interest rate risk, one of the more prominent risks in terms of potential earnings impact, is an inevitable part of being a financial intermediary. For more information see Risk Management Interest Rate Risk in the Mercantile Bankshares Corporation's 2003 Annual Report on Form 10-K.

EARNINGS SIMULATION MODEL PROJECTIONS

The following table summarizes the effect a positive 100 and 200 bp change and a negative 50 bp change in interest rates would have on Bankshares' net interest income over the next 12 months.

| Change in interest rates (basis points) | Calculated increase / (decrease) in projected net interest income | |
|--|--|----------------------|
| | June 30, 2004 | December 31, 2003 |

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| | | |
|-------|--------|--------|
| + 200 | 5.4% | 4.6% |
| + 100 | 3.2% | 2.4% |
| - 50 | (2.5)% | (2.1)% |

Bankshares' interest sensitivity has become modestly more asset sensitive since December 31, 2003. Based on its most recent simulation model, Bankshares' net interest income would increase by \$15.6 million and \$26.4 million if interest rates were to move up gradually over the next six months by 100 bp or 200 bp, respectively. A downward movement of 50 bp would reduce net interest income by \$12.3 million. In response to action by the Federal Reserve to increase short-term interest rates, Bankshares raised its prime interest rate by 25 bp on June 30, 2004.

Bankshares has approximately \$3.6 billion in loans that will reprice daily or monthly as prime rate changes. The 25 bp increase is expected to yield approximately \$4.5 million in additional income from these loans through the remainder of 2004. The effects of a rising rate environment on interest expense are less predictable due to customer behavior that shifts the mix. Current trends have seen very strong growth in noninterest bearing demand deposit accounts, while money market accounts and certificates of deposit have decreased. As rates begin to rise, management expects, based on Bankshares' interest sensitivity position, that the margin and net interest income will expand.

Market Risk

Market risk is defined as the impact of changes in market values of assets and liabilities as interest rates and equity markets fluctuate. Changes in market values also impact the fee income earned by IWM, where a significant portion of the fee schedule is tied to current asset values under management or administration. Bankshares has designated substantially all of its investment portfolio as available-for-sale and in accordance with financial reporting standards, this portfolio is reported at fair value. Changes in fair value, net of tax, are reflected as a component of shareholders' equity. Bankshares' maintenance of capital ratios well above regulatory requirements (see Footnote No. 9) provides management with the flexibility to utilize the available-for-sale portfolio for liquidity and interest rate risk management needs, even during a period when valuations are depressed. Maintaining a fairly short duration in the portfolio also mitigates market risk.

Liquidity Risk

Liquidity risk is the possibility that Bankshares will not be able to fund present and future financial obligations. The objective of liquidity management is to maintain the ability to meet commitments to fund loans, purchase securities and repay deposits and other liabilities in accordance with their terms. Core deposits and the available-for-sale investment portfolio are key elements in meeting this objective. For the three months ended June 30, 2004, core deposits (total deposits less certificates of deposit of \$100,000 and over), averaged \$9.1 billion compared to \$8.8 billion for the first quarter of 2004 and \$8.9 billion for the fourth quarter of 2003. Although not viewed as core deposits, a substantial portion of short-term borrowings comprised of securities sold under agreements to repurchase and commercial paper, originate from core deposit relationships tied to the overnight cash management program offered to customers.

By limiting the maturity of securities and maintaining a conservative investment posture, management can rely on the investment portfolio to help meet any short-term funding needs. U.S. Treasury and agency securities, which provide the greatest liquidity, averaged \$1.5 billion in the second quarter of 2004, a 1% decrease from the average of \$1.6 billion for the first quarter of 2004 and a 5% decrease from the average of \$1.6 billion for the fourth quarter 2003. In addition to these sources, Bankshares has access to national markets for certificates of deposit, commercial paper and debt financing. Should it need to further supplement its liquidity, Bankshares has \$1.8 billion in lines with the FHLB Atlanta and back-up commercial paper lines of \$40 million with commercial banks. Bankshares is required to obtain approval from holders of Bankshares 6.72% and 6.80% unsecured senior notes if it incrementally borrows in excess of \$150 million. For more information see Risk Management Liquidity Risk in the Mercantile Bankshares Corporation's 2003 Annual Report on Form 10-K.

In the normal course of business, Bankshares routinely evaluates alternative sources of funding and liquidity. With the current strong demand by real estate investors for stable commercial office properties, management is exploring the merits of a potential sale/leaseback transaction of its headquarters facility at Two Hopkins Plaza, Baltimore, MD. Such a transaction would enhance Bankshares' liquidity through the cash generated on the sale and a reduced investment in bank premises. Management is in the final stages of negotiations with an outside party.

Contractual Obligations and Commitments

Through the normal course of business, Bankshares enters into certain contractual obligations and other commitments. Such obligations generally relate to funding operations through debt arrangements as well as leases of premises and equipment. As a financial services provider, Bankshares routinely enters into commitments to extend credit, including loan commitments, standby letters of credit and financial guarantees. For a discussion of these commitments see Footnote No. 6 Commitments above. For a discussion of contractual commitments see Off-Balance

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Sheet Arrangements and Contractual Obligations in the Mercantile Bankshares Corporation's 2003 Annual Report on Form 10-K. Items disclosed in the Annual Report on Form 10-K have not materially changed since the report was filed with the exception of Bankshares entering into a 7 year service contract with SunGard Wealth Management Services to provide a new core accounting system and assume management of IWM's back-office operations. The table below summarizes the future minimum annual service fees associated with the SunGard contract:

| (Dollars in thousands) | Purchase Obligations |
|------------------------|-------------------------|
| 2004 | \$ 833 |
| 2005 | 5,000 |
| 2006 | 5,000 |
| 2007 | 5,000 |
| 2008 | 5,000 |
| 2009 | 5,000 |
| Thereafter | 9,167 |
| Total | \$ 35,000 |

Cautionary Statement

This report contains financial information determined by methods other than in accordance with Generally Accepted Accounting Principles (GAAP). Bankshares management uses these non-GAAP measures in their analysis of the Company s performance. In, particular, net interest income, net interest margin and the cash operating efficiency ratio are calculated on a fully tax-equivalent basis (FTE). The FTE basis is determined by adjusting net interest income to reflect tax-exempt interest income on a before-tax equivalent basis. These measures typically adjust GAAP performance measures to exclude intangible assets and the amortization of intangible assets related to the consummation of mergers. These operating earnings measures may also exclude other significant gains, losses or expenses that are not considered components of core earnings. Since these items and their impact on Bankshares performance are difficult to predict, management believes presentations of financial measures excluding the impact of these items provide useful supplemental information that is essential to a proper understanding of the operating results and financial position of Bankshares core businesses. These disclosures should not be viewed as a substitute for results determined in accordance with GAAP, nor are they necessarily comparable to operating earnings performance measures that may be presented by other companies.

This report contains forward-looking statements within the meaning of and pursuant to the safe harbor provisions of the Private Securities Litigation Reform Act of 1995. A forward-looking statement encompasses any estimate, prediction, opinion or statement of belief contained in this report, and the underlying management assumptions. Such statements in this report include: identification of trends; loan growth; comments on adequacy of the allowance for loan losses; credit quality; changes in leasing activities; effects of asset sensitivity and interest rate changes; information concerning market risk referenced in Item 3; expected pro forma assets, loans and deposits of the banks resulting from the planned reorganization; and the anticipated effect of the proposed reorganization on operations, regulatory compliance and service to banking customers. Forward-looking statements are based on current expectations and assessments of potential developments affecting market conditions, interest rates and other economic conditions, and results may ultimately vary from the statements made in this report. In addition, the following factors, among others, could cause actual results to differ materially from the anticipated results or expectations expressed in the forward-looking statements: Regulatory approvals for the transactions occurring in connection with the reorganization could be delayed or more burdensome to obtain than currently expected resulting in, among other things, an effective date later than July 2004; administrative and operational efficiencies may not improve to the degree projected; and competitive pressures and regulatory complexities that affect our banks may be stronger than expected.

Supplemental Information by Quarter

Select Financial Data

(in thousands, except per share data)

| | 2Q 04 | 1Q 04 | 4Q 03 | 3Q 03 | 2Q 03 | 2Q 04 vs 1Q 04 | 2Q 04 vs 2Q 03 |
|--|--------------|--------------|--------------|--------------|--------------|----------------------|----------------------|
| OPERATING RESULTS | | | | | | | |
| Net interest income (1) | \$ 133,060 | \$ 133,674 | \$ 133,249 | \$ 122,232 | \$ 112,723 | (0.5)% | 18.0% |
| Net interest income - taxable equivalent (1) | 134,735 | 135,399 | 135,130 | 123,989 | 114,297 | (0.5) | 17.9 |
| Provision for loan losses | 2,353 | 2,426 | 3,033 | 3,005 | 3,051 | (3.0) | (22.9) |
| Net income | 56,313 | 55,697 | 50,645 | 47,173 | 50,010 | 1.1 | 12.6 |
| PER COMMON SHARE DATA | | | | | | | |
| Basic net income | \$.71 | \$.70 | \$.64 | \$.64 | \$.73 | 1.4% | (2.7)% |
| Diluted net income | .71 | .69 | .63 | .63 | .72 | 2.9 | (1.4) |
| Dividends paid | .35 | .33 | .33 | .33 | .33 | 6.1 | 6.1 |
| Book value at period end | 23.28 | 23.61 | 23.08 | 22.89 | 19.91 | (1.4) | 16.9 |
| Market value at period end | 46.82 | 42.93 | 45.58 | 40.00 | 39.35 | 9.1 | 19.0 |
| Market range: | | | | | | | |
| High | 47.93 | 46.01 | 45.95 | 42.49 | 41.30 | 4.2 | 16.1 |
| Low | 40.31 | 41.50 | 39.76 | 38.91 | 33.90 | (2.9) | 18.9 |
| AVERAGE BALANCE SHEET DATA | | | | | | | |
| Total loans | \$ 9,623,884 | \$ 9,338,433 | \$ 9,129,330 | \$ 8,331,265 | \$ 7,513,576 | 3.1% | 28.1% |
| Total earning assets | 12,775,183 | 12,475,851 | 12,523,854 | 11,750,966 | 10,465,457 | 2.4 | 22.1 |
| Total assets | 13,939,185 | 13,618,193 | 13,666,099 | 12,622,100 | 11,033,724 | 2.4 | 26.3 |
| Total deposits | 10,398,257 | 10,066,645 | 10,168,699 | 9,388,714 | 8,313,714 | 3.3 | 25.1 |
| Shareholders' equity | 1,851,761 | 1,848,461 | 1,811,742 | 1,550,937 | 1,324,293 | 0.2 | 39.8 |
| STATISTICS AND RATIOS (Net income annualized) | | | | | | | |
| Return on average assets | 1.62% | 1.64% | 1.47% | 1.48% | 1.82% | | |
| Return on average equity (2) | 12.23 | 12.12 | 11.09 | 12.07 | 15.15 | | |
| Return on average tangible equity (2) | 18.14 | 18.01 | 16.49 | 15.70 | 17.05 | | |
| Average equity to average assets (2) | 13.28 | 13.57 | 13.26 | 12.29 | 12.00 | | |
| Average tangible equity to average tangible assets (2) | 9.55 | 9.75 | 9.51 | 9.91 | 10.91 | | |
| Net interest rate spread - taxable equivalent | 3.91 | 4.03 | 3.93 | 3.81 | 3.94 | | |
| Net interest margin on earning assets - taxable equivalent | 4.24 | 4.37 | 4.28 | 4.19 | 4.38 | | |
| Efficiency ratio (1),(3) | 50.12 | 50.40 | 54.47 | 53.67 | 48.24 | | |
| Operating efficiency ratio (1),(3) | 49.03 | 49.24 | 50.92 | 51.14 | 49.24 | | |
| Dividend payout ratio | 49.30 | 47.14 | 51.56 | 51.56 | 45.21 | | |
| Bank offices | 229 | 229 | 227 | 236 | 187 | | 42 |
| Employees | 3,508 | 3,575 | 3,565 | 3,642 | 3,035 | (67) | 473 |
| CREDIT QUALITY DATA AT PERIOD END | | | | | | | |
| Net charge-offs | \$ 557 | \$ 1,128 | \$ 3,450 | \$ 2,717 | \$ 1,217 | (50.6)% | (54.2)% |
| Nonaccrual loans | 39,888 | 48,007 | 50,352 | 51,001 | 37,768 | (16.9) | 5.6 |

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| | | | | | | | |
|------------------------------|---------------|--------|--------|--------|--------|--------|-----|
| Restructured loans | | | | | | | |
| Total nonperforming loans | 39,888 | 48,007 | 50,352 | 51,001 | 37,768 | (16.9) | 5.6 |
| Other real estate owned, net | 402 | 134 | 191 | 397 | 376 | 200.0 | 6.9 |
| Total nonperforming assets | 40,290 | 48,141 | 50,543 | 51,398 | 38,144 | (16.3) | 5.6 |

CREDIT QUALITY RATIOS

| | | | | | | | |
|--|---------------|--------|--------|--------|--------|--|--|
| Provision for loan losses (annualized) as a percent of period-end loans | .10% | .10% | .13% | .13% | .16% | | |
| Net charge-offs (annualized) as a percent of period-end loans | .02 | .05 | .15 | .12 | .06 | | |
| Nonperforming loans as a percent of period-end loans | .41 | .51 | .54 | .57 | .50 | | |
| Allowance for loan losses as a percent of period-end loans | 1.62 | 1.66 | 1.68 | 1.73 | 1.88 | | |
| Allowance for loan losses as a percent of nonperforming loans | 397.19 | 326.28 | 308.50 | 305.39 | 376.67 | | |
| Other real estate owned as a percent of period-end loans and other real estate owned | | | | | | | |
| Nonperforming assets as a percent of period-end loans and other real estate owned | .41 | .51 | .55 | .57 | .50 | | |
| Nonperforming assets as a percent of total assets | .29 | .34 | .37 | .37 | .33 | | |

(1),(2),(3) See Reconciliation of Non-GAAP measures on page 33 for additional information.

Statements of Consolidated Income

(in thousands, except per share data)

| | 2Q 04 | 1Q 04 | 4Q 03 | 3Q 03 | 2Q 03 | 2Q 04 vs 1Q 04 | 2Q 04 vs 2Q 03 |
|--|------------------|------------------|------------------|------------------|------------------|----------------------|----------------------|
| INTEREST INCOME | | | | | | | |
| Interest and fees on loans | \$ 132,116 | \$ 129,060 | \$ 129,288 | \$ 120,137 | \$ 111,962 | 2.4% | 18.0% |
| Interest and dividends on investment securities: | | | | | | | |
| Taxable interest income | 26,165 | 27,401 | 28,660 | 27,285 | 26,638 | (4.5) | (1.8) |
| Tax-exempt interest income | 820 | 877 | 999 | 783 | 497 | (6.5) | 65.0 |
| Dividends | 300 | 261 | 114 | 212 | 199 | 14.9 | 50.8 |
| Other investment income | (372) | 3,341 | 2,578 | 1,508 | 2,318 | (111.1) | (116.0) |
| | 26,913 | 31,880 | 32,351 | 29,788 | 29,652 | (15.6) | (9.2) |
| Other interest income | 589 | 175 | 630 | 1,291 | 1,314 | 236.6 | (55.2) |
| Total interest income | 159,618 | 161,115 | 162,269 | 151,216 | 142,928 | (0.9) | 11.7 |
| INTEREST EXPENSE | | | | | | | |
| Interest on deposits | 19,873 | 20,767 | 22,298 | 22,313 | 23,450 | (4.3) | (15.3) |
| Interest on short-term borrowings | 1,480 | 1,419 | 1,287 | 1,303 | 1,469 | 4.3 | 0.7 |
| Interest on long-term debt | 5,205 | 5,255 | 5,435 | 5,368 | 5,286 | (1.0) | (1.5) |
| Total interest expense | 26,558 | 27,441 | 29,020 | 28,984 | 30,205 | (3.2) | (12.1) |
| NET INTEREST INCOME | | | | | | | |
| Provision for loan losses | 2,353 | 2,426 | 3,033 | 3,005 | 3,051 | (3.0) | (22.9) |
| NET INTEREST INCOME AFTER PROVISION FOR LOAN LOSSES | 130,707 | 131,248 | 130,216 | 119,227 | 109,672 | (0.4) | 19.2 |
| NONINTEREST INCOME | | | | | | | |
| Investment and wealth management | 22,936 | 21,983 | 21,483 | 20,577 | 19,508 | 4.3 | 17.6 |
| Service charges on deposit accounts | 10,351 | 10,119 | 10,840 | 9,701 | 8,311 | 2.3 | 24.5 |
| Mortgage banking related fees | 2,293 | 2,940 | 2,813 | 3,403 | 2,507 | (22.0) | (8.5) |
| Investment securities gains and (losses) | 590 | (55) | 122 | (336) | 6,536 | | (91.0) |
| Other income | 15,380 | 14,898 | 12,140 | 12,558 | 8,575 | 3.2 | 79.4 |
| Total noninterest income | 51,550 | 49,885 | 47,398 | 45,903 | 45,437 | 3.3 | 13.5 |
| NONINTEREST EXPENSES | | | | | | | |
| Salaries | 44,689 | 44,788 | 45,724 | 43,870 | 36,317 | (0.2) | 23.1 |
| Employee benefits | 10,928 | 12,513 | 8,826 | 10,144 | 9,319 | (12.7) | 17.3 |
| Net occupancy expense of bank premises | 5,819 | 6,060 | 7,305 | 5,136 | 4,219 | (4.0) | 37.9 |
| Furniture and equipment expenses | 7,573 | 7,364 | 9,636 | 8,432 | 6,743 | 2.8 | 12.3 |
| Communications and supplies | 4,195 | 4,304 | 4,682 | 3,889 | 3,181 | (2.5) | 31.9 |
| Other expenses | 20,163 | 18,357 | 23,255 | 19,718 | 17,270 | 9.8 | 16.8 |
| Total noninterest expenses | 93,367 | 93,386 | 99,428 | 91,189 | 77,049 | | 21.2 |
| Income before income taxes | 88,890 | 87,747 | 78,186 | 73,941 | 78,060 | 1.3 | 13.9 |
| Applicable income taxes | 32,577 | 32,050 | 27,541 | 26,768 | 28,050 | 1.6 | 16.1 |
| NET INCOME | \$ 56,313 | \$ 55,697 | \$ 50,645 | \$ 47,173 | \$ 50,010 | 1.1 | 12.6 |
| Weighted average shares outstanding | | | | | | | |
| Weighted average shares outstanding | 79,119 | 79,725 | 79,554 | 74,253 | 68,860 | (0.8) | 14.9 |
| Adjusted weighted average shares outstanding | 79,751 | 80,258 | 80,196 | 74,840 | 69,318 | (0.6) | 15.1 |

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NET INCOME PER COMMON

SHARE:

| | | | | | | | | | | | | |
|---------|----|-----|----|-----|----|-----|----|-----|----|-----|-----|-------|
| Basic | \$ | .71 | \$ | .70 | \$ | .64 | \$ | .64 | \$ | .73 | 1.4 | (2.7) |
| Diluted | \$ | .71 | \$ | .69 | \$ | .63 | \$ | .63 | \$ | .72 | 2.9 | (1.4) |

Statements of Consolidated Noninterest Income and Noninterest Expenses

(in thousands)

| Noninterest Income | 2Q 04 | 1Q 04 | 4Q 03 | 3Q 03 | 2Q 03 | 2Q 04 vs 1Q 04 | 2Q 04 vs 2Q 03 |
|--|-----------|-----------|-----------|-----------|-----------|----------------------|----------------------|
| Investment and wealth management | \$ 22,936 | \$ 21,983 | \$ 21,483 | \$ 20,577 | \$ 19,508 | 4.3% | 17.6% |
| Service charges on deposit accounts | 10,351 | 10,119 | 10,840 | 9,701 | 8,311 | 2.3 | 24.5 |
| Mortgage banking related fees: | | | | | | | |
| Commercial | 1,563 | 1,920 | 1,555 | 1,773 | 1,693 | (18.6) | (7.7) |
| Residential | 730 | 1,020 | 1,258 | 1,630 | 814 | (28.4) | (10.3) |
| Total mortgage banking related fees | 2,293 | 2,940 | 2,813 | 3,403 | 2,507 | (22.0) | (8.5) |
| Investment securities gains and (losses) | 590 | (55) | 122 | (336) | 6,536 | | (91.0) |
| Other income: | | | | | | | |
| Electronic banking fees | 5,951 | 4,400 | 4,083 | 5,133 | 4,145 | 35.3 | 43.6 |
| Charges and fees on loans | 2,835 | 2,458 | 2,602 | 2,430 | 2,069 | 15.3 | 37.0 |
| Insurance | 3,267 | 3,828 | 2,670 | 1,653 | 175 | (14.7) | |
| Bank-owned life insurance | 785 | 794 | 576 | 559 | 439 | (1.1) | 78.8 |
| All other income | 2,542 | 3,418 | 2,209 | 2,783 | 1,747 | (25.6) | 45.5 |
| Total other income | 15,380 | 14,898 | 12,140 | 12,558 | 8,575 | 3.2 | 79.4 |
| Total | \$ 51,550 | \$ 49,885 | \$ 47,398 | \$ 45,903 | \$ 45,437 | 3.3% | 13.5% |

| Noninterest Expenses | 2Q 04 | 1Q 04 | 4Q 03 | 3Q 03 | 2Q 03 | 2Q 04 vs 1Q 04 | 2Q 04 vs 2Q 03 |
|--|-----------|-----------|-----------|-----------|-----------|----------------------|----------------------|
| Salaries | \$ 44,689 | \$ 44,788 | \$ 45,724 | \$ 43,870 | \$ 36,317 | (0.2%) | 23.1% |
| Employee benefits | 10,928 | 12,513 | 8,826 | 10,144 | 9,319 | (12.7) | 17.3 |
| Net occupancy expense of bank premises | 5,819 | 6,060 | 7,305 | 5,136 | 4,219 | (4.0) | 37.9 |
| Furniture and equipment expenses | 7,573 | 7,364 | 9,636 | 8,432 | 6,743 | 2.8 | 12.3 |
| Communications and supplies | 4,195 | 4,304 | 4,682 | 3,889 | 3,181 | (2.5) | 31.9 |
| Other expenses: | | | | | | | |
| Professional services | 4,996 | 3,834 | 7,080 | 5,380 | 4,962 | 30.3 | 0.7 |
| Advertising and promotional expenses | 2,135 | 1,703 | 3,275 | 2,168 | 2,247 | 25.4 | (5.0) |
| Electronic banking expenses | 2,485 | 1,929 | 1,791 | 2,432 | 1,851 | 28.8 | 34.3 |
| Amortization of intangible assets | 2,056 | 2,032 | 1,847 | 1,688 | 848 | 1.2 | 142.5 |
| Outsourcing expenses | 1,227 | 1,459 | 1,136 | 1,049 | 1,010 | (15.9) | 21.5 |
| All other expenses | 7,264 | 7,400 | 8,126 | 7,001 | 6,352 | (1.8) | 14.4 |
| Total other expenses | 20,163 | 18,357 | 23,255 | 19,718 | 17,270 | 9.8 | 16.8 |
| Total | \$ 93,367 | \$ 93,386 | \$ 99,428 | \$ 91,189 | \$ 77,049 | % | 21.2% |

Consolidated Average Balance Sheets

(in thousands)

| | 2Q04 | | 1Q04 | | 4Q03 | | 3Q03 | | 2Q03 | | Average Balance 2Q 04 vs 1Q 04 vs 2Q 03 | |
|--|--------------------|-----------------|--------------------|-----------------|--------------------|-----------------|--------------------|-----------------|--------------------|-----------------|--|--------|
| | Average Balance | Yield*/ Rate | Average Balance | Yield*/ Rate | Average Balance | Yield*/ Rate | Average Balance | Yield*/ Rate | Average Balance | Yield*/ Rate | | |
| Earning assets | | | | | | | | | | | | |
| Loans: ** | | | | | | | | | | | | |
| Commercial | \$ 2,727,051 | 5.13% | \$ 2,632,605 | 5.14% | \$ 2,628,283 | 5.13% | \$ 2,508,721 | 5.28% | \$ 2,411,227 | 5.57% | 3.6% | 13.1% |
| Commercial real estate | | | | | | | | | | | | |
| estate | 2,871,615 | 5.83 | 2,768,779 | 5.91 | 2,664,891 | 6.00 | 2,391,892 | 6.02 | 2,116,259 | 6.31 | 3.7 | 35.7 |
| Construction | 1,113,301 | 5.21 | 1,103,901 | 5.18 | 1,053,049 | 5.25 | 969,251 | 5.34 | 870,955 | 5.51 | 0.9 | 27.8 |
| Residential real estate | | | | | | | | | | | | |
| estate | 1,437,331 | 5.91 | 1,358,975 | 6.06 | 1,309,345 | 6.13 | 1,205,020 | 6.28 | 1,089,772 | 6.63 | 5.8 | 31.9 |
| Consumer | 1,474,586 | 5.81 | 1,474,173 | 5.79 | 1,473,762 | 5.94 | 1,256,381 | 6.18 | 1,025,363 | 6.42 | | 43.8 |
| Total loans | 9,623,884 | 5.57 | 9,338,433 | 5.61 | 9,129,330 | 5.67 | 8,331,265 | 5.78 | 7,513,576 | 6.04 | 3.1 | 28.1 |
| Federal funds sold, et al | | | | | | | | | | | | |
| | 95,504 | 2.48 | 47,791 | 1.47 | 215,329 | 1.15 | 413,675 | 1.19 | 313,844 | 1.68 | 99.8 | (69.6) |
| Securities: *** | | | | | | | | | | | | |
| Taxable securities | | | | | | | | | | | | |
| U.S. Treasury and gov. agencies | | | | | | | | | | | | |
| | 1,543,661 | 3.74 | 1,560,700 | 3.89 | 1,629,554 | 4.01 | 1,629,544 | 4.19 | 1,741,380 | 4.32 | (1.1) | (11.4) |
| Mortgage-backed | | | | | | | | | | | | |
| | 1,254,512 | 3.78 | 1,277,802 | 3.87 | 1,275,875 | 3.79 | 1,150,073 | 3.48 | 760,630 | 4.15 | (1.8) | 64.9 |
| Other investments | | | | | | | | | | | | |
| | 159,282 | (.17) | 146,592 | 9.90 | 142,405 | 7.51 | 120,093 | 5.70 | 98,277 | 10.38 | 8.7 | 62.1 |
| Tax-exempt securities | | | | | | | | | | | | |
| States and political subdivisions | | | | | | | | | | | | |
| | 98,182 | 5.55 | 104,375 | 5.59 | 117,374 | 5.59 | 84,944 | 6.05 | 37,412 | 8.82 | (5.9) | 162.4 |
| Total securities | | | | | | | | | | | | |
| | 3,055,637 | 3.61 | 3,089,469 | 4.23 | 3,165,208 | 4.14 | 2,984,654 | 4.03 | 2,637,699 | 4.56 | (1.1) | 15.8 |
| Interest-bearing deposits in other banks | | | | | | | | | | | | |
| | 158 | 1.06 | 158 | 1.09 | 13,987 | .23 | 21,372 | .85 | 338 | 3.50 | | (53.3) |
| Total earning assets | | | | | | | | | | | | |
| | 12,775,183 | 5.08 | 12,475,851 | 5.25 | 12,523,854 | 5.20 | 11,750,966 | 5.16 | 10,465,457 | 5.54 | 2.4 | 22.1 |
| Cash and due from banks | | | | | | | | | | | | |
| | 298,440 | | 285,524 | | 298,581 | | 295,289 | | 243,728 | | 4.5 | 22.4 |
| Bank premises and equipment, net | | | | | | | | | | | | |
| | 141,757 | | 141,632 | | 139,022 | | 124,275 | | 104,825 | | 0.1 | 35.2 |
| Other assets | | | | | | | | | | | | |
| | 881,921 | | 871,583 | | 861,348 | | 602,614 | | 361,951 | | 1.2 | 143.7 |
| Less: allowance for loan losses | | | | | | | | | | | | |
| | (158,116) | | (156,397) | | (156,706) | | (151,044) | | (142,237) | | 1.1 | 11.2 |
| Total assets | | | | | | | | | | | | |
| | \$ 13,939,185 | | \$ 13,618,193 | | \$ 13,666,099 | | \$ 12,622,100 | | \$ 11,033,724 | | 2.4 | 26.3 |
| Interest-bearing liabilities | | | | | | | | | | | | |
| Deposits: | | | | | | | | | | | | |
| Savings | | | | | | | | | | | | |
| | \$ 1,434,288 | .29 | \$ 1,364,181 | .29 | \$ 1,341,697 | .30 | \$ 1,218,813 | .30 | \$ 1,078,760 | .51 | 5.1 | 33.0 |
| Checking plus interest | | | | | | | | | | | | |
| | 1,302,313 | .15 | 1,236,552 | .15 | 1,217,573 | .16 | 1,119,989 | .16 | 993,268 | .22 | 5.3 | 31.1 |
| Money market | | | | | | | | | | | | |
| | 1,564,295 | .54 | 1,590,460 | .60 | 1,606,119 | .62 | 1,431,262 | .61 | 1,201,044 | .81 | (1.6) | 30.2 |

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| | | | | | | | | | | | | |
|---|----------------------|--------------|---------------|------|---------------|------|---------------|------|---------------|------|-------|------|
| Time deposits | | | | | | | | | | | | |
| \$100,000 and over | 1,315,119 | 1.82 | 1,287,695 | 1.99 | 1,316,951 | 2.08 | 1,270,016 | 2.20 | 1,277,652 | 2.37 | 2.1 | 2.9 |
| Other time deposits | 1,955,632 | 2.12 | 1,979,433 | 2.15 | 2,038,739 | 2.21 | 1,942,113 | 2.39 | 1,708,177 | 2.72 | (1.2) | 14.5 |
| Total interest-bearing deposits | 7,571,647 | 1.06 | 7,458,321 | 1.12 | 7,521,079 | 1.18 | 6,982,193 | 1.27 | 6,258,901 | 1.50 | 1.5 | 21.0 |
| Short-term borrowings | 910,854 | .65 | 919,388 | .62 | 907,914 | .56 | 944,979 | .55 | 771,892 | .76 | (0.9) | 18.0 |
| Long-term debt | 648,576 | 3.23 | 649,058 | 3.26 | 649,516 | 3.32 | 611,801 | 3.48 | 527,223 | 4.02 | (0.1) | 23.0 |
| Total interest-bearing funds | 9,131,077 | 1.17 | 9,026,767 | 1.22 | 9,078,509 | 1.27 | 8,538,973 | 1.35 | 7,558,016 | 1.60 | 1.2 | 20.8 |
| Noninterest-bearing deposits | 2,826,610 | | 2,608,324 | | 2,647,620 | | 2,406,521 | | 2,054,813 | | 8.4 | 37.6 |
| Other liabilities and accrued expenses | 129,737 | | 134,641 | | 128,228 | | 125,669 | | 96,602 | | (3.6) | 34.3 |
| Total liabilities | 12,087,424 | | 11,769,732 | | 11,854,357 | | 11,071,163 | | 9,709,431 | | 2.7 | 24.5 |
| Shareholders equity | 1,851,761 | | 1,848,461 | | 1,811,742 | | 1,550,937 | | 1,324,293 | | 0.2 | 39.8 |
| Total liabilities & shareholders equity | \$ 13,939,185 | | \$ 13,618,193 | | \$ 13,666,099 | | \$ 12,622,100 | | \$ 11,033,724 | | 2.4 | 26.3 |
| Net interest rate spread | | 3.91% | 4.03% | | 3.93% | | 3.81% | | 3.94% | | | |
| Effect of noninterest-bearing funds | | .33 | .34 | | .35 | | .38 | | .44 | | | |
| Net interest margin on earning assets | | 4.24% | 4.37% | | 4.28% | | 4.19% | | 4.38% | | | |

* Presented on a tax-equivalent basis using the statutory federal corporate income tax rate of 35% (see reconciliation of non-GAAP measures on page 33)

** Nonaccrual loans are included in average loans

*** Balances reported at amortized cost; excludes pretax unrealized gains (losses) on securities available-for-sale

Reconciliation of Non-GAAP Measures (unaudited)

(In thousands, except per share data)

| | YTD 2004 | YTD 2003 | 2 Q 04 | 1 Q 04 | 4 Q 03 | 3 Q 03 | 2 Q 03 |
|--|-------------|-------------|--------|--------|--------|--------|--------|
|--|-------------|-------------|--------|--------|--------|--------|--------|

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

| | | | | | | | |
|--|------------|------------|------------|------------|------------|------------|------------|
| Net interest income (GAAP basis) | \$ 266,734 | \$ 223,849 | \$ 133,060 | \$ 133,674 | \$ 133,249 | \$ 122,232 | \$ 112,723 |
| Taxable-equivalent adjustment | 3,400 | 3,122 | 1,675 | 1,725 | 1,881 | 1,757 | 1,574 |
| Net interest income - taxable equivalent | \$ 270,134 | \$ 226,971 | \$ 134,735 | \$ 135,399 | \$ 135,130 | \$ 123,989 | \$ 114,297 |

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

| | | | | | | | |
|--|--------|--------|--------|--------|--------|--------|--------|
| Return on average assets (GAAP basis) | 1.63% | 1.85% | 1.62% | 1.64% | 1.47% | 1.48% | 1.82% |
| Impact of excluding average intangible Assets and amortization | 0.11 | 0.04 | 0.11 | 0.12 | 0.10 | 0.08 | 0.04 |
| Return on average tangible assets | 1.74% | 1.89% | 1.73% | 1.76% | 1.57% | 1.56% | 1.86% |
| Return on average equity (GAAP basis) | 12.18% | 15.24% | 12.23% | 12.12% | 11.09% | 12.07% | 15.15% |
| Impact of excluding average intangible Assets and amortization | 5.92 | 1.78 | 5.91 | 5.89 | 5.40 | 3.63 | 1.90 |
| Return on average tangible equity | 18.10% | 17.02% | 18.14% | 18.01% | 16.49% | 15.70% | 17.05% |
| Average equity to average assets (GAAP basis) | 13.42% | 12.15% | 13.28% | 13.57% | 13.26% | 12.29% | 12.00% |
| Impact of excluding average intangible Assets and amortization | (3.78) | (1.05) | (3.73) | (3.82) | (3.75) | (2.38) | (1.09) |
| Average tangible equity to average tangible assets | 9.64% | 11.10% | 9.55% | 9.75% | 9.51% | 9.91% | 10.91% |

When computing the cash operating efficiency ratio and cash operating earnings, management excludes the amortization of intangible assets, restructuring charges, merger-related expenses, gains on building sales and gains and losses from sales of investment securities in order to assess the core operating results of the Company and because of the uncertainty as to timing and amount of gain or losses to be recognized.

(3) The efficiency ratio is measured by dividing noninterest expenses by the sum of net interest income on a FTE basis and noninterest income.

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| | | | | | | | |
|-------------------------------------|--------|--------|--------|--------|--------|--------|--------|
| Efficiency ratio (GAAP basis) | 50.26% | 47.32% | 50.12% | 50.40% | 54.47% | 53.67% | 48.24% |
| Impact of excluding: | | | | | | | |
| Securities gains and (losses) | 0.07 | 1.11 | 0.16 | (0.01) | 0.04 | (0.10) | 2.05 |
| Gains on building sales | 0.13 | 0.04 | 0.08 | 0.17 | | | 0.02 |
| Amortization of deposit intangibles | (0.74) | (0.23) | (0.73) | (0.74) | (0.60) | (0.69) | (0.23) |
| Amortization of other intangibles | (0.36) | (0.21) | (0.37) | (0.36) | (0.40) | (0.30) | (0.32) |
| Restructuring charges | (0.11) | | (0.23) | | | | |
| Merger-related expenses | (0.11) | (0.27) | | (0.22) | (2.59) | (1.44) | (0.52) |
| Cash operating efficiency ratio | 49.14% | 47.76% | 49.03% | 49.24% | 50.92% | 51.14% | 49.24% |

(4) Bankshares presents cash operating earnings and diluted cash operating earnings per share in order to assess the core operating results of the Company.

| | | | | | | | | | | | | | | |
|---|----|---------|----|---------|----|--------|----|--------|----|--------|----|--------|----|---------|
| Net income (GAAP basis) | \$ | 112,010 | \$ | 98,996 | \$ | 56,313 | \$ | 55,697 | \$ | 50,645 | \$ | 47,173 | \$ | 50,010 |
| Less: Securities (gains) and losses, net of tax | | (323) | | (4,444) | | (357) | | 33 | | (74) | | 203 | | (3,951) |
| Gains on building sales | | (583) | | (138) | | (189) | | (394) | | | | | | (52) |
| Plus: Amortization of deposit intangibles, net of tax | | 1,653 | | 442 | | 826 | | 826 | | 670 | | 708 | | 221 |
| Amortization of other intangibles, net of tax | | 819 | | 409 | | 417 | | 402 | | 446 | | 311 | | 292 |
| Restructuring charges, net of tax | | 251 | | | | 251 | | | | | | | | |
| Merger-related expenses, net of tax | | 248 | | 518 | | | | 248 | | 2,847 | | 1,481 | | 487 |
| Cash operating earnings | \$ | 114,075 | \$ | 95,783 | \$ | 57,261 | \$ | 56,812 | \$ | 54,534 | \$ | 49,876 | \$ | 47,007 |
| Diluted net income per share (GAAP basis) | \$ | 1.40 | \$ | 1.43 | \$ | 0.71 | \$ | 0.69 | \$ | 0.63 | \$ | 0.63 | \$ | 0.72 |
| Less: Securities (gains) and losses, net of tax | | | | (0.08) | | | | | | | | | | (0.06) |
| Gains on building sales | | | | | | | | | | | | | | |
| Plus: Amortization of deposit intangibles, net of tax | | 0.02 | | 0.01 | | 0.01 | | 0.01 | | 0.01 | | 0.01 | | 0.01 |
| Amortization of other intangibles, net of tax | | 0.01 | | 0.01 | | | | 0.01 | | 0.01 | | 0.01 | | 0.01 |
| Restructuring charges, net of tax | | | | | | | | | | | | | | |
| Merger-related expenses, net of tax | | | | 0.01 | | | | | | 0.04 | | 0.02 | | 0.01 |
| Diluted cash operating earnings per share | \$ | 1.43 | \$ | 1.38 | \$ | 0.72 | \$ | 0.71 | \$ | 0.69 | \$ | 0.67 | \$ | 0.68 |

Item 3. Quantitative and Qualitative Disclosures About Market Risk

Information responsive to this item as of December 31, 2003 appears under the captions *Risk Management*, *Interest Rate Sensitivity Analysis (Static Gap)* and *Earnings Simulation Model Projections* of the registrant's Form 10-K for the year ended December 31, 2003. There was no material change in such information as of June 30, 2004.

Item 4. Controls and Procedures

As of June 30, 2004, Bankshares' management, under the supervision and with the participation of the Company's principal executive officer and principal financial officer, evaluated the effectiveness of the design and operation of the Company's disclosure controls and procedures, as that term is defined in Rule 13a-15(e) under the Securities and Exchange Act of 1934, as amended. Based on the evaluation, the principal executive officer and principal financial officer concluded that the Company's disclosure controls and procedures are effective. There were no significant changes in the Company's internal controls during the last fiscal quarter.

PART II OTHER INFORMATION

Item 1. Legal Proceedings

On July 12, former employee John Pileggi filed suit against Mercantile Bankshares Corp., Mercantile Safe Deposit and Trust Company and Edward J. Kelly. The complaint alleges that the public statements made by the defendants regarding the circumstances of Mr. Pileggi's termination gives rise to claims of libel, invasion of privacy and false light. Mr. Pileggi also alleges breach of contract. The complaint seeks actual and punitive damages amounting to \$240 million. The Bank terminated Mr. Pileggi's employment on March 18, 2004 for the reasons set out in a press release of that same date. Bankshares believes the suit is without merit.

Item 2. Changes in Securities, Use of Proceeds and Issuer Purchases of Equity Securities

(e) Issuer Purchases of Equity Securities:

| | (a) | (b) | (c) | (d) |
|------------------------------------|----------------------------------|------------------------------|--|---|
| | Total number of shares purchased | Average price paid per share | Number of shares purchased as part of publicly announced plans or programs | Maximum number of shares that may yet be purchased under the plan or programs (1) |
| January 1, 2004 - January 31, 2004 | | \$ | | 1,476,327 |

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| | | | | |
|--------------------------------------|-----------|----|-------|-----------|
| February 1, 2004 - February 29, 2004 | | | | 1,476,327 |
| March 1, 2004 - March 31, 2004 | | | | 1,476,327 |
| April 1, 2004 - April 30, 2004 | 1,000,000 | | 44.11 | 1,000,000 |
| May 1, 2004 - May 31, 2004 | | | | 476,327 |
| June 1, 2004 - June 30, 2004 | | | | 476,327 |
| Total | 1,000,000 | \$ | 44.11 | 1,000,000 |

(1) On December 11, 2001 Bankshares Board of Directors authorized the purchase of 2 million shares of Mercantile Bankshares common stock.

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

Matters voted upon and considered at the Annual Meeting of Shareholders held on May 11, 2004. There were 79,968,512 shares of Common Stock entitled to vote at the meeting and a total of 64,490,568 shares, or 80.8%, were represented at the meeting.

Elect the following individuals as directors of Bankshares to serve until the 2007 Annual Meeting of Stockholders and until successors are duly elected and qualify. The results of voting for election of directors were:

| | For | Withheld |
|------------------------|------------|-----------------|
| Cynthia A. Archer | 63,476,057 | 1,014,511 |
| Richard O. Berndt | 63,501,359 | 989,209 |
| Howard B. Bowen | 63,925,667 | 564,901 |
| William R. Brody, M.D. | 63,460,351 | 1,030,217 |
| Edward J. Kelly, III | 63,808,249 | 682,319 |
| Morton B. Plant | 63,876,328 | 614,240 |

The following directors terms of office continued after the meeting and were not up for reelection:

R. Carl Benna

Eddie C. Brown

George L. Bunting, Jr.

Anthony W. Deering

Darrell D. Friedman

Freeman A. Hrabowski, III

Robert A. Kinsley

Jenny G. Morgan

Christian H. Poindexter

Clayton S. Rose

James L. Shea

Donald J. Shepard

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Ratified the appointment of PricewaterhouseCoopers LLP as Bankshares Independent Public Accountant for 2004. The voting results of shares represented by proxy were:

| For | Against | Abstained | Broker nonvotes |
|------------|-----------|-----------|-----------------|
| 62,585,378 | 1,420,400 | 484,790 | |

Approve the Mercantile Bankshares Corporation 1999 Omnibus Stock Plan, as amended. The results of voting regarding the 1999 Omnibus Stock Plan were:

| For | Against | Abstained | Broker nonvotes |
|------------|-----------|-----------|-----------------|
| 45,088,196 | 5,435,231 | 1,210,452 | 12,756,689 |

Approve the Mercantile Bankshares Corporation and Affiliates Unfunded Deferred Compensation Plan for Directors, as amended. The results of voting regarding the Unfunded Deferred Compensation Plan for Directors were:

| For | Against | Abstained | Broker nonvotes |
|------------|-----------|-----------|-----------------|
| 45,003,956 | 5,419,240 | 1,310,682 | 12,756,690 |

Item 6. Exhibits and Reports on Form 8-K

(a) Exhibits

31.1 Section 302 Certification of Chief Executive Officer. Filed as an exhibit hereto and incorporated herein by reference

31.2 Section 302 Certification of Chief Financial Officer. Filed as an exhibit hereto and incorporated herein by reference

32.1 Section 906 Certification of Chief Executive Officer. Filed as an exhibit hereto and incorporated herein by reference

32.2 Section 906 Certification of Chief Financial Officer. Filed as an exhibit hereto and incorporated herein by reference

(b) Reports on Form 8-K

Form 8-K filed, dated April 20, 2004, Item 9. Regulation FD Disclosure, announced first quarter earnings.

Form 8-K filed, dated April 26, 2004, Item 5. Other Events and Regulation FD Disclosure, announced that its Board of Directors has determined that a significant majority are independent under the Nasdaq Rules.

Form 8-K filed, dated April 30, 2004, Item 5. Other Events and Regulation FD Disclosure, announced that it has initiated a significant reorganization within its affiliate bank network

Form 8-K filed, dated June 8, 2004, Item 5. Other Events and Regulation FD Disclosure, announced quarterly cash dividend

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.

Mercantile Bankshares Corporation
(Registrant)

August 6, 2004
Date

/s/ Edward J. Kelly, III
By: Edward J. Kelly, III
Chairman of the Board,
President and
Chief Executive Officer

August 6, 2004
Date

/s/ Terry L. Troupe
By: Terry L. Troupe
Chief Financial Officer

August 6, 2004
Date

/s/ William T. Skinner, Jr.
By: William T. Skinner, Jr.
Controller