

SHORE BANCSHARES INC  
Form 10-K  
March 16, 2009

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

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FORM 10-K

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

For the Year Ended December 31, 2008

Commission File No. 0-22345

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

Maryland  
(State or Other Jurisdiction of  
Incorporation or Organization)

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

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

21601  
(Zip Code)

(410) 822-1400

Registrant's Telephone Number, Including Area Code

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

Title of Each Class:  
Common stock, par value \$.01 per share

Name of Each Exchange on Which Registered:  
Nasdaq Global Select Market

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

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

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

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

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

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

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

Yes  No

State the aggregate market value of the voting and non-voting common equity held by non-affiliates computed by reference to the price at which the common equity was last sold, or the average bid and asked price of such common equity, as of the last business day of the registrant's most recently completed second fiscal quarter: \$147,590,539.

The number of shares outstanding of the registrant's common stock as of the latest practicable date: 8,404,709 as of March 2, 2009.

Documents Incorporated by Reference

Certain information required by Part III of this annual report is incorporated herein by reference to the definitive proxy statement for the 2009 Annual Meeting of Stockholders.

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

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

## PART I

### Item 1. Business.

#### BUSINESS

##### General

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

Talbot Bank owns all of the issued and outstanding securities of Dover Street Realty, Inc., a Maryland corporation that engages in the business of holding and managing real property acquired by Talbot Bank as a result of loan foreclosures.

We operate in two business segments: community banking and insurance products and services. Financial information related to our operations in these segments for each of the two years ended December 31, 2008 is provided in Note 25 to the Company's Consolidated Financial Statements included in Item 8 of Part II of this report.

#### Banking Products and Services

Centreville National Bank is a national banking association that commenced operations in 1876. Talbot Bank is a Maryland commercial bank that commenced operations in 1885 and was acquired by the Company in its December 2000 merger with Talbot Bancshares, Inc. ("Talbot Bancshares"). Felton Bank is a Delaware commercial bank that commenced operations in 1908 and was acquired by the Company in April 2004 when it merged with Midstate Bancorp, Inc. The Banks operate 18 full service branches and 22 ATMs and provide a full range of commercial and consumer banking products and services to

individuals, businesses, and other organizations in the Kent County, Queen Anne's County, Caroline County, Talbot County and Dorchester County in Maryland and in Kent County, Delaware. The Banks' deposits are insured by the Federal Deposit Insurance Corporation (the "FDIC").

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

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

#### Lending Activities

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

Commercial real estate loans are primarily those secured by land for residential and commercial development, agricultural purpose properties, service industry buildings such as restaurants and motels, retail buildings and general purpose business space. The Banks attempt to mitigate the risks associated with these loans through thorough financial analyses, conservative underwriting procedures, including prudent loan to value ratio standards, obtaining additional collateral when prudent, closely monitoring construction projects to control disbursement of funds on loans, and management's knowledge of the local economy in which the Banks lend.

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

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

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

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

### Deposit Activities

The Banks offer a full array of deposit products including checking, savings and money market accounts, regular and IRA certificates of deposit, and Christmas Savings accounts. The Banks also offer the CDARS program, providing up to \$50 million of FDIC insurance to our customers. In addition, we offer our commercial customers packages which include Cash Management services and various checking opportunities.

### Trust Services

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

### Insurance Activities

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

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

### Seasonality

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

### Employees

At February 28, 2009, we employed 369 persons, of which 337 were employed on a full-time basis.

### COMPETITION

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

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



offered, and quality, personalized service.

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

The following tables set forth deposit data for FDIC-insured institutions in Kent County, Queen Anne's County, Caroline County, Talbot County and Dorchester County in Maryland and for Kent County, Delaware as of June 30, 2008, the most recent date for which comparative information is available.

| Kent County, Maryland                     | Deposits<br>(in thousands) | % of<br>Total |
|---|----------------------------|---------------|
| Peoples Bank of Kent County, Maryland     | \$ 169,416                 | 33.86%        |
| PNC Bank National Assn                    | 166,204                    | 33.22         |
| Chesapeake Bank and Trust Co.             | 62,942                     | 12.58         |
| Branch Banking & Trust                    | 43,590                     | 8.71          |
| The Centreville National Bank of Maryland | 31,286                     | 6.25          |
| SunTrust Bank                             | 26,921                     | 5.38          |
| Total                                     | \$ 500,359                 | 100.00%       |

Source: FDIC DataBook

| Queen Anne's County, Maryland             | Deposits<br>(in thousands) | % of<br>Total |
|---|----------------------------|---------------|
| The Queenstown Bank of Maryland           | \$ 313,163                 | 42.69%        |
| The Centreville National Bank of Maryland | 191,853                    | 26.15         |
| PNC Bank National Assn                    | 60,719                     | 8.28          |
| Bank of America, National Association     | 54,247                     | 7.40          |
| Bank Annapolis                            | 40,340                     | 5.50          |
| M&T                                       | 40,138                     | 5.47          |
| Branch Banking & Trust                    | 24,220                     | 3.30          |
| Sun Trust Bank                            | 5,079                      | 0.69          |
| Branch Banking & Trust                    | 3,780                      | 0.52          |
| Total                                     | \$ 733,539                 | 100.00%       |

Source: FDIC DataBook

| Caroline County, Maryland                 | Deposits<br>(in thousands) | % of<br>Total |
|---|----------------------------|---------------|
| Provident State Bank of Preston, Maryland | \$ 147,542                 | 36.07%        |
| PNC Bank National Assn                    | 106,091                    | 25.94         |
| The Centreville National Bank of Maryland | 54,343                     | 13.29         |
| Branch Banking & Trust                    | 44,325                     | 10.84         |
| M&T                                       | 28,629                     | 7.00          |
| Bank of America, National Association     | 16,877                     | 4.13          |
| Easton Bank & Trust                       | 11,204                     | 2.74          |
| Total                                     | \$ 409,011                 | 100.00%       |

Source: FDIC DataBook



| Talbot County, Maryland   | Deposits<br>(in thousands) | % of<br>Total  |
|---|----------------------------|----------------|
| The Talbot Bank of Easton, Maryland                             | \$ 456,354                 | 45.46%         |
| PNC Bank National Assn  | 145,184                    | 14.46          |
| Easton Bank & Trust   | 111,451                    | 11.10          |
| Bank of America, National Association<br>Branch Banking & Trust | 89,861                     | 8.95           |
| SunTrust Bank   | 57,787                     | 5.76           |
| M&T   | 41,605                     | 4.14           |
| The Queenstown Bank of Maryland                                 | 28,479                     | 2.84           |
| First Mariner Bank  | 26,912                     | 2.68           |
| Chevy Chase Bank  | 17,324                     | 1.73           |
| Provident State Bank of Preston, Maryland                       | 14,765                     | 1.47           |
|   | 14,182                     | 1.41           |
| <b>Total</b>  | <b>\$ 1,003,904</b>        | <b>100.00%</b> |

Source: FDIC DataBook

| Dorchester County, Maryland               | Deposits<br>(in thousands) | % of<br>Total  |
|---|----------------------------|----------------|
| The National Bank of Cambridge            | \$ 187,071                 | 31.97%         |
| Bank of the Eastern Shore                 | 182,882                    | 31.25          |
| Hebron Savings Bank                       | 55,996                     | 9.57           |
| Branch Banking & Trust                    | 42,290                     | 7.23           |
| Provident State Bank of Preston, Maryland | 35,459                     | 6.06           |
| Bank of America, National Association     | 25,672                     | 4.39           |
| M&T                                       | 20,710                     | 3.54           |
| The Talbot Bank of Easton, Maryland       | 17,979                     | 3.07           |
| SunTrust Bank                             | 17,109                     | 2.92           |
| <b>Total</b>                              | <b>\$ 585,168</b>          | <b>100.00%</b> |

Source: FDIC DataBook

| Kent County, Delaware           | Deposits<br>(in thousands) | % of<br>Total  |
|---------------------------------|----------------------------|----------------|
| Wilmington Trust                | \$ 536,436                 | 31.39%         |
| PNC Bank Delaware               | 250,866                    | 14.68          |
| RBS Citizens National Assn      | 243,050                    | 14.22          |
| First NB of Wyoming             | 201,660                    | 11.80          |
| Wachovia Bank of Delaware       | 158,922                    | 9.30           |
| The Felton Bank                 | 80,282                     | 4.70           |
| Artisans Bank                   | 69,307                     | 4.06           |
| Wilmington Savings Fund Society | 65,890                     | 3.86           |
| TD Bank National Assn           | 57,824                     | 3.38           |
| County Bank                     | 39,985                     | 2.34           |
| Fort Sill National Bank         | 4,517                      | 0.26           |
| <b>Total</b>                    | <b>\$ 1,708,739</b>        | <b>100.00%</b> |

Source: FDIC DataBook

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

#### SUPERVISION AND REGULATION

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

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## General

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

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

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

## Regulation of Financial Holding Companies

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

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

Federal Regulation of Banks

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

of directives to increase capital, the issuance of formal and informal agreements, the removal of or restrictions on directors, officers, employees and institution-affiliated parties, and the enforcement of any such mechanisms through restraining orders or other court actions.

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

The Banks are also subject to certain restrictions on extensions of credit to executive officers, directors, and principal stockholders or any related interest of such persons, which generally require that such credit extensions be made on substantially the same terms as are available to third parties dealing with the Banks and not involve more than the normal risk of repayment. Other laws tie the maximum amount that may be loaned to any one customer and its related interests to capital levels.

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

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

On October 14, 2008, the FDIC announced the creation of the Temporary Liquidity Guarantee Program (the "TLGP") to decrease the cost of bank funding and, hopefully, normalize lending. This program is comprised of two components. The first component guarantees senior unsecured debt issued between October 14, 2008 and June 30, 2009. The guarantee will remain in effect until June 30, 2012 for such debts that mature beyond June 30, 2009. The second component provides full coverage for non-interest bearing transaction deposit accounts, IOLTAs, and NOW accounts with interest rates of 0.50 percent or less, regardless of account balance, until December 31, 2009. We elected to participate in both programs and expect FDIC premiums to increase in 2009 as a result.

#### Capital Requirements

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



capital level for any capital measure. An “adequately capitalized” institution is defined as one that has a total risk based capital ratio of 8% or greater, a Tier 1 risk based capital ratio of 4% or greater and a leverage ratio of 4% or greater (or 3% or greater in the case of a bank with a composite CAMELS rating of 1).

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

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

As of December 31, 2008, the Banks were each deemed to be “well capitalized.” For more information regarding the capital condition of the Company, see Note 17 of Consolidated Financial Statements appearing in Item 8 of Part II of this report.

#### Deposit Insurance

The deposits of the Banks are insured to a maximum of \$100,000 per depositor through the Deposit Insurance Fund, which is administered by the FDIC, and the Banks are required to pay semi-annual deposit insurance premium assessments to the FDIC. The Deposit Insurance Fund was created pursuant to the Federal Deposit Insurance Reform Act of 2005, which was signed into law on February 8, 2006. Under this new law, (i) the current \$100,000 deposit insurance coverage will be indexed for inflation (with adjustments every five years, commencing January 1, 2011), and (ii) deposit insurance coverage for retirement accounts was increased to \$250,000 per participant subject to adjustment for inflation. In addition, the FDIC will be given greater latitude in setting the assessment rates for insured depository institutions which could be used to impose minimum assessments. Effective October 3, 2008, the Emergency Economic Stabilization Act of 2008 (the “EESA”) was enacted to temporarily raise the basic limit on federal deposit insurance coverage from \$100,000 to \$250,000 per depositor. The legislation states the limit will return to \$100,000 after December 31, 2009. The coverage for retirement accounts did not change and remains at \$250,000. The Banks paid a total of \$377 thousand in FDIC premiums during 2008. The Banks’ portion of the one-time credit assessment was \$541,000. Further information about deposit insurance premiums is provided in Item 7 of Part II of this report under the heading “Recent Developments”.

#### USA PATRIOT Act

Congress adopted the USA PATRIOT Act (the “Patriot Act”) on October 26, 2001 in response to the terrorist attacks that occurred on September 11, 2001. Under the Patriot Act, certain financial institutions, including banks, are required to maintain and prepare additional records and reports that are designed to assist the government’s efforts to combat terrorism. The Patriot Act includes sweeping anti-money laundering and financial transparency laws and required additional regulations, including, among other things, standards for verifying client identification when opening an account and rules to promote cooperation among financial institutions, regulators and law enforcement entities in identifying parties that may be involved in terrorism or money laundering.

#### Federal Securities Laws

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

#### Governmental Monetary and Credit Policies and Economic Controls

The earnings and growth of the banking industry and ultimately of the Bank are affected by the monetary and credit policies of governmental authorities, including the FRB. An important function of the FRB is to regulate the national supply of bank credit in order to control recessionary and inflationary pressures. Among the instruments of monetary policy used by the FRB to implement these objectives are open market operations in U.S. Government securities, changes in the federal funds rate, changes in the discount rate of member bank borrowings, and changes in reserve

requirements against member bank deposits. These means are used in varying combinations to influence overall growth of bank loans, investments and deposits and may also affect interest rates charged on loans or paid for deposits. The monetary policies of the FRB authorities have had a significant effect on the operating results of commercial banks in the past and are expected to continue to have such an effect in the future. In view of changing conditions in the national economy and in the money markets, as well as the effect of actions by monetary and fiscal authorities, including the FRB, no prediction can be made as to possible future changes in interest rates, deposit levels, loan demand or their effect on the business and earnings of the Company and its subsidiaries.

#### AVAILABLE INFORMATION

The Company maintains an Internet site at [www.shbi.net](http://www.shbi.net) on which it makes available, free of charge, its Annual Report on Form 10-K, Quarterly Reports on Form 10-Q, Current Reports on Form 8-K, and all amendments to the foregoing as soon as reasonably practicable after these reports are electronically filed with, or furnished to, the SEC. In addition, stockholders may access these reports and documents on the SEC's web site at [www.sec.gov](http://www.sec.gov).

## Item 1A. RISK FACTORS

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

### Risks Relating to Our Business

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

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

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

Because most of our loans are made to customers who reside on the Eastern Shore of Maryland and in Delaware, a decline in local economic conditions may have a greater effect on our earnings and capital than on the earnings and capital of larger financial institutions whose loan portfolios are geographically diverse. Further, we make many real estate secured loans, including construction and land development loans, all of which are in greater demand when interest rates are low and economic conditions are good. The national and local economies have significantly weakened during the past two years in large part due to the widely-reported problems in the sub-prime mortgage loan market and the more recent meltdown of the financial industry as a whole. As a result, real estate values across the country, including in our market areas, have decreased and the general availability of credit, especially credit to be secured by real estate, has also decreased. These conditions have made it more difficult for real estate owners and owners of loans secured by real estate to sell their assets at the times and at the prices they desire. In addition, these conditions have increased the risk that the market values of the real estate securing our loans may deteriorate, which could cause us to lose money in the event a borrower fails to repay a loan and we are forced to foreclose on the property. There can be no guarantee as to when or whether economic conditions will improve.

Additionally, the FRB and the FDIC, along with the other federal banking regulators, issued final guidance on December 6, 2006 entitled "Concentrations in Commercial Real Estate Lending, Sound Risk Management Practices" directed at institutions that have particularly high concentrations of commercial real estate loans within their lending portfolios. This guidance suggests that institutions whose commercial real estate loans exceed certain percentages of capital should implement heightened risk management practices appropriate to their concentration risk and may be required to maintain higher capital ratios than institutions with lower concentrations in commercial real estate lending. Based on our commercial real estate concentration as of December 31, 2008, we may be subject to further supervisory analysis during future examinations. We cannot guarantee that any risk management practices we implement will be effective to prevent losses relating to our commercial real estate portfolio. Management cannot predict the extent to which this guidance will impact our operations or capital requirements.

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

The national economy and, to a lesser extent, the local economy have significantly weakened during the past two years, primarily as a result of the widely reported financial institution meltdown. This weakening has caused real

estate values to drop, decreased the demand for credit, and caused public anxiety regarding the health and future of the financial services industry as a whole.

Our results of operations may be materially and adversely affected by changes in prevailing economic conditions, including declines in real estate values, rapid changes in interest rates and the monetary and fiscal policies of the federal government. Our profitability is in part a function of the spread between the interest rates earned on assets and the interest rates paid on deposits and other interest-bearing liabilities (i.e., net interest income), including advances from the Federal Home Loan Bank (the "FHLB") of Atlanta and the FHLB of Pittsburgh. Interest rate risk arises from mismatches (i.e., the interest sensitivity gap) between the dollar amount of repricing or maturing assets and liabilities and is measured in terms of the ratio of the interest rate sensitivity gap to total assets. More assets

repricing or maturing than liabilities over a given time period is considered asset-sensitive and is reflected as a positive gap, and more liabilities repricing or maturing than assets over a given time period is considered liability-sensitive and is reflected as negative gap. An asset-sensitive position (i.e., a positive gap) could enhance earnings in a rising interest rate environment and could negatively impact earnings in a falling interest rate environment, while a liability-sensitive position (i.e., a negative gap) could enhance earnings in a falling interest rate environment and negatively impact earnings in a rising interest rate environment. Fluctuations in interest rates are not predictable or controllable. We have attempted to structure our asset and liability management strategies to mitigate the impact on net interest income of changes in market interest rates, but there can be no assurance that these attempts will be successful in the event of future changes.

The Banks may experience credit losses in excess of their allowances

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

The market value of our investments might decline

As of December 31, 2008, we had classified 89% of our investment securities as available-for-sale pursuant to Statement of Financial Accounting Standards No. 115 ("SFAS 115") relating to accounting for investments. SFAS 115 requires that unrealized gains and losses in the estimated value of the available-for-sale portfolio be "marked to market" and reflected as a separate item in stockholders' equity (net of tax) as accumulated other comprehensive income. The remaining investment securities are classified as held-to-maturity in accordance with SFAS 115 and are stated at amortized cost.

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

Talbot Bank and Centreville National Bank are members of the FHLB of Atlanta and Felton Bank is a member of the FHLB of Pittsburgh. A member of the FHLB system is required to purchase stock issued by the relevant FHLB bank based on how much it borrows from the FHLB and the quality of the collateral pledged to secure that borrowing. Accordingly, our investments include stock issued by the FHLB of Atlanta and the FHLB of Pittsburgh. In recent months, the banking industry has become concerned about the financial strength of the banks in

the FHLB system, and some FHLB banks have stopped paying dividends on and redeeming FHLB stock. On January 30, 2009, the FHLB of Atlanta announced that it was deferring the declaration of a dividend on its stock for the quarter ended December 31, 2008 until it completes its year-end analysis of other-than-temporary impairment which is critical to its net income determination. The FHLB of Atlanta stated that it anticipates a decision regarding the dividend to be made in March 2009. Similarly, the FHLB of Pittsburgh announced in December 2008 that it voluntarily suspended the payment of dividends and the repurchase of excess capital stock from member banks, citing a significant reduction in the level of core earnings resulting from lower short-term interest rates, the increased cost of maintaining liquidity and constrained access to the debt markets at attractive rates and maturities as the main reasons for the decision to suspend dividends and the repurchase of excess capital stock. The FHLB of Pittsburgh last paid a dividend in the third quarter of 2008. Accordingly, there can be no guaranty that the FHLB of Atlanta or the FHLB of Pittsburgh will declare future dividends. Moreover, accounting guidance indicates that an investor in FHLB stock should recognize impairment if it concludes that it is not probable that it will ultimately recover the par value of its shares. The decision of whether impairment exists is a matter of judgment that should reflect the investor's view of an FHLB bank's long-term performance, which includes factors such as its operating performance, the severity and duration of declines in the market value of its net assets related to its capital stock amount, its commitment to make payments required by law or regulation and the level of such payments in relation to its operating performance, the impact of legislation and regulatory changes on the FHLB bank, and accordingly, on the members of that FHLB bank and its liquidity and funding position. After evaluating all of these considerations, we believe the par value of our FHLB stock will be recovered, but future evaluations of the above mentioned factors could result in the Company recognizing an impairment charge.

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

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

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

We operate in a highly competitive market

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

In addition, current banking laws facilitate interstate branching, merger activity among banks, and expanded activities. Since September 1995, certain bank holding companies have been authorized to acquire banks throughout the United States. Since June 1, 1997, certain banks have been permitted to merge with banks organized under the laws of different states. As a result, interstate banking is now an accepted element of competition in the banking industry and the Corporation may be brought into competition with institutions with which it does not presently compete. Moreover, as discussed above, the GLB Act revised the BHC Act in 2000 and repealed the affiliation



provisions of the Glass-Steagall Act of 1933, which, taken together, limited the securities, insurance and other non-banking activities of any company that controls an FDIC insured financial institution. These laws may increase the competition we face in our market areas in the future, although management cannot predict the degree to which such competition will impact our financial conditions or results of operations.

Our regulatory expenses will likely increase due to the enactment of the Emergency Economic Stabilization Act and related government programs

Among other things, the EESA included a provision to increase the amount of deposits insured by FDIC to \$250,000. The TLGP provides, until December 31,

2009, unlimited deposit insurance on funds in non-interest-bearing transaction deposit accounts and certain IOLTAs and NOW accounts not otherwise covered by the existing deposit insurance limit of \$250,000, as well as a 100% guarantee of the newly issued senior debt of all FDIC-insured institutions and their holding companies issued between October 14, 2008 and June 30, 2009. All eligible institutions will be covered under the TLGP for the first 30 days without incurring any costs. After the initial period, participating institutions will be assessed a charge of 10 basis points per annum for the additional insured deposits and a charge of 75 basis points per annum for guaranteed senior unsecured debt. We elected to participate in both portions of the TLGP, so we expect to incur additional regulatory fees associated with our participation.

Customer concern about deposit insurance may cause a decrease in deposits held at the Banks

With recent increased concerns about bank failures, customers increasingly are concerned about the extent to which their deposits are insured by the FDIC. Customers may withdraw deposits from the Banks in an effort to ensure that the amount they have on deposit with us is fully insured. Decreases in deposits may adversely affect our funding costs and net income.

Our funding sources may prove insufficient to replace deposits and support our future growth

We rely on customer deposits, advances from the FHLB, and lines of credit at other financial institutions to fund our operations. Although we have historically been able to replace maturing deposits and advances if desired, no assurance can be given that we would be able to replace such funds in the future if our financial condition or the financial condition of the FHLB or market conditions were to change. Our financial flexibility will be severely constrained and/or our cost of funds will increase if we are unable to maintain our access to funding or if financing necessary to accommodate future growth is not available at favorable interest rates. Finally, if we are required to rely more heavily on more expensive funding sources to support future growth, our revenues may not increase proportionately to cover our costs. In this case, our profitability would be adversely affected.

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

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

We may lose key personnel because of our participation in the Troubled Asset Relief Program Capital Purchase Program

On January 9, 2009, we participated in the Troubled Asset Relief Program (“TARP”) Capital Purchase Program (the “CPP”) adopted by the U.S. Department of Treasury (“Treasury”) by selling \$25 million in shares of our Fixed Rate Cumulative Perpetual Preferred Stock, Series A (the “Series A Preferred Stock”) to Treasury and issuing a 10-year common stock purchase warrant (the “Warrant”) to Treasury. As part of these transactions, we adopted Treasury’s standards for executive compensation and corporate governance for the period during which Treasury holds any shares of the Series A Preferred Stock and/or any shares of common stock that may be acquired upon exercise of the Warrant. On February 17, 2009, the American Recovery and Reinvestment Act of 2009 (the “Recovery Act”) was signed into law, which, among other things, imposes additional executive compensation restrictions on institutions that participate in TARP for so long as any TARP assistance remains outstanding. Among these restrictions is a

prohibition against making most severance payments to our “senior executive officers”, which term includes our Chairman and Chief Executive Officer, our Chief Financial Officer and, generally, the three next most highly compensated executive officers, and to the next five most highly compensated employees. The restrictions also limit the type, timing and amount of bonuses, retention awards and incentive compensation that may be paid to our five most highly compensated employees. These restrictions, coupled with the competition we face from other institutions, including institutions that did not participate in TARP, may make it more difficult for us to attract and/or retain exceptional key employees.

Our lending activities subject us to the risk of environmental liabilities

A significant portion of our loan portfolio is secured by real property. During the ordinary course of business, we may foreclose on and take title to properties securing certain loans. In doing so, there is a risk that hazardous or toxic substances could be found on these properties. If hazardous or toxic substances are found, we may be liable for remediation costs, as well as for personal injury and property damage. Environmental laws may require us to incur substantial expenses and may materially reduce the affected property’s value or limit our ability to use or sell the affected property. In addition, future laws or more stringent interpretations or enforcement policies with respect to existing laws may increase our exposure to environmental liability. Although we have policies

and procedures to perform an environmental review before initiating any foreclosure action on real property, these reviews may not be sufficient to detect all potential environmental hazards. The remediation costs and any other financial liabilities associated with an environmental hazard could have a material adverse effect on our financial condition and results of operations.

#### We may be subject to other claims

We may from time to time be subject to claims from customers for losses due to alleged breaches of fiduciary duties, errors and omissions of employees, officers and agents, incomplete documentation, the failure to comply with applicable laws and regulations, or many other reasons. Also, our employees may knowingly or unknowingly violate laws and regulations. Management may not be aware of any violations until after their occurrence. This lack of knowledge may not insulate the Company or our subsidiaries from liability. Claims and legal actions may result in legal expenses and liabilities that may reduce our profitability and hurt our financial condition.

#### We may be adversely affected by other recent legislation

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

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

The Patriot Act requires certain financial institutions, such as the Banks, to maintain and prepare additional records and reports that are designed to assist the government's efforts to combat terrorism. This law includes sweeping anti-money laundering and financial transparency laws and required additional regulations, including, among other things, standards for verifying client identification when opening an account and rules to promote cooperation among financial institutions, regulators and law enforcement entities in identifying parties that may be involved in terrorism or money laundering. If we fail to comply with this law, we could be exposed to adverse publicity as well as fines and penalties assessed by regulatory agencies.

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

We use various technologies in our business, including telecommunication, data processing, computers, automation, internet-based banking, and debit cards. Technology changes rapidly. Our ability to compete successfully with other banks and non-bank entities may depend on whether we can exploit technological changes. We may not be able to exploit technological changes, and any investment we do make may not make us more profitable. We are planning to convert to a new core data processing system during the second quarter of 2009. Although management expects that this new system will improve operating efficiencies, there can be no guaranty that it will do so or that software, hardware or other technical problems will not delay its implementation or effectiveness.

### Risks Relating to the Company's Securities

The Company's shares of common stock, Series A Preferred Stock, and the Warrant are not insured

The shares of the Company's common stock, including the shares that may be acquired upon exercise of the Warrant, the Series A Preferred Stock and the Warrant are not deposits and are not insured against loss by the FDIC or any other governmental or private agency.

The Company's ability to pay dividends is limited by applicable banking and corporate law

The Company's stockholders are entitled to dividends on their shares of common stock if, when, and as declared by the Company's Board of Directors out of funds legally available for that purpose. The Company's current ability to pay dividends to stockholders is largely dependent upon the receipt of dividends from the Banks. Both federal and state laws impose restrictions on the ability of the Banks to pay dividends. Federal law prohibits the payment of a dividend by an

insured depository institution if the depository institution is considered “undercapitalized” or if the payment of the dividend would make the institution “undercapitalized”. For a Maryland state-chartered bank, dividends may be paid out of undivided profits or, with the prior approval of the Maryland Commissioner, from surplus in excess of 100% of required capital stock. If, however, the surplus of a Maryland bank is less than 100% of its required capital stock, then cash dividends may not be paid in excess of 90% of net earnings. National banking associations are generally limited, subject to certain exceptions, to paying dividends out of undivided profits. For a Delaware state-chartered bank, dividends may be paid out of net profits, but only if its surplus fund is equal to or greater than 50% of its required capital stock. If a Delaware bank’s surplus is less than 100% of capital stock when it declares a dividend, then it must carry 25% of its net profits of the preceding period for which the dividend is paid to its surplus fund until the surplus amounts to 100% of its capital stock. In addition to these specific restrictions, bank regulatory agencies also have the ability to prohibit proposed dividends by a financial institution that would otherwise be permitted under applicable regulations if the regulatory body determines that such distribution would constitute an unsafe or unsound practice. Because of these limitations, there can be no guarantee that the Company’s Board will declare dividends in any fiscal quarter.

Because of the Company’s participation in the CPP, it is subject to several restrictions relating to shares of its capital stock, including restrictions on its ability to declare or pay dividends on and repurchase its shares

As stated above, the Company recently issued 25,000 shares of the Series A Preferred Stock and a Warrant to purchase 172,970 shares of common stock to Treasury. Under the terms of the transaction documents, the Company’s ability to declare or pay dividends on shares of its capital stock is limited. Specifically, the Company is unable to declare dividends on common stock, other stock ranking junior to the Series A Preferred Stock (“Junior Stock”), or preferred stock ranking on a parity with the Series A Preferred Stock (“Parity Stock”) if the Company is in arrears on the dividends on the Series A Preferred Stock. Further, the Company is not permitted to increase dividends on its common stock above the amount of the last quarterly cash dividend per share declared prior to October 14, 2008 without Treasury’s approval until January 9, 2012 unless all of the Series A Preferred Stock has been redeemed or transferred. In addition, the Company’s ability to repurchase shares of common stock, Junior Stock or Parity Stock is restricted. Treasury’s consent generally is required for the Company to make any such repurchase until January 9, 2012 unless all of the Series A Preferred Stock has been redeemed or transferred. Further, shares of common stock, Junior Stock or Parity Stock may not be repurchased if the Company is in arrears on the Series A Preferred Stock dividends.

There is no market for the Series A Preferred Stock or the Warrant, and the common stock is not heavily traded

There is no established trading market for the shares of the Series A Preferred Stock or the Warrant. The Company does not intend to apply for listing of the Series A Preferred Stock on any securities exchange or for inclusion of the Series A Preferred Stock in any automated quotation system unless requested by Treasury. The Company’s common stock is listed on the NASDAQ Global Select Market, but shares of the common stock are not heavily traded. Securities that are not heavily traded can be more volatile than stock trading in an active public market. Factors such as our financial results, the introduction of new products and services by us or our competitors, and various factors affecting the banking industry generally may have a significant impact on the market price of the shares the common stock. Management cannot predict the extent to which an active public market for any of the Company’s securities will develop or be sustained in the future. Accordingly, holders of the Company’s securities may not be able to sell such securities at the volumes, prices, or times that they desire.

The Company’s Articles of Incorporation and By-Laws and Maryland law may discourage a corporate takeover

The Company’s Amended and Restated Articles of Incorporation, as supplemented (the “Charter”), and Amended and Restated By-Laws, as amended (the “By-Laws”), contain certain provisions designed to enhance the ability of the Board

of Directors to deal with attempts to acquire control of the Company. The Charter and By-Laws provide for the classification of the Board into three classes; directors of each class generally serve for staggered three-year periods. No director may be removed except for cause and then only by a vote of at least two-thirds of the total eligible stockholder votes. The Charter gives the Board certain powers in respect of the Company's securities. First, the Board has the authority to classify and reclassify unissued shares of stock of any class or series of stock by setting, fixing, eliminating, or altering in any one or more respects the preferences, rights, voting powers, restrictions and qualifications of, dividends on, and redemption, conversion, exchange, and other rights of, such securities. Second, a majority of the Board, without action by the stockholders, may amend the Charter to increase or decrease the aggregate number of shares of stock or the number of shares of stock of any class that the Company has authority to issue. The Board could use these powers, along with its authority to authorize the issuance of securities of any class or series, to issue securities having terms favorable to management to persons affiliated with or otherwise friendly to management.

Maryland law also contains anti-takeover provisions that apply to the Company. The Maryland Business Combination Act generally prohibits, subject to certain limited exceptions, corporations from being involved in any "business combination" (defined as a variety of transactions, including a merger,

consolidation, share exchange, asset transfer or issuance or reclassification of equity securities) with any “interested shareholder” for a period of five years following the most recent date on which the interested shareholder became an interested shareholder. An interested shareholder is defined generally as a person who is the beneficial owner of 10% or more of the voting power of the outstanding voting stock of the corporation after the date on which the corporation had 100 or more beneficial owners of its stock or who is an affiliate or associate of the corporation and was the beneficial owner, directly or indirectly, of 10% percent or more of the voting power of the then outstanding stock of the corporation at any time within the two-year period immediately prior to the date in question and after the date on which the corporation had 100 or more beneficial owners of its stock. The Maryland Control Share Acquisition Act applies to acquisitions of “control shares”, which, subject to certain exceptions, are shares the acquisition of which entitle the holder, directly or indirectly, to exercise or direct the exercise of the voting power of shares of stock of the corporation in the election of directors within any of the following ranges of voting power: one-tenth or more, but less than one-third of all voting power; one-third or more, but less than a majority of all voting power or a majority or more of all voting power. Control shares have limited voting rights. The By-Laws exempt the Company’s capital securities from the Maryland Control Share Acquisition Act, but the Board has the authority to eliminate the exemption without stockholder approval.

Although these provisions do not preclude a takeover, they may have the effect of discouraging, delaying or deferring a tender offer or takeover attempt that a shareholder might consider in his or her best interest, including those attempts that might result in a premium over the market price for the common stock. Such provisions will also render the removal of the Board of Directors and of management more difficult and, therefore, may serve to perpetuate current management. These provisions could potentially adversely affect the market price of the Company’s common stock.

Item 1B. Unresolved Staff Comments

None.

Item 2. Properties.

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

The Talbot Bank of Easton, Maryland

| Branches   |  |   |
|--|--|---|
| Main Office<br>18 East Dover Street<br>Easton, Maryland 21601                        | Tred Avon Square Branch<br>212 Marlboro Road<br>Easton, Maryland 21601 | St. Michaels Branch<br>1013 South Talbot Street<br>St. Michaels, Maryland 21663 |
| Elliott Road Branch<br>8275 Elliott Road<br>Easton, Maryland 21601                   | Sunburst Branch<br>424 Dorchester Avenue<br>Cambridge, Maryland 21613  | Tilghman Branch<br>5804 Tilghman Island Road<br>Tilghman, Maryland 21671        |
| ATMs   |  |   |
| Memorial Hospital at Easton<br>219 South Washington Street<br>Easton, Maryland 21601 | Sailwinds Amoco<br>511 Maryland Avenue<br>Cambridge, Maryland 21613    | Talbottown<br>218 North Washington Street<br>Easton, Maryland 21601             |





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The Centreville National Bank of Maryland

Branches

|   |  |  |
|---|--|--|
| Main Office<br>109 North Commerce Street<br>Centreville, Maryland 21617   | Route 213 South Office<br>2609 Centreville Road<br>Centreville, Maryland 21617 | Stevensville Office<br>408 Thompson Creek Road<br>Stevensville, Maryland 21666   |
| Chestertown Office<br>305 East High Street<br>Chestertown, Maryland 21620 | Hillsboro Office<br>21913 Shore Highway<br>Hillsboro, Maryland 21641           | Denton Office<br>850 South 5th Street<br>Denton, Maryland 21629                  |
| Chester Office<br>300 Castle Marina Road<br>Chester, Maryland 21619       | Grasonville Office<br>202 Pullman Crossing<br>Grasonville, Maryland 21638      | Washington Square Office<br>899 Washington Avenue<br>Chestertown, Maryland 21620 |

Division Office-Wye Financial  
& Trust  
16 North Washington Street  
Suite 1  
Easton, Maryland 21601

ATM

Queenstown Harbor Golf Links  
Queenstown, Maryland 21658

The Felton Bank

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

The Avon-Dixon Agency, LLC

|   |   |  |
|---|---|--|
| Easton Office<br>28969 Information Lane<br>Easton, Maryland 21601 | Grasonville Office<br>202 Pullman Crossing<br>Grasonville, Maryland 21638 | Centreville Office<br>105 Lawyers Row<br>Centreville, Maryland 21617 |
|---|---|--|

|  |  |  |
|--|--|--|
| Elliott-Wilson Insurance, LLC<br>106 North Harrison Street<br>Easton, Maryland 21601 | Mubell Finance, LLC<br>106 North Harrison Street<br>Easton, Maryland 21601 | Wye Financial Services, LLC<br>16 North Washington Street<br>Suite 1<br>Easton, Maryland 21601 |
|--|--|--|

|   |   |  |
|---|---|--|
| Wye Mortgage Group, LLC<br>17 East Dover Street<br>Easton, Maryland 21601 | Jack Martin & Associates, Inc.<br>326 First Street<br>Annapolis, Maryland 21403 | Tri-State General Insurance<br>Agencies and ESFS, Inc.<br>One Plaza East, 4th Floor<br>Salisbury, Maryland 21802 |
|---|---|--|

Talbot Bank owns the real property on which all of its offices are located, except that it operates under leases at its St. Michaels and Tilghman branches. Centreville National Bank owns the real property on which all of its offices are located, except that it operates under leases at its Hillsboro branch and the office of Wye Financial and Trust in Easton. Felton Bank leases the real property on which all of its offices are located. The Insurance Subsidiaries do not own any real property, but operate under leases. Wye Mortgage occupies space in Talbot Bank's main office. For

information about rent expense for all leased premises, see Note 6 to the Consolidated Financial Statements appearing in Item 8 of Part II of this report.

Item 3. Legal Proceedings

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

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

None.

## PART II

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

### MARKET PRICE, HOLDERS AND CASH DIVIDENDS

The shares of the common stock of the Company are listed on the NASDAQ Global Select Market under the symbol "SHBI". As of March 3, 2009, the Company had approximately 1,684 holders of record. The high and low sales prices for the shares of common stock of the Company, as reported on the NASDAQ Global Select Market, and the cash dividends declared on those shares for each quarterly period of 2008 and 2007 are set forth in the table below.

|                | 2008                |          |                   | 2007                |          |                   |
|----------------|---------------------|----------|-------------------|---------------------|----------|-------------------|
|                | Price Range<br>High | Low      | Dividends<br>Paid | Price Range<br>High | Low      | Dividends<br>Paid |
| First Quarter  | \$ 23.40            | \$ 20.00 | \$ 0.16           | \$ 30.76            | \$ 23.54 | \$ 0.16           |
| Second Quarter | 26.47               | 18.52    | 0.16              | 29.15               | 23.98    | 0.16              |
| Third Quarter  | 27.25               | 18.00    | 0.16              | 27.05               | 20.52    | 0.16              |
| Fourth Quarter | 25.97               | 17.50    | 0.16              | 24.72               | 20.00    | 0.16              |
|                |                     |          | \$ 0.64           |                     |          | \$ 0.64           |

On March 3, 2009, the closing sales price for the shares of common stock as reported on the NASDAQ Global Select Market was \$11.85 per share.

Stockholders received cash dividends totaling \$5.4 million in 2008 and in 2007. The ratio of dividends per share to earnings per share was 46.72% in 2008, compared to 39.75% in 2007. Cash dividends are typically declared on a quarterly basis and are at the discretion of the Board of Directors, based upon such factors as operating results, financial condition, capital adequacy, regulatory requirements, and stockholder return. The Company's ability to pay dividends is limited by federal banking and state corporate law and is generally dependent on the ability of the Company's subsidiaries, particularly the Banks, to declare dividends to the Company. The Company's ability to pay dividends is further limited by the terms of its Series A Preferred Stock. For more information regarding these limitations, see Item 1A of Part I of this report under the headings, "The Company's ability to pay dividends is limited by applicable banking and corporate law" and "Because of the Company's participation in the CPP, it is subject to several restrictions relating to shares of its capital stock, including restrictions on its ability to declare or pay dividends on and repurchase its shares", which are incorporated herein by reference.

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

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

The performance graph below compares the cumulative total shareholder return on the common stock of the Company with the cumulative total return on the equity securities included in the NASDAQ Composite Index (reflecting overall stock market performance), the NASDAQ Bank Index (reflecting changes in banking industry stocks), and the SNL Small Cap Bank Index (reflecting changes in stocks of banking institutions of a size similar to the Company) assuming in each case an initial \$100 investment on December 31, 2003 and reinvestment of dividends as of the end of the Company's fiscal years. Returns are shown on a total return basis. The performance graph represents past performance and should not be considered to be an indication of future performance.

| Index                  | Period Ending |          |          |          |          |          |
|------------------------|---------------|----------|----------|----------|----------|----------|
|                        | 12/31/03      | 12/31/04 | 12/31/05 | 12/31/06 | 12/31/07 | 12/31/08 |
| Shore Bancshares, Inc. | 100.00        | 97.51    | 87.37    | 127.42   | 95.10    | 106.86   |
| NASDAQ Composite       | 100.00        | 108.59   | 110.08   | 120.56   | 132.39   | 78.72    |
| NASDAQ Bank            | 100.00        | 110.99   | 106.18   | 117.87   | 91.85    | 69.88    |
| SNL Small Cap Bank     | 100.00        | 122.54   | 120.69   | 137.76   | 99.60    | 83.72    |

#### ISSUER REPURCHASES

On February 2, 2006, the Company's Board of Directors authorized the Company to repurchase up to 165,000 shares of its common stock over a period not to exceed 60 months. Shares may be repurchased in the open market or in privately negotiated transactions at such times and in such amounts per transaction as the President of the Company determines to be appropriate, subject to Board oversight. The Company intends to use the repurchased shares to fund the Company's employee benefit plans and for other general corporate purposes. No shares were repurchased by or on behalf of the Company and its affiliates (as defined by Exchange Act Rule 10b-18) during 2008.

#### EQUITY COMPENSATION PLAN INFORMATION

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

The following table contains information about these equity compensation plans as of December 31, 2008:

| Plan Category  | Number of securities to be issued upon exercise of outstanding options, warrants and rights<br>(a) | Weighted-average exercise price of outstanding options, warrants, and rights<br>(b) | Number of securities remaining available for future issuance under equity compensation plans [excluding securities reflected in column (a)]<br>(c) |
|--|--|---|--|
| Equity compensation plans approved by security holders (1) | 18,550   | \$ 15.52  | 611,176  |
| Equity compensation plans not approved by security holders | 0  | 0.00  | 0  |
| <b>Total</b>   | <b>18,550</b>  | <b>\$ 15.52</b>   | <b>611,176</b>   |

(1) In addition to stock options and stock appreciation rights, the 2006 Plan permits the grant of stock awards, stock units, and performance units, and the shares available for issuance shown in column (c) may be granted pursuant to such awards. Subject to the anti-dilution provisions of the Omnibus Plan, the maximum number of shares of restricted stock that may be granted to any participant in any calendar year is 45,000; the maximum number of restricted stock units that may be granted to any one participant in any calendar year is 45,000; and the maximum dollar value of performance units that may be granted to any one participant in any calendar year is \$1,500,000. As of December 31, 2008, the Company has granted 16,859 shares of restricted stock that are not reflected in column (a) of this table.

## Item 6. Selected Financial Data.

The following table sets forth certain selected financial data for the five years ended December 31, 2008 and is qualified in its entirety by the detailed statistical and other information contained in this report, including “Management’s Discussion and Analysis of Financial Condition and Results of Operations” appearing in Item 7 of Part II of this report and the financial statements and notes thereto appearing in Item 8 of Part II of this report.

|   | Years Ended December 31, |                  |                  |                  |                  |
|---|--------------------------|------------------|------------------|------------------|------------------|
| (Dollars in thousands, except per share data)                       | 2008                     | 2007             | 2006             | 2005             | 2004             |
| <b>RESULTS OF OPERATIONS:</b>                                       |                          |                  |                  |                  |                  |
| Interest income   | \$ 61,474                | \$ 65,141        | \$ 57,971        | \$ 47,384        | \$ 38,291        |
| Interest expense  | 21,555                   | 24,105           | 19,074           | 11,899           | 9,010            |
| Net interest income   | 39,919                   | 41,036           | 38,897           | 35,485           | 29,281           |
| Provision for credit losses   | 3,337                    | 1,724            | 1,493            | 810              | 931              |
| Net interest income after provision for credit losses               | 36,582                   | 39,312           | 37,404           | 34,675           | 28,350           |
| Noninterest income  | 20,350                   | 14,679           | 12,839           | 11,498           | 10,224           |
| Noninterest expense   | 38,370                   | 32,539           | 28,535           | 25,431           | 22,535           |
| Income before income taxes  | 18,562                   | 21,452           | 21,708           | 20,742           | 16,039           |
| Income tax expense  | 7,092                    | 8,002            | 8,154            | 7,854            | 5,841            |
| <b>NET INCOME</b>   | <b>\$ 11,470</b>         | <b>\$ 13,450</b> | <b>\$ 13,554</b> | <b>\$ 12,888</b> | <b>\$ 10,198</b> |
| <b>PER SHARE DATA:</b>  |                          |                  |                  |                  |                  |
| Net income – basic  | \$ 1.37                  | \$ 1.61          | \$ 1.62          | \$ 1.55          | \$ 1.24          |
| Net income – diluted  | 1.37                     | 1.60             | 1.61             | 1.54             | 1.23             |
| Dividends paid  | 0.64                     | 0.64             | 0.59             | 0.54             | 0.48             |
| Book value (at year end)  | 15.16                    | 14.35            | 13.28            | 12.17            | 11.24            |
| Tangible book value (at year end) <sup>1</sup>                      | 12.55                    | 11.68            | 11.67            | 10.51            | 9.53             |
| <b>FINANCIAL CONDITION (at year end):</b>                           |                          |                  |                  |                  |                  |
| Assets  | \$ 1,044,641             | \$ 956,911       | \$ 945,649       | \$ 851,638       | \$ 790,598       |
| Deposits  | 845,371                  | 765,895          | 774,182          | 704,958          | 658,672          |
| Total loans, net of unearned income and allowance for credit losses | 879,208                  | 768,799          | 693,419          | 622,227          | 590,766          |
| Long-term debt  | 7,947                    | 12,485           | 25,000           | 4,000            | 5,000            |
| Stockholders’ equity  | 127,385                  | 120,235          | 111,327          | 101,448          | 92,976           |
| <b>PERFORMANCE RATIOS (for the year):</b>                           |                          |                  |                  |                  |                  |
| Return on average assets  | 1.13%                    | 1.42%            | 1.52%            | 1.51%            | 1.32%            |
| Return on average stockholders’ equity                              | 9.22                     | 11.79            | 12.66            | 13.20            | 11.17            |
| Net interest margin   | 4.23                     | 4.64             | 4.70             | 4.69             | 4.10             |
| Efficiency ratio <sup>2</sup>                                       | 63.66                    | 58.40            | 55.15            | 54.13            | 57.04            |
| Dividend payout ratio   | 46.72                    | 39.75            | 36.42            | 34.84            | 38.71            |
| Average stockholders’ equity to average total assets                | 12.30                    | 12.04            | 11.98            | 11.86            | 11.79            |



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

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

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

The following discussion compares the Company's financial condition at December 31, 2008 to its financial condition at December 31, 2007 and the results of operations for the years ended December 31, 2008, 2007, and 2006. This discussion should be read in conjunction with the Consolidated Financial Statements and the Notes thereto appearing in Item 8 of Part II of this report.

## RECENT DEVELOPMENTS

### Capital Purchase Program

As discussed above, on January 9, 2009 the Company participated in the TARP CPP by issuing 25,000 shares of Series A Preferred Stock and a Warrant covering 172,970 shares of common stock to the Treasury for a total sales price of \$25 million. The Warrant may be exercised at any time until January 9, 2019 at an exercise price of \$21.68 per share, or an aggregate exercise price of approximately \$3.75 million. The Series A Preferred Stock qualifies as Tier 1 capital. The Warrant counts as tangible common equity.

Holders of the Series A Preferred Stock are entitled to receive if, as and when declared by the Board of Directors, out of assets legally available for payment, cumulative cash dividends at a rate per annum of 5% per share on a liquidation amount of \$1,000 per share of Series A Preferred Stock with respect to each dividend period from January 9, 2009 to, but excluding, February 15, 2014. From and after February 15, 2014, holders of Series A Preferred Stock are entitled to receive cumulative cash dividends at a rate per annum of 9% per share on a liquidation amount of \$1,000 per share with respect to each dividend period thereafter. Under the terms of the Series A Preferred Stock, on and after February 15, 2012, the Company may, at its option, redeem shares of Series A Preferred Stock, in whole or in part, at any time and from time to time, for cash at a per share amount equal to the sum of the liquidation preference per share plus any accrued and unpaid dividends to but excluding the redemption date. The terms of the Series A Preferred Stock further provide that, prior to February 15, 2012, the Company may redeem shares of Series A Preferred Stock only if it has received aggregate gross proceeds of not less than \$6.25 million from one or more qualified equity offerings, and the aggregate redemption price may not exceed the net proceeds received by the Company from such offerings. The redemption of the Series A Preferred Stock requires prior regulatory approval.

Until the earlier of (i) January 9, 2012 or (ii) the date on which the Series A Preferred Stock has been redeemed in full or Treasury has transferred all of the Series A Preferred Stock to non-affiliates, the terms of the Series A Preferred Securities prohibit the Company from increasing its quarterly cash dividend paid on common stock above \$0.16 per share or repurchasing any shares of common stock or other capital stock or equity securities or trust preferred securities without the consent of the Treasury. Accordingly, the Company's previously-announced common stock repurchase plan has been suspended effective January 9, 2009.

On February 17, 2009, President Obama signed the Recovery Act into law. The Recovery Act permits any institution that receives assistance under TARP (including pursuant to the CPP), after consultation with the appropriate banking regulators, to repay any such assistance at any time notwithstanding any repayment restrictions contained in the instruments defining such assistance. Recent guidance issued by Treasury states that, as a general rule, any partial repayment must equal at least 25% of the outstanding assistance. Treasury may waive this minimum repayment amount. Accordingly, the Company may, at any time and notwithstanding the restrictions on redemption discussed above, and assuming its regulators do not object, repay all of or a portion of (in 25% increments, unless waived by Treasury) the \$25 million it received as consideration for the Series A Preferred Stock and the Warrant. If the Company were to repay any assistance, it could also repurchase any or all of the portion of the Warrant that relates to the repayment. Any portion of the Warrant that relates to the repayment that the Company chooses not to repurchase must be liquidated by Treasury, at the current market price.

### FDIC Deposit Insurance Fund Restoration Plan Announced

On February 27, 2009, the FDIC announced a proposed rule outlining its plan to implement an emergency special assessment of 20 basis points on all insured depository institutions in order to restore the Deposit Insurance Fund to an acceptable level. The assessment, which would be payable on September 30, 2009, would be in addition to a planned increase in premiums and a change in the way regular premiums are assessed which the FDIC also approved on

February 27, 2009. In addition, the proposed rule provides that, after June 30, 2009, if the reserve ratio of the Deposit Insurance Fund is estimated to fall to a level that the FDIC believes would adversely affect public confidence or to a level which is close to or less than zero at the end of a calendar quarter, then an additional emergency special assessment of up to 10 basis points may be imposed on all insured depository institutions. If this rule is adopted as proposed, it will significantly increase the Banks' FDIC premiums in 2009.

#### PERFORMANCE OVERVIEW

The Company recorded a decline in net income for 2008 when compared to 2007. Net income for the year ended December 31, 2008 was \$11.47 million, compared to \$13.45 million and \$13.55 million for the years ended December 31, 2007 and 2006, respectively. Basic earnings per share for 2008 was \$1.37, a decrease of 14.9% from 2007. Basic earnings per share was \$1.61 and \$1.62 for 2007 and 2006, respectively. Diluted earnings per share for 2008 was also \$1.37, a decrease of 14.4% when compared to 2007. Diluted earnings per share was \$1.60 and \$1.61 for 2007 and 2006, respectively.

Return on average assets was 1.13% for 2008, compared to 1.42% for 2007 and 1.52% for 2006. Return on stockholders' equity for 2008 was 9.22%, compared to 11.79% for 2007 and 12.66% for 2006. Comparing the year ended December 31, 2008 to the year ended December 31, 2007, average assets increased 6.7% to \$1.011 billion, average loans increased 15.0% to \$837.7 million, average deposits increased 6.0% to \$815.7 million, and average stockholders' equity increased 9.1% to \$124.4 million.

## CRITICAL ACCOUNTING POLICIES

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

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

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

## RECENT ACCOUNTING PRONOUNCEMENTS AND DEVELOPMENTS

Note 1 to the Consolidated Financial Statements discusses new accounting policies that the Company adopted during 2008 and the expected impact of accounting policies recently issued or proposed but not yet required to be adopted. To the extent the adoption of new accounting standards materially affects our financial condition, results of operations or liquidity, the impacts are discussed in the applicable section(s) of this discussion and Notes to the

Consolidated Financial Statements.

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## RESULTS OF OPERATIONS

### Net Interest Income and Net Interest Margin

During 2008, the FRB reduced the fed funds rate by 400 basis points. The FRB began its current reductions in the fed funds rate by decreasing rates 100 basis points in 2007. The New York Prime rate, the primary index used for variable rate loans, declined by 400 basis points during 2008 and 100 basis points during 2007. These rate changes had a significant impact on our overall yields earned and rates paid.

Net interest income remains the most significant component of our earnings. It is the excess of interest and fees earned on loans, investment securities, and federal funds sold over interest owed on deposits and borrowings. Tax equivalent net interest income for 2008 was \$40.3 million, representing a 2.7% decrease from 2007. Tax equivalent net interest income for 2007 was \$41.4 million, a 5.6% increase over 2006. A decrease in yields on earning assets was the reason for the decline in 2008; the increase in the volume of earning assets was not enough to offset the decrease in yields. An increase in the volume of earning assets was the reason for the growth in 2007. The tax equivalent yield on earning assets was 6.49% for 2008, compared to 7.34% and 6.98% for 2007 and 2006, respectively. Average earning assets increased to \$954.0 million during 2008, compared to \$893.0 million and \$835.5 million for 2007 and 2006, respectively.

The rate paid for interest bearing liabilities was 2.81% for the year ended December 31, 2008, representing a decrease of 55 basis points from the 3.36% paid for the year ended December 31, 2007. Conversely, in 2007, the overall rate paid for interest bearing liabilities increased 50 basis points when compared to the rate paid for the year ended December 31, 2006.

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The following table sets forth the major components of net interest income, on a tax equivalent basis, for the years ended December 31, 2008, 2007, and 2006.

|   | Average      | 2008         | Yield/ | Average    | 2007         | Yield/ | Average    | 2006         | Yield |
|---|--------------|--------------|--------|------------|--------------|--------|------------|--------------|-------|
| (Dollars in thousands)                    | Balance      | Interest (1) | Rate   | Balance    | Interest (1) | Rate   | Balance    | Interest (1) | /Rate |
| <b>Earning asset</b>                      |              |              |        |            |              |        |            |              |       |
| Loans (2) (3)                             | \$ 837,739   | \$ 57,041    | 6.81%  | \$ 728,666 | \$ 57,637    | 7.91%  | \$ 664,244 | \$ 50,633    | 7.62% |
| <b>Investment securities:</b>             |              |              |        |            |              |        |            |              |       |
| Taxable                                   | 85,105       | 3,788        | 4.45   | 112,384    | 5,105        | 4.54   | 110,354    | 4,486        | 4.07  |
| Tax-exempt                                | 11,031       | 646          | 5.86   | 13,424     | 786          | 5.85   | 13,593     | 791          | 5.82  |
| Federal funds sold                        | 16,427       | 308          | 1.87   | 21,312     | 1,108        | 5.20   | 28,663     | 1,459        | 5.09  |
| Interest bearing deposits                 | 3,666        | 92           | 2.51   | 17,086     | 893          | 5.23   | 18,665     | 939          | 5.03  |
| Total earning assets                      | 953,968      | 61,875       | 6.49%  | 892,972    | 65,529       | 7.34%  | 835,519    | 58,308       | 6.98% |
| Cash and due from banks                   | 14,829       |              |        | 16,938     |              |        | 20,589     |              |       |
| Other assets                              | 50,275       |              |        | 44,136     |              |        | 42,962     |              |       |
| Allowance for credit losses               | (8,270)      |              |        | (6,898)    |              |        | (5,653)    |              |       |
| Total assets                              | \$ 1,010,802 |              |        | \$ 947,148 |              |        | \$ 893,417 |              |       |
| <b>Interest bearing liabilities</b>       |              |              |        |            |              |        |            |              |       |
| Demand deposits                           | \$ 113,002   | \$ 437       | 0.39%  | \$ 112,553 | \$ 1,069     | 0.95%  | \$ 104,371 | \$ 702       | 0.67% |
| Money market and savings deposits         | 175,376      | 2,406        | 1.37   | 177,256    | 3,175        | 1.79   | 189,699    | 2,724        | 1.44  |
| Certificates of deposit \$100,000 or more | 193,678      | 7,955        | 4.11   | 159,532    | 7,748        | 4.86   | 135,568    | 5,988        | 4.42  |
| Other time deposits                       | 226,201      | 9,079        | 4.01   | 213,823    | 9,701        | 4.54   | 191,234    | 7,714        | 4.03  |
| Interest bearing deposits                 | 708,257      | 19,877       | 2.81   | 663,164    | 21,693       | 3.27   | 620,872    | 17,128       | 2.76  |
| Short-term borrowings                     | 47,765       | 1,147        | 2.40   | 33,138     | 1,264        | 3.81   | 29,302     | 1,002        | 3.42  |
|   | 11,598       | 531          | 4.58   | 21,271     | 1,148        | 5.40   | 17,831     | 944          | 5.29  |

|  |              |           |       |            |           |       |            |           |       |
|--|--------------|-----------|-------|------------|-----------|-------|------------|-----------|-------|
| Long-term debt                             |              |           |       |            |           |       |            |           |       |
| Total interest bearing liabilities         | 767,620      | 21,555    | 2.81% | 717,573    | 24,105    | 3.36% | 668,005    | 19,074    | 2.86% |
| Noninterest bearing deposits               | 107,430      |           |       | 106,462    |           |       | 110,657    |           |       |
| Other liabilities                          | 11,388       |           |       | 9,074      |           |       | 7,709      |           |       |
| Stockholders' equity                       | 124,364      |           |       | 114,039    |           |       | 107,046    |           |       |
| Total liabilities and stockholders' equity | \$ 1,010,802 |           |       | \$ 947,148 |           |       | \$ 893,417 |           |       |
| Net interest spread                        |              | \$ 40,320 | 3.68% |            | \$ 41,424 | 3.98% |            | \$ 39,234 | 4.12% |
| Net interest margin                        |              |           | 4.23% |            |           | 4.64% |            |           | 4.70% |

(1) All amounts are reported on a tax equivalent basis computed using the statutory federal income tax rate of 35% exclusive of the alternative minimum tax rate and nondeductible interest expense. The taxable equivalent adjustment amounts utilized in the above table to compute yields aggregated \$401,000 in 2008, \$388,000 in 2007, and \$337,000 in 2006.

(2) Average loan balances include nonaccrual loans.

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

On a tax equivalent basis, total interest income was \$61.9 million for 2008, compared to \$65.5 million for 2007 and \$58.3 million for 2006. The Company's largest source of interest income is loans. The tax equivalent yield on loans decreased to 6.81% for 2008, compared to 7.91% for 2007 and 7.62% for 2006. The \$109.0 million increase in average loans was not enough to offset the decrease of 110 basis points in the yield on loans which was the primary reason for the decline in interest income in 2008. An increase in both the volume and yield on loans was the reason for the increase in interest income in 2007. Volume and yields on all other earning assets decreased during 2008. In 2007, volume decreased but yields increased for all other earning assets. During 2008, the overall decrease in yields on earning assets produced \$3.7 million less in interest income, \$5.8 million of which was due to lower rates net of \$2.1 million due to increased volume. In 2007, increased volume and yields on earning assets generated \$7.2 million in additional interest income. Of that amount, increased volume generated an additional \$4.7 million in interest income, while \$2.5 million was attributable to increased yields on earning assets.



Interest expense was \$21.6 million for 2008, compared to \$24.1 million for 2007 and \$19.1 million for 2006. Although overall volume increased, lower rates paid for interest bearing liabilities, primarily deposits, was the main reason for the decrease in interest expense in 2008. An increase in volume and higher rates paid for interest bearing liabilities resulted in an increase in interest expense for 2007 when compared to 2006. The Company incurs the largest amount of interest expense from time deposits. The average rate paid for certificates of deposit of \$100,000 or more decreased 75 basis points to 4.11% for 2008 from 4.86% for 2007. The average rate paid for certificates of deposit of \$100,000 or more increased 44 basis points in 2007 from 2006. The rate paid for all other time deposits decreased to 4.01% for 2008, compared to 4.54% for 2007. The rate paid for all other time deposits increased 51 basis points in 2007 from 2006. During 2008, the overall decrease in rates on interest bearing liabilities produced \$2.5 million less in interest expense, \$3.9 million of which was due to lower rates net of \$1.4 million due to increased volume. In 2007, increased volume and rates on deposits and other interest bearing liabilities generated \$5.0 million in additional interest expense. Of that amount, increased volume generated an additional \$2.3 million in interest expense, while \$2.7 million was attributable to increased rates.

Average earning assets grew \$61.0 million, or 6.8%, for the year ended December 31, 2008, driven primarily by growth in loans. In 2007, average earning assets increased \$57.5 million, or 6.9%, when compared to 2006, also mainly due to loan growth. Average loans increased \$109.0 million, or 15.0%, totaling \$837.7 million for the year ended December 31, 2008, compared to an increase of \$64.5 million, or 9.7%, for 2007. For the year ended December 31, 2008, average investment securities decreased \$30.0 million and federal funds sold and interest bearing deposits in other banks decreased \$18.3 million when compared to 2007. Average investment securities increased \$1.9 million and federal funds sold and interest bearing deposits in other banks decreased \$8.9 million for 2007 when compared to 2006. As a percentage of total average earning assets, loans and investment securities were 87.8% and 10.1%, respectively, for 2008, compared to 81.6% and 14.1%, respectively, for 2007 and 79.5% and 14.8%, respectively, for 2006.

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

| (Dollars in thousands)                                  | 2008 over (under) 2007 |                |              | 2007 over (under) 2006 |              |              |
|---|------------------------|----------------|--------------|------------------------|--------------|--------------|
|   | Total<br>Variance      | Caused By      |              | Total<br>Variance      | Caused By    |              |
|   |                        | Rate           | Volume       |                        | Rate         | Volume       |
| <b>Interest income from earning assets:</b>             |                        |                |              |                        |              |              |
| Loans   | \$ (596)               | \$ (4,880)     | \$ 4,284     | \$ 7,004               | \$ 1,878     | \$ 5,126     |
| Taxable investment securities                           | (1,317)                | (111)          | (1,206)      | 619                    | 549          | 70           |
| Tax-exempt investment securities                        | (140)                  | 1              | (141)        | (5)                    | 5            | (10)         |
| Federal funds sold                                      | (800)                  | (455)          | (345)        | (351)                  | 30           | (381)        |
| Interest bearing deposits                               | (801)                  | (320)          | (481)        | (46)                   | 40           | (86)         |
| <b>Total interest income</b>                            | <b>(3,654)</b>         | <b>(5,765)</b> | <b>2,111</b> | <b>7,221</b>           | <b>2,502</b> | <b>4,719</b> |
| <b>Interest expense on deposits and borrowed funds:</b> |                        |                |              |                        |              |              |
| Interest bearing demand deposits                        | (632)                  | (636)          | 4            | 367                    | 317          | 50           |
| Money market and savings deposits                       | (769)                  | (801)          | 32           | 451                    | 647          | (196)        |
| Time deposits   | (415)                  | (1,727)        | 1,312        | 3,747                  | 1,655        | 2,092        |

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|                        |            |            |       |          |          |          |
|------------------------|------------|------------|-------|----------|----------|----------|
| Short-term borrowings  | (117)      | (627)      | 510   | 262      | 52       | 210      |
| Long-term debt         | (617)      | (155)      | (462) | 204      | 19       | 185      |
| Total interest expense | (2,550)    | (3,946)    | 1,396 | 5,031    | 2,690    | 2,341    |
| Net interest income    | \$ (1,104) | \$ (1,819) | 715   | \$ 2,190 | \$ (188) | \$ 2,378 |

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

Our net interest margin (i.e., tax equivalent net interest income divided by average earning assets) represents the net yield on earning assets. The net interest margin is managed through loan and deposit pricing and asset/liability strategies. The net interest margin was 4.23% for 2008, compared to 4.64% for 2007 and 4.70% for 2006. The main reason for the lower net interest margin in 2008 was decreased yields on earning assets. The increased cost of interest bearing liabilities in 2007 slightly decreased the net interest margin from 2006. The net interest spread, which is the difference between the average yield on earning assets and the rate paid for interest bearing liabilities, was 3.68% for 2008, 3.98% for 2007 and 4.12% for 2006.

## Noninterest Income

Noninterest income increased \$5.7 million, or 38.6%, in 2008, compared to an increase of \$1.8 million, or 14.3%, in 2007. The increases were primarily related to the acquisition of two insurance entities during the fourth quarter of 2007. Service charges on deposit accounts increased \$228 thousand in 2008, relatively unchanged from the increase of \$235 thousand in 2007. Other service charges and fees increased \$834 thousand in 2008 and \$677 thousand in 2007. Approximately half of the 2008 increase was from the new insurance entities, 30% was from the trust division, and the remainder was from banking activities. The 2007 increase was the result of an increase in interchange income relating to bank debit and ATM cards (\$166 thousand), and fee income generated by the trust division (\$303 thousand). Investment securities losses were \$15 thousand in 2008, compared to gains of \$5 thousand and \$3 thousand in 2007 and 2006, respectively. The securities losses in 2008 were from the sale of 10,000 shares of Federal Home Loan Mortgage Corporation (Freddie Mac) preferred stock. The Company also incurred a \$371 thousand other than temporary impairment loss on these securities during 2008. Insurance agency commissions income was \$12.1 million in 2008, compared to \$7.7 million and \$6.7 million in 2007 and 2006, respectively. The increase in 2008 and 2007 was primarily due to the two insurance entities acquired in the fourth quarter of 2007. Gains on disposals of premises and equipment were \$1.2 million in 2008, compared to losses of \$136 thousand in 2007 and gains of \$6 thousand in 2006. The gains on disposals in 2008 included the sale of a bank branch to the state of Maryland as part of a road widening project. The branch remains open but management expects to move branch operations to a new facility in the future. During 2008, the Company sold its investment in Delmarva Bank Data Processing Center, Inc., an unconsolidated subsidiary, for a loss of \$337 thousand. Other noninterest income decreased \$438 thousand in 2008 and increased \$114 thousand in 2007. The decrease in 2008 was primarily due to less income generated by the mortgage subsidiary.

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

| (Dollars in thousands)                                | Years Ended |          |          | Change from Prior Year |         |        |           |
|---|-------------|----------|----------|------------------------|---------|--------|-----------|
|   | 2008        | 2007     | 2006     | 2008/07                | 2007/06 |        |           |
|   |             |          |          | Amount                 | Percent | Amount | Percent   |
| Service charges on deposit accounts                   | \$ 3,600    | \$ 3,372 | \$ 3,137 | \$ 228                 | 6.8%    | \$ 235 | 7.5%      |
| Other service charges and fees                        | 3,029       | 2,195    | 1,518    | 834                    | 38.0    | 677    | 44.6      |
| (Losses) gains on sales of investment securities      | (15)        | 5        | 3        | (20)                   | (400.0) | 2      | 66.7      |
| Other than temporary impairment of securities         | (371)       | -        | -        | (371)                  | -       | -      | -         |
| Insurance agency commissions income                   | 12,090      | 7,698    | 6,744    | 4,392                  | 57.1    | 954    | 14.1      |
| Gains (losses) on disposals of premises and equipment | 1,247       | (136)    | 6        | 1,383                  | 1,016.9 | (142)  | (2,366.7) |

|   |           |           |           |          |        |       |      |
|---|-----------|-----------|-----------|----------|--------|-------|------|
| Loss on sale of investment in unconsolidated subsidiary | (337)     | -         | -         | (337)    | -      | -     | -    |
| Other noninterest income                                | 1,107     | 1,545     | 1,431     | (438)    | (28.3) | 114   | 8.0  |
| Total   | \$ 20,350 | \$ 14,679 | \$ 12,839 | \$ 5,671 | 38.6   | 1,840 | 14.3 |

#### Noninterest Expense

Total noninterest expense increased \$5.8 million or 17.9% in 2008, compared to an increase of \$4.0 million or 14.0% in 2007. The increase in 2008 was primarily attributable to the operating costs of the two insurance entities acquired during the fourth quarter of 2007. These operating costs included salaries, benefits, occupancy, amortization of intangibles, insurance agency commissions and other noninterest expenses. Furniture and equipment, data processing and directors' fees expenses either decreased or remained relatively flat compared to 2007. The majority of the noninterest expense increase in 2007 was related to salaries and employee benefits expense. In 2007, the salaries and benefits cost increases that were not related to acquisitions resulted from an increase in the number of full-time equivalent employees, the increased cost of operating two additional bank branches, increased commission expense related to the increased income from the trust and advisory services and secondary market mortgage programs, the additional costs associated with segregating the CEO positions at the Company and The Talbot Bank, and the costs associated with hiring a new CEO at Talbot Bank in the third quarter of 2006. Increases in occupancy and equipment expense, data processing and other noninterest expenses in 2007 were attributable to overall growth. Amortization of other intangible assets relate to

Felton Bank and the operation of the Insurance Subsidiaries. See Note 8 to the Consolidated Financial Statements for further information regarding the impact of goodwill and other intangible assets on the financial statements. We had 333 full-time equivalent employees at December 31, 2008, compared to 338 and 292 at December 31, 2007 and 2006, respectively.

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

| (Dollars in thousands)               | Years Ended |           |           | Change from Prior Year |         |                   |         |
|--------------------------------------|-------------|-----------|-----------|------------------------|---------|-------------------|---------|
|                                      | 2008        | 2007      | 2006      | 2008/07<br>Amount      | Percent | 2007/06<br>Amount | Percent |
| Salaries and employee benefits       | \$ 23,321   | \$ 19,991 | \$ 17,693 | \$ 3,330               | 16.7%   | \$ 2,298          | 13.0%   |
| Occupancy and equipment              | 3,364       | 3,274     | 2,948     | 90                     | 2.7     | 326               | 11.1    |
| Data processing                      | 1,872       | 1,820     | 1,559     | 52                     | 2.9     | 261               | 16.7    |
| Directors' fees                      | 558         | 605       | 536       | (47)                   | (7.8)   | 69                | 12.9    |
| Amortization of intangible assets    | 515         | 333       | 337       | 182                    | 54.7    | (4)               | (1.2)   |
| Insurance agency commissions expense | 2,248       | 557       | -         | 1,691                  | 303.6   | 557               | -       |
| Other noninterest expense            | 6,492       | 5,959     | 5,462     | 533                    | 8.9     | 497               | 9.1     |
| Total                                | \$ 38,370   | \$ 32,539 | \$ 28,535 | \$ 5,831               | 17.9    | \$ 4,004          | 14.0    |

#### Income Taxes

Income tax expense was \$7.1 million for 2008, compared to \$8.0 million for 2007 and \$8.2 million for 2006. The effective tax rates on earnings were 38.2%, 37.3% and 37.6% for 2008, 2007, and 2006, respectively. The increase in the effective tax rate in 2008 was primarily due to a 1.25% increase in the Maryland corporate income tax rate at the beginning of 2008.

#### REVIEW OF FINANCIAL CONDITION

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

#### Assets

Total assets increased 9.2% during 2008 to \$1.045 billion at December 31, 2008, compared to an increase of 1.2% for 2007. Average total assets for the year ended December 31, 2008 were \$1.011 billion, an increase of 6.7% over 2007. Average total assets increased 6.0% in 2007, totaling \$947.1 million for the year. The loan portfolio is the primary source of our income, and it represented 87.8%, 81.6% and 79.6% of average earning assets for 2008, 2007 and 2006, respectively.

Funding for loans is provided primarily by core deposits. Additional funding is obtained through short-term and long-term borrowings. Average total deposits increased 6.0% to \$815.7 million at December 31, 2008, compared to a 5.2% increase for 2007. Deposits provided funding for approximately 85.5%, 86.2% and 87.6% of average earning assets for 2008, 2007 and 2006, respectively.

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

|  | 2008   | 2007   | 2006   | 2005   | 2004   |
|--|--------|--------|--------|--------|--------|
| Loans                                      | 87.8%  | 81.6%  | 79.6%  | 79.6%  | 76.8%  |
| Investment securities                      | 10.1   | 14.1   | 14.8   | 15.9   | 19.7   |
| Federal funds sold                         | 1.7    | 2.4    | 3.4    | 4.1    | 2.8    |
| Interest bearing deposits with other banks | 0.4    | 1.9    | 2.2    | 0.4    | 0.7    |
|  | 100.0% | 100.0% | 100.0% | 100.0% | 100.0% |

#### Interest Bearing Deposits With Other Banks and Federal Funds Sold

We invest excess cash balances in interest bearing accounts and federal funds sold offered by our correspondent banks. These liquid investments are maintained at a level necessary to meet immediate liquidity needs. Average interest bearing deposits with other banks and federal funds sold decreased \$18.3 million to \$20.1 million for the year ended December 31, 2008, compared to a decrease of \$8.9 million in 2007.

## Investment Securities

The investment portfolio is structured to provide us with liquidity and also plays an important role in the overall management of interest rate risk. Investment securities available for sale are stated at estimated fair value based on quoted market prices. They represent securities which may be sold as part of the asset/liability management strategy or which may be sold in response to changing interest rates. Net unrealized holding gains and losses on these securities are reported net of related income taxes as accumulated other comprehensive income, a separate component of stockholders' equity. Investment securities in the held to maturity category are stated at cost adjusted for amortization of premiums and accretion of discounts. We have the intent and current ability to hold such securities until maturity. At December 31, 2008, 89% of the portfolio was classified as available for sale and 11% as held to maturity, compared to 88% and 12%, respectively, at December 31, 2007 and 89% and 11%, respectively, at December 31, 2006. The percentage of securities designated as available for sale reflects the amount needed to support our anticipated growth and liquidity needs. With the exception of municipal securities, our general practice is to classify all newly purchased securities as available for sale.

Investment securities available for sale decreased \$17.9 million or 18.5% in 2008, totaling \$79.2 million at December 31, 2008, compared to \$97.1 million at December 31, 2007. In 2007, investment securities available for sale decreased \$19.1 million or 16.5%.

Investment securities held to maturity, consisting primarily of tax-exempt municipal bonds, totaled \$10.3 million at December 31, 2008, compared to \$12.9 million at December 31, 2007 and \$14.0 million at December 31, 2006. We do not typically invest in structured notes or other derivative securities.

The following table sets forth the maturities and weighted average yields of the bond investment portfolio as of December 31, 2008.

| (Dollars in thousands)  | 1 Year or Less  |               | 1-5 Years        |               | 5-10 Years      |               | Over 10 Years    |               |
|---|-----------------|---------------|------------------|---------------|-----------------|---------------|------------------|---------------|
|   | Carrying Amount | Average Yield | Carrying Amount  | Average Yield | Carrying Amount | Average Yield | Carrying Amount  | Average Yield |
| <b>Available for sale:</b>                                    |                 |               |                  |               |                 |               |                  |               |
| U.S. Treasury and Government agencies                         | \$ 7,892        | 4.68%         | \$ 44,555        | 4.07%         | \$ -            | -%            | \$ -             | -%            |
| Mortgage-backed securities                                    | 1,042           | 4.48          | 4,066            | 4.77          | 5,155           | 4.86          | 12,636           | 5.21          |
| <b>Total available for sale</b>                               | <b>\$ 8,934</b> | <b>4.66</b>   | <b>\$ 48,621</b> | <b>4.13</b>   | <b>\$ 5,155</b> | <b>4.86</b>   | <b>\$ 12,636</b> | <b>5.21</b>   |
| <b>Held to maturity:</b>                                      |                 |               |                  |               |                 |               |                  |               |
| Obligations of states and political subdivisions <sup>1</sup> | \$ 4,357        | 5.44%         | \$ 4,753         | 5.68%         | \$ 1,142        | 5.26%         | \$ -             | -%            |

<sup>1</sup> Yields adjusted to reflect a tax equivalent basis assuming a federal tax rate of 35%.

## Loans

During 2008, we continued to experience strong growth trends in real estate lending. The markets in which we operate have experienced a considerable amount of construction and land development activity over the last several

years, which has been a significant factor behind overall loan growth. Loans, net of unearned income, totaled \$888.5 million at December 31, 2008, an increase of \$112.2 million or 14.4% over 2007. Loans increased \$76.6 million or 11.0% in 2007 when compared to 2006. Real estate construction loans increased \$24.3 million or 15.6% in 2008, compared to a decrease of \$3.4 million or 2.2% in 2007. Residential real estate mortgage loans increased \$33.3 million or 13.0% in 2008, similar to the increase of \$33.5 million or 15.0% in 2007. Commercial real estate mortgage loans increased \$55.4 million or 22.3% in 2008, compared to an increase of \$31.2 million or 14.3% in 2007. Commercial loans, which include financial and agricultural loans, decreased \$614 thousand or less than 1% in 2008, compared to an increase of \$12.1 million or 15.1% in 2007. Consumer loans, a small percentage of the overall loan portfolio, decreased \$300 thousand in 2008 and increased \$3.3 million in 2007. At December 31, 2008, 56.5% of the loan



portfolio had fixed interest rates and 43.5% had adjustable interest rates. We have brokered long-term fixed rate residential mortgage loans for sale on the secondary market since 2002. At December 31, 2008, 2007 and 2006, there were no loans held for sale. We do not engage in foreign or subprime lending activities.

The table below sets forth trends in the composition of the loan portfolio over the past five years (including net deferred loan fees/costs).

| (Dollars in thousands)     | December 31, |            |            |            |            |
|----------------------------|--------------|------------|------------|------------|------------|
|                            | 2008         | 2007       | 2006       | 2005       | 2004       |
| Real estate – construction | \$ 179,847   | \$ 155,513 | \$ 158,943 | \$ 134,380 | \$ 97,021  |
| Real estate – residential  | 289,510      | 256,195    | 222,687    | 212,769    | 240,464    |
| Real estate – commercial   | 304,396      | 248,953    | 217,781    | 187,860    | 165,589    |
| Commercial                 | 91,644       | 92,258     | 80,186     | 75,527     | 73,757     |
| Consumer                   | 23,131       | 23,431     | 20,122     | 16,927     | 18,627     |
| Total                      | \$ 888,528   | \$ 776,350 | \$ 699,719 | \$ 627,463 | \$ 595,458 |

The table below sets forth the maturities and interest rate sensitivity of the loan portfolio at December 31, 2008.

| (Dollars in thousands)         | Maturities               |  |                           | Total      |
|--------------------------------|--------------------------|--|---------------------------|------------|
|                                | Maturing within one year | Maturing after one but within five years | Maturing after five years |            |
| Real estate – construction     | \$ 111,598               | \$ 63,406                                | \$ 4,843                  | \$ 179,847 |
| Real estate – residential      | 92,752                   | 93,645                                   | 103,113                   | 289,510    |
| Real estate – commercial       | 91,323                   | 194,962                                  | 18,111                    | 304,396    |
| Commercial                     | 48,650                   | 35,016                                   | 7,978                     | 91,644     |
| Consumer                       | 13,618                   | 8,201                                    | 1,312                     | 23,131     |
| Total                          | \$ 357,941               | \$ 395,230                               | \$ 135,357                | \$ 888,528 |
| <b>Rate terms:</b>             |                          |  |                           |            |
| Fixed-interest rate loans      | \$ 145,532               | \$ 304,480                               | \$ 51,650                 | \$ 501,662 |
| Adjustable-interest rate loans | 212,410                  | 90,750                                   | 83,706                    | 386,866    |
| Total                          | \$ 357,942               | \$ 395,230                               | \$ 135,356                | \$ 888,528 |

## Deposits

We use core deposits primarily to fund loans and to purchase investment securities. Average deposits increased \$46.1 million or 6.0% in 2008, compared to a 5.2% increase in 2007. The majority of the deposit growth was in certificates of deposit during 2008 and 2007. Certificates of deposit \$100,000 or more increased \$34.1 million or 21.4% in 2008, compared to an increase of \$24.0 million or 17.7% in 2007. Other time deposits increased \$12.4 million in 2008, considerably less than the increase of \$22.6 million in 2007. Average noninterest bearing demand deposits increased slightly in 2008, compared to a decrease of 3.8% in 2007. Average interest bearing demand deposits increased less than one percent in 2008, compared to an increase of 7.8% in 2007. For 2008, the average balances of money market and savings accounts decreased by \$1.9 million, somewhat less of a decline than the \$12.4 million for 2007. In 2007, the competitive environment and higher rates offered for certificates of deposit caused a shifting of balances from money market to certificates of deposit. This shifting continued to occur in 2008.

We have not historically relied on brokered deposits or purchased deposits as funding sources for loans.



The following table sets forth the average balances of deposits and the percentage of each category to total average deposits for the years ended December 31.

| (Dollars in thousands)                    | Average Balances |        |            |        |            |        |
|---|------------------|--------|------------|--------|------------|--------|
|   | 2008             |        | 2007       |        | 2006       |        |
| Noninterest bearing demand                | \$ 107,430       | 13.2%  | \$ 106,462 | 13.9%  | \$ 110,657 | 15.1%  |
| Interest bearing deposits                 |                  |        |            |        |            |        |
| Demand                                    | 113,002          | 13.9   | 112,553    | 14.6   | 104,371    | 14.3   |
| Money market and savings                  | 175,376          | 21.5   | 177,256    | 23.0   | 189,699    | 25.9   |
| Certificates of deposit \$100,000 or more | 193,678          | 23.7   | 159,532    | 20.7   | 135,568    | 18.5   |
| Other time deposits                       | 226,201          | 27.7   | 213,823    | 27.8   | 191,234    | 26.2   |
|   | \$ 815,687       | 100.0% | \$ 769,626 | 100.0% | \$ 731,529 | 100.0% |

The following table sets forth the maturity ranges of certificates of deposit with balances of \$100,000 or more as of December 31, 2008.

| (Dollars in thousands)           |            |
|----------------------------------|------------|
| Three months or less             | \$ 63,062  |
| Over three through twelve months | 116,975    |
| Over twelve months               | 55,198     |
|                                  | \$ 235,235 |

#### Short-Term Borrowings

Short-term borrowings primarily consist of securities sold under agreements to repurchase and short-term borrowings from the FHLB. Securities sold under agreements to repurchase are issued in conjunction with cash management services for commercial depositors. We also borrow from the FHLB on a short-term basis and occasionally borrow from correspondent banks under federal fund lines of credit arrangements to meet short-term liquidity needs.

The average balance of short-term borrowings increased \$14.6 million or 44.1% in 2008, considerably more than the increase of \$3.8 million or 13.1% in 2007.

The following table sets forth our position with respect to short-term borrowings.

| (Dollars in thousands)               | 2008      |               | 2007      |               | 2006      |               |
|--------------------------------------|-----------|---------------|-----------|---------------|-----------|---------------|
|                                      | Balance   | Interest Rate | Balance   | Interest Rate | Balance   | Interest Rate |
| Average outstanding for the year     | \$ 47,765 | 2.40%         | \$ 33,138 | 3.81%         | \$ 29,302 | 3.42%         |
| Outstanding at year end              | 52,969    | 0.49          | 47,694    | 3.86          | 28,524    | 3.97          |
| Maximum outstanding at any month end | 73,094    | -             | 57,036    | -             | 42,273    | -             |

### Long-Term Debt

We use long-term borrowings from the FHLB to meet longer term liquidity needs, specifically to fund loan growth where deposit growth is not sufficient. At December 31, 2008, our long-term debt was \$7.9 million, a decrease of \$4.5 million from year-end 2007. Long-term debt at December 31, 2007 decreased \$12.5 million when compared to year-end 2006. Acquisition-related debt was \$1.9 million and \$2.5 million of total long-term debt at year-end 2008 and 2007, respectively. There was no acquisition-related debt at December 31, 2006.

### Capital Management

Total stockholders' equity for the Company was \$127.4 million at December 31, 2008, 5.9% higher than the previous year. Stockholders' equity at December 31, 2007 increased 8.0% over December 31, 2006. The increases in stockholders' equity in 2008 and 2007 were due primarily to earnings for those years, reduced by dividends paid on shares of the common stock of the Company. The Banks paid dividends to the Company in 2007 in order to facilitate the acquisition of two new insurance entities, which reduced their overall capital levels and resulted in lower capital ratios at December 31, 2007. However, the Company and the Banks continue to maintain capital at levels in excess of the risk-based capital guidelines adopted by the federal banking agencies. At year-end 2008, the Company remained well in excess of regulatory requirements for well capitalized institutions.

We record unrealized holding gains (losses), net of tax, on investment securities available for sale as accumulated other comprehensive income (loss), a separate component of stockholders' equity. At December 31, 2008, the portion of the investment portfolio designated as "available for sale" had net unrealized holding gains, net of tax, of \$1.4 million, compared to net unrealized holding gains, net of tax, of \$247 thousand at December 31, 2007 and net unrealized holding losses, net of tax, of \$724 thousand at December 31, 2006.

The following table compares the Company's capital ratios as of December 31 to the minimum regulatory requirements.

| (Dollars in thousands)        | 2008       | 2007      | 2006      | Minimum<br>Regulatory<br>Requirements |
|-------------------------------|------------|-----------|-----------|---------------------------------------|
| Tier 1 capital                | \$ 104,117 | \$ 97,744 | \$ 98,766 |                                       |
| Tier 2 capital                | 9,755      | 7,950     | 6,636     |                                       |
| Total risk-based capital      | 113,872    | 105,694   | 105,402   |                                       |
| Net risk weighted assets      | 894,024    | 804,240   | 750,471   |                                       |
| Adjusted average total assets | 1,013,815  | 930,619   | 928,551   |                                       |
| Risk-based capital ratios:    |            |           |           |                                       |
| Tier 1                        | 11.65%     | 12.15%    | 13.16%    | 4.0%                                  |
| Total capital                 | 12.74      | 13.14     | 14.04     | 8.0                                   |
| Tier 1 leverage ratio         | 10.27      | 10.50     | 10.64     | 4.0                                   |

Management knows of no trends or demands, commitments, events or uncertainties that are likely to have a material adverse impact on capital. See Note 17 to the Consolidated Financial Statements for further information about the regulatory capital positions of the Company and the Banks.

#### Provision for Credit Losses and Risk Management

Originating loans involves a degree of risk that credit losses will occur in varying amounts according to, among other factors, the types of loans being made, the credit-worthiness of the borrowers over the term of the loans, the quality of the collateral for the loan, if any, as well as general economic conditions. The Company's Board of Directors demands accountability of management, keeping the interests of stockholders in focus. Through its Asset/Liability Management and Audit Committee, the Board actively reviews critical risk positions, including market, credit, liquidity and operational risk. The Company's goal in managing risk is to reduce earnings volatility, control exposure to unnecessary risk, and ensure appropriate returns for risk assumed. Senior members of management actively manage risk at the product level, supplemented with corporate level oversight through the Asset/Liability Management Committee and internal audit function. The risk management structure is designed to identify risk issues through a systematic process, enabling timely and appropriate action to avoid and mitigate risk.

Credit risk is mitigated through portfolio diversification, limiting exposure to any single industry or customer, collateral protection and standard lending policies and underwriting criteria. The following discussion provides information and statistics on the overall quality of the Company's loan portfolio. Note 1 to the Consolidated Financial Statements describes the accounting policies related to nonperforming loans and charge-offs and describes the methodologies used to develop the allowance for credit losses, including the specific, formula and nonspecific components. Management believes the policies governing nonperforming loans and charge-offs are consistent with regulatory standards. The amount of the allowance for credit losses and the resulting provision are reviewed monthly by senior members of management and approved quarterly by the Board of Directors.

The allowance is increased by provisions for credit losses charged to expense and recoveries of loans previously charged-off. It is decreased by loans charged-off in the current period. Provisions for credit losses are made to bring the allowance for credit losses within the range of balances that are considered appropriate based upon the allowance methodology and to reflect losses within the loan portfolio as of the balance sheet date.

The adequacy of the allowance for credit losses is determined based upon management's estimate of the inherent risks associated with lending activities, estimated fair value of collateral, past experience and present indicators such as loan delinquency trends, nonaccrual loans and current market conditions. Management believes the allowance is adequate; however, future changes in the composition of the loan portfolio and financial condition of borrowers may result in additions to the allowance. Examination of the portfolio and allowance by various regulatory agencies and consultants engaged by the Company may result in the need for additional provisions based upon information available at the time of the examination.

Each of the Banks maintains a separate allowance for credit losses, which is only available to absorb losses from their respective loan portfolios. The allowance set by each of the Banks is subject to regulatory examination and determination as to its adequacy.

The allowance for credit losses is comprised of three parts: the specific allowance, the formula allowance and the nonspecific allowance. The specific allowance is the portion of the allowance that results from management's evaluation of specific loss allocations for identified problem loans and pooled reserves based on historical loss experience for each loan category. The formula allowance is determined based on management's assessment of industry trends and economic factors in the markets in which we operate. The determination of the formula allowance involves a higher risk of uncertainty and considers current risk factors that may not have yet manifested themselves in our historical loss factors. The nonspecific allowance captures losses that have impacted the portfolio but have yet to be recognized in either the specific or formula allowance.

The specific allowance is used to individually allocate an allowance to loans identified as impaired. An impaired loan may show deficiencies in the borrower's overall financial condition, payment history, support available from financial guarantors and/or the fair market value of collateral. When a loan is identified as impaired, a specific allowance is established based on our assessment of the loss that may be associated with the individual loan.

The formula allowance is used to estimate the loss on internally risk rated loans, exclusive of those identified as impaired. Loans identified as special mention, substandard, doubtful and loss, as well as impaired, are segregated from performing loans. Remaining loans are then grouped by type (commercial, commercial real estate and construction, residential real estate or consumer). Each loan type is assigned an allowance factor based on management's estimate of the risk, complexity and size of individual loans within a particular category. Classified loans are assigned higher allowance factors than non-rated loans due to management's concerns regarding collectibility or management's knowledge of particular elements regarding the borrower. Allowance factors grow with the worsening of the internal risk rating.

The nonspecific allowance is used to estimate the loss of non-classified loans stemming from more global factors such as delinquencies, loss history, trends in volume and terms of loans, effects of changes in lending policy, the experience and depth of management, national and local economic trends, concentrations of credit, the quality of the loan review system and the effect of external factors such as competition and regulatory requirements.

As stated elsewhere in this report, the economy has significantly weakened over the past two years. Although the local economy does not appear to show to the same extent of weakness as in other parts of the country, the effects of continued weakness in the national economy and/or an increasing weakness in the local economy could result in even higher loss levels for us in the future.

At December 31, 2008, the allowance for credit losses was \$9.3 million, or 1.11% of average outstanding loans, and 115% of total nonaccrual loans. This compares to an allowance of \$7.6 million, or 1.04% of average outstanding loans and 213% of nonaccrual loans, at December 31, 2007, and an allowance for credit losses of \$6.3 million, or 0.90% of outstanding loans and 82% of nonaccrual loans, at December 31, 2006. The ratio of net charge-offs to average loans was 0.19% in 2008 and 0.06% in both 2007 and 2006.

The provision for credit losses was \$3.3 million for 2008, compared to \$1.7 million and \$1.5 million for 2007 and 2006, respectively. The increased provision in 2008 reflected the overall growth of the loan portfolio, an increase in loan charge-offs and nonperforming assets, and a deterioration in overall economic conditions. Net loan charge-offs totaled \$1.6 million for 2008, a \$1.1 million increase when compared to \$473 thousand in net charge-offs for 2007. Net charge-offs were \$429 thousand in 2006.





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The following table sets forth a summary of our loan loss experience for the years ended December 31.

| (Dollars in thousands)   | 2008       | 2007       | 2006       | 2005       | 2004       |
|--|------------|------------|------------|------------|------------|
| Balance, beginning of year   | \$ 7,551   | \$ 6,300   | \$ 5,236   | \$ 4,692   | \$ 4,060   |
| <b>Loans charged off</b>   |            |            |            |            |            |
| Real estate – construction   | (536)      | -          | -          | -          | -          |
| Real estate – residential  | (316)      | (137)      | -          | -          | -          |
| Real estate – commercial   | (238)      | -          | (2)        | -          | (131)      |
| Commercial   | (447)      | (276)      | (539)      | (266)      | (662)      |
| Consumer   | (276)      | (301)      | (137)      | (183)      | (94)       |
|  | (1,813)    | (714)      | (678)      | (449)      | (887)      |
| <b>Recoveries</b>  |            |            |            |            |            |
| Real estate – construction   | -          | -          | -          | -          | -          |
| Real estate – residential  | 19         | -          | -          | -          | -          |
| Real estate – commercial   | -          | -          | 46         | 2          | 20         |
| Commercial   | 136        | 165        | 123        | 110        | 79         |
| Consumer   | 90         | 76         | 80         | 71         | 63         |
|  | 245        | 241        | 249        | 183        | 162        |
| Net loans charged off  | (1,568)    | (473)      | (429)      | (266)      | (725)      |
| Allowance of acquired institution  | -          | -          | -          | -          | 426        |
| Provision for credit losses  | 3,337      | 1,724      | 1,493      | 810        | 931        |
| Balance, end of year   | \$ 9,320   | \$ 7,551   | \$ 6,300   | \$ 5,236   | \$ 4,692   |
| Average loans outstanding  | \$ 837,739 | \$ 728,766 | \$ 664,244 | \$ 607,017 | \$ 555,259 |
| Percentage of net charge-offs to average loans outstanding during the year | 0.19%      | 0.06%      | 0.06%      | 0.04%      | 0.13%      |
| Percentage of allowance for loan losses at year-end to average loans       | 1.11%      | 1.04%      | 0.90%      | 0.86%      | 0.85%      |

Total nonaccrual loans increased to 0.91% of total loans at December 31, 2008, compared to 0.46% at December 31, 2007 and 1.09% at December 31, 2006. Specific valuation allowances totaling \$341 thousand, \$819 thousand and \$883 thousand were established to address nonaccrual loans at December 31, 2008, 2007 and 2006, respectively. Loans 90 days past due and still accruing were \$1.4 million, \$1.6 million and \$641 thousand at year-end 2008, 2007 and 2006, respectively. Nonaccrual loans and loans 90 days past due and still accruing at December 31, 2008 are represented primarily by real estate loans. Management believes these loans have been adequately provided for in the allowance for credit losses.

The following table summarizes our past due and nonperforming assets as of December 31.

| (Dollars in thousands)                    | 2008     | 2007     | 2006     | 2005   | 2004     |
|---|----------|----------|----------|--------|----------|
| <b>Non-performing asset</b>               |          |          |          |        |          |
| Non-accrual loans                         | \$ 8,115 | \$ 3,540 | \$ 7,658 | \$ 846 | \$ 1,469 |
| Other real estate and other assets owned  | 148      | 176      | 398      | 302    | 391      |
| Total non-performing assets               | 8,263    | 3,716    | 8,056    | 1,148  | 1,860    |
| Loans 90 days past due and still accruing | 1,381    | 1,606    | 641      | 818    | 2,969    |

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|  |          |          |          |          |          |
|--|----------|----------|----------|----------|----------|
| Total non-performing assets and past due loans                     | \$ 9,644 | \$ 5,322 | \$ 8,697 | \$ 1,966 | \$ 4,829 |
| Non-accrual loans to total loans at period end                     | 0.91%    | 0.46%    | 1.09%    | 0.13%    | 0.25%    |
| Non-accrual loans and past due loans, to total loans at period end | 1.07%    | 0.66%    | 1.19%    | 0.27%    | 0.75%    |

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During 2008, there was no change in the methods or assumptions affecting the allowance methodology. The amount of the provision is determined based upon management's analysis of the portfolio, growth and changes in the condition of credits and their resultant specific loss allocations. Historically, we have experienced the majority of our losses in the commercial loan portfolio, which are typically not secured by real estate. However, during 2008 the Company experienced significantly higher losses on real estate secured loans due to declining real estate values and the slowing economy.

As seen in the table below, the unallocated portion of the allowance for credit losses was \$216 thousand at December 31, 2008. There was no unallocated portion of the allowance at December 31, 2007 and 2006. At December 31, 2008, 65.3% and 21.8% of our total loans were real estate mortgage loans and real estate construction and land development loans, respectively, compared to 65.1% and 20.0% at December 31, 2007 and 62.9% and 22.7% at December 31, 2006.

The following table sets forth the allocation of the allowance for credit losses and the percentage of loans in each category to total loans for the years ended December 31,

| (Dollars in thousands)     | 2008     |            | 2007     |            | 2006     |            | 2005     |            | 2004     |            |
|----------------------------|----------|------------|----------|------------|----------|------------|----------|------------|----------|------------|
|                            | Amount   | % of Loans | Amount   | % of Loans | Amount   | % of Loans | Amount   | % of Loans | Amount   | % of Loans |
| Real estate - construction | \$ 2,749 | 21.8%      | \$ 1,398 | 20.0%      | \$ 1,229 | 22.7%      | \$ 945   | 21.4%      | \$ 429   | 16.3%      |
| Real estate - mortgage     | 4,001    | 65.3       | 4,075    | 65.1       | 3,275    | 62.9       | 2,299    | 63.9       | 2,262    | 68.3       |
| Commercial                 | 2,073    | 10.3       | 1,826    | 11.9       | 1,525    | 11.5       | 1,780    | 12.0       | 1,863    | 12.3       |
| Consumer                   | 281      | 2.6        | 252      | 3.0        | 271      | 2.9        | 212      | 2.7        | 138      | 3.1        |
| Unallocated                | 216      | -          | -        | -          | -        | -          | -        | -          | -        | -          |
|                            | \$ 9,320 | 100.0%     | \$ 7,551 | 100.0%     | \$ 6,300 | 100.0%     | \$ 5,236 | 100.0%     | \$ 4,692 | 100.0%     |

### Market Risk Management

Market risk is the risk of loss arising from adverse changes in the fair value of financial instruments due to changes in interest rates, exchange rates or equity pricing. Our principal market risk is interest rate risk that arises from our lending, investing and deposit taking activities. Our profitability is largely dependent on the Banks' net interest income. Interest rate risk can significantly affect net interest income to the degree that interest bearing liabilities mature or reprice at different intervals than interest earning assets. The Banks' Asset/Liability Management Committees oversee the management of interest rate risk. The primary purpose of these committees is to manage the exposure of net interest margins to unexpected changes due to interest rate fluctuations. These efforts affect our loan pricing and deposit rate policies as well as the asset mix, volume guidelines, and liquidity and capital planning.

We do not utilize derivative financial or commodity instruments or hedging strategies in the management of interest rate risk. Because we are not exposed to market risk from trading activities and do not utilize hedging strategies or off-balance sheet management strategies, the Asset/Liability Management Committees of the Banks rely on "gap" analysis as its primary tool in managing interest rate risk. Gap analysis summarizes the amount of interest sensitive assets and liabilities, which will reprice over various time intervals. The excess between the volume of assets and liabilities repricing in each interval is the interest sensitivity "gap". "Positive gap" occurs when more assets reprice in a given time interval, while "negative gap" occurs when more liabilities reprice. As of December 31, 2008, we had an overall negative gap position within the one-year repricing interval because the interest sensitive liabilities exceeded the interest sensitive assets within the one-year repricing interval by \$101.3 million, or 9.7% of total assets, similar to

the negative gap position within the one-year interval at December 31, 2007, which totaled \$99.1 million, or 10.4% of total assets. The negative gap position within the one-year interval at December 31, 2006, totaled \$80.9 million, or 8.6% of total assets.

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The following table summarizes our interest sensitivity at December 31, 2008. Loans, federal funds sold, time deposits and short-term borrowings are classified based upon contractual maturities if fixed-rate or earliest repricing date if variable rate. Investment securities are classified by contractual maturities or, if they have call provisions, by the most likely repricing date.

| December 31, 2008<br>(Dollars in thousands)       | Within<br>3 Months | 3 Months<br>through<br>12 Months | 1 Year<br>through<br>3 Years | 3 Years<br>through<br>5 Years | After<br>5 Years | Non-<br>Sensitive<br>Funds | Total            |
|---|--------------------|----------------------------------|------------------------------|-------------------------------|------------------|----------------------------|------------------|
| <b>ASSETS</b>                                     |                    |                                  |                              |                               |                  |                            |                  |
| Loans, net  | \$ 419,646         | \$ 92,401                        | \$ 235,945                   | \$ 100,303                    | \$ 40,233        | \$ (9,320)                 | \$ 879,208       |
| Investment securities                             | 19,054             | 18,402                           | 23,516                       | 10,509                        | 17,975           | -                          | 89,456           |
| Federal funds sold                                | 10,010             | -                                | -                            | -                             | -                | -                          | 10,010           |
| Interest bearing deposits with other banks        | 481                | -                                | -                            | -                             | -                | -                          | 481              |
| Other assets                                      | -                  | -                                | -                            | -                             | -                | 65,486                     | 65,486           |
| <b>Total assets</b>                               | <b>449,191</b>     | <b>110,803</b>                   | <b>259,461</b>               | <b>110,812</b>                | <b>58,208</b>    | <b>56,166</b>              | <b>1,044,641</b> |
| <b>LIABILITIES</b>                                |                    |                                  |                              |                               |                  |                            |                  |
| Noninterest bearing demand deposits               | -                  | -                                | -                            | -                             | -                | 102,584                    | 102,584          |
| Interest bearing demand deposits                  | 125,370            | -                                | -                            | -                             | -                | -                          | 125,370          |
| Money market and savings deposits                 | 150,958            | -                                | -                            | -                             | -                | -                          | 150,958          |
| Certificates of deposit, \$100,000 or more        | 63,062             | 116,975                          | 39,150                       | 16,048                        | -                | -                          | 235,235          |
| Other time deposits                               | 32,032             | 116,392                          | 57,274                       | 25,526                        | -                | -                          | 231,224          |
| Short-term borrowings                             | 52,969             | -                                | -                            | -                             | -                | -                          | 52,969           |
| Long-term debt                                    | -                  | 3,487                            | 3,973                        | 487                           | -                | -                          | 7,947            |
| Other liabilities                                 | -                  | -                                | -                            | -                             | -                | 10,969                     | 10,969           |
| <b>STOCKHOLDERS' EQUITY</b>                       |                    |                                  |                              |                               |                  |                            |                  |
| <b>Total Liabilities and Stockholders' Equity</b> | <b>424,391</b>     | <b>236,854</b>                   | <b>100,397</b>               | <b>42,061</b>                 | <b>-</b>         | <b>240,938</b>             | <b>1,044,641</b> |
| Excess  | \$ 24,800          | \$ (126,051)                     | \$ 159,064                   | \$ 68,751                     | \$ 58,208        | \$ (184,772)               | \$ -             |
| Cumulative excess                                 | \$ 24,800          | \$ (101,251)                     | \$ 57,813                    | \$ 126,564                    | \$ 184,772       | \$ -                       | \$ -             |
| Cumulative excess as percent of total assets      | 2.4%               | (9.7)%                           | 5.5%                         | 12.1%                         | 17.7%            | -%                         | -%               |

In addition to gap analysis, the Banks utilize simulation models to quantify the effect a hypothetical immediate plus or minus 300 basis point change in rates would have on their net interest income and the fair value of capital. The model takes into consideration the effect of call features of investment securities as well as prepayments of loans in periods of declining rates. When actual changes in interest rates occur, the changes in interest earning assets and interest bearing liabilities may differ from the assumptions used in the model. The chart below provides the sensitivity profiles for net interest income and the fair value of capital as of year-end 2008 and 2007. As of December 31, 2008, due to the low interest-rate environment, we believe the results of the minus 300 basis point change in rates is not meaningful.

|                                    | Immediate Change in Rates |                         |                         |                         |                         |                         |
|------------------------------------|---------------------------|-------------------------|-------------------------|-------------------------|-------------------------|-------------------------|
|                                    | -300<br>Basis<br>Points   | -200<br>Basis<br>Points | -100<br>Basis<br>Points | +100<br>Basis<br>Points | +200<br>Basis<br>Points | +300<br>Basis<br>Points |
| <b>2008</b>                        |                           |                         |                         |                         |                         |                         |
| % Change in Net Interest<br>Income | N/A                       | (16.65)%                | (7.10)%                 | 6.49%                   | 12.55%                  | 17.54%                  |
| % Change in Value of<br>Capital    | N/A                       | 5.31%                   | 1.20%                   | 2.51%                   | 5.43%                   | 7.25%                   |
| <b>2007</b>                        |                           |                         |                         |                         |                         |                         |
| % Change in Net Interest<br>Income | (14.58)%                  | (9.25)%                 | (4.37)%                 | 3.49%                   | 6.82%                   | 9.58%                   |
| % Change in Value of<br>Capital    | (9.42)%                   | (4.69)%                 | (1.73)%                 | 1.37%                   | 2.30%                   | 1.99%                   |

### Off-Balance Sheet Arrangements

In the normal course of business, to meet the financing needs of its customers, the Banks are parties to financial instruments with off-balance sheet risk. These financial instruments include commitments to extend credit and standby letters of credit. The Banks' exposure to credit loss in the event of nonperformance by the other party to these financial instruments is represented by the contractual amount of the instruments. The Banks use the same credit policies in making commitments and conditional obligations as they use for on-balance sheet instruments. The Banks generally require collateral or other security to support the financial instruments with credit risk. The amount of collateral or other security is determined based on management's credit evaluation of the counterparty. The Banks evaluate each customer's creditworthiness on a case-by-case basis.

Commitments to extend credit are agreements to lend to a customer as long as there is no violation of any condition established in the contract. Letters of credit are conditional commitments issued by the Banks to guarantee the performance of a customer to a third party. Letters of credit and other commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. Because many of the letters of credit and commitments are expected to expire without being drawn upon, the total commitment amount does not necessarily represent future cash requirements. Further information about these arrangements is provided in Note 21 to the Consolidated Financial Statements.

Management does not believe that any of the foregoing arrangements have or are reasonably likely to have a current or future effect on our financial condition, revenues or expenses, results of operations, liquidity, capital expenditures or capital resources that is material to investors.

### Liquidity Management

Liquidity describes our ability to meet financial obligations that arise during the normal course of business. Liquidity is primarily needed to meet the borrowing and deposit withdrawal requirements of customers and to fund current and planned expenditures. Liquidity is derived through increased customer deposits, maturities in the investment portfolio, loan repayments and income from earning assets. To the extent that deposits are not adequate to fund customer loan demand, liquidity needs can be met in the short-term funds markets. We have arrangements with correspondent banks whereby we have \$57.5 million available in federal funds lines of credit and a reverse repurchase agreement available to meet any short-term needs which may not otherwise be funded by the Banks' portfolio of readily marketable investments that can be converted to cash. The Banks are also members of the Federal Home Loan Bank, which provides another source of liquidity. At December 31, 2008, the Banks had credit availability of approximately \$62.1 million from the Federal Home Loan Bank.

At December 31, 2008, our loan to deposit ratio was approximately 105%, compared to 101% and 90% at year-end 2007 and 2006, respectively. Investment securities available for sale totaling \$79.2 million at the end of 2008 were available for the management of liquidity and interest rate risk. The comparable amounts were \$97.1 million and \$116.3 million at December 31, 2007 and 2006, respectively. Cash and cash equivalents were \$27.3 million at December 31, 2008, compared to \$26.9 million at year-end 2007 and \$79.7 million at year-end 2006. Management is not aware of any demands, commitments, events or uncertainties that will materially affect our ability to maintain liquidity at satisfactory levels.

We have various financial obligations, including contractual obligations and commitments that may require future cash payments. The purchase obligations in the table below include costs associated with a new core data processing system. The conversion to the new system is scheduled for the second quarter of 2009. With the new system, we expect to achieve automation efficiencies and cost savings.

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The following table presents, as of December 31, 2008, significant fixed and determinable contractual obligations to third parties by payment date.

| (Dollars in thousands)                 | Within<br>one year | One to<br>three years | Three to<br>five years | Over<br>five years | Total      |
|--|--------------------|-----------------------|------------------------|--------------------|------------|
| Deposits without a stated maturity (a) | \$ 378,917         | \$ -                  | \$ -                   | \$ -               | \$ 378,917 |
| Certificates of deposit (a)            | 330,712            | 96,518                | 41,574                 | -                  | 468,804    |
| Short-term borrowings                  | 52,969             | -                     | -                      | -                  | 52,969     |
| Long-term debt                         | 3,518              | 3,497                 | 932                    | -                  | 7,947      |
| Operating leases                       | 721                | 1,020                 | 685                    | 2,098              | 4,524      |
| Purchase obligations                   | 2,306              | 3,534                 | 3,466                  | 9,647              | 18,953     |
|  | \$ 769,143         | \$ 104,569            | \$ 46,657              | \$ 11,745          | \$ 932,114 |

(a) Includes accrued interest payable



Item 7A. Quantitative and Qualitative Disclosures About Market Risk.

The information required by this item may be found in Item 7 of Part II of this report under the caption “Market Risk Management”, which is incorporated herein by reference.

Item 8. Financial Statements and Supplementary Data.

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## MANAGEMENT'S REPORT ON INTERNAL CONTROL OVER FINANCIAL REPORTING

Management of Shore Bancshares, Inc. (the "Company") is responsible for the preparation, integrity and fair presentation of the consolidated financial statements included in this annual report. The Company's consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America and, as such, include some amounts that are based on the best estimates and judgments of management.

The Company's management is responsible for establishing and maintaining adequate internal control over financial reporting. This internal control system is designed to provide reasonable assurance to management and the Board of Directors regarding the reliability of the Company's financial reporting and the preparation and presentation of financial statements for external reporting purposes in conformity with accounting principles generally accepted in the United States of America, as well as to safeguard assets from unauthorized use or disposition. The system of internal control over financial reporting is evaluated for effectiveness by management and tested for reliability through a program of internal audit with actions taken to correct potential deficiencies as they are identified. Because of inherent limitations in any internal control system, no matter how well designed, misstatement due to error or fraud may occur and not be detected, including the possibility of the circumvention or overriding of controls. Accordingly, even an effective internal control system can provide only reasonable assurance with respect to financial statement preparation. Further, because of changes in conditions, internal control effectiveness may vary over time.

Management assessed the effectiveness of the Company's internal control over financial reporting as of December 31, 2008 based upon criteria set forth in Internal Control – Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO).

Based on this assessment and on the foregoing criteria, management has concluded that, as of December 31, 2008, the Company's internal control over financial reporting is effective. Stegman & Company, the Company's independent registered public accounting firm that audited the financial statements included in this annual report, has issued a report on the Company's internal control over financial reporting, which appears on the following page.

March 12, 2009

/s/ W. Moorhead Vermilye  
W. Moorhead Vermilye  
President and Chief Executive Officer

/s/ Susan E. Leaverton  
Susan E. Leaverton, CPA  
Principal Accounting Officer

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors and  
Stockholders of Shore Bancshares, Inc.

We have audited the accompanying consolidated balance sheets of Shore Bancshares, Inc. (the “Company”) as of, December 31, 2008 and 2007, and the consolidated statements of income, changes in stockholders’ equity and cash flows for each of the years in the three-year period ended December 31, 2008. We also have audited the Company’s internal control over financial reporting as of December 31, 2008, based on criteria established in Internal Control—Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). The Company’s management is responsible for these financial statements, for maintaining effective internal control over financial reporting, and for its assessment of the effectiveness of internal control over financial reporting, included in the accompanying Management’s Report on Internal Control over Financial Reporting. Our responsibility is to express an opinion on these consolidated financial statements and an opinion on the Company’s internal control over financial reporting based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement and whether effective internal control over financial reporting was maintained in all material respects. Our audits of the consolidated financial statements included examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. Our audit of internal control over financial reporting included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, and testing and evaluating the design and operating effectiveness of internal control based on the assessed risk. Our audits also included performing such other procedures as we considered necessary in the circumstances. We believe that our audits provide a reasonable basis for our opinions.

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

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

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Shore Bancshares, Inc. as of December 31, 2008 and 2007, and the results of its operations and its cash flows for each of the years in the three-year period ended December 31, 2008 in conformity with accounting principles generally accepted in the United States of America. Also in our opinion, Shore Bancshares, Inc. maintained, in all material respects, effective internal control over financial reporting as of December 31, 2008, based

on criteria established in Internal Control—Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO).

*/s/ Stegman & Company*

Baltimore, Maryland  
March 12, 2009

SHORE BANCSHARES, INC.  
CONSOLIDATED BALANCE SHEETS  
December 31,

| (In thousands, except share data)  | 2008                | 2007              |
|--|---------------------|-------------------|
| <b>ASSETS</b>  |                     |                   |
| Cash and due from banks  | \$ 16,803           | \$ 17,198         |
| Interest-bearing deposits with other banks   | 481                 | 3,036             |
| Federal funds sold   | 10,010              | 6,646             |
| Investment securities:   |                     |                   |
| Available for sale, at fair value  | 79,204              | 97,137            |
| Held to maturity, at amortized cost –fair value of \$10,390 (2008) and \$12,924 (2007)   | 10,252              | 12,896            |
| Loans  | 888,528             | 776,350           |
| Less: allowance for credit losses  | (9,320)             | (7,551)           |
| Loans, net   | 879,208             | 768,799           |
| Insurance premiums receivable  | 1,348               | 1,083             |
| Premises and equipment, net  | 13,855              | 15,617            |
| Accrued interest receivable  | 4,606               | 5,008             |
| Investment in unconsolidated subsidiary  | -                   | 937               |
| Goodwill   | 15,954              | 15,954            |
| Other intangible assets, net   | 5,921               | 6,436             |
| Deferred income taxes  | 1,579               | 1,847             |
| Other real estate owned  | 148                 | 176               |
| Other assets   | 5,272               | 4,141             |
| <b>Total assets</b>  | <b>\$ 1,044,641</b> | <b>\$ 956,911</b> |
| <b>LIABILITIES</b>   |                     |                   |
| Deposits:  |                     |                   |
| Noninterest-bearing demand   | \$ 102,584          | \$ 104,081        |
| Interest-bearing demand  | 125,370             | 115,623           |
| Money market and savings   | 150,958             | 169,896           |
| Certificates of deposit, \$100,000 or more   | 235,235             | 161,568           |
| Other time   | 231,224             | 214,727           |
| Total deposits   | 845,371             | 765,895           |
| Accrued interest payable   | 2,350               | 2,793             |
| Short-term borrowings  | 52,969              | 47,694            |
| Long-term debt   | 7,947               | 12,485            |
| Other liabilities  | 8,619               | 7,809             |
| <b>Total liabilities</b>   | <b>917,256</b>      | <b>836,676</b>    |
| <b>STOCKHOLDERS' EQUITY</b>  |                     |                   |
| Common stock, par value \$.01, authorized 35,000,000 shares; shares issued and outstanding—8,404,684 (2008) and 8,380,530 (2007) | 84                  | 84                |
| Additional paid in capital   | 29,768              | 29,539            |

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|  |              |            |
|--|--------------|------------|
| Retained earnings                          | 96,140       | 90,365     |
| Accumulated other comprehensive income     | 1,393        | 247        |
| Total stockholders' equity                 | 127,385      | 120,235    |
| Total liabilities and stockholders' equity | \$ 1,044,641 | \$ 956,911 |

The notes to the consolidated financial statements are an integral part of these statements.

SHORE BANCSHARES, INC.  
CONSOLIDATED STATEMENTS OF INCOME  
For the Years Ended December 31,

| (Dollars in thousands, except per share data)                | 2008          | 2007          | 2006          |
|--|---------------|---------------|---------------|
| <b>INTEREST INCOME</b>                                       |               |               |               |
| Interest and fees on loans                                   | \$ 56,866     | \$ 57,524     | \$ 50,572     |
| Interest and dividends on investment securities:             |               |               |               |
| Taxable  | 3,788         | 5,105         | 4,452         |
| Tax-exempt   | 420           | 511           | 549           |
| Interest in federal funds sold                               | 308           | 1,108         | 1,459         |
| Interest in deposits with other banks                        | 92            | 893           | 939           |
| Total interest income  | 61,474        | 65,141        | 57,971        |
| <b>INTEREST EXPENSE</b>                                      |               |               |               |
| Interest on deposits   | 19,877        | 21,693        | 17,128        |
| Interest on short-term borrowings                            | 1,147         | 1,264         | 1,034         |
| Interest on long-term debt                                   | 531           | 1,148         | 912           |
| Total interest expense                                       | 21,555        | 24,105        | 19,074        |
| <b>NET INTEREST INCOME</b>                                   | <b>39,919</b> | <b>41,036</b> | <b>38,897</b> |
| Provision for credit losses                                  | 3,337         | 1,724         | 1,493         |
| <b>NET INTEREST INCOME AFTER PROVISION FOR CREDIT LOSSES</b> | <b>36,582</b> | <b>39,312</b> | <b>37,404</b> |
| <b>NONINTEREST INCOME</b>                                    |               |               |               |
| Service charges on deposit accounts                          | 3,600         | 3,372         | 3,137         |
| Other service charges and fees                               | 3,029         | 2,195         | 1,518         |
| (Losses) gains on sales of investment securities             | (15)          | 5             | 3             |
| Other than temporary impairment of securities                | (371)         | -             | -             |
| Insurance agency commissions income                          | 12,090        | 7,698         | 6,744         |
| Gains(losses) on disposals of premises and equipment         | 1,247         | (136)         | 6             |
| Loss on sale of investment in unconsolidated subsidiary      | (337)         | -             | -             |
| Other noninterest income                                     | 1,107         | 1,545         | 1,431         |
| Total noninterest income                                     | 20,350        | 14,679        | 12,839        |
| <b>NONINTEREST EXPENSE</b>                                   |               |               |               |
| Salaries and wages   | 18,426        | 15,947        | 14,103        |
| Employee benefits  | 4,895         | 4,044         | 3,590         |
| Occupancy expense  | 2,179         | 1,962         | 1,655         |
| Furniture and equipment expense                              | 1,185         | 1,312         | 1,293         |
| Data processing  | 1,872         | 1,820         | 1,559         |
| Directors' fees  | 558           | 605           | 536           |
| Amortization of intangible assets                            | 515           | 333           | 337           |
| Insurance agency commissions expense                         | 2,248         | 557           | -             |
| Other noninterest expenses                                   | 6,492         | 5,959         | 5,462         |
| Total noninterest expense                                    | 38,370        | 32,539        | 28,535        |

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|                                      |           |           |           |
|--------------------------------------|-----------|-----------|-----------|
| INCOME BEFORE INCOME TAXES           | 18,562    | 21,452    | 21,708    |
| Income tax expense                   | 7,092     | 8,002     | 8,154     |
| NET INCOME                           | \$ 11,470 | \$ 13,450 | \$ 13,554 |
| Basic earnings per common share      | \$ 1.37   | \$ 1.61   | \$ 1.62   |
| Diluted earnings per common share    | \$ 1.37   | \$ 1.60   | \$ 1.61   |
| Cash dividends paid per common share | \$ 0.64   | \$ 0.64   | \$ 0.59   |

The notes to the consolidated financial statements are an integral part of these statements.



SHORE BANCSHARES, INC.  
CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY  
For the Years Ended December 31, 2008, 2007, and 2006

| (Dollars in thousands, except per share data)  | Common<br>Stock | Additional<br>Paid In<br>Capital | Retained<br>Earnings | Accumulated<br>Other<br>Comprehensive<br>Income (Loss) | Total<br>Stockholders'<br>Equity |
|--|-----------------|----------------------------------|----------------------|--|----------------------------------|
| Balances, January 1, 2006  | \$ 56           | \$ 29,014                        | \$ 73,642            | \$ (1,264)   | \$ 101,448                       |
| Comprehensive income:  |                 |                                  |                      |  |                                  |
| Net income   | -               | -                                | 13,554               | -  | 13,554                           |
| Unrealized gains on available-for-sale securities, net of reclassification adjustment of \$14, net of taxes    | -               | -                                | -                    | 540  | 540                              |
| Total comprehensive income   |                 |                                  |                      |  | 14,094                           |
| Shares issued for employee stock-based awards  |                 |                                  |                      |  |                                  |
|  | -               | 654                              | -                    | -  | 654                              |
| Stock-based compensation expense   | -               | 48                               | -                    | -  | 48                               |
| Stock dividend and cash in lieu of fractional shares paid  | 28              | (28)                             | (9)                  | -  | (9)                              |
| Cash dividends paid (\$0.59 per share)   | -               | -                                | (4,908)              | -  | (4,908)                          |
| Balances, December 31, 2006  | 84              | 29,688                           | 82,279               | (724)  | 111,327                          |
| Comprehensive income:  |                 |                                  |                      |  |                                  |
| Net income   | -               | -                                | 13,450               | -  | 13,450                           |
| Unrealized gains on available-for-sale securities, net of reclassification adjustment of \$21, net of taxes    | -               | -                                | -                    | 971  | 971                              |
| Total comprehensive income   |                 |                                  |                      |  | 14,421                           |
| Shares issued for employee stock-based awards  |                 |                                  |                      |  |                                  |
|  | -               | 54                               | -                    | -  | 54                               |
| Stock-based compensation expense   | -               | 63                               | -                    | -  | 63                               |
| Stock repurchased and retired  | -               | (266)                            | -                    | -  | (266)                            |
| Cash dividends paid (\$0.64 per share)   | -               | -                                | (5,364)              | -  | (5,364)                          |
| Balances, December 31, 2007  | 84              | 29,539                           | 90,365               | 247  | 120,235                          |
| Adjustment to initially apply EITF Issue 06-4  | -               | -                                | (318)                | -  | (318)                            |
| Comprehensive income:  |                 |                                  |                      |  |                                  |
| Net income   | -               | -                                | 11,470               | -  | 11,470                           |
| Unrealized gains on available-for-sale securities, net of reclassification adjustment of \$(326), net of taxes | -               | -                                | -                    | 1,146  | 1,146                            |
| Total comprehensive income   |                 |                                  |                      |  | 12,616                           |
| Shares issued for employee stock-based awards  |                 |                                  |                      |  |                                  |
|  | -               | 138                              | -                    | -  | 138                              |

|  |    |    |         |        |         |        |    |       |    |         |
|--|----|----|---------|--------|---------|--------|----|-------|----|---------|
| Stock-based compensation expense       | -  | 91 | -       | -      | 91      |        |    |       |    |         |
| Cash dividends paid (\$0.64 per share) |    |    | (5,377) |        | (5,377) |        |    |       |    |         |
| Balances, December 31, 2008            | \$ | 84 | \$      | 29,768 | \$      | 96,140 | \$ | 1,393 | \$ | 127,385 |

The notes to the consolidated financial statements are an integral part of these statements.

SHORE BANCSHARES, INC.  
CONSOLIDATED STATEMENTS OF CASH FLOWS  
For the Years Ended December 31,

| (Dollars in thousands)  | 2008            | 2007            | 2006            |
|---|-----------------|-----------------|-----------------|
| <b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>                                      |                 |                 |                 |
| Net income  | \$ 11,470       | \$ 13,450       | \$ 13,554       |
| Adjustments to reconcile net income to net cash provided by operating activities: |                 |                 |                 |
| Depreciation and amortization   | 1,784           | 1,523           | 1,445           |
| Discount accretion on debt securities   | (199)           | (190)           | (143)           |
| Provision for credit losses   | 3,337           | 1,724           | 1,493           |
| Stock-based compensation expense  | 91              | 63              | 48              |
| Excess tax benefits from stock-based arrangements                                 | (4)             | (3)             | (279)           |
| Deferred income taxes   | (498)           | (377)           | (424)           |
| Loss (gain) on sales of securities  | 15              | (5)             | (3)             |
| Other than temporary impairment of securities                                     | 371             | -               | -               |
| (Gain) loss on disposals of premises and equipment                                | (1,247)         | 136             | (6)             |
| Loss on sale of investment in unconsolidated subsidiary                           | 337             | -               | -               |
| Loss (gain) on sale of other real estate owned                                    | 50              | (51)            | -               |
| Net changes in:   |                 |                 |                 |
| Insurance premiums receivable   | (265)           | (510)           | 517             |
| Accrued interest receivable   | 402             | (116)           | (995)           |
| Other assets  | (1,683)         | 1,503           | (342)           |
| Accrued interest payable  | (443)           | 550             | 1,029           |
| Other liabilities   | 491             | 30              | 240             |
| <b>Net cash provided by operating activities</b>                                  | <b>14,009</b>   | <b>17,727</b>   | <b>16,134</b>   |
| <b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>                                      |                 |                 |                 |
| Proceeds from maturities and principal payments of securities available for sale  | 82,063          | 92,293          | 48,648          |
| Proceeds from sales of securities available for sale                              | 2               | 3,500           | 51              |
| Purchases of securities available for sale  | (62,551)        | (74,897)        | (57,833)        |
| Proceeds from maturities and principal payments of securities held to maturity    | 3,666           | 1,174           | 1,127           |
| Purchases of securities held to maturity  | (1,026)         | (117)           | (203)           |
| Net increase in loans   | (114,033)       | (77,977)        | (73,036)        |
| Purchases of premises and equipment   | (331)           | (695)           | (1,886)         |
| Proceeds from sales of premises and equipment                                     | 2,773           | -               | 40              |
| Proceeds from sale of investment in unconsolidated subsidiary                     | 600             | -               | -               |
| Proceeds from sales of other real estate owned                                    | 264             | 1,148           | 255             |
| Acquisition, net of cash acquired   | -               | (5,259)         | -               |
| <b>Net cash used in investing activities</b>                                      | <b>(88,573)</b> | <b>(60,830)</b> | <b>(82,837)</b> |
| <b>CASH FLOWS FROM FINANCING ACTIVITIES</b>                                       |                 |                 |                 |
| Net decrease in demand, money market and savings deposits                         | (10,688)        | (18,843)        | (12,428)        |
| Net increase in certificates of deposit   | 90,163          | 10,556          | 81,652          |

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|   |         |          |         |
|---|---------|----------|---------|
| Excess tax benefits from stock-based arrangements | 4       | 3        | 279     |
| Net increase (decrease) in short-term borrowings  | 5,276   | 19,170   | (7,323) |
| Proceeds from issuance of long-term debt          | 3,000   | 3,000    | 21,000  |
| Repayment of long-term debt                       | (7,538) | (18,000) | -       |
| Proceeds from issuance of common stock            | 138     | 54       | 654     |
| Stock repurchased and retired                     | -       | (266)    | -       |
| Dividends paid                                    | (5,377) | (5,364)  | (4,917) |
| Net cash provided (used) by financing activities  | 74,978  | (9,690)  | 78,917  |

SHORE BANCSHARES, INC.  
CONSOLIDATED STATEMENTS OF CASH FLOWS (CONTINUED)  
For the Years Ended December 31,

| (Dollars in thousands)                               | 2008      | 2007      | 2006      |
|--|-----------|-----------|-----------|
| NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS | 414       | (52,793)  | 12,214    |
| CASH AND CASH EQUIVALENTS AT BEGINNING OF YEAR       | 26,880    | 79,673    | 67,459    |
| CASH AND CASH EQUIVALENTS AT END OF YEAR             | \$ 27,294 | \$ 26,880 | \$ 79,673 |
| Supplemental cash flow information:                  |           |           |           |
| Interest paid  | \$ 21,998 | \$ 23,555 | \$ 18,045 |
| Income taxes paid                                    | \$ 9,704  | \$ 8,462  | \$ 8,281  |
| Transfers from loans to other real estate owned      | \$ 286    | \$ 874    | \$ 352    |
| Details of acquisitions:                             |           |           |           |
| Fair value of assets acquired                        | \$ -      | \$ 3,705  | \$ -      |
| Fair value of liabilities assumed                    | -         | (3,404)   | -         |
| Fair value of debt issued                            | -         | (2,485)   | -         |
| Purchase price in excess of net assets acquired      | -         | 9,215     | -         |
| Net cash paid for acquisition                        | \$ -      | \$ 7,031  | \$ -      |

The notes to consolidated financial statements are an integral part of these statements.

SHORE BANCSHARES, INC.  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
For the Years Ended December 31, 2008, 2007 and 2006

NOTE 1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

The consolidated financial statements include the accounts of Shore Bancshares, Inc. and its subsidiaries (collectively referred to in these Notes as the “Company”), with all significant intercompany transactions eliminated. The investments in subsidiaries are recorded on the Company’s books (Parent only) on the basis of its equity in the net assets of the subsidiaries. The accounting and reporting policies of the Company conform to accounting principles generally accepted in the United States of America. For purposes of comparability, certain reclassifications have been made to amounts previously reported to conform with the current period presentation.

Nature of Operations

The Company provides commercial banking services from its Maryland locations in Talbot County, Queen Anne’s County, Kent County, Caroline County, and Dorchester County, and from its locations in Kent County, Delaware. Its primary source of revenue is interest earned on commercial, real estate and consumer loans made to customers located on the Delmarva Peninsula. A full range of insurance and investment services are offered through the Company’s nonbank subsidiaries.

Use of Estimates

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 disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

The allowance for credit losses is a material estimate that is particularly susceptible to significant changes in the near term. Management believes that the allowance for credit losses is sufficient to address the probable losses in the current portfolio. While management uses available information to recognize losses on loans, future additions to the allowance may be necessary based on changes in economic conditions. In addition, various regulatory agencies, as an integral part of their examination processes, periodically review the Company’s allowance for credit losses. Such agencies may require the Company to recognize additions to the allowance based on their judgments about information available to them at the time of their examination.

Investment Securities Available for Sale

Investment securities available for sale are stated at estimated fair value based on quoted market prices. They represent those securities which management may sell as part of its asset/liability strategy or which may be sold in response to changing interest rates, changes in prepayment risk or other similar factors. The cost of securities sold is determined by the specific identification method. Purchase premiums and discounts are recognized in interest income using the interest method over the terms of the securities. Net unrealized holding gains and losses on these securities are reported as accumulated other comprehensive income, a separate component of stockholders’ equity, net of related income taxes. Declines in the fair value of individual available-for-sale securities below their cost that are other than temporary result in write-downs of the individual securities to their fair value and are reflected in earnings as realized losses. Factors affecting the determination of whether an other-than-temporary impairment has occurred include a downgrading of the security by a rating agency, a significant deterioration in the financial condition of the issuer, or that management would not have the intent and ability to hold a security for a period of time sufficient to allow for any anticipated recovery in fair value. Equity securities include Federal Home Loan Bank stock, Federal Reserve

Bank stock and Atlantic Central Banker's Bank stock which are considered restricted as to marketability and are recorded at cost.

#### Investment Securities Held to Maturity

Investment securities held to maturity are stated at cost adjusted for amortization of premiums and accretion of discounts. Purchase premiums and discounts are recognized in interest income using the interest method over the terms of the securities. The Company intends and has the ability to hold such securities until maturity. Declines in the fair value of individual held-to-maturity securities below their cost that are other than temporary result in write-downs of the individual securities to their fair value. Factors affecting the determination of whether an other-than-temporary impairment has occurred include a downgrading of the security by the rating agency, a significant deterioration in the financial condition of the issuer, or that management would not have the ability to hold a security for a period of time sufficient to allow for any anticipated recovery in fair value.

## Loans

Loans are stated at their principal amount outstanding net of any deferred fees and costs. Interest income on loans is accrued at the contractual rate based on the principal amount outstanding. Fees charged and costs capitalized for originating loans are being amortized substantially on the interest method over the term of the loan. A loan is placed on nonaccrual when it is specifically determined to be impaired or when principal or interest is delinquent for 90 days or more, unless the loan is well secured and in the process of collection. Any unpaid interest previously accrued on those loans is reversed from income. Interest income generally is not recognized on specific impaired loans unless the likelihood of further loss is remote. Interest payments received on nonaccrual loans are applied as a reduction of the loan principal balance unless collectability of the principal amount is reasonably assured, in which case interest is recognized on a cash basis. Loans are returned to accrual status when all principal and interest amounts contractually due are brought current and future payments are reasonably assured.

Loans are considered impaired when it is probable that the Company will not collect all principal and interest payments according to the loan's contractual terms. The impairment of a loan is measured at the present value of expected future cash flows using the loan's effective interest rate, or at the loan's observable market price or the fair value of the collateral if the loan is collateral dependent. Generally, the Company measures impairment on such loans by reference to the fair value of the collateral. Income on impaired loans is recognized on a cash basis, and payments are first applied against the principal balance outstanding. Impaired loans do not include groups of smaller balance homogeneous loans such as residential mortgage and consumer installment loans that are evaluated collectively for impairment. Reserves for probable credit losses related to these loans are based upon historical loss ratios and are included in the allowance for credit losses.

## Allowance for Credit Losses

The allowance for credit losses is maintained at a level believed adequate by management to absorb losses inherent in the loan portfolio as of the balance sheet date and is based on the size and current risk characteristics of the loan portfolio, an assessment of individual problem loans and actual loss experience, current economic events in specific industries and geographical areas, including unemployment levels, and other pertinent factors, including regulatory guidance and general economic conditions and other observable data. Determination of the allowance is inherently subjective as it requires significant estimates, including the amounts and timing of expected future cash flows or collateral value of impaired loans, estimated losses on pools of homogeneous loans that are based on historical loss experience, and consideration of current economic trends, all of which may be susceptible to significant change. Loan losses are charged off against the allowance, while recoveries of amounts previously charged off are credited to the allowance. A provision for credit losses is charged to operations based on management's periodic evaluation of the factors previously mentioned, as well as other pertinent factors. Evaluations are conducted at least quarterly and more often if deemed necessary.

The allowance for credit losses is an estimate of the losses that may be sustained in the loan portfolio. The allowance is based on two basic principles of accounting: (i) SFAS No. 5, Accounting for Contingencies, which requires that losses be accrued when they are probable of occurring and estimable, and (ii) SFAS No. 114, Accounting by Creditors for Impairment of a Loan, which requires that losses be accrued based on the differences between the loan balance and the value of collateral, present value of future cash flows or values that are observable in the secondary market. Management uses many factors, including economic conditions and trends, the value and adequacy of collateral, the volume and mix of the loan portfolio, and our internal loan processes in determining the inherent loss that may be present in our loan portfolio. Actual losses could differ significantly from management's estimates. In addition, GAAP itself may change from one previously acceptable method to another. Although the economics of transactions would be the same, the timing of events that would impact the transactions could change.



The allowance for credit losses is comprised of three parts: the specific allowance, the formula allowance and the nonspecific allowance. The specific allowance is the portion of the allowance that results from management's evaluation of specific loss allocations for identified problem loans and pooled reserves based on historical loss experience for each loan category. The formula allowance is determined based on management's assessment of industry trends and economic factors in the markets in which we operate. The determination of the formula allowance involves a higher risk of uncertainty and considers current risk factors that may not have yet manifested themselves in our historical loss factors. The nonspecific allowance captures losses that have impacted the portfolio but have yet to be recognized in either the specific or formula allowance.

### Premises and Equipment

Premises and equipment are stated at cost less accumulated depreciation and amortization. Depreciation and amortization are calculated using the straight-line method over the estimated useful lives of the assets. Useful lives range from three to ten years for furniture, fixtures and equipment; three to five years for computer hardware and data handling equipment; and ten to forty years for buildings and building improvements. Land improvements are amortized over a period of fifteen years and leasehold improvements are amortized over the term of the respective lease. Sale-leaseback transactions are considered normal leasebacks and any realized gains are deferred and amortized to other income on a straight-line basis over the initial lease term. Maintenance and repairs are charged to expense as incurred, while improvements which extend the useful life of an asset are capitalized and depreciated over the estimated remaining life of the asset.

Long-lived assets are evaluated periodically for impairment when events or changes in circumstances indicate the carrying amount may not be recoverable. Impairment exists when the expected undiscounted future cash flows of a long-lived asset are less than its carrying value. In that event, the Company recognizes a loss for the difference between the carrying amount and the estimated fair value of the asset.

### Goodwill and Other Intangible Assets

Goodwill represents the excess of the cost of an acquisition over the fair value of the net assets acquired. Other intangible assets represent purchased assets that also lack physical substance but can be distinguished from goodwill because of contractual or other legal rights or because the asset is capable of being sold or exchanged either on its own or in combination with a related contract, asset or liability. Under the provisions of SFAS No. 142, "Goodwill and Other Intangible Assets", goodwill and other intangible assets with indefinite lives are no longer ratably amortized into the income statement over an estimated life, but rather tested at least annually for impairment. Intangible assets that have finite lives continue to be amortized over their estimated useful lives and also continue to be subject to impairment testing. The Company's other intangible assets that have finite lives are amortized on a straight-line basis over varying periods not exceeding 21 years. Prior to adoption of SFAS No. 142, the Company's goodwill was amortized on a straight-line basis over fifteen years. Note 8 includes a summary of the Company's goodwill and other intangible assets.

### Other Real Estate Owned

Other real estate owned represents assets acquired in satisfaction of loans either by foreclosure or deeds taken in lieu of foreclosure. Properties acquired are recorded at the lower of cost or fair value less estimated selling costs at the time of acquisition with any deficiency charged to the allowance for credit losses. Thereafter, costs incurred to operate or carry the properties as well as reductions in value as determined by periodic appraisals are charged to operating expense. Gains and losses resulting from the final disposition of the properties are included in noninterest income.

### Short-Term Borrowings

Short-term borrowings are comprised primarily of Federal Home Loan Bank advances and repurchase agreements. The repurchase agreements are securities sold to the Company's customers, at the customers' request, under a continuing "roll-over" contract that matures in one business day. The underlying securities sold are U.S. Government agency securities, which are segregated from the Company's other investment securities by its safekeeping agents.

### Long-Term Debt

Long-term debt primarily consists of advances from the Federal Home Loan Bank. These borrowings are used to fund earning asset growth of the Company.

#### Income Taxes

The Company and its subsidiaries file a consolidated federal income tax return. The Company accounts for income taxes using the liability method pursuant to Statement of Financial Accounting Standards No. 109, "Accounting for Income Taxes". Under this method, deferred tax assets and liabilities are determined by applying the applicable federal and state income tax rates to its cumulative temporary differences. These temporary differences represent differences between financial statement carrying amounts and the corresponding tax bases of certain assets and liabilities. Deferred taxes are provided as a result of such temporary differences.

Deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in the period that includes the enactment date.

The Company adopted the provisions of Financial Accounting Standards Board (“FASB”) Interpretation No. 48, “Accounting for Uncertainty in Income Taxes” (“FIN 48”) on January 1, 2007. The adoption of FIN 48 did not have a material impact on the Company’s consolidated financial statements. The Company recognizes accrued interest and penalties related to unrecognized tax benefits as a component of tax expense.

#### Basic and Diluted Earnings Per Common Share

Basic earnings per share is derived by dividing net income available to common stockholders by the weighted-average number of common shares outstanding and does not include the effect of any potentially dilutive common stock equivalents. Diluted earnings per share is derived by dividing net income by the weighted-average number of shares outstanding, adjusted for the dilutive effect of outstanding stock options and restricted stock awards.

#### Transfers of Financial Assets

Transfers of financial assets are accounted for as sales, when control over the assets has been surrendered. Control over transferred assets is deemed to be surrendered when (1) the assets have been isolated from the Company, (2) the transferee obtains the right (free of conditions that constrain it from taking advantage of that right) to pledge or exchange the transferred assets, and (3) the Company does not maintain effective control over the transferred assets through an agreement to repurchase them before their maturity.

#### Statement of Cash Flows

Cash and due from banks, interest bearing deposits with other banks and federal funds sold are considered “cash and cash equivalents” for financial reporting purposes.

#### Stock-Based Compensation

The Company adopted the provisions of SFAS No. 123, “Share-Based Payment (Revised 2004),” on January 1, 2006. SFAS 123R eliminates the ability to account for stock-based compensation using APB 25 and requires that such transactions be recognized as compensation cost in the income statement based on their fair values on the measurement date which, for the Company, is the date of the grant. The Company transitioned to fair-value based accounting for stock-based compensation using a modified version of prospective application (“modified prospective application”). Under modified prospective application, as it is applicable to the Company, SFAS 123R applies to new awards and to awards modified, repurchased, or cancelled after January 1, 2006. Additionally, compensation cost for the portion of awards for which the requisite service has not been rendered (generally referring to non-vested awards) that were outstanding as of January 1, 2006 will be recognized as the remaining requisite service is rendered during the period of and/or the periods after the adoption of SFAS 123R. The attribution of compensation cost for those earlier awards is based on the same method and on the same grant-date fair values previously determined for the pro forma disclosures required for companies that did not previously adopt the fair value accounting method for stock-based employee compensation. Compensation expense for non-vested stock awards is based on the fair value of the awards, which is generally the market price of the stock on the measurement date, which, for the Company, is the date of grant, and is recognized ratably over the service period of the award.

Advertising Costs

Advertising costs are generally expensed as incurred. The Company incurred advertising costs of approximately \$513 thousand, \$473 thousand and \$430 thousand for the years ended December 31, 2008, 2007 and 2006, respectively.

## New Accounting Pronouncements

### Pronouncements adopted

SFAS No. 157, "Fair Value Measurements." SFAS 157 defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles, and expands disclosures about fair value measurements. SFAS 157 requires disclosures about the fair value of assets and liabilities recognized in the balance sheet in periods subsequent to initial recognition, whether the measurements are made on a recurring basis (for example, available for sale investment securities) or on a nonrecurring basis (for example, impaired loans). SFAS 157 defines fair value as the exchange price that would be received for an asset or paid to transfer a liability (an exit price) in the principal or most advantageous market for the asset or liability in an orderly transaction between market participants on the measurement date. SFAS 157 also establishes a fair value hierarchy, which requires an entity to maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair value. The adoption of SFAS 157 on January 1, 2008, did not have a significant impact on the Company's consolidated financial statements.

FASB Financial Staff Position ("FSP") No. 157-2, "Partial Deferral of the Effective Date of Statement 157." FSP 157-2 defers the effective date of SFAS 157 for all nonfinancial assets and nonfinancial liabilities to fiscal years beginning after November 15, 2008.

SFAS No. 158, "Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans, an amendment of FASB Statements No. 87, 88 106, and 132(R)." SFAS 158 requires an employer to recognize the overfunded or underfunded status of defined benefit post-retirement benefit plans as an asset or a liability in its statement of financial position. The funded status is measured as the difference between plan assets at fair value and the benefit obligation (the projected benefit obligation for pension plans or the accumulated benefit obligation for other post-retirement benefit plans). An employer is also required to measure the funded status of a plan as of the date of its year-end statement of financial position with changes in the funded status recognized through comprehensive income. SFAS 158 also requires certain disclosures regarding the effects on net periodic benefit cost for the next fiscal year that arise from delayed recognition of gains or losses, prior service costs or credits, and the transition asset or obligation. The adoption of SFAS 158's requirement to recognize the funded status in the financial statements for fiscal years ending after December 15, 2006 did not have a significant impact on the Company's consolidated financial statements. SFAS 158's requirement to use the fiscal year-end date as the measurement date was effective for fiscal years ending after December 15, 2008, and did not have a significant impact on the Company's consolidated financial statements.

SFAS No. 159, "The Fair Value Option for Financial Assets and Financial Liabilities-Including an amendment of FASB Statement No. 115." SFAS 159 permits entities to choose to measure eligible items at fair value at specified election dates. Unrealized gains and losses on items for which the fair value option has been elected are reported in earnings at each subsequent reporting date. The fair value option (1) may be applied instrument by instrument, with certain exceptions, (2) is irrevocable (unless a new election date occurs) and (3) is applied only to entire instruments and not to portions of instruments. The objective is to improve financial reporting by providing entities with the opportunity to mitigate volatility in reported earnings caused by measuring related assets and liabilities differently without having to apply complex hedge accounting provisions. This Statement is expected to expand the use of fair value measurement, which is consistent with the FASB's long-term measurement objectives for accounting for financial instruments. The Company adopted SFAS 159 on January 1, 2008, and has not elected the fair value option for any financial assets or liabilities at December 31, 2008.

The Emerging Issues Task Force ("EITF") of the FASB issued EITF Issue No. 06-4, "Accounting for Deferred Compensation and Postretirement Benefit Aspects of Endorsement Split-Dollar Life Insurance Arrangements," which was effective January 1, 2008. EITF 06-4 requires the recognition of a liability and related compensation costs for endorsement split-dollar life insurance policies that provide a benefit to an employee that extends to postretirement

periods as defined in SFAS 106, "Employers' Accounting for Postretirement Benefits Other Than Pensions." The EITF reached a consensus that Bank Owned Life Insurance policies purchased for this purpose do not effectively settle the entity's obligation to the employee in this regard and thus the entity must record compensation cost and a related liability. Entities should recognize the effects of applying this Issue through either, (1) a change in accounting principle through a cumulative-effect adjustment to retained earnings or to other components of equity or net assets in the balance sheet as of the beginning of the year of adoption, or (2) a change in accounting principle through retrospective application to all prior periods. This Issue was effective for fiscal years beginning after December 15, 2007. The effects of the guidance have been applied as a change in accounting principle through a cumulative-effect adjustment to retained earnings of \$318 thousand.

EITF Issue No. 06-11, "Accounting for Income Tax Benefits of Dividends on Share-Based Payment Awards." EITF 06-11 requires that tax benefits generated by

dividends paid during the vesting period on certain equity-classified share-based compensation awards be classified as additional paid-in capital and included in a pool of excess tax benefits available to absorb tax deficiencies from share-based payment awards. EITF 06-11 was effective for years beginning after December 31, 2007. The adoption of EITF 06-11 did not have a material impact on the Company's consolidated financial position or results of operations.

FSP No. 157-3, "Determining the Fair Value of a Financial Asset When the Market for That Asset is not Active." This FSP clarifies the application of SFAS 157, "Fair Value Measurements," in a market that is not active and provides an example to illustrate key considerations in determining the fair value of a financial asset when the market for that financial asset is not active. This FSP shall be effective upon issuance, including prior periods for which financial statements have not been issued. Revisions resulting from a change in the valuation technique or its application shall be accounted for as a change in accounting estimate in accordance with SFAS 154, "Accounting Changes and Error Corrections." The disclosure provisions of SFAS 154 for a change in accounting estimate are not required for revisions resulting from a change in valuation technique or its application. The adoption of this Statement did not have a material impact on the Company's consolidated financial statements.

The SEC issued Staff Accounting Bulletin ("SAB") No. 109, "Written Loan Commitments Recorded at Fair Value through Earnings." Previously, SAB 105, "Application of Accounting Principles to Loan Commitments," stated that in measuring the fair value of a derivative loan commitment, a company should not incorporate the expected net future cash flows related to the associated servicing of the loan. SAB 109 supersedes SAB 105 and indicates that the expected net future cash flows related to the associated servicing of the loan should be included in measuring fair value for all written loan commitments that are accounted for at fair value through earnings. SAB 105 also indicated that internally-developed intangible assets should not be recorded as part of the fair value of a derivative loan commitment, and SAB 109 retains that view. SAB 109 is effective for derivative loan commitments issued or modified in fiscal quarters beginning after December 15, 2007. The impact of SAB 109 did not have a material impact on the Company's consolidated financial statements.

#### Pronouncements issued but not yet effective

SFAS No. 141R, "Business Combinations." SFAS 141R's objective is to improve the relevance, representational faithfulness, and comparability of the information that a reporting entity provides in its financial reports about a business combination and its effects. SFAS 141R applies prospectively to business combinations for which the acquisition date is on or after December 31, 2008. This statement will change the Company's accounting treatment for business combinations on a prospective basis.

SFAS No. 160, "Noncontrolling Interests in Consolidated Financial Statements." SFAS 160's objective is to improve the relevance, comparability, and transparency of the financial information that a reporting entity provides in its consolidated financial statements by establishing accounting and reporting standards for the noncontrolling interest in a subsidiary and for the deconsolidation of a subsidiary. SFAS 160 was effective for fiscal years and interim periods within those fiscal years, beginning on or after December 15, 2008. The Company does not expect the adoption of SFAS 160 to have a material impact on its consolidated financial statements.

SFAS No. 161, "Disclosures about Derivative Instruments and Hedging Activities – an amendment of FASB Statement No. 133". SFAS 161 is intended to enhance the disclosures previously required for derivative instruments and hedging activities under SFAS 133, "Accounting for Derivative Instruments and Hedging Activities", to include how and why an entity uses derivative instruments, how derivative instruments and related hedge items are accounted for and their impact on an entity's financial positions, results of operations and cash flows. SFAS 161 was effective for financial statements issued for fiscal years and interim periods beginning after November 15, 2008, with early application encouraged. The Company does not expect the implementation of SFAS 161 to have a material impact on its consolidated financial statements.



SFAS No. 162, “The Hierarchy of Generally Accepted Accounting Principles.” SFAS 162 identifies the sources of accounting principles and the framework for selecting the principles to be used in the preparation of financial statements of nongovernmental entities that are presented in conformity with GAAP in the United States (the “GAAP hierarchy”). The FASB concluded that the GAAP hierarchy should reside in the accounting literature established by the FASB and is issuing this Statement to achieve that result. This Statement is effective 60 days following the Security and Exchange Commission’s approval of the Public Company Accounting Oversight Board amendments to AU Section 411, The Meaning of Present Fairly in Conformity with Generally Accepted Accounting Principles. The Company does not expect the implementation of SFAS 162 to have a material impact on its consolidated financial statements.

SFAS No. 163, “Accounting for Financial Guarantee Insurance Contracts – an interpretation of FASB Statement No. 60.” SFAS 163 requires that an insurance enterprise recognize a claim liability prior to an event of default (insured event) when there is evidence that credit deterioration has occurred in an insured financial obligation. This Statement also clarifies how Statement 60 applies to financial guarantee insurance contracts, including the recognition and

measurement to be used to account for premium revenue and claim liabilities. The accounting and expanded disclosure requirements of SFAS 163 will improve the quality and comparability of financial information that will be provided to users of financial statements. This Statement is effective for financial statements issued for fiscal years beginning after December 15, 2008, and all interim periods within those fiscal years. This Statement also requires that disclosures about the risk-management activities of the insurance enterprise be effective for the first period (including interim periods) beginning after issuance of this Statement. The Company does not expect the implementation of SFAS 163 to have a material impact on its consolidated financial statements.

FSP No. FAS 140-3, "Accounting for Transfers of Financial Assets and Repurchase Financing Transactions." This FSP concludes that a transferor and transferee should not separately account for a transfer of a financial asset and a related repurchase financing unless (a) the two transactions have a valid and distinct business or economic purpose for being entered into separately and (b) the repurchase financing does not result in the initial transferor regaining control over the financial asset. The FSP is effective for financial statements issued for fiscal years beginning on or after November 15, 2008, and interim periods within those fiscal years. The adoption of this FSP is not expected to have a material effect on the Company's consolidated financial statements.

FSP No. 142-3, "Determination of the Useful Life of Intangible Assets." FSP 142-3 amends the factors that should be considered in developing assumptions about renewal or extension used in estimating the useful life of a recognized intangible asset under SFAS 142, "Goodwill and Other Intangible Assets." This standard is intended to improve the consistency between the useful life of a recognized intangible asset under SFAS 142 and the period of expected cash flows used to measure the fair value of the asset under SFAS 141R and other GAAP. FSP 142-3 is effective for financial statements issued for fiscal years beginning after December 15, 2008. The measurement provisions of this standard will apply only to intangible assets of the Company acquired after the effective date.

FSP No. EITF 03-6-1, "Determining Whether Instruments Granted in Share-Based Payment Transactions Are Participating Securities". This FSP clarifies that instruments granted in share-based payment transactions can be participating securities prior to the requisite service having been rendered. A basic principle of the FSP is that unvested share-based payment awards that contain nonforfeitable rights to dividends or dividend equivalents (whether paid or unpaid) are participating securities and are to be included in the computation of EPS pursuant to the two-class method. The provisions of this FSP are effective for financial statements issued for fiscal years beginning after December 15, 2008, and interim periods within those years. All prior-period EPS data presented (including interim financial statements, summaries of earnings, and selected financial data) are required to be adjusted retrospectively to conform with the provisions of the FSP. The adoption of this FSP is not expected to have a material effect on the Company's consolidated financial statements.

## NOTE 2. ACQUISITIONS

Effective October 1, 2007, the Company acquired Jack Martin & Associates, Inc. ("JM"), a marine insurance agency located in Annapolis, Maryland. Pursuant to the acquisition agreement, the Company paid \$3.7 million in cash for all of the issued and outstanding capital stock of JM. The total fair value of assets acquired was \$484 thousand and the total of liabilities assumed was \$433 thousand. Total intangible assets recorded relating to the acquisition of JM included \$1.9 million of goodwill, \$1.2 million of intangible assets subject to amortization, and \$0.8 million of intangible assets not subject to amortization. In addition to the purchase price, the acquisition agreement calls for a deferred payment to be made on or before February 14, 2011 if the acquired business meets certain performance criteria through December 31, 2010.

Effective October 1, 2007, the Company acquired TSGIA, Inc. and its operating subsidiaries, Tri-State General Insurance Agency, LTD, Tri-State General Insurance Agency of New Jersey, Inc., Tri-State General Insurance

Agency of Virginia, Inc., and ESFS, Inc. (collectively, "TSGIA"). In accordance with the purchase agreement, the Company paid \$5.85 million for TSGIA. The total fair value of assets acquired was \$3.2 million and the total of liabilities assumed was \$3.0 million. Additionally, the Company assumed \$2.5 million in long-term debt. Total intangible assets recorded relating to the acquisition of TSGIA included \$2.1 million of goodwill, \$1.5 million of intangible assets subject to amortization, and \$1.7 million of intangible assets not subject to amortization. In addition to the purchase price, the acquisition agreement calls for a deferred payment to be made on or before February 14, 2013 if the acquired business meets certain performance criteria through December 31, 2012.

The results of operations of JM and TSGIA subsequent to the acquisition date are included in the Company's Consolidated Statements of Income.

## NOTE 3. CASH AND DUE FROM BANKS

The Board of Governors of the Federal Reserve System (the "FRB") requires banks to maintain certain minimum cash balances consisting of vault cash and deposits in the appropriate Federal Reserve Bank or in other commercial banks. Such balances for the Company's bank subsidiaries averaged approximately \$1.4 million and \$1.7 million during 2008 and 2007, respectively.

## NOTE 4. INVESTMENT SECURITIES

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

| (Dollars in thousands)  | Amortized<br>Cost | Gross<br>Unrealized<br>Gains | Gross<br>Unrealized<br>Losses | Estimated<br>Fair<br>Value |
|---|-------------------|------------------------------|-------------------------------|----------------------------|
| <b>Available-for-sale securities:</b>                             |                   |                              |                               |                            |
| December 31, 2008:  |                   |                              |                               |                            |
| Obligations of U.S. Treasury                                      | \$ 1,000          | \$ -                         | \$ -                          | \$ 1,000                   |
| Obligations of U.S. Government agencies and corporations          | 49,996            | 1,451                        | -                             | 51,447                     |
| Mortgage-backed securities  | 22,028            | 879                          | 8                             | 22,899                     |
| Federal Home Loan Bank stock                                      | 3,003             | -                            | -                             | 3,003                      |
| Federal Reserve Bank stock  | 302               | -                            | -                             | 302                        |
| Other equity securities   | 551               | 2                            | -                             | 553                        |
|   | \$ 76,880         | \$ 2,332                     | \$ 8                          | \$ 79,204                  |
| December 31, 2007:  |                   |                              |                               |                            |
| Obligations of U.S. Government agencies and corporations          | \$ 67,204         | \$ 624                       | \$ 95                         | \$ 67,733                  |
| Mortgage-backed securities  | 25,810            | 137                          | 193                           | 25,754                     |
| Federal Home Loan Bank stock                                      | 2,984             | -                            | -                             | 2,984                      |
| Federal Reserve Bank stock  | 302               | -                            | -                             | 302                        |
| Federal Home Loan Mortgage Corporation cumulative preferred stock | 389               | -                            | 61                            | 328                        |
| Other equity securities   | 35                | 1                            | -                             | 36                         |
|   | \$ 96,724         | \$ 762                       | \$ 349                        | \$ 97,137                  |
| <b>Held-to-maturity securities:</b>                               |                   |                              |                               |                            |
| December 31, 2008:  |                   |                              |                               |                            |
| Obligations of states and political subdivisions                  | \$ 10,252         | \$ 159                       | \$ 21                         | \$ 10,390                  |
| December 31, 2007:  |                   |                              |                               |                            |
| Obligations of states and political subdivisions                  | \$ 12,895         | \$ 86                        | \$ 58                         | \$ 12,923                  |
| Mortgage-backed securities  | 1                 | -                            | -                             | 1                          |
|   | \$ 12,896         | \$ 86                        | \$ 58                         | \$ 12,924                  |

Gross unrealized losses and fair value by length of time that the individual available-for-sale securities have been in a continuous unrealized loss position at December 31, 2008, are as follows:

| (Dollars in thousands)                | Fair Value | Continuous unrealized losses existing for:<br>Less Than 12 Months | More Than 12 Months | Total Unrealized Losses |
|---------------------------------------|------------|---|---------------------|-------------------------|
| <b>Available-for-sale securities:</b> |            |   |                     |                         |

|                            |    |     |    |   |    |   |    |   |
|----------------------------|----|-----|----|---|----|---|----|---|
| Mortgage-backed securities | \$ | 865 | \$ | 3 | \$ | 5 | \$ | 8 |
|----------------------------|----|-----|----|---|----|---|----|---|

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The available-for-sale investment portfolio has a fair value of approximately \$79.2 million, of which approximately \$865 thousand have unrealized losses from their purchase price. All of these securities are mortgage-backed securities. The securities representing the unrealized losses in the available-for-sale portfolio all have modest duration risk, low credit risk, and minimal loss (approximately 0.01%) when compared to amortized cost. The unrealized losses that exist are the result of market changes in interest rates since the original purchase. These factors, coupled with the Company's intent and ability to hold these investments for a period of time sufficient to allow for any anticipated recovery in fair value, substantiates that the unrealized losses in the available-for-sale portfolio are temporary.

Gross unrealized losses and fair value by length of time that the individual held-to-maturity securities have been in a continuous unrealized loss position at December 31, 2008, are as follows:

| (Dollars in thousands)                           | Fair Value | Continuous unrealized losses existing for: |                     | Total Unrealized Losses |
|--|------------|--|---------------------|-------------------------|
|  |            | Less Than 12 Months                        | More Than 12 Months |                         |
| <b>Held-to-maturity securities:</b>              |            |  |                     |                         |
| Obligations of states and political subdivisions | \$ 1,071   | \$ 15                                      | \$ 6                | \$ 21                   |

The held-to-maturity investment portfolio has a fair value of approximately \$10.4 million, of which approximately \$1.1 million have unrealized losses from their purchase price. The securities representing the unrealized losses in the held-to-maturity portfolio are all municipal securities with modest duration risk, low credit risk, and minimal losses (approximately 0.20%) when compared to amortized cost. The unrealized losses that exist are the result of market changes in interest rates since the original purchase. These factors, coupled with the Company's intent and ability to hold these investments for a period of time sufficient to allow for any anticipated recovery in fair value, substantiates that the unrealized losses in the held-to-maturity portfolio are temporary.

The amortized cost and estimated fair values of investment securities by maturity date at December 31, 2008, are as follows:

| (Dollars in thousands)                 | Available-for-sale |                      | Held-to-maturity |                      |
|--|--------------------|----------------------|------------------|----------------------|
|  | Amortized Cost     | Estimated Fair Value | Amortized Cost   | Estimated Fair Value |
| Due in one year or less                | \$ 8,818           | \$ 8,934             | \$ 4,357         | \$ 4,385             |
| Due after one year through five years  | 47,125             | 48,621               | 4,753            | 4,873                |
| Due after five years through ten years | 4,990              | 5,155                | 1,142            | 1,132                |
| Due after ten years                    | 12,091             | 12,636               | -                | -                    |
|  | 73,024             | 75,346               | 10,252           | 10,390               |
| Equity securities                      | 3,856              | 3,858                | -                | -                    |
|  | \$ 76,880          | \$ 79,204            | \$ 10,252        | \$ 10,390            |

The maturity date for mortgage-backed securities is determined by its expected maturity. The maturity date for the remaining debt securities is determined using its contractual maturity date.

The following table sets forth the amortized cost and estimated fair values of securities which have been pledged as collateral for obligations to federal, state and local government agencies, and other purposes as required or permitted by law, or sold under agreements to repurchase. All pledged securities are in the available-for-sale investment portfolio.

| (Dollars in thousands) | December 31, 2008 |                      | December 31, 2007 |                      |
|------------------------|-------------------|----------------------|-------------------|----------------------|
|                        | Amortized Cost    | Estimated Fair Value | Amortized Cost    | Estimated Fair Value |

|                                       |    |        |    |        |    |        |    |        |
|---------------------------------------|----|--------|----|--------|----|--------|----|--------|
| Pledged available-for-sale securities | \$ | 69,124 | \$ | 71,322 | \$ | 88,274 | \$ | 88,805 |
|---------------------------------------|----|--------|----|--------|----|--------|----|--------|

There were no obligations of states or political subdivisions whose carrying value, as to any issuer, exceeded 10% of stockholders' equity at December 31, 2008, or 2007.

Proceeds from sales of investment securities were \$2 thousand, \$3.5 million, and \$51 thousand for the years ended December 31, 2008, 2007, and 2006, respectively. Gross gains from sales of investment securities were \$0, \$5 thousand, and \$3 thousand for the years ended December 31, 2008, 2007, and 2006, respectively. Gross losses were \$15 thousand for the year ended December 31, 2008. There were no gross losses for the years ended December 31, 2007 and 2006. The investment securities losses in 2008 resulted from the sale of 10,000 shares of Freddie Mac preferred stock. The Company also incurred a \$371 thousand other than temporary impairment loss on these securities during 2008.

## NOTE 5. LOANS AND ALLOWANCE FOR CREDIT LOSSES

The Company makes residential mortgage, consumer and commercial loans to customers primarily in the Maryland counties of Talbot, Queen Anne's, Kent, Caroline and Dorchester and in Kent County, Delaware. The principal categories of the loan portfolio at December 31 are summarized as follows:

| (Dollars in thousands)  | 2008       | 2007       |
|---|------------|------------|
| Real estate loans:  |            |            |
| Construction and land development   | \$ 179,847 | \$ 155,527 |
| Secured by farmland   | 24,797     | 23,741     |
| Secured by residential properties   | 289,510    | 255,688    |
| Secured by non-farm, non-residential properties                                   | 279,599    | 225,478    |
| Loans to farmers (loans to finance agricultural production and other loans)       | 2,724      | 2,779      |
| Commercial and industrial loans   | 80,107     | 82,382     |
| Loans to individuals for household, family, and other personal expenditures       | 22,606     | 23,053     |
| Obligations of states and political subdivisions in the United States, tax-exempt | 7,419      | 5,355      |
| All other loans   | 1,919      | 2,347      |
|   | 888,528    | 776,350    |
| Allowance for credit losses   | (9,320)    | (7,551)    |
|   | \$ 879,208 | \$ 768,799 |

Loans are net of unearned income of \$504 thousand at year-end 2008 and \$673 thousand at year-end 2007.

In the normal course of banking business, loans are made to officers and directors and their affiliated interests. These loans are made on substantially the same terms and conditions as those prevailing at the time for comparable transactions with outsiders and are not considered to involve more than the normal risk of collectibility. As of December 31, 2008, and 2007, such loans outstanding, both direct and indirect (including guarantees), to directors, their associates and policy-making officers, totaled approximately \$9.5 million and \$11.0 million, respectively. During 2008 and 2007, loan additions were approximately \$913 thousand and \$1.1 million, respectively, and loan repayments were approximately \$2.4 million and \$2.3 million, respectively.

Activity in the allowance for credit losses is summarized as follows:

| (Dollars in thousands)     | 2008     | 2007     | 2006     |
|----------------------------|----------|----------|----------|
| Balance beginning of year: | \$ 7,551 | \$ 6,300 | \$ 5,236 |
| Loans charged off:         |          |          |          |
| Real estate – construction | (536)    | -        | -        |
| Real estate – residential  | (316)    | (137)    | -        |
| Real estate – commercial   | (238)    | -        | (2)      |
| Commercial                 | (447)    | (276)    | (539)    |
| Consumer                   | (276)    | (301)    | (137)    |
|                            | (1,813)  | (714)    | (678)    |
| Recoveries:                |          |          |          |
| Real estate – construction | -        | -        | -        |
| Real estate – residential  | 19       | -        | -        |
| Real estate – commercial   | -        | -        | 46       |
| Commercial                 | 136      | 165      | 123      |
| Consumer                   | 90       | 76       | 80       |



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|                             |          |          |          |
|-----------------------------|----------|----------|----------|
|                             | 245      | 241      | 249      |
| Net loans charged off       | (1,568)  | (473)    | (429)    |
| Provision for credit losses | 3,337    | 1,724    | 1,493    |
| Balance, end of year        | \$ 9,320 | \$ 7,551 | \$ 6,300 |

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Information with respect to impaired loans and the related valuation allowance as of December 31 is as follows:

| (Dollars in thousands)  | 2008            | 2007            | 2006            |
|---|-----------------|-----------------|-----------------|
| Impaired loans with a valuation allowance                           | \$ 2,550        | \$ 3,413        | \$ 7,658        |
| Impaired loans with no valuation allowance                          | 5,565           | 127             | -               |
| <b>Total impaired loans</b>   | <b>\$ 8,115</b> | <b>\$ 3,540</b> | <b>\$ 7,658</b> |
| Allowance for credit losses applicable to impaired loans            | \$ 341          | \$ 819          | \$ 883          |
| Allowance for credit losses applicable to other than impaired loans | 8,979           | 6,732           | 5,417           |
| <b>Total allowance for credit losses</b>                            | <b>\$ 9,320</b> | <b>\$ 7,551</b> | <b>\$ 6,300</b> |
| <b>Average recorded investment in impaired loans</b>                | <b>\$ 5,477</b> | <b>\$ 3,958</b> | <b>\$ 1,857</b> |

Gross interest income of \$476 thousand and \$404 thousand would have been recorded in 2008 and 2007, respectively, if nonaccrual loans had been current and performing in accordance with their original terms. Interest actually recorded on such loans was \$193 thousand and \$142 thousand for 2008 and 2007, respectively.

#### NOTE 6. PREMISES AND EQUIPMENT

A summary of premises and equipment at December 31 is as follows:

| (Dollars in thousands)          | 2008      | 2007      |
|---------------------------------|-----------|-----------|
| Land                            | \$ 4,337  | \$ 4,395  |
| Buildings and land improvements | 11,202    | 12,322    |
| Furniture and equipment         | 7,195     | 7,212     |
|                                 | 22,734    | 23,929    |
| Accumulated depreciation        | (8,879)   | (8,312)   |
|                                 | \$ 13,855 | \$ 15,617 |

Depreciation expense totaled \$1.1 million for each of the three years in the period ended December 31, 2008. The decrease in premises and equipment was primarily from the sale of a bank branch.

On April 17, 2008, the Company entered into a sale-leaseback agreement with Milford Plaza Enterprises, LLC ("Purchaser"). Under the agreement, the Company terminated its ground lease with the Purchaser and conveyed to the Purchaser title to the Company's improvements to the property, generally consisting of the Company's branch banking facility in Milford, Delaware. The Company received \$1.3 million for this sale and an immaterial loss was recorded on the transaction. The Company has leased back the facility for an initial period of 12 years. Monthly rental expense under the agreement is approximately \$11 thousand.

The Company leases facilities under operating leases. Rental expense for the years ended December 31, 2008, 2007 and 2006 was \$607 thousand, \$380 thousand and \$304 thousand, respectively. The increase in 2008 was mainly due to the rent on the property in the sales-leaseback transaction discussed above and rent incurred by the insurance entities acquired in the fourth quarter of 2007. Future minimum annual rental payments are approximately as follows (dollars in thousands):

|      |        |
|------|--------|
| 2009 | \$ 721 |
| 2010 | 542    |

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|                              |          |
|------------------------------|----------|
| 2011                         | 478      |
| 2012                         | 386      |
| 2013                         | 299      |
| Thereafter                   | 2,098    |
| Total minimum lease payments | \$ 4,524 |

## NOTE 7. INVESTMENT IN UNCONSOLIDATED SUBSIDIARY

During 2008, the Company sold its investment in 20.0% of the outstanding common stock of the Delmarva Data Bank Processing Center, Inc. ("Delmarva Data"). The Company recorded a \$337 thousand loss on the sale.

| (Dollars in thousands)     | 2008   | December 31, |        |
|----------------------------|--------|--------------|--------|
|                            |        | 2007         | 2006   |
| Balance, beginning of year | \$ 937 | \$ 937       | \$ 909 |
| Equity in net income       | -      | -            | 28     |
| Sale of investment         | (937)  | -            | -      |
| Balance, end of year       | \$ -   | \$ 937       | \$ 937 |

Data processing and other expenses paid to Delmarva Data totaled approximately \$1.9 million, \$2.0 million and \$1.9 million for the years ended December 31, 2008, 2007 and 2006, respectively.

## NOTE 8. GOODWILL AND OTHER INTANGIBLE ASSETS

Goodwill totaled \$16.0 million at both December 31, 2008 and December 31, 2007. The Community banking segment had \$4.1 million in goodwill and the Insurance segment had \$11.9 million in goodwill at December 31, 2008, unchanged from December 31, 2007. The Insurance segment increased its goodwill by \$4.0 million during 2007 due to the acquisition of two insurance companies, JM and TSGIA.

The significant components of goodwill and acquired intangible assets are as follows:

| (Dollars in thousands)                                       | December 31, 2008     |                          |                     |                                 | December 31, 2007     |                          |                     |                                 |
|--|-----------------------|--------------------------|---------------------|---------------------------------|-----------------------|--------------------------|---------------------|---------------------------------|
|  | Gross Carrying Amount | Accumulated Amortization | Net Carrying Amount | Weighted Average Remaining Life | Gross Carrying Amount | Accumulated Amortization | Net Carrying Amount | Weighted Average Remaining Life |
| Goodwill   | \$ 16,621             | \$ 667                   | \$ 15,954           | -                               | \$ 16,621             | \$ 667                   | \$ 15,954           | -                               |
| Other intangible assets                                      |                       |                          |                     |                                 |                       |                          |                     |                                 |
| Amortized other intangible assets                            |                       |                          |                     |                                 |                       |                          |                     |                                 |
| Employment agreements  | \$ 1,730              | \$ 312                   | \$ 1,418            | 5.7                             | \$ 1,730              | \$ 62                    | \$ 1,668            | 6.7                             |
| Insurance expirations  | 1,270                 | 555                      | 715                 | 8.5                             | 1,270                 | 471                      | 799                 | 9.5                             |
| Core deposit intangible                                      | 968                   | 575                      | 393                 | 3.3                             | 968                   | 454                      | 514                 | 4.3                             |
| Customer relationships                                       | 960                   | 75                       | 885                 | 14.7                            | 960                   | 15                       | 945                 | 15.7                            |
| Unidentifiable intangible resulting from branch acquisitions | -                     | -                        | -                   | -                               | 104                   | 104                      | -                   | -                               |

|                                     |          |          |          |   |          |          |          |   |
|-------------------------------------|----------|----------|----------|---|----------|----------|----------|---|
| Other identifiable intangibles      | -        | -        | -        | - | 621      | 621      | -        | - |
|                                     | 4,928    | 1,517    | 3,411    |   | 5,653    | 1,727    | 3,926    |   |
| Unamortized other intangible assets |          |          |          |   |          |          |          |   |
| Carrier relationships               | 1,300    | -        | 1,300    | - | 1,300    | -        | 1,300    | - |
| Trade name                          | 1,210    | -        | 1,210    | - | 1,210    | -        | 1,210    | - |
|                                     | 2,510    | -        | 2,510    |   | 2,510    | -        | 2,510    |   |
| Total other intangible assets       | \$ 7,438 | \$ 1,517 | \$ 5,921 |   | \$ 8,163 | \$ 1,727 | \$ 6,436 |   |

The current period and estimated future amortization expense for amortized other intangible assets is as follows:

| (Dollars in thousands)                |      | Amortization Expense |
|---------------------------------------|------|----------------------|
| Year ended December 31, 2008          |      | \$ 515               |
| Estimate for years ended December 31, | 2009 | 515                  |
|                                       | 2010 | 515                  |
|                                       | 2011 | 515                  |
|                                       | 2012 | 402                  |
|                                       | 2013 | 306                  |

Under the provisions of SFAS No. 142, goodwill was subjected to an annual assessment for impairment during 2008. As a result of annual assessment reviews, the Company determined that there was no impairment of goodwill. The Company will continue to review goodwill on an annual basis for impairment and as events occur or circumstances change.

#### NOTE 9. DEPOSITS

The approximate amount of certificates of deposit of \$100,000 or more at December 31, 2008 and 2007 was \$235.2 million and \$161.6 million, respectively.

The approximate maturities of time deposits at December 31 are as follows:

| (Dollars in thousands)     | 2008       | 2007       |
|----------------------------|------------|------------|
| Due in one year or less    | \$ 328,367 | \$ 277,952 |
| Due in one to three years  | 96,518     | 71,350     |
| Due in three to five years | 41,574     | 26,993     |
|                            | \$ 466,459 | \$ 376,295 |

#### NOTE 10. SHORT-TERM BORROWINGS

The following table summarizes certain information for short-term borrowings for the years ended December 31:

| (Dollars in thousands)           | 2008             |             | 2007             |             |
|----------------------------------|------------------|-------------|------------------|-------------|
|                                  | Amount           | Rate        | Amount           | Rate        |
| <b>Average for the Year:</b>     |                  |             |                  |             |
| Retail repurchase agreements     | \$ 24,229        | 1.48%       | \$ 25,785        | 3.60%       |
| Federal Home Loan Bank advances  | 22,219           | 3.39        | 7,000            | 4.50        |
| Other short-term borrowings      | 1,317            | 2.69        | 353              | 5.51        |
| <b>Total</b>                     | <b>\$ 47,765</b> | <b>2.40</b> | <b>\$ 33,138</b> | <b>3.81</b> |
| <b>At Year End:</b>              |                  |             |                  |             |
| Retail repurchase agreements     | \$ 24,469        | 0.45%       | \$ 27,494        | 3.27%       |
| Federal Home Loan Bank advances  | 24,050           | 0.51        | 20,000           | 4.65        |
| Other short-term borrowings      | 4,450            | 0.45        | 200              | 4.92        |
| <b>Total</b>                     | <b>\$ 52,969</b> | <b>0.49</b> | <b>\$ 47,694</b> | <b>3.86</b> |
| <b>Maximum Month-End Balance</b> |                  |             |                  |             |
| Retail repurchase agreements     | \$ 33,094        |             | \$ 34,536        |             |
| Federal Home Loan Bank advances  | 31,500           |             | 20,000           |             |
| Other short-term borrowings      | 8,500            |             | 2,500            |             |

Securities sold under agreements to repurchase are securities sold to customers, at the customers' request, under a "roll-over" contract that matures in one business day. The underlying securities sold are U.S. Government agency securities, which are segregated in the Company's custodial accounts from other investment securities.

The Company may periodically borrow from a correspondent federal funds line of credit arrangement, under a secured reverse repurchase agreement, or from the Federal Home Loan Bank to meet short-term liquidity needs.

## NOTE 11. LONG-TERM DEBT

As of December 31, the Company had the following long-term debt:

| (Dollars in thousands)   | 2008     | 2007      |
|--|----------|-----------|
| Federal Home Loan Bank (FHLB) 5.69% Advance due in 2008              | \$ -     | \$ 7,000  |
| FHLB 4.17% Advance due in 2009                                       | 3,000    | 3,000     |
| FHLB 3.09% Advance due in 2010                                       | 3,000    | -         |
| Acquisition-related debt, 4.08% interest, amortizing over five years | 1,947    | 2,485     |
|  | \$ 7,947 | \$ 12,485 |

The Company has pledged its real estate mortgage loan portfolio under a blanket floating lien as collateral for the FHLB advances.

The acquisition-related debt was incurred as part of the purchase price of TSGIA and is payable to the seller thereof, who remains the President of that subsidiary.

## NOTE 12. BENEFIT PLANS

## 401(k) and Profit Sharing Plan

The Company has a 401(k) and profit sharing plan covering substantially all full-time employees. The plan calls for matching contributions by the Company, and the Company makes discretionary contributions based on profits. Company contributions to this plan included in expense totaled \$1.4 million, \$1.1 million, and \$1.0 million for 2008, 2007, and 2006, respectively.

TSGIA had a separate 401(k) plan covering substantially all of its full-time employees in 2007. The Company's total expense under this plan was \$11 thousand for 2007.

## NOTE 13. STOCK-BASED COMPENSATION

At December 31, 2008, the Company had three equity compensation plans: (i) the Shore Bancshares, Inc. 2006 Stock and Incentive Compensation Plan ("2006 Equity Plan"); (ii) the Shore Bancshares, Inc. Employee Stock Purchase Plan ("ESPP"); and (iii) the Shore Bancshares, Inc. 1998 Stock Option Plan (the "1998 Option Plan"). The ability of the Company to grant options under the 1998 Option Plan terminated by its terms on March 3, 2008, but stock options granted under the 1998 Option Plan were outstanding at December 31, 2008.

Under the 2006 Equity Plan, stock-based awards may be granted periodically to directors, executive officers, and key employees at the discretion of the Compensation Committee of the Company's Board. Stock-based awards granted to date under the 2006 Equity Plan are generally time-based, vesting on each anniversary of the grant date over a three to five year period of time and, in the case of stock options, expiring 10 years from the grant date. The 2006 Equity Plan originally reserved 600,000 shares of common stock for grant, and 581,972 shares remained available for grant at December 31, 2008.

Under the ESPP, employees are allowed to purchase shares of the Company's common stock at 85% of the fair market value on the date of grant. ESPP grants are 100% vested at date of grant and have a 27-month term. As amended, the plan reserved 67,500 shares of common stock for issuance under the ESPP and 29,204 shares remained available for grant at December 31, 2008.

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The following table summarizes restricted stock award activity for the Company under the 2006 Equity Plan for the two years ended December 31, 2008:

|                                | Year Ended December 31, 2008 |   | Year Ended December 31, 2007 |  |
|--------------------------------|------------------------------|---|------------------------------|--|
|                                | Number<br>of Shares          | Weighted Average Grant<br>Date Fair Value | Number<br>of Shares          | Weighted<br>Average<br>Grant<br>Date Fair<br>Value |
| Nonvested at beginning of year | 3,845                        | \$ 25.31                                  | -                            | \$ -   |
| Granted                        | 13,783                       | 21.93                                     | 4,245                        | 25.28  |
| Vested                         | (769)                        | 25.31                                     | (400)                        | 25.00  |
| Cancelled                      | -                            | -   | -                            | -  |
| Nonvested at end of year       | 16,859                       | 22.55                                     | 3,845                        | 25.31  |

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The total fair value of restricted stock awards vested was \$16 thousand in 2008 and \$10 thousand in 2007.

The following is a summary of stock option activity for the 1998 Option Plan and the ESPP for 2008 and 2007:

|                                  | Year Ended December 31, 2008 |                                 | Year Ended December 31, 2007 |                                 |
|----------------------------------|------------------------------|---------------------------------|------------------------------|---------------------------------|
|                                  | Number of Shares             | Weighted Average Exercise Price | Number of Shares             | Weighted Average Exercise Price |
| Outstanding at beginning of year | 33,797                       | \$ 15.67                        | 37,515                       | \$ 15.82                        |
| Granted                          | -                            | -                               | -                            | -                               |
| Exercised                        | (13,181)                     | 15.46                           | (3,444)                      | 17.07                           |
| Expired/Cancelled                | (2,066)                      | 18.47                           | (274)                        | 18.47                           |
| Outstanding at end of year       | 18,550                       | 15.52                           | 33,797                       | 15.67                           |

The following summarizes information about stock options outstanding at December 31, 2008:

| Options Outstanding |                | Options Outstanding and Exercisable |   |
|---------------------|----------------|-------------------------------------|---|
| Number              | Exercise Price | Number                              | Weighted Average Remaining Contract Life (in years) |
| 5,000               | \$ 21.33       | 5,000                               | 0.05  |
| 3,255               | 14.00          | 3,255                               | 1.05  |
| 10,295              | 13.17          | 10,295                              | 3.28  |
| 18,550              |                | 18,550                              |   |

The fair value of stock options issued is measured on the date of grant and recognized over the vesting period. The Company estimates the fair value of stock options using the Black-Scholes option-pricing model with the following weighted average assumptions for options granted pursuant to the ESPP during 2006; there were no options granted in 2008 and 2007:

|                           | 2006   |
|---------------------------|--------|
| Dividend yield            | 2.40%  |
| Expected volatility       | 23.57% |
| Risk free interest rate   | 4.53%  |
| Expected lives (in years) | 2.25   |

The total intrinsic value of outstanding stock options and outstanding exercisable stock options was \$157 thousand at December 31, 2008. The total intrinsic value of stock options exercised during the years ended December 31, 2008, 2007, and 2006 was \$80 thousand, \$32 thousand and \$814 thousand, respectively. The total fair value of stock options vested was \$0 for 2008 and \$30 thousand for both 2007 and 2006.

Stock-based compensation expense totaled \$91 thousand, \$63 thousand and \$48 thousand in 2008, 2007, and 2006, respectively. Stock-based compensation expense is recognized ratably over the requisite service period for all awards. The total income tax benefit recognized in the accompanying consolidated statements of income related to stock-based compensation was \$4 thousand, \$3 thousand, and \$279 thousand in 2008, 2007, and 2006, respectively. Unrecognized stock-based compensation expense related to stock-based awards totaled \$300 thousand at December 31, 2008. At such date, the weighted-average period over which this unrecognized expense was expected to be recognized was 3.5 years.

NOTE 14. DEFERRED COMPENSATION

During 2006, the Company adopted the Shore Bancshares, Inc. Executive Deferred Compensation Plan (the “Plan”) for members of management and highly compensated employees of the Company and its subsidiaries. The Plan permits a participant to elect, each year, to defer receipt of up to 100% of his or her salary and bonus to be earned in the following year. The Plan also permits the participant to defer the receipt of performance-based compensation not later than six months before the end of the period for which it is to be earned. The deferred amounts will be credited to an account maintained on behalf of the participant and will be invested at the discretion of each participant in certain deemed investment options selected from time to time by the Compensation Committee of the Company’s Board. The Company may also make matching, mandatory and discretionary contributions for certain participants. A participant is fully vested at all times in the amounts that he or she elects to defer. Any contributions by the Company will vest over a five-year period. The Company made contributions to the Plan totaling \$84 thousand, \$167 thousand, and \$0 for 2008, 2007, and 2006, respectively. Elective deferrals were made by one plan participant during 2007 and 2006.

The Company has a supplemental deferred compensation plan to provide retirement benefits to its President and Chief Executive Officer. The participant is 100% vested in amounts credited to his account. No contributions were made to this plan in 2008 or 2007. Contributions to the plan were \$20 thousand in 2006.

Centreville National Bank has agreements with certain of its directors under which they have deferred part of their fees and compensation. The amounts deferred are invested in insurance policies, owned by the Company, on the lives of the respective individuals. Amounts available under the policies are to be paid to the individuals as retirement benefits over future years. The cash surrender value and the accrued benefit obligation included in other assets and other liabilities at December 31 are as follows:

| (Dollars in thousands)     | 2008     | 2007     |
|----------------------------|----------|----------|
| Cash surrender value       | \$ 2,276 | \$ 2,204 |
| Accrued benefit obligation | 1,252    | 902      |

#### NOTE 15. INCOME TAXES

Income taxes included in the balance sheets as of December 31 are as follows:

| (Dollars in thousands)                    | 2008     | 2007  |
|---|----------|-------|
| Federal income taxes currently receivable | \$ 1,180 | \$ 66 |
| State income taxes currently receivable   | 143      | 66    |
| Deferred income tax benefit               | 1,579    | 1,847 |

Components of income tax expense for each of the three years ended December 31 are as follows:

| (Dollars in thousands)       | 2008     | 2007     | 2006     |
|------------------------------|----------|----------|----------|
| Currently payable:           |          |          |          |
| Federal                      | \$ 6,120 | \$ 7,162 | \$ 7,367 |
| State                        | 1,470    | 1,217    | 1,211    |
|                              | 7,590    | 8,379    | 8,578    |
| Deferred income tax benefit: |          |          |          |
| Federal                      | (334)    | (255)    | (351)    |
| State                        | (164)    | (122)    | (73)     |
|                              | (498)    | (377)    | (424)    |
|                              | \$ 7,092 | \$ 8,002 | \$ 8,154 |

A reconciliation of tax computed at the statutory federal tax rate of 35% to the actual tax expense for the three years ended December 31 follows:

| (Dollars in thousands)                     | 2008  | 2007  | 2006  |
|--|-------|-------|-------|
| Tax at federal statutory rate              | 35.0% | 35.0% | 35.0% |
| Tax effect of:                             |       |       |       |
| Tax-exempt income                          | (1.2) | (1.0) | (0.9) |
| Non-deductible expenses                    | 0.1   | 0.2   | 0.1   |
| State income taxes, net of federal benefit | 4.6   | 3.4   | 3.5   |
| Other                                      | (0.3) | (0.3) | (0.1) |
| Income tax expense                         | 38.2% | 37.3% | 37.6% |



Significant components of the Company's deferred tax assets and liabilities as of December 31 are as follows:

| (Dollars in thousands)                            | 2008            | 2007            |
|---|-----------------|-----------------|
| <b>Deferred tax assets:</b>                       |                 |                 |
| Allowance for credit losses                       | \$ 3,688        | \$ 2,997        |
| Provision for off-balance sheet commitments       | 171             | 157             |
| Net operating loss carry forward                  | 115             | 41              |
| Deferred gain on sale leaseback                   | 52              | 55              |
| Recognized loss on impaired securities            | -               | 45              |
| Deferred income                                   | 271             | 99              |
| Accrued employee benefits                         | 710             | 460             |
| Other   | 8               | 18              |
| <b>Total deferred tax assets</b>                  | <b>5,015</b>    | <b>3,872</b>    |
| <b>Deferred tax liabilities:</b>                  |                 |                 |
| Depreciation                                      | 389             | 389             |
| Purchase accounting adjustments                   | 1,161           | 959             |
| Federal Home Loan Bank stock dividend             | 29              | 29              |
| Undistributed income of unconsolidated subsidiary | -               | 76              |
| Deferred capital gain on branch sale              | 493             | -               |
| Deferred loan costs                               | 377             | 332             |
| Unrealized gains on available-for-sale securities | 932             | 166             |
| Other   | 55              | 74              |
| <b>Total deferred tax liabilities</b>             | <b>3,436</b>    | <b>2,025</b>    |
| <b>Net deferred tax assets</b>                    | <b>\$ 1,579</b> | <b>\$ 1,847</b> |

#### NOTE 16. EARNINGS PER COMMON SHARE

Basic earnings per share are calculated by dividing net income available to common stockholders by the weighted average number of common shares outstanding during the period. Diluted earnings per share are calculated by dividing net income by the weighted average number of common shares outstanding during the period, adjusted for the dilutive effect of outstanding stock options and awards. The following table provides information relating to the calculation of earnings per share:

| (In thousands, except per share data)                | 2008             | 2007             | 2006             |
|--|------------------|------------------|------------------|
| <b>Net Income</b>                                    | <b>\$ 11,470</b> | <b>\$ 13,450</b> | <b>\$ 13,554</b> |
| <b>Weighted average shares outstanding – basic</b>   | <b>8,384</b>     | <b>8,380</b>     | <b>8,366</b>     |
| <b>Dilutive effect of stock-based awards</b>         | <b>7</b>         | <b>14</b>        | <b>27</b>        |
| <b>Weighted average shares outstanding – diluted</b> | <b>8,391</b>     | <b>8,394</b>     | <b>8,393</b>     |
| <b>Earnings per common share – Basic</b>             | <b>\$ 1.37</b>   | <b>\$ 1.61</b>   | <b>\$ 1.62</b>   |
| <b>Earnings per common share – Diluted</b>           | <b>\$ 1.37</b>   | <b>\$ 1.60</b>   | <b>\$ 1.61</b>   |

There were 3,284 antidilutive stock-based awards excluded from the earnings per share calculation for 2008. For the years ended December 31, 2007 and 2006, there were no antidilutive stock-based awards to exclude from the earnings per share calculation.

NOTE 17. REGULATORY CAPITAL REQUIREMENTS

The Company and each of the Banks are subject to various regulatory capital requirements administered by the federal banking agencies. Failure to meet minimum capital requirements can initiate certain mandatory - and possibly additional discretionary - actions by regulators that, if undertaken, could have a direct material effect on the Company's financial statements. Under capital adequacy guidelines and the regulatory framework for prompt corrective action, the Banks must meet specific capital guidelines that involve quantitative measures of the Banks' assets, liabilities, and certain off-balance sheet items as calculated under regulatory accounting practices. The Banks' capital amounts and classification are also subject to qualitative judgments by the regulators about components, risk weightings, and other factors.

Quantitative measures established by regulation to ensure capital adequacy require the Banks to maintain amounts and ratios (set forth in the table below) of Tier 1 and total capital (as defined in the regulations) to risk-weighted assets (as defined), and of Tier 1 capital (as defined) to average assets (leverage ratio). Management believes, as of December 31, 2008, that the Company and the Banks met all capital adequacy requirements to which they are subject.

As of December 31, 2008 and 2007, the most recent notification from the Federal Deposit Insurance Corporation and the Office of the Comptroller of the Currency categorized the Banks as well capitalized under the regulatory framework for prompt corrective action. To be categorized as well capitalized, the Banks must maintain minimum Tier 1 risk-based and total risk-based capital ratios, and Tier 1 leverage ratios. Management knows of no trends or demands, commitments, events or uncertainties that are likely to have a material adverse impact on the ability of the Company or any of the Banks to remain in the well capitalized category.

The minimum ratios for capital adequacy purposes are 4.00%, 8.00% and 4.00% for the Tier 1 risk-based capital, total risk-based 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 1 risk-based capital, total risk-based capital and leverage ratios, respectively. Shore Bancshares, Inc., as a financial holding company, is subject to the well-capitalized requirement.

Capital amounts and ratios for Shore Bancshares, Inc., Talbot Bank, Centreville National Bank and Felton Bank as of December 31, 2008 and 2007 are presented below:

| December 31, 2008<br>(Dollars in thousands) | Tier 1<br>Capital | Total<br>Risk-<br>Based<br>Capital | Net<br>Risk-<br>Weighted<br>Assets | Adjusted<br>Average<br>Total<br>Assets | Tier 1<br>Risk-Based<br>Capital<br>Ratio | Total<br>Risk-Based<br>Capital<br>Ratio | Tier 1<br>Leverage<br>Ratio |
|---|-------------------|------------------------------------|------------------------------------|--|--|---|-----------------------------|
| Company                                     | \$ 104,117        | \$ 113,872                         | \$ 894,024                         | \$ 1,013,815                           | 11.65%                                   | 12.74%                                  | 10.27%                      |
| Talbot Bank                                 | 64,302            | 70,101                             | 556,417                            | 605,533                                | 11.56                                    | 12.60                                   | 10.62                       |
| Centreville National Bank                   | 30,817            | 33,327                             | 257,864                            | 314,232                                | 11.95                                    | 12.92                                   | 9.81                        |
| Felton Bank                                 | 7,182             | 8,161                              | 79,085                             | 89,802                                 | 9.08                                     | 10.32                                   | 8.00                        |

| December 31, 2007<br>(Dollars in thousands) | Tier 1<br>Capital | Total<br>Risk-<br>Based<br>Capital | Net<br>Risk-<br>Weighted<br>Assets | Adjusted<br>Average<br>Total<br>Assets | Tier 1<br>Risk-Based<br>Capital<br>Ratio | Total<br>Risk-Based<br>Capital<br>Ratio | Tier 1<br>Leverage<br>Ratio |
|---|-------------------|------------------------------------|------------------------------------|--|--|---|-----------------------------|
| Company                                     | \$ 97,744         | \$ 105,694                         | \$ 804,240                         | \$ 930,619                             | 12.15%                                   | 13.14%                                  | 10.50%                      |
| Talbot Bank                                 | 59,298            | 64,209                             | 473,288                            | 532,486                                | 12.53                                    | 13.57                                   | 11.14                       |
| Centreville National Bank                   | 29,575            | 31,604                             | 249,569                            | 308,789                                | 11.85                                    | 12.66                                   | 9.58                        |
| Felton Bank                                 | 7,024             | 7,988                              | 77,107                             | 90,647                                 | 9.11                                     | 10.36                                   | 7.75                        |

Federal and state laws and regulations applicable to banks and their holding companies impose certain restrictions on dividend payments by the Banks, as well as restricting extensions of credit and transfers of assets between the Banks and the Company. The Banks paid dividends of \$5.0 million to the Company during 2008. At December 31, 2008, the Banks could have paid dividends to the Company of approximately \$10.5 million without the prior consent and approval of the regulatory agencies. The Company had no outstanding receivables from subsidiaries at December 31, 2008 or 2007.

#### NOTE 18. LINES OF CREDIT

The Banks had \$57.5 million in unsecured federal funds lines of credit and a reverse repurchase agreement available on a short-term basis from correspondent banks at December 31, 2008. The comparable amount was \$20.5 million at

December 31, 2007. In addition, the Banks had credit availability of approximately \$62.1 million and \$86.9 million from the Federal Home Loan Bank at December 31, 2008 and 2007, respectively. The Banks have pledged as collateral, under a blanket lien, all qualifying residential loans under borrowing agreements with the Federal Home Loan Bank. At December 31, 2008 and 2007, the Federal Home Loan Bank had issued letters of credit in the amounts of \$65.0 million and \$35.0 million, respectively, on behalf of the Banks to local government entities as collateral for their deposits. The Banks had short-term borrowings from the Federal Home Loan Bank at December 31, 2008 and 2007 of \$24.1 million and \$20.0 million, respectively.



## NOTE 19. DISCLOSURES ABOUT FAIR VALUE OF FINANCIAL INSTRUMENTS

The following methods and assumptions were used to estimate the fair value of each class of financial instruments for which it is practicable to estimate that value:

**Cash and Cash Equivalents**

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

**Investment Securities**

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

**Loan Receivables**

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

**Financial Liabilities**

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

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

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

The estimated fair values of the Company's financial instruments, excluding goodwill, as of December 31 are as follows:

| (Dollars in thousands)          | 2008            |                      | 2007            |                      |
|---------------------------------|-----------------|----------------------|-----------------|----------------------|
|                                 | Carrying Amount | Estimated Fair Value | Carrying Amount | Estimated Fair Value |
| <b>Financial assets:</b>        |                 |                      |                 |                      |
| Cash and cash equivalents       | \$ 27,294       | \$ 27,294            | \$ 26,880       | \$ 26,797            |
| Investment securities           | 89,456          | 89,594               | 110,033         | 110,060              |
| Loans                           | 888,528         | 914,695              | 776,350         | 789,247              |
| Less: allowance for loan losses | (9,320)         | -                    | (7,551)         | -                    |
|                                 | \$ 995,958      | \$ 1,031,583         | \$ 905,712      | \$ 926,104           |
| <b>Financial liabilities:</b>   |                 |                      |                 |                      |
| Deposits                        | \$ 845,371      | \$ 861,951           | \$ 765,895      | \$ 771,697           |
| Short-term borrowings           | 52,969          | 52,969               | 47,694          | 47,703               |
| Long-term debt                  | 7,947           | 8,060                | 12,485          | 12,657               |

|            |            |            |            |
|------------|------------|------------|------------|
| \$ 906,287 | \$ 922,980 | \$ 826,074 | \$ 832,057 |
|------------|------------|------------|------------|

| (Dollars in thousands)                     | 2008            |                      | 2007            |                      |
|--|-----------------|----------------------|-----------------|----------------------|
|  | Carrying Amount | Estimated Fair Value | Carrying Amount | Estimated Fair Value |
| <b>Unrecognized financial instruments:</b> |                 |                      |                 |                      |
| Commitments to extend credit               | \$ 211,423      | \$ -                 | \$ 246,295      | \$ -                 |
| Standby letters of credit                  | 12,508          | -                    | 18,276          | -                    |
|  | \$ 223,931      | \$ -                 | \$ 264,571      | \$ -                 |

#### NOTE 20. FAIR VALUE MEASUREMENTS

Effective January 1, 2008, the Company adopted SFAS No. 157, "Fair Value Measurements" which provides a framework for measuring and disclosing fair value under GAAP. SFAS 157 requires disclosures about the fair value of assets and liabilities recognized in the balance sheet in periods subsequent to initial recognition, whether the measurements are made on a recurring basis or on a nonrecurring basis.

SFAS 157 defines fair value as the exchange price that would be received for an asset or paid to transfer a liability (an exit price) in the principal or most advantageous market for the asset or liability in an orderly transaction between market participants on the measurement date. SFAS 157 also establishes a fair value hierarchy, which requires an entity to maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair value.

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

Under SFAS 157, assets and liabilities are grouped at fair value in three levels, based on the markets in which the assets and liabilities are traded and the reliability of the assumptions used to determine the fair value. These hierarchy levels are:

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

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

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

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

#### Investment Securities Available for Sale

Investment securities available for sale are recorded at fair value on a recurring basis. Fair value measurement is based upon quoted prices, if available. If quoted prices are not available, fair values are measured using independent pricing

models or other model-based valuation techniques such as the present value of future cash flows, adjusted for the security's credit rating, prepayment assumptions and other factors such as credit loss assumptions. Level 1 securities include those traded on an active exchange such as the New York Stock Exchange, Treasury securities that are traded by dealers or brokers in active over-the-counter markets and money market funds. Level 2 securities include mortgage-backed securities issued by government sponsored entities, municipal bonds and corporate debt securities. Securities classified as Level 3 include asset-backed securities in less liquid markets.

## Loans

The Company does not record loans at fair value on a recurring basis, however, from time to time, a loan is considered impaired and an allowance for loan loss is established. Loans for which it is probable that payment of interest and principle will not be made in accordance with the contractual terms of the loan are considered impaired. Once a loan is identified as individually impaired, management measures impairment in accordance with SFAS 114, "Accounting by Creditors for Impairment of a Loan." The fair value of impaired loans is estimated using one of several methods, including the collateral value, market value of similar debt, enterprise value, liquidation value and discounted cash flows. Those impaired loans not requiring a specific allowance represent loans for which the fair value of expected repayments or collateral exceed the recorded investment in such loans. At December 31, 2008, substantially all of the impaired loans were evaluated based upon the fair value of the collateral. In accordance with SFAS 157, impaired loans that have an allowance established based on the fair value of collateral require classification in the fair value hierarchy. When the fair value of the collateral is based on an observable market price or a current appraised value, the Company records the loan as nonrecurring Level 2. When an appraised value is not available or management determines the fair value of the collateral is further impaired below the appraised value and there is no observable market price, the Company records the loan as nonrecurring Level 3.

## Assets Recorded at Fair Value on a Recurring Basis

The table below presents the recorded amount of assets measured at fair value on a recurring basis at December 31, 2008.

| (Dollars in thousands)        | Fair Value | Quoted<br>Prices<br>(Level 1) | Significant<br>Other<br>Observable<br>Inputs<br>(Level 2) | Significant<br>Unobservable<br>Inputs<br>(Level 3) |
|-------------------------------|------------|-------------------------------|---|--|
| Securities available for sale | \$ 79,204  | \$ -                          | \$ 79,204   | \$ -   |

## Assets Recorded at Fair Value on a Nonrecurring Basis

The table below presents the recorded amount of assets measured at fair value on a nonrecurring basis at December 31, 2008.

| (Dollars in thousands) | Fair Value | Quoted<br>Prices<br>(Level 1) | Significant<br>Other<br>Observable<br>Inputs<br>(Level 2) | Significant<br>Unobservable<br>Inputs<br>(Level 3) |
|------------------------|------------|-------------------------------|---|--|
| Impaired loans         | \$ 7,774   | \$ -                          | \$ -  | \$ 7,774   |

Impaired loans had a carrying amount of \$8.1 million with a valuation allowance of \$341 thousand at December 31, 2008.

## NOTE 21. FINANCIAL INSTRUMENTS WITH OFF-BALANCE SHEET RISK

In the normal course of business, to meet the financing needs of its customers, the Banks are parties to financial instruments with off-balance sheet risk. These financial instruments include commitments to extend credit and standby letters of credit. The Banks' exposure to credit loss in the event of nonperformance by the other party to these financial instruments is represented by the contractual amount of the instruments. The Banks use the same credit

policies in making commitments and conditional obligations as they do for on-balance sheet instruments. The Banks generally require collateral or other security to support the financial instruments with credit risk. The amount of collateral or other security is determined based on management's credit evaluation of the counterparty. The Banks evaluate each customer's creditworthiness on a case-by-case basis.

Commitments to extend credit are agreements to lend to a customer as long as there is no violation of any condition established in the contract. Letters of credit are conditional commitments issued by the Company to guarantee the performance of a customer to a third party. Letters of credit and other commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. Because many of the letters of credit and commitments are expected to expire without being drawn upon, the total commitment amount does not necessarily represent future cash requirements.

Commitments outstanding as of December 31 are as follows:

| (Dollars in thousands)       | 2008       | 2007       |
|------------------------------|------------|------------|
| Commitments to extend credit | \$ 211,423 | \$ 246,295 |
| Letters of credit            | 12,508     | 18,276     |
|                              | \$ 223,931 | \$ 264,571 |

#### NOTE 22. CONTINGENCIES

In the normal course of business, the Company and its subsidiaries may become involved in litigation arising from banking, financial, and other activities. Management, after consultation with legal counsel, does not anticipate that the future liability, if any, arising out of current proceedings will have a material effect on the Company's financial condition, operating results, or liquidity.

#### NOTE 23. PARENT COMPANY FINANCIAL INFORMATION

Condensed financial information for Shore Bancshares, Inc. (Parent Company Only) is as follows:

|   | Condensed Balance Sheets |                   |
|---|--------------------------|-------------------|
|   | December 31,             |                   |
| (Dollars in thousands)                            | 2008                     | 2007              |
| <b>Assets</b>                                     |                          |                   |
| Cash  | \$ 1,936                 | \$ 1,441          |
| Investment in subsidiaries                        | 125,642                  | 118,995           |
| Income taxes receivable                           | 314                      | 577               |
| Premises and equipment, net                       | 2,885                    | 2,997             |
| Other assets                                      | 604                      | 172               |
| <b>Total assets</b>                               | <b>\$ 131,381</b>        | <b>\$ 124,182</b> |
| <b>Liabilities</b>                                |                          |                   |
| Accounts payable                                  | \$ 1,083                 | \$ 640            |
| Deferred tax liability                            | 966                      | 822               |
| Long-term debt                                    | 1,947                    | 2,485             |
| <b>Total liabilities</b>                          | <b>3,996</b>             | <b>3,947</b>      |
| <b>Stockholders' equity</b>                       |                          |                   |
| Common stock                                      | 84                       | 84                |
| Additional paid in capital                        | 29,768                   | 29,539            |
| Retained earnings                                 | 96,140                   | 90,365            |
| Accumulated other comprehensive income            | 1,393                    | 247               |
| <b>Total stockholders' equity</b>                 | <b>127,385</b>           | <b>120,235</b>    |
| <b>Total liabilities and stockholders' equity</b> | <b>\$ 131,381</b>        | <b>\$ 124,182</b> |

Condensed Statements of Income  
For the Years Ended December 31,

| (Dollars in thousands)  | 2008      | 2007      | 2006      |
|---|-----------|-----------|-----------|
| <b>Income</b>   |           |           |           |
| Dividends from subsidiaries   | \$ 6,131  | \$ 11,234 | \$ 5,115  |
| Management and other fees from subsidiaries   | 5,285     | 5,078     | 3,982     |
| Rental income   | 76        | 76        | 108       |
| Interest income   | 20        | 14        | 10        |
| Total income  | 11,512    | 16,402    | 9,215     |
| <b>Expenses</b>   |           |           |           |
| Salaries and employee benefits  | 4,111     | 3,675     | 3,034     |
| Occupancy and equipment expense   | 367       | 333       | 257       |
| Other operating expenses  | 1,389     | 1,346     | 1,195     |
| Total expenses  | 5,867     | 5,354     | 4,486     |
| Income before income tax expense and equity in undistributed net income of subsidiaries | 5,645     | 11,048    | 4,729     |
| Income tax (benefit) expense  | (86)      | 109       | 331       |
| Income before equity in undistributed net income of subsidiaries                        | 5,731     | 10,939    | 4,398     |
| Equity in undistributed net income of subsidiaries                                      | 5,739     | 2,511     | 9,156     |
| Net income  | \$ 11,470 | \$ 13,450 | \$ 13,554 |



Condensed Statements of Cash Flow  
For the Years Ended December 31,

| (Dollars in thousands)   | 2008           | 2007           | 2006           |
|--|----------------|----------------|----------------|
| <b>Cash flows from operating activities:</b>   |                |                |                |
| Net income   | \$ 11,470      | \$ 13,450      | \$ 13,554      |
| <b>Adjustments to reconcile net income to cash provided by operating activities:</b> |                |                |                |
| Equity in undistributed net income of subsidiaries                                   | (5,739)        | (2,511)        | (9,156)        |
| Depreciation   | 233            | 166            | 125            |
| Loss on disposals of premises and equipment  | 1              | 2              | -              |
| Stock-based compensation expense   | 91             | 63             | 48             |
| Excess tax benefits from stock-based arrangements                                    | (4)            | (3)            | (279)          |
| Net (increase) decrease in other assets  | (169)          | (267)          | 186            |
| Net increase in other liabilities  | 592            | 553            | 186            |
| <b>Net cash provided by operating activities</b>                                     | <b>6,475</b>   | <b>11,453</b>  | <b>4,664</b>   |
| <b>Cash flows from investing activities:</b>   |                |                |                |
| Acquisition  | -              | (8,001)        | -              |
| Purchase of premises and equipment   | (122)          | (135)          | (281)          |
| Investment in subsidiaries   | (85)           | -              | -              |
| <b>Net cash used by investing activities</b>   | <b>(207)</b>   | <b>(8,136)</b> | <b>(281)</b>   |
| <b>Cash flows from financing activities:</b>   |                |                |                |
| Proceeds from long-term debt   | -              | 2,485          | -              |
| Repayment of long-term debt  | (538)          | -              | -              |
| Excess tax benefits from stock-based arrangements                                    | 4              | 3              | 279            |
| Proceeds from issuance of common stock   | 138            | 54             | 654            |
| Stock repurchased and retired  | -              | (266)          | -              |
| Dividends paid   | (5,377)        | (5,364)        | (4,917)        |
| <b>Net cash used by financing activities</b>   | <b>(5,773)</b> | <b>(3,088)</b> | <b>(3,984)</b> |
| Net increase in cash and cash equivalents  | 495            | 229            | 399            |
| Cash and cash equivalents at beginning of year                                       | 1,441          | 1,212          | 813            |
| Cash and cash equivalents at end of year   | \$ 1,936       | \$ 1,441       | \$ 1,212       |

## NOTE 24. QUARTERLY FINANCIAL RESULTS (unaudited)

A summary of selected consolidated quarterly financial data for the two years ended December 31, 2008, is reported as follows:

| (In thousands, except per share data) | First<br>Quarter | Second<br>Quarter | Third<br>Quarter | Fourth<br>Quarter |
|---------------------------------------|------------------|-------------------|------------------|-------------------|
| <b>2008</b>                           |                  |                   |                  |                   |
| Interest income                       | \$ 15,923        | \$ 15,127         | \$ 15,298        | \$ 15,126         |
| Net interest income                   | 10,030           | 9,632             | 9,909            | 10,348            |
| Provision for credit losses           | 462              | 615               | 875              | 1,385             |
| Income before income taxes            | 5,479            | 4,482             | 4,851            | 3,750             |
| Net income                            | 3,372            | 2,766             | 3,071            | 2,261             |
| Basic earnings per common share       | \$ 0.40          | \$ 0.33           | \$ 0.37          | \$ 0.27           |
| Diluted earnings per common share     | \$ 0.40          | \$ 0.33           | \$ 0.37          | \$ 0.27           |
| <b>2007</b>                           |                  |                   |                  |                   |
| Interest income                       | \$ 15,890        | \$ 16,255         | \$ 16,543        | \$ 16,453         |
| Net interest income                   | 9,905            | 10,242            | 10,463           | 10,426            |
| Provision for credit losses           | 242              | 413               | 604              | 465               |
| Income before income taxes            | 5,420            | 5,343             | 5,315            | 5,374             |
| Net income                            | 3,403            | 3,356             | 3,351            | 3,340             |
| Basic earnings per common share       | \$ 0.41          | \$ 0.40           | \$ 0.40          | \$ 0.40           |
| Diluted earnings per common share     | \$ 0.41          | \$ 0.40           | \$ 0.40          | \$ 0.40           |

Earnings per share are based upon quarterly results and may not be additive to the annual earnings per share amounts.

## NOTE 25. SEGMENT REPORTING

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

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

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Selected financial information by business segments is included in the following table:

| (Dollars in thousands)            | Community<br>Banking | Insurance<br>Products<br>and Services | Parent<br>Company | Total        |
|-----------------------------------|----------------------|---------------------------------------|-------------------|--------------|
| <b>2008</b>                       |                      |                                       |                   |              |
| Interest income                   | \$ 61,400            | \$ 74                                 | \$ -              | \$ 61,474    |
| Interest expense                  | (21,434)             | -                                     | (121)             | (21,555)     |
| Provision for credit losses       | (3,337)              | -                                     | -                 | (3,337)      |
| Noninterest income                | 7,644                | 12,707                                | (1)               | 20,350       |
| Noninterest expense               | (20,864)             | (11,967)                              | (5,539)           | (38,370)     |
| Net intersegment (expense) income | (4,763)              | (412)                                 | 5,175             | -            |
| Income (loss) before taxes        | 18,646               | 402                                   | (486)             | 18,562       |
| Income tax (expense) benefit      | (7,124)              | (154)                                 | 186               | (7,092)      |
| Net income (loss)                 | \$ 11,522            | \$ 248                                | \$ (300)          | \$ 11,470    |
| <b>Total assets</b>               |                      |                                       |                   |              |
|                                   | \$ 1,021,715         | \$ 20,146                             | \$ 2,780          | \$ 1,044,641 |
| <b>2007</b>                       |                      |                                       |                   |              |
| Interest income                   | \$ 61,133            | \$ 8                                  | \$ -              | \$ 65,141    |
| Interest expense                  | (24,105)             | -                                     | -                 | (24,105)     |
| Provision for credit losses       | (1,724)              | -                                     | -                 | (1,724)      |
| Noninterest income                | 6,775                | 7,906                                 | (2)               | 14,679       |
| Noninterest expense               | (20,205)             | (7,124)                               | (5,210)           | (32,539)     |
| Net intersegment (expense) income | (4,646)              | (381)                                 | 5,027             | -            |
| Income (loss) before taxes        | 21,228               | 409                                   | (185)             | 21,452       |
| Income tax (expense) benefit      | (7,918)              | (153)                                 | 69                | (8,002)      |
| Net income (loss)                 | \$ 13,310            | \$ 256                                | \$ (116)          | \$ 13,450    |
| <b>Total assets</b>               |                      |                                       |                   |              |
|                                   | \$ 933,583           | \$ 20,405                             | \$ 2,923          | \$ 956,911   |
| <b>2006</b>                       |                      |                                       |                   |              |
| Interest income                   | \$ 57,971            | \$ -                                  | \$ -              | \$ 57,971    |
| Interest expense                  | (19,074)             | -                                     | -                 | (19,074)     |
| Provision for credit losses       | (1,493)              | -                                     | -                 | (1,493)      |
| Noninterest income                | 5,994                | 6,812                                 | 33                | 12,839       |
| Noninterest expense               | (18,592)             | (5,561)                               | (4,382)           | (28,535)     |
| Net intersegment (expense) income | (3,673)              | (291)                                 | 3,964             | -            |
| Income (loss) before taxes        | 21,133               | 960                                   | (385)             | 21,708       |
| Income tax (expense) benefit      | (7,939)              | (360)                                 | 145               | (8,154)      |
| Net income (loss)                 | \$ 13,194            | \$ 600                                | \$ (240)          | \$ 13,554    |
| <b>Total assets</b>               |                      |                                       |                   |              |
|                                   | \$ 932,616           | \$ 9,777                              | \$ 3,256          | \$ 945,649   |

NOTE 26. SUBSEQUENT EVENT

On January 9, 2009, pursuant to the U.S. Department of Treasury's TARP Capital Purchase Program, the Corporation issued the following securities to the initial selling security holder for an aggregate consideration of \$25,000,000: (i) 25,000 shares of Fixed Rate Cumulative Perpetual Preferred Stock, Series A, par value \$.01 per share (the "Series A Preferred Stock"); and (ii) an immediately exercisable warrant to purchase 172,970 shares of common stock, par value

\$.01 per share, for an exercise price of \$21.68 per share. The proceeds from this transaction count as Tier 1 capital and the warrant qualifies as tangible common equity. The Series A Preferred Stock pay a cumulative preferred dividend of 5% per annum per \$1,000 of liquidation amount from January 9, 2009 to February 15, 2014, and a cumulative preferred dividend of 9% per annum per \$1,000 of liquidation amount on and after February 16, 2014. The operative documents relating to this transaction have been filed with the U.S. Securities and Exchange Commission and are referenced as Exhibits 3.1(ii) and 4.1 through 4.4 to this annual report.

Item 9. Changes in and Disagreements with Accountants on Accounting and Financial Disclosure.

None.

Item 9A. Controls and Procedures.

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

An evaluation of the effectiveness of these disclosure controls as of December 31, 2008, was carried out under the supervision and with the participation of the Company's management, including the CEO and the PAO. Based on that evaluation, the Company's management, including the CEO and the PAO, has concluded that the Company's disclosure controls and procedures are, in fact, effective at the reasonable assurance level.

During the fourth quarter of 2008, there was no change in the Company's internal control over financial reporting that has materially affected, or is reasonably likely to materially affect, the Company's internal control over financial reporting.

As required by Section 404 of the Sarbanes-Oxley Act of 2002, management has performed an evaluation and testing of the Company's internal control over financial reporting as of December 31, 2008. Management's report on the Company's internal control over financial reporting and the related attestation report of the Company's independent registered public accounting firm are included in Item 8 of Part II of this annual report, and each such report is incorporated into this Item 9A by reference thereto.

Item 9B. Other Information

None.

### PART III

Item 10. Directors, Executive Officers and Corporate Governance.

The Company has adopted a Code of Ethics that applies to all of its directors, officers, and employees, including its principal executive officer, principal financial officer, principal accounting officer, or controller, or persons performing similar functions. A written copy of the Company's Code of Ethics will be provided to stockholders, free of charge, upon request to: W. David Morse, Secretary, Shore Bancshares, Inc., 18 E. Dover Street, Easton, Maryland 21601 or (410) 822-1400.

All other information required by this item is incorporated herein by reference to the Company's definitive proxy statement to be filed in connection with the 2009 Annual Meeting of Stockholders.

Item 11. Executive Compensation.

The information required by this item is incorporated herein by reference to the Company's definitive proxy statement to be filed in connection with the 2009 Annual Meeting of Stockholders.

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Item 12. Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters.

The information provided in Item 5 of Part II of this report under the heading "EQUITY COMPENSATION PLAN INFORMATION" is incorporated herein by reference. All other information required by this item is incorporated herein by reference to the Company's definitive proxy statement to be filed in connection with the 2009 Annual Meeting of Stockholders.

Item 13. Certain Relationships and Related Transactions, and Director Independence.

The information required by this item is incorporated herein by reference to the Company's definitive proxy statement to be filed in connection with the 2009 Annual Meeting of Stockholders.

Item 14. Principal Accountant Fees and Services.

The information required by this item is incorporated herein by reference to the Company's definitive proxy statement to be filed in connection with the 2009 Annual Meeting of Stockholders.

PART IV

Item 15. Exhibits and Financial Statement Schedules.

(a)(1), (2) and (c) Financial statements and schedules:

Report of Independent Registered Public Accounting Firm  
Consolidated Balance Sheets at December 31, 2008 and 2007  
Consolidated Statements of Income — Years Ended December 31, 2008, 2007, and 2006  
Consolidated Statements of Changes in Stockholders' Equity — Years Ended December 31, 2008, 2007 and 2006  
Consolidated Statements of Cash Flows — Years Ended December 31, 2008, 2007 and 2006  
Notes to Consolidated Financial Statements for the years ended December 31, 2008, 2007 and 2006

(a)(3) and (b) Exhibits required to be filed by Item 601 of Regulation S-K:

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





/s/ Susan E. Leaverton  
Susan E. Leaverton

Treasurer/  
Principal Accounting Officer

March 13, 2009

EXHIBIT LIST

| Exhibit No. | Description  |
|-------------|--|
| 3.1(i)      | Amended and Restated Articles of Incorporation (incorporated by reference to Exhibit 3.1 of the Company's Form 8-K filed on December 14, 2000).  |
| 3.1(ii)     | Articles Supplementary relating to the Fixed Rate Cumulative Perpetual Preferred Stock, Series A (incorporated by reference Exhibit 4.1 of the Company's Form 8-K filed on January 13, 2009)   |
| 3.2(i)      | Amended and Restated By-Laws (filed herewith).   |
| 3.2(ii)     | First Amendment to Amended and Restated By-Laws (filed herewith).  |
| 4.1         | Letter Agreement, including the related Securities Purchase Agreement – Standard Terms, dated January 9, 2009 by and between the Company and the U.S. Department of Treasury (incorporated by reference to Exhibit 10.1 of the Company's Form 8-K filed on January 13, 2009) |
| 4.2         | Form of Stock Certificate for the Series A Preferred Stock (incorporated by reference to Exhibit 4.2 of the Company's Registration Statement on Form S-3, File No. 333-157141)   |
| 4.3         | Common Stock Purchase Warrant dated January 9, 2009 issued to the U.S. Department of Treasury (incorporated by reference to Exhibit 4.2 of the Company's Form 8-K filed on January 13, 2009)   |
| 10.1        | Form of Employment Agreement with W. Moorhead Vermilye (incorporated by reference to Appendix XIII of Exhibit 2.1 of the Company's Form 8-K filed on July 31, 2000).   |
| 10.2        | Employment Termination Agreement among Centreville National Bank, the Company, and Daniel T. Cannon dated December 7, 2006 (incorporated by reference to Exhibit 10.1 of the Company's Form 8-K filed on December 12, 2006).   |
| 10.3        | Employment Agreement with Thomas H. Evans, as amended on November 3, 2005 (incorporated by reference to Exhibit 10.1 of the Company's Form 8-K filed on November 9, 2005).   |
| 10.4        | Summary of Compensation Arrangement for Lloyd L. Beatty, Jr. (incorporated by reference to Exhibit 10.1 of the Company's Form 8-K filed on August 1, 2006).  |
| 10.5        | Amended Summary of Compensation Arrangement for William W. Duncan, Jr. (incorporated by reference to Exhibit 10.1 of the Company's Form 8-K filed on February 14, 2007, as amended by Form 8-K/A filed on May 3, 2007).  |
| 10.6        | Summary of Compensation Arrangement between Centreville National Bank and F. Winfield Trice, Jr. (incorporated by reference to Exhibit 10.1 of the Company's Form 8-K filed on August 13, 2007).   |
| 10.7        | Employment Agreement between The Avon-Dixon Agency, LLC and Mark M. Freestate (incorporated by reference to Exhibit 10.6 of the Company's Annual Report on Form 10-K for the year ended December 31, 2006).  |
| 10.8        | Shore Bancshares, Inc. Management Incentive Plan (incorporated by reference to Exhibit 10.1 of the Company's Form 8-K filed on April 3, 2007).   |

- 10.9 Revised Schedule A to the Shore Bancshares, Inc. Management Incentive Plan (incorporated by reference to Exhibit 10.2 of the Company's Form 8-K filed on August 13, 2007).
- 10.10 Shore Bancshares, Inc. Amended and Restated Executive Deferred Compensation Plan (incorporated by reference to Exhibit 10.2 of the Company's Form 8-K filed on February 14, 2007)
- 10.11 Deferral Election, Investment Designation, and Beneficiary Designation Forms under the Shore Bancshares, Inc. Amended and Restated Executive Deferred Compensation Plan (incorporated herein by reference to Exhibit 10.1 to the Company's Form 8-K filed on October 2, 2006).

- 10.12 Form of Centreville National Bank of Maryland Director Indexed Fee Continuation Plan Agreement with Messrs. Cannon, Freestate and Pierson (incorporated by reference to Exhibit 10.2 to the Company's Form 8-K filed on December 12, 2006).
- 10.13 Form of Amended and Restated Director Indexed Fee Continuation Plan Agreement between Centreville National Bank and Messrs. Cannon, Freestate and Pierson (incorporated by reference to Exhibit 10.2 of the Company's Current Report on Form 8-K filed on January 7, 2009).
- 10.14 Form of Centreville National Bank Life Insurance Endorsement Split Dollar Plan Agreement with Messrs. Cannon, Freestate and Pierson (incorporated by reference to Exhibit 10.3 to the Company's Form 8-K filed on December 12, 2006).
- 10.15 Form of Executive Supplemental Retirement Plan Agreement between The Centreville National Bank of Maryland and Daniel T. Cannon (incorporated by reference to Exhibit 10.4 of the Company's Quarterly Report on Form 10-Q for the period ended September 30, 2003).
- 10.16 Form of Life Insurance Endorsement Method Split Dollar Plan Agreement between The Centreville National Bank of Maryland and Daniel T. Cannon (incorporated by reference to Exhibit 10.5 of the Company's Quarterly Report on Form 10-Q for the period ended September 30, 2003).
- 10.17 Talbot Bank of Easton, Maryland Supplemental Deferred Compensation Plan (incorporated by reference to Exhibit 10.7 of the Company's Quarterly Report on Form 10-Q for the period ended September 30, 2005).
- 10.18 First Amendment to The Talbot Bank of Easton, Maryland Supplemental Deferred Compensation Plan for the benefit of W. Moorhead Vermilye (incorporated by reference to Exhibit 10.1 of the Company's Current Report on Form 8-K filed on January 7, 2009).
- 10.19 Talbot Bank of Easton, Maryland Supplemental Deferred Compensation Plan Trust Agreement (incorporated by reference to Exhibit 10.7 of the Company's Quarterly Report on Form 10-Q for the period ended September 30, 2005).
- 10.20 1998 Employee Stock Purchase Plan, as amended (incorporated by reference to Appendix A of the Company's definitive Proxy Statement on Schedule 14A for the 2003 Annual Meeting of Stockholders filed on March 31, 2003).
- 10.21 1998 Stock Option Plan (incorporated by reference to Exhibit 10 of the Company's Registration Statement on Form S-8 filed with the SEC on September 25, 1998 (Registration No. 333-64319)).
- 10.22 Talbot Bancshares, Inc. Employee Stock Option Plan (incorporated by reference to Exhibit 10 of the Company's Registration Statement on Form S-8 filed May 4, 2001 (Registration No. 333-60214)).
- 10.23 Shore Bancshares, Inc. 2006 Stock and Incentive Compensation Plan (incorporated by reference to Appendix A of the Company's 2006 definitive proxy statement filed on March 24, 2006).
- 10.24 Form of Restricted Stock Award Agreement under the 2006 Stock and Incentive Compensation Plan (incorporated by reference to Exhibit 10.1 to the Company's Form 8-K filed on April 11, 2007).
- 10.25 Changes to Director Compensation Arrangements (incorporated by reference to Exhibit 10.1 of the Company's Form 8-K filed on February 6, 2006).

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| 21 | Subsidiaries of the Company (included in the “BUSINESS—General” section of Item 1 of Part I of this Annual Report on Form 10-K). |
| 23 | Consent of Stegman & Company (filed herewith).   |
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- 31.1 Certifications of the CEO pursuant to Section 302 of the Sarbanes-Oxley Act (filed herewith).
- 31.2 Certifications of the PAO pursuant to Section 302 of the Sarbanes-Oxley Act (filed herewith).
- 32 Certification pursuant to Section 906 of the Sarbanes-Oxley Act (furnished herewith).

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