SHORE BANCSHARES INC
Form 10-K
March 13, 2015

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

# 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, 2014

Commission File No. 0-22345

# SHORE BANCSHARES, INC.

(Exact name of registrant as specified in its charter)

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

28969 Information Lane, Easton, Maryland | 21601
(Address of Principal Executive Offices) | (Zip Code)
Registrant s Telephone Number, Including Area Code: (410) 763-7800

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

| Title of Each Class: | Name of Each Exchange on Which Registered: |
|---|---|
| Common stock, par value $.01 per share | 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. o Yes þ No

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 16(d) of the Act. o Yes þ No

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 þ No o

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

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of 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 o

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 o Accelerated filer þ Non-accelerated filer o Smaller Reporting Company o

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

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: $111,512,355.

The number of shares outstanding of the registrant s common stock as of the latest practicable date: 12,625,276 as of February 28, 2015.

# Documents Incorporated by Reference

Certain information required by Part III of this annual report is incorporated therein by reference to the definitive proxy statement for the 2015 Annual Meeting of Stockholders.

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TABLE OF CONTENTS

# INDEX


| | |
|---|---|
| Part I | |
| Item 1. Business | 1 |
| Item 1A. Risk Factors | 15 |
| Item 1B. Unresolved Staff Comments | 25 |
| Item 2. Properties | 26 |
| Item 3. Legal Proceedings | 27 |
| Item 4. Mine Safety Disclosures | 27 |
| Part II | |
| Item 5. Market for Registrant s Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities | 28 |
| Item 6. Selected Financial Data | 29 |
| Item 7. Management s Discussion and Analysis of Financial Condition and Results of Operations | 30 |
| Item 7A. Quantitative and Qualitative Disclosures About Market Risk | 49 |
| Item 8. Financial Statements and Supplementary Data | 49 |
| Item 9. Changes in and Disagreements with Accountants on Accounting and Financial Disclosure | 96 |
| Item 9A. Controls and Procedures | 96 |
| Item 9B. | 96 |

Other Information
Part III
Item 10. Directors, Executive Officers and Corporate Governance 97
Item 11. Executive Compensation 97
Item 12. Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters 97
Item 13. Certain Relationships and Related Transactions, and Director Independence 98
Item 14. Principal Accounting Fees and Services 98
Part IV
Item 15. Exhibits and Financial Statement Schedules 99
SIGNATURES 100
EXHIBIT LIST 101

TABLE OF CONTENTS

This Annual Report on Form 10-K of Shore Bancshares, Inc. (the Company and we, our or us on a consolidated ba contains forward-looking statements within the meaning of The Private Securities Litigation Reform Act of 1995. These forward looking statements represent plans, estimates, objectives, goals, guidelines, expectations, intentions, projections and statements of our beliefs concerning future events, business plans, expected operating results and the assumptions upon which those statements are based. In some cases, you can identify these forward-looking statements by words like may, will, should, expect, plan, anticipate, intend, believe, estimate, predict, pote negative of those words and other comparable terminology, although not all forward-looking statements contain these words. Forward-looking statements are not a guarantee of future performance or results, and will not necessarily be accurate indications of the times at, or by, which such performance or results will be achieved. We caution that the forward-looking statements are based largely on our expectations and information available at the time the statements are made and are subject to a number of known and unknown risks and uncertainties that are subject to change based on factors which are in many instances, beyond our control. Actual results, performance or achievements could differ materially from those contemplated, expressed, or implied by the forward-looking statements. You should bear this in mind when reading this annual report and not place undue reliance on these forward-looking statements. The following factors, among others, could cause our financial performance to differ materially from that expressed in such forward-looking statements:

general economic conditions, whether national or regional, and conditions in the lending markets in which we participate that may have an adverse effect on the demand for our loans and other products, our credit quality and related levels of nonperforming assets and loan losses, and the value and salability of the real estate that we own or that is the collateral for our loans;

results of examinations of us by our regulators, including the possibility that our regulators may, among other things, require us to increase our reserve for loan losses or to write-down assets;

changing bank regulatory conditions, policies or programs, whether arising as new legislation or regulatory initiatives, that could lead to restrictions on activities of banks generally, or our subsidiary banks in particular, more restrictive regulatory capital requirements, increased costs, including deposit insurance premiums, regulation or prohibition of certain income producing activities or changes in the secondary market for loans and other products;

changes in market rates and prices may adversely impact the value of securities, loans, deposits and other financial instruments and the interest rate sensitivity of our balance sheet;

our liquidity requirements could be adversely affected by changes in our assets and liabilities;

the effect of legislative or regulatory developments, including changes in laws concerning taxes, banking, securities, insurance and other aspects of the financial services industry;

competitive factors among financial services organizations, including product and pricing pressures and our ability to attract, develop and retain qualified banking professionals;

the growth and profitability of non-interest or fee income being less than expected;

the effect of changes in accounting policies and practices, as may be adopted by the Financial Accounting Standards Board, the Securities and Exchange Commission (the SEC ), the Public Company Accounting Oversight Board and other regulatory agencies; and

the effect of fiscal and governmental policies of the United States federal government.

You should also consider carefully the Risk Factors contained in Item 1A of Part I of this annual report, which address additional factors that could cause our actual results to differ from those set forth in the forward-looking statements and could materially and adversely affect our business, operating results and financial condition. The risks discussed in this annual report are factors that, individually or in the aggregate, management believes could cause our actual results to differ materially from expected and historical results. You should understand that it is not possible to predict or identify all such factors. Consequently, you should not consider such disclosures to be a complete discussion of all potential risks or uncertainties.

TABLE OF CONTENTS

The forward-looking statements speak only as of the date on which they are made, and, except to the extent required by federal securities laws, we undertake no obligation to update any forward-looking statement to reflect events or circumstances after the date on which the statement is made or to reflect the occurrence of unanticipated events. In addition, we cannot assess the impact of each factor on our business or the extent to which any factor, or combination of factors, may cause actual results to differ materially from those contained in any forward-looking statements.

TABLE OF CONTENTS

# 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 is the largest independent financial holding company located on the Eastern Shore of Maryland. 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 CNB, a Maryland commercial bank with trust powers and The Talbot Bank of Easton, Maryland, a Maryland commercial bank ( Talbot Bank ). As used in this annual report, the term Banks refers to CNB and Talbot Bank and Felton Bank for periods prior to January 1, 2011 and to CNB and Talbot Bank for all other periods.

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; a insurance premium finance company, Mubell Finance, LLC, a Maryland limited liability company, (all of the foregoing are collectively referred to as the Insurance Subsidiaries ). The Company owned a wholesale insurance company, Tri-State General Insurance Agency, LTD ( TSGIA ), whose assets and liabilities were sold on June 6, 2014, and subsequently became known as SHB2, Inc.

The Company has three inactive subsidiaries, SHBI, Inc. and SHB2, Inc. (formerly known as TSGIA, Inc. and Tri-State General Insurance, LTD), and Wye Financial Services, Inc. all of which were organized under Maryland law.

The Company dissolved its subsidiary, Shore Pension Services, LLC and allowed the charter to expire and be classified as forfeiture status for its subsidiary Wye Mortgage, LLC.

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.

During the second quarter of 2014, the Company sold 4,140,000 shares of its common stock for a price of $8.25 per share (the stock sale ). The Company received $31.3 million in net proceeds after deducting certain direct costs related to the stock sale, primarily underwriting discounts and commissions. The Company contributed $20.0 million of the net proceeds to Talbot Bank to satisfy regulatory capital requirements, with the remaining proceeds used for general corporate purposes.

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 three years ended December 31, 2014 is provided in Note 26 to the Company s Consolidated Financial Statements included in Item 8 of Part II of this annual report.

# Banking Products and Services

CNB is a Maryland chartered commercial bank with trust powers that commenced operations in 1876. CNB was originally chartered as a national banking association but converted to its present charter effective January 1, 2010. Talbot Bank is a Maryland chartered commercial bank that commenced operations in 1885 and was acquired by the Company in its December 2000 merger with Talbot Bancshares, Inc. The Banks operate 18 full service branches and 20 ATMs and provide a full range of commercial and consumer banking products and services to individuals, businesses, and other organizations in 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 that serve businesses and individuals in their respective market areas. Services offered are essentially the same as those offered by larger regional institutions that

1

compete with the Banks. Services provided to businesses include commercial checking, savings, certificates 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 and 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 upon 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 Banks general policy to obtain personal guarantees from the principals of the commercial loan borrowers.

The Banks commercial real estate loans are primarily 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 loan to value ratio standards, obtaining additional collateral, 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 at origination, 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 upon the borrower s continuing financial stability, which can be adversely impacted by job loss, divorce, illness, or personal bankruptcy, among other factors. Underwriting standards recommend loan to value ratios not to exceed 80% at origination 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.

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 ongoing monitoring of loans outstanding is performed in an effort to minimize risk of loss by identifying problem loans early.

2

### Deposit Activities

The Banks offer a full array of deposit products including checking, savings and money market accounts, and regular and IRA certificates of deposit. 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

CNB has a trust department through which it markets trust, asset management and financial planning services to customers within our market areas using the trade name Wye Financial & Trust.

*Internet Access to Company Documents.* The Company provides access to its Securities and Exchange Commission ( SEC ) filings through its web site at *www.shorebancshares.com.* After accessing the web site, the filings are available upon selecting Investor Relations Documents. Reports available include the annual reports on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K, and all amendments to those reports as soon as reasonably practicable after the reports are electronically filed with or furnished to the SEC.

## 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., and Tri-State General Insurance Agency of Virginia, Inc. were acquired on October 1, 2007. On June 6, 2014, the Company sold the assets and liabilities of its wholesale insurance subsidiary, Tri-State General Insurance Agency, LTD and changed the name to SHB2, Inc.

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.

## Employees

At February 28, 2015, we employed 309 persons, of which 279 were employed on a full-time basis.

## COMPETITION

The banking business 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

TABLE OF CONTENTS

to meet 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 whom 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 in Kent County, Delaware as of June 30, 2014, the most recent date for which comparative information is available.

| Kent County, Maryland | Deposits | % of Total | |
|---|---|---|---|
| | (in thousands) | | |
| Peoples Bank of Kent County, Maryland | $ 176,979 | 32.75 | % |
| PNC Bank, NA | 150,145 | 27.79 | |
| Branch Banking & Trust | 77,011 | 14.25 | |
| Chesapeake Bank & Trust Co. | 63,993 | 11.84 | |
| CNB | **45,533** | **8.43** | |
| SunTrust Bank | 26,674 | 4.94 | |
| Total | $ 540,335 | 100.00 | % |

**Source: FDIC DataBook**

| Queen Anne s County, Maryland | Deposits | % of Total | |
|---|---|---|---|
| | (in thousands) | | |
| The Queenstown Bank of Maryland | $ 348,228 | 38.34 | % |
| CNB | **242,508** | **26.70** | |
| Bank of America, NA | 73,036 | 8.04 | |
| PNC Bank, NA | 64,589 | 7.11 | |
| M&T | 58,300 | 6.42 | |
| First National Bank of Pennsylvania | 43,544 | 4.79 | |
| Branch Banking & Trust | 25,456 | 2.80 | |
| Capital One Bank, NA | 24,443 | 2.69 | |
| Peoples Bank | 20,635 | 2.27 | |
| Sun Trust Bank | 7,611 | 0.84 | |
| Total | $ 908,350 | 100.00 | % |

**Source: FDIC DataBook**

| Caroline County, Maryland | Deposits | % of Total | |
|---|---|---|---|
| | (in thousands) | | |
| Provident State Bank, Inc. | $ 155,293 | 41.93 | % |
| PNC Bank, NA | 94,348 | 25.48 | |
| CNB | **60,811** | **16.42** | |

| | | |
|---|---|---|
| M&T | 27,450 | 7.41 |
| Branch Banking & Trust | 26,283 | 7.10 |
| The Queenstown Bank of Maryland | 6,157 | 1.66 |
| Total | $ 370,342 | 100.00 % |

**Source: FDIC DataBook**

4

TABLE OF CONTENTS

| Talbot County, Maryland | Deposits | % of Total | |
|---|---|---|---|
| | (in thousands) | | |
| The Talbot Bank of Easton, Maryland | **$ 474,266** | **40.93** | **%** |
| Bank of America, NA | 168,721 | 14.56 | |
| PNC Bank, NA | 139,848 | 12.07 | |
| Easton Bank & Trust | 118,374 | 10.22 | |
| Branch Banking & Trust | 69,066 | 5.96 | |
| M&T | 52,497 | 4.53 | |
| The Queenstown Bank of Maryland | 47,011 | 4.06 | |
| SunTrust Bank | 35,215 | 3.04 | |
| Capital One Bank, NA | 27,271 | 2.35 | |
| Provident State Bank, Inc. | 26,510 | 2.28 | |
| Total | $ 1,158,779 | 100.00 | % |

**Source: FDIC DataBook**

| Dorchester County, Maryland | Deposits | % of Total | |
|---|---|---|---|
| | (in thousands) | | |
| The National Bank of Cambridge | $ 167,980 | 30.78 | % |
| Hebron Savings Bank | 116,559 | 21.36 | |
| Provident State Bank, Inc. | 72,245 | 13.24 | |
| Branch Banking & Trust | 58,043 | 10.63 | |
| M&T | 37,484 | 6.87 | |
| The Talbot Bank of Easton, Maryland | **35,766** | **6.55** | |
| Bank of America, NA | 31,683 | 5.81 | |
| SunTrust Bank | 26,019 | 4.76 | |
| Total | $ 545,779 | 100.00 | % |

**Source: FDIC DataBook**

| Kent County, Delaware | Deposits | % of Total | |
|---|---|---|---|
| | (in thousands) | | |
| M&T | $ 511,858 | 27.75 | % |
| PNC Bank Delaware | 344,411 | 18.67 | |
| WSFS Bank | 244,124 | 13.24 | |
| RBS Citizens NA | 176,683 | 9.58 | |
| Wells Fargo | 166,496 | 9.03 | |
| Wilmington Savings Fund Society | 139,587 | 7.57 | |
| CNB | **71,786** | **3.89** | |
| TD Bank National Assn | 61,193 | 3.32 | |
| Artisans Bank | 48,689 | 2.64 | |

| | | |
|---|---|---|
| County Bank | 40,134 | 2.18 |
| Midcoast Community Bank | 31,516 | 1.71 |
| Fort Sill National Bank | 8,034 | 0.42 |
| Total | $ 1,844,511 | 100.00 % |

**Source: FDIC DataBook**

For further information about competition in our market areas, see the Risk Factor entitled We operate in a highly competitive market and our inability to effectively compete in our markets could have an adverse impact on our financial condition and results of operations in Item 1A of Part I of this annual report.

5

TABLE OF CONTENTS

# 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 operations.

## 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.

CNB and Talbot Bank are Maryland chartered commercial banks 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). The primary federal regulator of CNB is the FRB. The primary federal regulator of Talbot 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 and the other federal banking agencies.

## Regulation of Financial Holding Companies

In November 1999, the 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 underwriting and agency activities, merchant banking, and insurance company portfolio investment activities, with new expedited notice procedures. The Company is a financial holding company.

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. This support may be required at times when the bank holding company may not have the resources to provide the support. Under the prompt corrective action provisions, if a controlled bank is undercapitalized, then the regulators could require the bank holding company to guarantee the bank s capital restoration plan. In addition, if the FRB believes that a bank holding company s activities, assets or affiliates represent a significant risk to the financial safety, soundness or stability of a controlled bank, then the FRB could require the

bank holding company to terminate the activities, liquidate the assets or divest the affiliates. The regulators may require these and other actions in support of controlled banks even if such actions are not in the best interests of the bank holding company or its stockholders. Because the Company is a bank holding company, it is viewed as a source of financial and managerial strength for any controlled depository institutions, like the Banks.

On July 21, 2010, President Obama signed into law the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Dodd-Frank Act ), which made sweeping changes to the financial regulatory landscape that impacts all financial institutions, including the Company and the Banks. The Dodd-Frank Act directs federal bank regulators to require that all companies that directly or indirectly control an insured depository institution serve as sources of financial strength for the institution. The term source of financial strength is defined under the Dodd-Frank Act as the ability of a company to provide financial assistance to its insured

TABLE OF CONTENTS

depository institution subsidiaries in the event of financial distress. The appropriate federal banking agency for such a depository institution may require reports from companies that control the insured depository institution to assess their abilities to serve as sources of strength and to enforce compliance with the source-of-strength requirements. The appropriate federal banking agency may also require a holding company to provide financial assistance to a bank with impaired capital. Under this requirement, in the future the Company could be required to provide financial assistance to the Banks should they experience financial distress.

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 believe 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 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.

7

TABLE OF CONTENTS

The Banks are also subject to a variety of other laws and regulations with respect to the operation of their businesses, including, but not limited to, the Truth in Lending Act, the Truth in Savings Act, the Equal Credit Opportunity Act, the Electronic Funds Transfer Act, the Fair Housing Act, the Home Mortgage Disclosure Act, the Fair Debt Collection Practices Act, the Fair Credit Reporting Act, Expedited Funds Availability (Regulation CC), Reserve Requirements (Regulation D), Privacy of Consumer Information (Regulation P), Margin Stock Loans (Regulation U), the Right To Financial Privacy Act, the Flood Disaster Protection Act, the Homeowners Protection Act, the Servicemembers Civil Relief Act, the Real Estate Settlement Procedures Act, the Telephone Consumer Protection Act, the CAN-SPAM Act, the Children s Online Privacy Protection Act, and the John Warner National Defense Authorization Act.

# The Dodd-Frank Act

The Dodd-Frank Act significantly changed the bank regulatory structure and affected the lending, investment, trading and operating activities of financial institutions and their holding companies. The Dodd-Frank Act requires the FRB to set minimum capital levels for bank holding companies that are as stringent as those required for insured depository institutions. The legislation also establishes a floor for capital of insured depository institutions that cannot be lower than the standards in effect today, and directs the federal banking regulators to implement new leverage and capital requirements. The new leverage and capital requirements must take into account off-balance sheet activities and other risks, including risks relating to securitized products and derivatives. Pursuant to the Dodd-Frank Act, the FDIC has backup enforcement authority over a depository institution holding company, such as the Company, if the conduct or threatened conduct of such holding company poses a risk to the Deposit Insurance Fund ( DIF ), although such authority may not be used if the holding company is generally in sound condition and does not pose a foreseeable and material risk to the DIF. In addition, the Dodd-Frank Act contains a wide variety of provisions (many of which are not yet effective) affecting the regulation of depository institutions, including restrictions related to mortgage originations, risk retention requirements as to securitized loans and the establishment of the Consumer Financial Protection Bureau ( CFPB ).

The full impact of the Dodd-Frank Act on our business and operations will not be known for years until all regulations implementing the statute are written and adopted. The Dodd-Frank Act will increase our regulatory compliance burden and costs and may restrict the financial products and services we offer to our customers. In particular, the Dodd-Frank Act will require us to invest significant management attention and resources so that we can evaluate the impact of this law and its regulations and make any necessary changes to our product offerings and operations. These impacts may be material.

# Capital Requirements

## General

FDICIA established a system of prompt corrective action to resolve the problems of undercapitalized institutions. Under this system, the federal banking regulators are required to rate supervised institutions on the basis of five capital categories: well capitalized, adequately capitalized, undercapitalized, significantly undercapitalized, and critica 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 CAMEL 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.

8

TABLE OF CONTENTS

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, 2014, Talbot Bank was categorized as adequately capitalized and CNB as well capitalized. Talbot Bank would be considered well capitalized based on its capital ratios as of December 31, 2014, however, must remain in the adequately capitalized category until the consent order is terminated by the FDIC and the Commissioner. For more information regarding the consent order, see Regulatory Enforcement Actions herein and Note 1 to the Consolidated Financial Statements under the caption Regulatory Enforcement Actions. For more information regarding the capital condition of the Company, see Note 17 to the Consolidated Financial Statements appearing in Item 8 of Part II of this annual report.

## The Collins Amendment provisions of the Dodd-Frank Act

The Collins Amendment provision of the Dodd-Frank Act imposes increased capital requirements in the future. The Collins Amendment also requires federal banking regulators to establish minimum leverage and risk-based capital requirements to apply to insured depository institutions, bank and thrift holding companies, and systemically important nonbank financial companies. These capital requirements must not be less than the Generally Applicable Risk Based Capital Requirements and the Generally Applicable Leverage Capital Requirements as of July 21, 2010, and must not be quantitatively lower than the requirements that were in effect for insured depository institutions as of July 21, 2010. The Collins Amendment defines Generally Applicable Risk Based Capital Requirements and Generally Applicable Leverage Capital Requirements to mean the risk-based capital requirements and minimum ratios of Tier 1 risk-based capital to average total assets, respectively, established by the appropriate federal banking agencies to apply to insured depository institutions under the Prompt Corrective Action provisions, regardless of total consolidated asset size or foreign financial exposure.

## Basel III Capital, Liquidity and Stress Testing Requirements

The Basel Committee on Banking Supervision ( Basel ) has drafted frameworks for the regulation of capital and liquidity of internationally active banking organizations, generally referred to as Basel III. On June 7, 2012, the FRB issued a notice of proposed rulemaking that would implement elements of Sections 165 and 166 of the Dodd-Frank Act that encompass certain aspects of Basel III with respect to capital and liquidity. In July 2013, the U.S. federal banking agencies published the final rules (the Basel III Capital Rules ) establishing a new comprehensive capital framework for U.S. banking organizations.

### Capital Requirements

The Basel III Capital Rules implement the Basel III capital standards and establish minimum capital levels required under the Dodd-Frank Act, which apply to all U.S. banks, subject to various transition periods. The Basel III Capital Rules substantially revise the risk-based capital requirements applicable to bank holding companies and depository institutions compared to the current U.S. risk-based capital rules. The Basel III Capital Rules define the components of capital and address other issues affecting the numerator in banking institutions regulatory capital ratios. The Basel III Capital Rules also address risk weights and other issues affecting the denominator in banking institutions regulatory capital ratios and replace the existing risk-weighting approach with a more risk-sensitive approach. The Basel III Capital Rules are effective for the Company on January 1, 2015 and will be fully phased in on January 1,

2019.

The Basel III Capital Rules, among other things, (i) introduce a new capital measure called Common Equity Tier 1 ( CET1 ), (ii) specify that Tier 1 capital consist of CET1 and Additional Tier 1 capital instruments meeting specified requirements, (iii) define CET1 narrowly by requiring that most deductions/adjustments to regulatory capital measures be made to CET1 and not to the other components of capital and (iv) expand the scope of the deductions/adjustments as compared to existing regulations.

9

When fully phased in on January 1, 2019, the Basel III Capital Rules will require the Company to maintain (i) a minimum ratio of CET1 to risk-weighted assets of at least 4.5%, plus a 2.5% capital conservation buffer, (ii) a minimum ratio of Tier 1 capital to risk-weighted assets of at least 6.0% (increased from 4.0%), plus the capital conservation buffer, (iii) a minimum ratio of Total capital to risk-weighted assets of at least 8.0% (unchanged from current rules), plus the capital conservation buffer and (iv) a minimum leverage ratio of 4% (unchanged from current rules), calculated as the ratio of Tier 1 capital to average assets. The Basel III Capital Rules eliminate the inclusion of certain instruments, such as trust preferred securities, from Tier 1 capital. Instruments issued prior to May 19, 2010 will be grandfathered for companies with consolidated assets of $15 billion or less.

The capital conservation buffer is designed to absorb losses during periods of economic stress. Banking institutions with a ratio of CET1 to risk-weighted assets above the minimum but below the conservation buffer will face constraints on dividends, equity repurchases and compensation based on the amount of the shortfall. The implementation of the capital conservation buffer will begin on January 1, 2016 at 0.625% of risk-weighted assets and be phased in over a four-year period, increasing by that amount on each January 1, until it reaches 2.5% on January 1, 2019.

The Basel III Capital Rules also revise the prompt corrective action regulations by (i) introducing a CET1 ratio requirement at each level (other than critically undercapitalized), with the required CET1 ratio being 6.5% for well-capitalized status and (ii) increasing the minimum Tier 1 capital ratio requirement for each category (other than critically undercapitalized), with the minimum Tier 1 capital ratio for well-capitalized status being 8% (as compared to the current 6%). The Basel III Capital Rules do not change the total risk-based capital requirement for any prompt corrective action category.

The Basel III Capital Rules prescribe a standardized approach for risk weightings that expand the risk-weighting categories from the current four categories (0%, 20%, 50% and 100%) to a much larger and more risk-sensitive number of categories, depending on the nature of the assets, generally ranging from 0% for U.S. government and agency securities, to 600% for certain equity exposures, and resulting in higher risk weights for a variety of asset categories. Specific changes to current rules impacting the Company s risk-weighted assets include, among other things:

Applying a 150% risk weight instead of a 100% risk weight for certain high volatility commercial real estate acquisition, development and construction loans.
Assigning a 150% risk weight to loans (other than residential mortgage) that are 90 days or more past due or on nonaccrual.
Providing for a 20% credit conversion factor for the unused portion of a commitment with an original maturity of one year or less that is not unconditionally cancellable, currently at 0%.
Management believes that the Company will meet all capital adequacy requirements under the Basel III Capital Rules.

**Liquidity Requirements**

Historically, regulation and monitoring of bank and bank holding company liquidity has been addressed as a supervisory matter, without required formulaic measures. The Basel III liquidity framework, however, requires banks and bank holding companies to measure their liquidity against specific liquidity tests that, although similar in some respects to liquidity measures historically applied by banks and regulators for management and supervisory purposes, going forward would be required by regulation. Current rules and proposals from the U.S. federal banking agencies do not specifically address the Basel III liquidity requirements.

## Deposit Insurance

The Banks are members of the FDIC and pay an insurance premium on a quarterly basis. Deposits are insured by the FDIC through the Deposit Insurance Fund (the DIF ) and such insurance is backed by the full faith and credit of the United States Government. Under the Dodd-Frank Act, a permanent increase in deposit insurance to $250,000 was authorized. The coverage limit is per depositor, per insured depository institution, for each account ownership category.

10

TABLE OF CONTENTS

The Dodd-Frank Act also set a new minimum DIF reserve ratio at 1.35% of estimated insured deposits. The FDIC is required to attain this ratio by September 30, 2020. The Dodd-Frank Act required the FDIC to redefine the deposit insurance assessment base for an insured depository institution. Prior to the Dodd-Frank Act, an institution s assessment base has historically been its domestic deposits, with some adjustments. As redefined pursuant to the Dodd-Frank Act, an institution s assessment base is now an amount equal to the institution s average consolidated total assets during the assessment period minus average tangible equity. Institutions with $1.0 billion or more in assets at the end of a fiscal quarter must report their average consolidated total assets on a daily basis and report their average tangible equity on an end-of-month balance basis. Institutions with less than $1.0 billion in assets at the end of a fiscal quarter may opt to report average consolidated total assets and average tangible equity on a weekly and end-of-quarter basis, respectively.

The Federal Deposit Insurance Reform Act of 2005, which created the DIF, gave the FDIC greater latitude in setting the assessment rates for insured depository institutions which could be used to impose minimum assessments. Deposit insurance assessments are based on average consolidated total assets minus average tangible equity. Under the FDIC s risk-based assessment system, insured institutions with less than $10 billion in assets are assigned to one of four risk categories based on supervisory evaluations, regulatory capital level, and certain other factors, with less risky institutions paying lower assessments. An institution s assessment rate depends upon the category to which it is assigned and certain other factors. The Banks expensed a total of $1.6 million in FDIC premiums during 2014. The FDIC has the flexibility to adopt actual deposit assessment rates that are higher or lower than the total base assessment rates adopted without notice and comment, if certain conditions are met.

DIF-insured institutions pay a Financing Corporation ( FICO ) assessment in order to fund the interest on bonds issued in the 1980s in connection with the failures in the thrift industry. For the fourth quarter of 2014, the FICO assessment was equal to 0.150 basis points computed on assets as required by the Dodd-Frank Act. These assessments will continue until the bonds mature in 2019.

The FDIC is authorized to conduct examinations of and require reporting by FDIC-insured institutions. It is also authorized to terminate a depository bank s deposit insurance upon a finding by the FDIC that the bank s financial condition is unsafe or unsound or that the institution has engaged in unsafe or unsound practices or has violated any applicable rule, regulation, order or condition enacted or imposed by the bank s regulatory agency. The termination of deposit insurance for either of the Banks would have a material adverse effect on our earnings, operations and financial condition.

## Bank Secrecy Act/Anti-Money Laundering

The Bank Secrecy Act ( BSA ), which is intended to require financial institutions to develop policies, procedures, and practices to prevent and deter money laundering, mandates that every national bank have a written, board-approved program that is reasonably designed to assure and monitor compliance with the BSA.

The program must, at a minimum: (i) provide for a system of internal controls to assure ongoing compliance; (ii) provide for independent testing for compliance; (iii) designate an individual responsible for coordinating and monitoring day-to-day compliance; and (iv) provide training for appropriate personnel. In addition, state-chartered banks are required to adopt a customer identification program as part of its BSA compliance program. State-chartered banks are also required to file Suspicious Activity Reports when they detect certain known or suspected violations of federal law or suspicious transactions related to a money laundering activity or a violation of the BSA.

In addition to complying with the BSA, the Banks are subject to the Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism Act of 2001 (the USA Patriot Act ). The USA Patriot Act is designed to deny terrorists and criminals the ability to obtain access to the United States financial system and has significant implications for depository institutions, brokers, dealers, and other businesses involved in the transfer of money. The USA Patriot Act mandates that financial service companies implement additional policies and procedures and take heightened measures designed to address any or all of the following matters: (i) customer identification programs; (ii) money laundering; (iii) terrorist financing; (iv) identifying and reporting suspicious activities and currency transactions; (v) currency crimes; and (vi) cooperation between financial institutions and law enforcement authorities.

11

TABLE OF CONTENTS

## Ability-to-Repay and Qualified Mortgage Rule

Pursuant to the Dodd Frank Act, the CFPB issued a final rule on January 10, 2013 (effective on January 10, 2014), amending Regulation Z, as implemented by the Truth in Lending Act, that requires mortgage lenders to make a reasonable and good faith determination based on verified and documented information that a consumer applying for a mortgage loan has a reasonable ability to repay the loan according to its terms. Mortgage lenders are required to determine consumers ability to repay in one of two ways. The first alternative requires the mortgage lender to consider the following eight underwriting factors when making the credit decision: (i) current or reasonably expected income or assets; (ii) current employment status; (iii) the monthly payment on the covered transaction; (iv) the monthly payment on any simultaneous loan; (v) the monthly payment for mortgage-related obligations; (vi) current debt obligations, alimony, and child support; (vii) the monthly debt-to-income ratio or residual income; and (viii) credit history. Alternatively, the mortgage lender can originate qualified mortgages, which are entitled to a presumption that the creditor making the loan satisfied the ability-to-repay requirements. In general, a qualified mortgage is a mortgage loan without negative amortization, interest-only payments, balloon payments, or terms exceeding 30 years. In addition, to be a qualified mortgage the points and fees paid by a consumer cannot exceed three percent of the total loan amount. Qualified mortgages that are higher-priced (e.g. subprime loans) garner a rebuttable presumption of compliance with the ability-to-repay rules, while qualified mortgages that are not higher-priced (e.g. prime loans) are given a safe harbor of compliance.

## Volcker Rule

The Dodd-Frank Act prohibits insured depository institutions from engaging in proprietary trading except in limited circumstances, and prohibits them from owning equity interests in excess of three percent (3%) of Tier 1 Capital in private equity and hedge funds (known as the Volcker Rule ). The FRB released a final rule on February 9, 2011 (effective on April 1, 2011) which requires a banking entity, a term that is defined to now include banks like the Banks, to bring its proprietary trading activities and investments into compliance with the Dodd-Frank Act restrictions.

On December 10, 2013, the U.S. federal banking agencies, including the FRB, adopted a final rule implementing the Volcker Rule. Although the final rule provides some tiering of compliance and reporting obligations based on size, the fundamental prohibitions of the Volcker Rule apply to banking entities of any size. Banking entities with total assets of $10 billion or more that engage in activities subject to the Volcker Rule will be required to establish a six-element compliance program to address the prohibitions of, and exemptions from, the Volcker Rule. The final rule became effective April 1, 2014; however, at the time the agencies released the final Volcker Rule, the FRB announced an extension of the conformance period for all banking entities until July 21, 2015. In response to industry questions regarding the final Volcker Rule, the U.S. federal banking agencies, the SEC, and the Commodity Futures Trading Commission issued a clarifying interim final rule on January 14, 2014, permitting banking entities to retain interests in certain collateralized debt obligations ( CDOs ) backed by trust preferred securities if the CDO meets certain requirements.

The Banks do not, nor intend to, engage in proprietary trading or own equity interests in private equity and hedge funds restricted by the Dodd-Frank Act. However, the Banks intend to review the implications of the interagency rules on their investments once those rules are issued and will plan for any adjustments of their activities or their holdings so that they will be in compliance by the announced compliance date.

## Federal Securities Laws

The shares of the Company s common stock are registered with 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 and the rules of The NASDAQ Stock Market, LLC. 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 Company is generally required to comply with certain corporate governance requirements.

TABLE OF CONTENTS

# Governmental Monetary and Credit Policies and Economic Controls

The earnings and growth of the banking industry and ultimately of the Company 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.

# REGULATORY ENFORCEMENT ACTIONS

Talbot Bank entered into a Stipulation and Consent to the Issuance of a Consent Order (the Consent Agreement ) with the FDIC, a Stipulation and Consent to the Issuance of a Consent Order (the Maryland Consent Agreement and together with the Consent Agreement, the Consent Agreements ) with the Maryland Commissioner of Financial Regulation (the Commissioner ) and an Acknowledgement of Adoption of the Order by the Commissioner (the Acknowledgement ). The FDIC and the Commissioner issued the related Consent Order (the Order ), effective May 24, 2013. The description of the Consent Agreements, the Order and the Acknowledgement along with Talbot Bank s progress with the requirements, are set forth below.

***Management***. Talbot Bank is required to have and retain experienced, qualified management, and to assess management s ability to (1) comply with the requirements of the Order; (2) operate Talbot Bank in a safe and sound manner; (3) comply with all applicable laws, rules and regulations; and (4) restore all aspects of Talbot Bank to a safe and sound condition, including capital adequacy, asset quality, and management effectiveness. Talbot Bank has implemented certain changes to comply with the Order, which include expanding its credit administration and loan workout units with the addition of experienced new staff members, in an effort to accelerate the resolution of Talbot Bank s credit issues and position Talbot Bank for future growth. Additionally, Talbot Bank has appointed a chief financial officer.

***Board Participation***. Talbot Bank s board of directors is required to increase its participation in the affairs of Talbot Bank, assuming full responsibility for the approval of sound policies and objectives and for the supervision of all Talbot Bank activities, including comprehensive, documented meetings to be held no less frequently than monthly. The board of directors must also develop a program to monitor Talbot Bank s compliance with the Order. Talbot Bank has completed a plan to increase the participation of its board of directors which includes increasing the frequency of board meetings from monthly to biweekly and establishing a risk management committee of the board which is responsible for monitoring Talbot Bank s compliance with the Order.

***Loss Charge-Offs***. The Order requires that Talbot Bank eliminate from its books, by charge-off or collection, all assets or portions of assets classified Loss by the FDIC or the Commissioner. Talbot Bank has eliminated from its books all such classified assets.

***Classified Assets Reduction***. Within 60 days of the effective date of the Order, Talbot Bank was required to submit a Classified Asset Plan to the FDIC and the Commissioner to reduce the risk position in each asset in excess of $750,000 which was classified Substandard and Doubtful by the FDIC or the Commissioner. Talbot Bank revised its existing Classified Asset Plan to address the terms of the Order and submitted the updated plan to the FDIC and the Commissioner in accordance with the Order.

***Allowance for Loan and Lease Losses***. Within 60 days of the effective date of the Order, the boards of directors were required to review the adequacy of the allowance for loan and lease losses (the ALLL ), establish a policy for determining the adequacy of the ALLL and submit such ALLL policy to the FDIC and

13

TABLE OF CONTENTS

the Commissioner. Talbot Bank amended its ALLL policy to comply with the terms of the Order and submitted the updated policy to the FDIC and the Commissioner in accordance with the Order.

***Loan Policy***. Within 60 days from the effective date of the Order, Talbot Bank was required to (i) review its loan policies and procedures ( Loan Policy ) for adequacy, (ii) make all appropriate revisions to the Loan Policy to address the lending deficiencies identified by the FDIC, and (iii) submit the Loan Policy to the FDIC and the Commissioner. Talbot Bank completed its review of and made the required revisions to the Loan Policy. The updated Loan Policy was submitted to the FDIC and the Commissioner in accordance with the terms of the Order.

***Loan Review Program***. Within 30 days from the effective date of the Order, the Board was required to establish a program of independent loan review that will provide for a periodic review of Talbot Bank s loan portfolio and the identification and categorization of problem credits (the Loan Review Program ) and submit the Loan Review Program to the FDIC and the Commissioner. Talbot Bank enhanced its existing Loan Review Program and submitted it to the FDIC and the Commissioner in accordance with the terms of the Order.

***Capital Requirements***. Within 90 days from the effective date of the Order, Talbot Bank was required to meet and maintain the following minimum capital levels, after establishing an appropriate ALLL, (i) a leverage ratio (the ratio of Tier 1 capital to total assets) of at least 8%, and (ii) a total risk-based capital ratio (the ratio of qualifying total capital to risk-weighted assets) of at least 12%. As of December 31, 2014, the leverage ratio and total risk-based capital ratio were 8.91% and 14.16%, respectively, for Talbot Bank, which exceeded the Order s minimum capital requirements.

***Profit and Budget Plan***. Within 60 days from the effective date of the Order and within 30 days of each calendar year-end thereafter, Talbot Bank was required to, and will on an ongoing basis, submit a profit and budget plan to the FDIC and the Commissioner consisting of goals and strategies, consistent with sound banking practices, and taking into account Talbot Bank s other plans, policies or other actions required by the Order. In accordance with the Order, Talbot Bank developed a profit and budget plan which was submitted to the FDIC and the Commissioner within 60 days from the effective date of the Order and one which was submitted within 30 days of the end of 2014. The profit and budget plan was approved by the FDIC; additionally the FDIC approved the Talbot Bank capital plan.

***Dividend Restriction***. While the Order is in effect, Talbot Bank cannot declare or pay dividends or fees to the Company without the prior written consent of the FDIC and the Commissioner. Talbot Bank is in compliance with this provision of the Order.

***Brokered Deposits***. The Order provides that Talbot Bank may not accept, renew, or rollover any brokered deposits unless it is in compliance with the requirements of the FDIC regulations governing brokered deposits. Talbot Bank is in compliance with this provision of the Order.

***Oversight Committee***. Within 30 days from the effective date of the Order, Talbot Bank must establish a board committee to monitor and coordinate compliance with the Order. Talbot Bank has established a board committee to comply with this provision of the Order.

***Progress Reports***. Within 45 days from the end of each calendar quarter following the effective date of the Order, Talbot Bank must furnish the FDIC and Commissioner with progress reports detailing the form, manner and results of any actions taken to secure compliance with the Order. Talbot Bank has and will continue to submit progress reports to comply with this provision of the Order.

The Order will remain in effect until modified or terminated by the FDIC and the Commissioner.

# AVAILABLE INFORMATION

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

TABLE OF CONTENTS

# Item 1A. RISK FACTORS.

An investment in our common stock involves significant risks. You should consider carefully the risk factors included below together with all of the information included in or incorporated by reference into this annual report, as the same may be updated from time to time by our future filings with the SEC under the Exchange Act, before making a decision to invest in our common stock. The risks and uncertainties described below are not the only ones we face. Additional risks and uncertainties not presently known to us or that we currently deem immaterial may also have a material adverse effect on our business, financial condition and results of operations. If any of the matters included in the following information about risk factors were to occur, our business, financial condition, results of operations, cash flows or prospects could be materially and adversely affected. In such case, you may lose all or a substantial part of your investment.

# Risks Relating to Our Business

## The current economic environment poses significant challenges for us and could adversely affect our financial condition and results of operations.

The Banks are operating in an economic climate which is still in the early stages of rebounding from one of the largest financial crisis in U.S. history. Although national indexes reflect modest overall increases in the housing market, home prices, and the unemployment rate, the local environment in which the Banks operate have continued to lag national averages. While conditions appear to have begun to improve, the post crisis regulatory environment has remained stringent on the Banks, coupled with low interest rates which limit the profitability on lending opportunities. New stringent regulatory policies or a return to declines in the real estate market and constrained financial markets could have an adverse effect on the Banks borrowers or their customers, which would adversely affect our financial condition and results of operations. For example, deterioration in local economic conditions in our markets could drive losses beyond that which is provided for in our allowance for loan losses. We may also face the following risks in connection with these events:

Economic conditions that negatively affect housing prices and the job market may result in deterioration in credit quality of our loan portfolio, and such deterioration in credit quality could have a negative impact on our business;
Market developments may affect consumer confidence levels and may cause adverse changes in payment patterns, causing increases in delinquencies and default rates on loans and other credit facilities;
Demand for our products and services may decline;
Collateral for loans made by us may decline in value, in turn reducing a client s borrowing power, and reducing the value of assets and collateral associated with our loans held for investment;
Our loan customers may not repay their loans according to their terms and any collateral securing payment may be insufficient to fully compensate us for the outstanding balance of the loan plus the costs we incur disposing of the collateral;
The processes we use to estimate the allowance for loan losses may no longer be reliable because they rely on complex judgments, including forecasts of economic conditions, which may no longer be capable of accurate estimation;
A reduction in the size, spending or employment levels of the federal, state and/or local governments in the Washington, DC metropolitan area could have a negative effect on the economy of the region, on our customers, and on real estate prices;

The current economic environment poses significant challenges for us andcould adversely affect our financial condi

TABLE OF CONTENTS

Continued erratic fluctuations in the market, and loss of confidence in the banking system, could require the Banks to pay higher interest rates to obtain deposits to meet the needs of their depositors and borrowers, resulting in reduced margin and net interest income. If conditions worsen significantly, it is possible that banks such as the Banks may be unable to meet the needs of their depositors and borrowers, which could, in the worst case, result in the Bank being placed into receivership; and

Compliance with increased regulation of the banking industry may increase our costs, limit our ability to pursue business opportunities, and divert management efforts.

As these conditions or similar ones continue to exist or worsen, we could experience continuing or increased adverse effects on our financial condition and results of operations.

## A majority of our business is concentrated in Maryland and Delaware, a significant amount of which is concentrated in real estate lending, so a decline in the local economy and real estate markets could adversely impact our financial condition and results of operations.

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, a significant portion of our loan portfolio is secured by real estate, including construction and land development loans, all of which are in greater demand when interest rates are low and economic conditions are good. Accordingly, a decline in local economic conditions would likely have an adverse impact on our financial condition and results of operations, and the impact on us would likely be greater than the impact felt by larger financial institutions whose loan portfolios are geographically diverse. We cannot guarantee that any risk management practices that we implement to address our geographic and loan concentrations will be effective in preventing losses relating to our loan portfolio.

In the case of real estate acquisition, construction and development projects that we had financed, challenging economic conditions caused some of our borrowers to default on their loans. Because of the deterioration in the market values of real estate collateral caused by the recession, banks, including the Banks, had been unable to recover the full amount due under their loans when forced to foreclose on and sell real estate collateral. As a result, the Banks had realized significant impairments and losses in their loan portfolios, which had materially and adversely impacted our financial condition and results of operations. Management cannot predict the extent to which these conditions may cause future impairments or losses, nor can it provide any assurances as to when, or if, economic conditions will improve.

## Our concentrations of commercial real estate loans could subject us to increased regulatory scrutiny and directives, which could force us to preserve or raise capital and/or limit our future commercial lending activities.

The FRB and the FDIC, along with the other federal banking regulators, issued guidance in December 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 these institutions face a heightened risk of financial difficulties in the event of adverse changes in the economy and commercial real estate markets. Accordingly, the guidance suggests that institutions whose concentrations exceed certain percentages of capital should implement heightened risk management practices appropriate to their concentration risk. The guidance provides that banking regulators may require such institutions to reduce their concentrations and/or maintain higher capital ratios than institutions with lower concentrations in

commercial real estate. Based on our concentration of commercial real estate and construction lending as of December 31, 2014, we may be subject to heightened supervisory scrutiny during future examinations and/or be required to take steps to address our concentration and capital levels. Management cannot predict the extent to which this guidance will impact our operations or capital requirements. Further, we cannot guarantee that any risk management practices we implement will be effective to prevent losses resulting from concentrations in our commercial real estate portfolio.

16

TABLE OF CONTENTS

## Interest rates and other economic conditions will impact our results of operations.

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 results of operations are significantly impacted by 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. Interest rate risk arises from mismatches (i.e., the interest sensitivity gap) between the dollar amount of repricing or maturing assets and liabilities. If more assets reprice or mature than liabilities during a falling interest rate environment, then our earnings could be negatively impacted. Conversely, if more liabilities reprice or mature than assets during a rising interest rate environment, then our earnings could be negatively impacted. Fluctuations in interest rates are not predictable or controllable.

Changes in interest rates, particularly by the Federal Reserve Board, which implements national monetary policy in order to mitigate recessionary and inflationary pressures, also affect the value of our loans. In setting its policy, the Federal Reserve Board may utilize techniques such as: (i) engaging in open market transactions in United States government securities; (ii) setting the discount rate on member bank borrowings; and (iii) determining reserve requirements. These techniques may have an adverse effect on our deposit levels, net interest margin, loan demand or our business and operations. In addition, an increase in interest rates could adversely affect borrowers ability to pay the principal or interest on existing loans or reduce their desire to borrow more money. This may lead to an increase in our nonperforming assets, a decrease in loan originations, or a reduction in the value of and income from our loans, any of which could have a material and negative effect on our results of operations. We try to minimize our exposure to interest rate risk, but we are unable to completely eliminate this risk. Fluctuations in market rates and other market disruptions are neither predictable nor controllable and may have a material and negative effect on our business, financial condition and results of operations.

## The Banks may experience credit losses in excess of their allowances, which would adversely impact our financial condition and results of operations.

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. 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. 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.

Although we believe that our allowance for loan losses is maintained at a level adequate to absorb any inherent losses in our loan portfolio, these estimates of loan losses are necessarily subjective and their accuracy depends on the outcome of future events.

While we strive to carefully monitor credit quality and to identify loans that may become nonperforming, at any time there are loans included in the portfolio that have not been identified as nonperforming or potential problem loans, but

that will result in losses. We cannot be sure that we will be able to identify deteriorating loans before they become nonperforming assets, or that we will be able to limit losses on those loans that are identified. As a result, future additions to the allowance may be necessary.

Economic conditions and increased uncertainty in the financial markets could adversely affect our ability to accurately assess our allowance for loan losses. Our ability to assess the creditworthiness of our customers or to estimate the values of our assets and collateral for loans will be reduced if the models and approaches we use become less predictive of future behaviors, valuations, assumptions or estimates. We estimate losses inherent in our loan portfolio, the adequacy of our allowance for loan losses and the values of certain assets

TABLE OF CONTENTS

by using estimates based on difficult, subjective, and complex judgments, including estimates as to the effects of economic conditions and how those economic conditions might affect the ability of our borrowers to repay their loans or the value of assets.

## We may not be successful if we are not able to grow our subsidiaries and their businesses.

Our primary business activity for the foreseeable future will be to act as the holding company of CNB, Talbot Bank, and our other subsidiaries. Therefore, our future profitability will depend on the success and growth of these subsidiaries.

## The market value of our investments might decline.

As of December 31, 2014, we had classified 98% of our investment securities as available-for-sale pursuant to the Accounting Standards Codification ( ASC ) Topic 320 ( ASC 320 ) of the Financial Accounting Standards Board ( FASB ) relating to accounting for investments. ASC 320 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 (loss). The remaining investment securities are classified as held-to-maturity in accordance with ASC 320 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.

CNB and Talbot Bank are members of the FHLB of Atlanta. 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. These investments could be subject to future impairment charges and there can be no guaranty of future dividends.

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.

## Impairment of investment securities, goodwill, other intangible assets, or deferred tax assets could require charges to earnings, which could result in a negative impact on our results of operations.

We are required to record a non-cash charge to earnings when management determines that an investment security is other-than-temporarily impaired. In assessing whether the impairment of investment securities is other-than-temporary, management considers the length of time and extent to which the fair value has been less than cost, the financial condition and near-term prospects of the issuer, and the intent and ability to retain our investment in the security for a period of time sufficient to allow for any anticipated recovery in fair value in the near term.

Under current accounting standards, goodwill is not amortized but, instead, is subject to impairment tests on at least an annual basis or more frequently if an event occurs or circumstances change that reduce the fair value of a reporting unit below its carrying amount. Intangible assets other than goodwill are also subject to impairment tests at least annually. A decline in the price of the Company s common stock or occurrence of a triggering event following any of our quarterly earnings releases and prior to the filing of the periodic report for that period could, under certain circumstances, cause us to perform goodwill and other intangible assets impairment tests and result in an impairment charge being recorded for that period which was not reflected in

TABLE OF CONTENTS

such earnings release. In the event that we conclude that all or a portion of our goodwill or other intangible assets may be impaired, a non-cash charge for the amount of such impairment would be recorded to earnings. At December 31, 2014, we had recorded goodwill of $11.9 million and other intangible assets of $1.3 million, representing approximately 8.5% and 0.95% of stockholders equity, respectively.

In assessing the realizability of deferred tax assets, management considers whether it is more likely than not that some portion or all of the deferred tax assets will not be realized. Assessing the need for, or the sufficiency of, a valuation allowance requires management to evaluate all available evidence, both negative and positive, including the recent trend of quarterly earnings. Positive evidence necessary to overcome the negative evidence includes whether future taxable income in sufficient amounts and character within the carryback and carry forward periods is available under the tax law, including the use of tax planning strategies. When negative evidence (e.g., cumulative losses in recent years, history of operating loss or tax credit carry forwards expiring unused) exists, more positive evidence than negative evidence will be necessary. At December 31, 2014, our deferred tax assets were approximately $15.7 million. There was no valuation allowance for deferred taxes recorded at December 31, 2014 as management believes it is more likely than not that all of the deferred taxes will be realized because they were supported by positive evidence such as the expected generation of a sufficient level of future taxable income from operations and tax planning strategies.

The impact of each of these impairment matters could have a material adverse effect on our business, results of operations, and financial condition. See Note 1 to the Consolidated Financial Statements included in Item 8 of Part II of this annual report for further information.

## The change of control rules under Section 382 of the Internal Revenue Code may limit our ability to use our net operating loss carryforwards ( NOLs ) and other tax attributes to reduce future tax payments which may have an adverse impact on our results of operations.

We have NOLs for federal and state income tax purposes that can be utilized to offset future taxable income. Our use of the NOLs would be limited, however, under Section 382 of the IRC, if we were to undergo a change in ownership of more than 50% of our capital stock over a three-year period as measured under Section 382 of the IRC. The annual limit generally would equal the product of the applicable federal long term tax exempt rate and the value of our capital stock immediately before the ownership change. Due to the stock sale in June, 2014 and other ownership changes by shareholders owning 5% or more of our common stock, we estimate that we have experienced an ownership change of approximately 44% within the three-year period ended December 31, 2014.

If we experience an ownership change, the resulting annual limit on the use of its NOLs could result in a meaningful increase in our federal and state income tax liability in future years. Whether an ownership change occurs by reason of public trading in our stock is largely outside our control, and the determination of whether an ownership change has occurred is complex. No assurance can be given that we will not in the future undergo an ownership change that would have an adverse effect on its results of operations and the value of our stock.

## Our future success will depend on our ability to compete effectively in the highly competitive financial services industry.

We face substantial competition in all phases of our operations from a variety of different competitors. We compete with commercial banks, credit unions, savings and loan associations, mortgage banking firms, consumer finance

companies, securities brokerage firms, insurance companies, money market funds and other mutual funds, as well as other local and community, super-regional, national and international financial institutions that operate offices in our primary market areas and elsewhere. Our future growth and success will depend on our ability to compete effectively in this highly competitive financial services environment.

Many of our competitors are well-established, larger financial institutions and many offer products and services that we do not. Many have substantially greater resources, name recognition and market presence that benefit them in attracting business. Some of our competitors are not subject to the same regulations that are imposed on us, including credit unions that do not pay federal income tax, and, therefore, have regulatory advantage over us in accessing funding and in providing various services. While we believe we compete effectively with these other financial institutions in our primary markets, we may face a competitive

disadvantage as a result of our smaller size, smaller asset base, lack of geographic diversification and inability to spread our marketing costs across a broader market. If we have to raise interest rates paid on deposits or lower interest rates charged on loans to compete effectively, our net interest margin and income could be negatively affected. Failure to compete effectively to attract new or to retain existing, clients may reduce or limit our net income and our market share and may adversely affect our results of operations, financial condition and growth.

## 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 place greater reliance 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.

In addition, the FRB has issued rules pursuant to the Dodd-Frank Act governing debit card interchange fees that apply to institutions with greater than $10 billion in assets. Although we are not subject to these rules, market forces may effectively require all banks to adopt debit card interchange fee structures that comply with these rules, in which case our non-interest income for future periods could be materially and 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.

## 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 of 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 adverse 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 us 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.

20

## Our exposure to operational, technological and organizational risk may adversely affect us.

We are exposed to many types of operational risks, including reputation, legal and compliance risk, the risk of fraud or theft by employees or outsiders, unauthorized transactions by employees or operational errors, clerical or record-keeping errors, and errors resulting from faulty or disabled computer or telecommunications systems.

Certain errors may be repeated or compounded before they are discovered and successfully rectified. Our necessary dependence upon automated systems to record and process transactions may further increase the risk that technical system flaws or employee tampering or manipulation of those systems will result in losses that are difficult to detect. We may also be subject to disruptions of our operating systems arising from events that are wholly or partially beyond our control (for example, computer viruses or electrical or telecommunications outages), which may give rise to disruption of service to customers and to financial loss or liability. We are further exposed to the risk that our external vendors may be unable to fulfill their contractual obligations (or will be subject to the same risk of fraud or operational errors by their respective employees as are we) and to the risk that our (or our vendors ) business continuity and data security systems prove to be inadequate.

## We depend on the accuracy and completeness of information about customers and counterparties and our financial condition could be adversely affected if we rely on misleading information.

In deciding whether to extend credit or to enter into other transactions with customers and counterparties, we may rely on information furnished to us by or on behalf of customers and counterparties, including financial statements and other financial information, which we do not independently verify. We also may rely on representations of customers and counterparties as to the accuracy and completeness of that information and, with respect to financial statements, on reports of independent auditors. For example, in deciding whether to extend credit to customers, we may assume that a customer s audited financial statements conform with accounting principles generally accepted in the U.S. ( GAAP ) and present fairly, in all material respects, the financial condition, results of operations and cash flows of the customer. Our financial condition and results of operations could be negatively impacted to the extent we rely on financial statements that do not comply with GAAP or are materially misleading.

## We rely on other companies to provide key components of our business infrastructure.

Third parties provide key components of our business operations such as data processing, recording and monitoring transactions, online banking interfaces and services, internet connections and network access. While we have selected these third party vendors carefully, we do not control their actions. Any problem caused by these third parties, including poor performance of services, failure to provide services, disruptions in communication services provided by a vendor and failure to handle current or higher volumes, could adversely affect our ability to deliver products and services to our customers and otherwise conduct our business, and may harm our reputation. Financial or operational difficulties of a third party vendor could also hurt our operations if those difficulties interface with the vendor s ability to serve us. Replacing these third party vendors could also create significant delay and expense. Accordingly, use of such third parties creates an unavoidable inherent risk to our business operations.

## Our information systems may experience an interruption or breach in security.

We rely heavily on communications and information systems to conduct business. Any failure, interruption, or breach in security of these systems could result in failures or disruptions in our internet banking, deposit, loan and other systems. While to date we have not been subject to material cyber-attacks or other cyber incidents, we cannot guarantee all our systems are free from vulnerability to attack, despite safeguards we and our vendors have instituted. While we have policies and procedures designed to prevent or limit the effect of such failure, interruption or security breach of our information systems, there can be no assurance that they will not occur or, if they do occur, that they will be adequately addressed. The occurrence of any failure, interruption or security breach of our communications and information systems could damage our reputation, result in a loss of customer business, subject us to additional regulatory scrutiny or expose us to civil litigation and possible financial liability.

TABLE OF CONTENTS

### Technological changes affect our business, and we may have fewer resources than many competitors to invest in technological improvements.

The financial services industry is undergoing rapid technological changes with frequent introductions of new technology-driven products and services. In addition to serving customers better, the effective use of technology may increase efficiency and may enable financial institutions to reduce costs. Our future success will depend, in part, upon our ability to use technology to provide products and services that provide convenience to customers and to create additional efficiencies in operations. We may need to make significant additional capital investments in technology in the future, and we may not be able to effectively implement new technology-driven products and services. Many of our competitors have substantially greater resources to invest in technological improvements.

## Risks Relating to the Regulation of our Industry

### We operate in a highly regulated environment, which could restrain our growth and profitability.

We are subject to extensive laws and regulations that govern almost all aspects of our operations. These laws and regulations, and the supervisory framework that oversees the administration of these laws and regulations, are primarily intended to protect depositors, the Deposit Insurance Fund and the banking system as a whole, and not shareholders and consumers. These laws and regulations, among other matters, affect our lending practices, capital structure, investment practices, dividend policy, operations and growth. Compliance with the myriad laws and regulations applicable to our organization can be difficult and costly. In addition, these laws, regulations and policies are subject to continual review by governmental authorities, and changes to these laws, regulations and policies, including changes in interpretation or implementation of these laws, regulations and policies, could affect us in substantial and unpredictable ways and often impose additional compliance costs. Further, any new laws, rules and regulations, such as the Dodd-Frank Act and regulatory capital rules, could make compliance more difficult or expensive. All of these laws and regulations, and the supervisory framework applicable to our industry, could have a material adverse effect on our business, financial condition and results of operations.

### Federal and state regulators periodically examine our business, and we may be required to remediate adverse examination findings.

The FRB, the FDIC and the Commissioner periodically examine our business, including our compliance with laws and regulations. If, as a result of an examination, the FRB, the FDIC or the Commissioner were to determine that our financial condition, capital resource, asset quality, earnings prospects, management, liquidity or other aspects of any of our operations had become unsatisfactory, or that we were in violation of any law or regulation, it may take a number of different remedial actions as it deems appropriate. These actions include the power to enjoin unsafe or unsound practices, to require affirmative action to correct any conditions resulting from any violation or practice, to issue an administrative order that can be judicially enforced, to direct an increase in our capital, to restrict our growth, to assess civil monetary penalties against our officers or directors, to remove officers and directors and, if it is concluded that such conditions cannot be corrected or there is an imminent risk of loss to depositors, to terminate our deposit insurance and place us into receivership or conservatorship. Any regulatory action against us could have a material adverse effect on our business, financial condition and results of operations. For more information, see Business-Regulatory Enforcement Actions.

## Our FDIC deposit insurance premiums and assessments may increase.

The deposits of the Banks are insured by the FDIC up to legal limits and, accordingly, subject to the payment of FDIC deposit insurance assessments. The Banks regular assessments are determined by their risk classifications, which are based on their regulatory capital levels and the level of supervisory concern that they pose. High levels of bank failures since the beginning of the financial crisis and increases in the statutory deposit insurance limits have increased resolution costs to the FDIC and put significant pressure on the Deposit Insurance Fund. In order to maintain a strong funding position and restore the reserve ratios of the Deposit Insurance Fund, the FDIC increased deposit insurance assessment rates and charged a special assessment to all FDIC-insured financial institutions. Further increase in assessment rates or special

assessments may occur in the future, especially if there are significant additional financial institution failures. Any future special assessments, increases in assessment rates or required prepayments in FDIC insurance premiums could reduce our profitability or limit our ability to pursue certain business opportunities, which could have a material adverse effect on our business, financial condition and results of operations. The FDIC deposit insurance assessments for Talbot Bank decreased $137 thousand, or 9.6%, for 2014 when compared to 2013.

## The short-term and long-term impact of recently adopted regulatory capital rules is uncertain.

In July 2013, the federal banking agencies approved rules that will significantly change the regulatory capital requirements of all banking institutions in the United States. The new rules are designed to implement the recommendations with respect to regulatory capital standards, commonly known as Basel III, approved by the International Basel Committee on Bank Supervision. We became subject to the new rules over a multi-year transition period commencing January 1, 2015. The new rules establish a new regulatory capital standard based on tier 1 common equity and increase the minimum leverage and risk-based capital ratios. The rules also change how a number of the regulatory capital components are calculated. The new rules will generally require us and the Banks to maintain greater amounts of regulatory capital. Although management believes that the Company will meet all capital adequacy requirements under the Basel III Capital Rules, a significant increase in our capital requirements could have a material adverse effect on our business, financial condition and results of operations.

## We are subject to numerous laws designed to protect consumers, including the Community Reinvestment Act and fair lending laws, and failure to comply with these laws could lead to a wide variety of sanctions.

The Community Reinvestment Act, the Equal Credit Opportunity Act, the Fair Housing Act and other fair lending laws and regulations impose nondiscriminatory lending requirements on financial institutions. The Department of Justice and other federal agencies are responsible for enforcing these laws and regulations. A successful regulatory challenge to an institution s performance under the Community Reinvestment Act or fair lending laws and regulations could result in a wide variety of sanctions, including damages and civil money penalties, injunctive relief, restrictions on mergers and acquisition activity, restrictions on expansion and restrictions on entering new business lines. Private parties may also have the ability to challenge an institution s performance under fair lending laws in private class action litigation. Such actions could have a material adverse effect on our business, financial condition and results of operations.

## We face a risk of noncompliance and enforcement action with the Bank Secrecy Act and other anti-money laundering statues and regulations.

The Bank Secrecy Act, the USA PATRIOT Act of 2001 and other laws and regulations require financial institutions, among other duties, to institute and maintain an effective anti-money laundering program and file suspicious activity and currency transaction reports as appropriate. The federal Financial Crimes Enforcement Network is authorized to impose significant civil money penalties for violations of those requirements and has recently engaged in coordinated enforcement efforts with the individual federal banking regulators, as well as the U.S. Department of Justice, Drug Enforcement Administration and Internal Revenue Service. We are also subject to increased scrutiny of compliance with the rules enforced by the Office of Foreign Assets Control. If our policies, procedures and systems are deemed deficient, we would be subject to liability, including fines and regulatory actions, which may include restrictions on our ability to pay dividends and the necessity to obtain regulatory approvals to proceed with certain aspects of our

business plan, including our acquisition plans. Failure to maintain and implement adequate programs to combat money laundering and terrorist financing could also have serious reputational consequences for us. Any of these results could have a material adverse effect on our business, financial condition and results of operations.

TABLE OF CONTENTS

# Risks Relating to the Company s Securities

## Our common stock is not insured by any governmental entity.

Our common stock is not a deposit account or other obligation of any bank and is not insured by the FDIC or any other governmental entity. Investment in our common stock is subject to risk, including possible loss.

## Our ability to pay dividends is limited.

Our ability to pay dividends is subject to the requirements of Maryland corporate laws, federal and state banking laws, and the policies and actions of our regulators. Moreover, our ability to pay dividends to stockholders is largely dependent upon its earnings in future periods and upon the receipt of dividends from the Banks. Under corporate law, stockholders are entitled to dividends on their shares of common stock if, when, and as declared by our board of directors out of funds legally available for that purpose. FRB guidance requires a bank holding company, like us, to consult with the FRB before paying dividends if our earnings do not exceed the aggregate amount of the proposed dividend. The FRB has the ability to prohibit a dividend in such a situation. 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. Maryland banking law provides that a state-chartered bank may pay dividends out of undivided profits or, with the prior approval of the 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. 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. Both the Company and Talbot Bank are currently prohibited from paying any dividends without the consent of the FRB or the FDIC and the Commissioner, respectively. Thus, even if the Company and/or Talbot Bank had cash sufficient under corporate and banking laws to lawfully pay dividends, the FRB and/or the FDIC and the Commissioner could deny a request to do so. Because of these limitations, there can be no guarantee that our board will declare dividends in any fiscal quarter.

## The shares of our common stock are not heavily traded.

Shares of our common stock are listed on the NASDAQ Global Select Market, but 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 of the common stock. Management cannot predict the extent to which an active public market for the shares of the common stock will develop or be sustained in the future. Accordingly, holders of shares of our common stock may not be able to sell them at the volumes, prices, or times that they desire.

## Our Articles of Incorporation and By-Laws and Maryland law may discourage a corporate takeover which may make it more difficult for stockholders to receive a change in control premium.

Our 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 us. 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 our 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



Our Articles of Incorporation and By-Laws and Maryland law may discouragea corporate takeover which may make

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 we have 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 us. 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% 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 our 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 stockholder 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 our common stock.

### We may issue debt and equity securities that are senior to the common stock as to distributions and in liquidation, which could negatively affect the value of the common stock.

In the future, we may increase our capital resources by entering into debt or debt-like financing or issuing debt or equity securities, which could include issuances of senior notes, subordinated notes, preferred stock or common stock. In the event of our liquidation, our lenders and holders of our debt or preferred securities would receive a distribution of our available assets before distributions to the holders of our common stock. Our decision to incur debt and issue securities in future offerings will depend on market conditions and other factors beyond our control. We cannot predict or estimate the amount, timing or nature of its future offerings and debt financings. Future offerings could reduce the value of shares of our common stock and dilute a stockholder s interest in us.

## Item 1B. Unresolved Staff Comments.

None.

TABLE OF CONTENTS

# Item 2. Properties.

Our offices are listed in the tables below. The address of the Company s main office is 28969 Information Lane in Easton, Maryland. The Company owns the real property at this location, which also 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 | Elliott Road Branch | Tred Avon Square Branch |
| 18 East Dover Street | 8275 Elliott Road | 212 Marlboro Road |
| Easton, Maryland 21601 | Easton, Maryland 21601 | Easton, Maryland 21601 |
| St. Michaels Branch | Sunburst Branch | Tilghman Branch |
| 1013 South Talbot Street | 424 Dorchester Avenue | 5804 Tilghman Island Road |
| St. Michaels, Maryland 21663 | Cambridge, Maryland 21613 | Tilghman, Maryland 21671 |
| | Trappe Branch | |
| | 29349 Maple Avenue, Suite 1 | |
| | Trappe, Maryland 21673 | |
| ATMs | | |
| Memorial Hospital at Easton | Talbottown | |
| 219 South Washington Street | 218 North Washington Street | |
| Easton, Maryland 21601 | Easton, Maryland 21601 | |
| CNB | | |
| Branches | | |
| Main Office | Route 213 South Branch | Chester Branch |
| 109 North Commerce Street | 2609 Centreville Road | 300 Castle Marina Road |
| Centreville, Maryland 21617 | Centreville, Maryland 21617 | Chester, Maryland 21619 |
| Denton Branch | Grasonville Branch | Stevensville Branch |
| 850 South 5th Avenue | 202 Pullman Crossing | 408 Thompson Creek Road |
| Denton, Maryland 21629 | Grasonville, Maryland 21638 | Stevensville, Maryland 21666 |
| Tuckahoe Branch | Washington Square Branch | Felton Branch |
| 22151 WES Street | 899 Washington Avenue | 120 West Main Street |
| Ridgely, Maryland 21660 | Chestertown, Maryland 21620 | Felton, Delaware 19943 |
| Milford Branch | Camden Branch | Division Office Wye Financial & Trust |
| 698-A North Dupont Boulevard | 4580 South DuPont Highway | 16 North Washington Street, Suite 1 |
| Milford, Delaware 19963 | Camden, Delaware 19934 | Easton, Maryland 21601 |
| The Avon-Dixon Agency, LLC | | |
| Headquarters | Benefits Office | Centreville Office |
| 106 North Harrison Street | 28969 Information Lane | 105 Lawyers Row |
| Easton, Maryland 21601 | Easton, Maryland 21601 | Centreville, Maryland 21617 |
| ***Elliott-Wilson Insurance, LLC*** | ***Mubell Finance, LLC*** | ***Jack Martin & Associates, Inc.*** |
| 106 North Harrison Street | 106 North Harrison Street | 135 Old Solomon s Island Road |
| Easton, Maryland 21601 | Easton, Maryland 21601 | Annapolis, Maryland 21401 |

26

TABLE OF CONTENTS

Talbot Bank owns the real property on which all of its offices are located, except that it operates under leases at its St. Michaels, Tilghman and Trappe branches. CNB owns the real property on which all of its Maryland offices are located, except that it operates under a lease at the office of Wye Financial and Trust in Easton. CNB leases the real property on which all of its Delaware offices are located, except that it owns the real property on which the Camden Branch is located. The Insurance Subsidiaries do not own any real property, but operate under leases. For information about rent expense for all leased premises, see Note 4 to the Consolidated Financial Statements appearing in Item 8 of Part II of this annual 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 operations.

# Item 4. Mine Safety Disclosures.

This item is not applicable.

TABLE OF CONTENTS

# 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 Company s common stock are listed on the NASDAQ Global Select Market under the symbol SHBI . As of February 28, 2015, the Company had approximately 1,491 registered 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 2014 and 2013 are set forth in the table below.

| | 2014 | | | 2013 | | |
|---|---|---|---|---|---|---|
| | Price Range | | Dividends | Price Range | | Dividends |
| | High | Low | Paid | High | Low | Paid |
| First Quarter | **$ 9.99** | **$ 9.02** | **$** | $ 6.91 | $ 5.20 | $ |
| Second Quarter | **10.49** | **6.88** | | 7.75 | 5.97 | |
| Third Quarter | **9.25** | **8.61** | | 9.06 | 7.06 | |
| Fourth Quarter | **9.78** | **8.87** | | 9.45 | 8.50 | |
| | | | **$** | | | $ |

On February 28, 2015, the closing sales price for the shares of common stock as reported on the NASDAQ Global Select Market was $9.24 per share.

The Company did not declare or pay any dividends in 2014. On May 3, 2012, the Company s Board of Directors voted to suspend quarterly cash dividends until further notice. As a general matter, the payment of dividends is at the discretion of the Company s Board of Directors, based on 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. Further, our regulators have the ability to prohibit the payment of dividends even if dividends could otherwise be paid under applicable law if they determine that such payment would not be in our best interests. As noted above, the Company and Talbot Bank are currently prohibited from paying any dividends without the prior consent of their respective regulators. For more information regarding these dividend limitations, see Business Regulatory Enforcement Actions and Risk Factors Our ability to pay dividends is limited , which is incorporated herein by reference.

The transfer agent for the Company s common stock is:

Broadridge
51 Mercedes Way
Edgewood, NY., 11717
Investor Relations: 1-800-353-0103
E-mail for investor inquiries: shareholder@broadridge.com.
*www.broadridge.com*

The performance graph below compares the cumulative total stockholder 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, 2009 and reinvestment of dividends as of the end of each of the Company s fiscal years between December 31, 2009 and December 31, 2014. 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.

TABLE OF CONTENTS

| | Period Ending | | | | | |
|---|---|---|---|---|---|---|
| Index | 12/31/09 | 12/31/10 | 12/31/11 | 12/31/12 | 12/31/13 | 12/31/14 |
| Shore Bancshares, Inc. | 100.00 | 74.23 | 36.68 | 38.45 | 65.78 | 66.64 |
| NASDAQ Composite | 100.00 | 118.15 | 117.22 | 138.02 | 193.47 | 222.16 |
| NASDAQ Bank | 100.00 | 114.16 | 102.17 | 121.26 | 171.86 | 180.31 |
| SNL Small Cap Bank | 100.00 | 122.16 | 116.68 | 135.91 | 189.56 | 199.80 |

# EQUITY COMPENSATION PLAN INFORMATION

Pursuant to the SEC s Regulation S-K Compliance and Disclosure Interpretation 106.01, the information regarding the Corporation s equity compensation plans required by this Item pursuant to Item 201(d) of Regulation S-K is located in Item 12 of Part III of this annual report and is incorporated herein by reference.

# Item 6. Selected Financial Data.

The following table sets forth certain selected financial data for each of the five years ended December 31, 2014, and is qualified in its entirety by the detailed statistical and other information contained in this annual report, including Management s Discussion and Analysis of Financial Condition and Results of Operations appearing in Item 7 of Part II of this annual report and the financial statements and notes thereto appearing in Item 8 of Part II of this annual report.

| | Years Ended December 31, | | | | |
|---|---|---|---|---|---|
| (Dollars in thousands, except per share data) | 2014 | 2013 | 2012 | 2011 | 2010 |
| RESULTS OF OPERATIONS: | | | | | |
| Interest income | **$38,289** | $41,351 | $45,901 | $50,852 | $55,461 |
| Interest expense | **4,247** | 6,475 | 10,562 | 11,088 | 12,822 |
| Net interest income | **34,042** | 34,876 | 35,339 | 39,764 | 42,639 |
| Provision for credit losses | **3,350** | 27,784 | 27,745 | 19,470 | 21,119 |
| Net interest income after provision for credit losses | **30,692** | 7,092 | 7,594 | 20,294 | 21,520 |
| Noninterest income | **16,781** | 17,459 | 15,758 | 17,318 | 18,041 |
| Noninterest expense | **39,361** | 40,686 | 39,555 | 39,167 | 41,720 |
| Income (loss) before income taxes | **8,112** | (16,135) | (16,203) | (1,555) | (2,159) |
| Income tax expense (benefit) | **3,061** | (6,501) | (6,565) | (658) | (492) |
| Net income (loss) | **$5,051** | $(9,634) | $(9,638) | $(897) | $(1,667) |

TABLE OF CONTENTS

| | Years Ended December 31, | | | | |
|---|---|---|---|---|---|
| (Dollars in thousands, except per share data) | 2014 | 2013 | 2012 | 2011 | 2010 |
| PER COMMON SHARE DATA: | | | | | |
| Net income (loss) basic | **$0.46** | $(1.14) | $(1.14) | $(0.11) | $(0.20) |
| Net income (loss) diluted | **0.46** | (1.14) | (1.14) | (0.11) | (0.20) |
| Dividends paid | | | 0.01 | 0.09 | 0.24 |
| Book value (at year end) | **11.13** | 12.19 | 13.48 | 14.34 | 14.51 |
| Tangible book value (at year end)[1] | **10.08** | 10.31 | 11.56 | 12.37 | 12.32 |
| FINANCIAL CONDITION (at year end): | | | | | |
| Loans | **$710,746** | $711,919 | $785,082 | $841,050 | $895,404 |
| Assets | **1,100,402** | 1,054,124 | 1,185,807 | 1,158,193 | 1,130,311 |
| Deposits | **949,004** | 933,468 | 1,049,273 | 1,009,919 | 979,516 |
| Long-term debt | | | | 455 | 932 |
| Stockholders equity | **140,469** | 103,299 | 114,026 | 121,249 | 122,513 |
| PERFORMANCE RATIOS (for the year): | | | | | |
| Return on average total assets | **0.47** % | (0.89)% | (0.82)% | (0.08)% | (0.15)% |
| Return on average stockholders equity | **4.04** | (8.64) | (8.07) | (0.74) | (1.33) |
| Net interest margin | **3.43** | 3.48 | 3.23 | 3.74 | 4.02 |
| Efficiency ratio[2] | **77.45** | 77.59 | 77.17 | 68.35 | 68.75 |
| Dividend payout ratio | | | (0.88) | (81.82) | (120.00) |
| Average stockholders equity to average total assets | **11.66** | 10.31 | 10.18 | 10.66 | 11.05 |
| ASSET QUALITY RATIOS (for the year): | | | | | |
| Nonperforming assets to total assets | **1.57** % | 2.11 % | 3.76 % | 5.48 % | 3.95 % |
| Nonperforming assets and accruing TDRs to total assets | **3.09** | 4.58 | 8.18 | 7.66 | 6.16 |
| Allowance for credit losses to average loans | **1.09** | 1.40 | 1.96 | 1.64 | 1.57 |
| Allowance for credit losses to nonaccrual loans | **57.14** | 59.10 | 43.84 | 27.81 | 39.26 |
| Allowance for credit losses to nonaccrual loans and TDRs | **25.53** | 24.25 | 18.00 | 18.66 | 23.25 |

(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, 2014 to its financial condition at December 31, 2013 and the results of operations for the years ended December 31, 2014, 2013, and 2012. 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 annual report.

# PERFORMANCE OVERVIEW

The Company recorded net income of $5.05 million for 2014 and a net loss of $9.6 million for both 2013 and 2012. The basic and diluted income per share was $0.46 for 2014 and a diluted loss per common share of $1.14 for both 2013 and 2012. When comparing 2014 to 2013 and 2012, earnings were significantly improved due to a decline in the provision for credit losses.

30

Total assets were $1.1 billion at December 31, 2014, a $46.3 million, or 4.4%, increase when compared to the $1.054 billion at December 31, 2013. The increase in total assets was mainly the result of a capital raise during the second quarter of 2014, in which the Company sold 4,140,000 shares of its common stock for a price of $8.25 per share (the stock sale ). The Company received $31.3 million in net proceeds after deducting certain direct costs related to the stock sale, consisting of underwriting discounts and commissions. The Company contributed $20 million of the net proceeds to its wholly-owned subsidiary, The Talbot Bank of Easton, Maryland ( Talbot Bank ), to satisfy regulatory capital requirements, with the remaining proceeds primarily used to purchase available for sale investment securities. Investment securities increased $89 million funded by an increase in deposits and use of interest bearing deposits with other banks and the proceeds from the stock sale. The slight decrease in loans of $1 million between December 31, 2014 and 2013 was the result of continued workout efforts and charge-offs on nonperforming assets which outpaced new loan generation in 2014.

Total deposits increased $15.5 million, or 1.7%, to $949 million at December 31, 2014. The increase in deposits was mainly due to an increase in noninterest-bearing deposits of $21 million as well as an increase in interest-bearing transaction accounts of $22 million, partially offset by a decline in time deposits of $25 million. Total stockholders equity increased $37.2 million, or 36%, to $140.5 million, or 12.77% of total assets at December 31, 2014.

# CRITICAL ACCOUNTING POLICIES

The Company s consolidated financial statements are prepared in accordance with GAAP 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 on quoted market prices, collateral value 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 notes to the financial statements 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 policies with respect to the allowance for credit losses, goodwill and other intangible assets, deferred tax assets, and fair value are critical accounting policies. These policies are considered critical because they relate to accounting areas that require the most subjective or complex judgments, and, as such, could be most subject to revision as new information becomes available.

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. A discussion of the factors driving changes in the amount of the allowance for credit losses is included in the Asset Quality Provision for Credit Losses and Risk Management section below.

Goodwill represents the excess of the cost of an acquisition over the fair value of the net assets acquired. Other intangible assets represent purchased assets that also lack physical substance but can be distinguished from goodwill because of contractual or other legal rights or because the asset is capable of being sold or exchanged either on its own or in combination with a related contract, asset or liability. Goodwill and other intangible assets are required to be recorded at fair value. Determining fair value is subjective, requiring the use of estimates, assumptions and management judgment. Goodwill and other intangible assets with indefinite lives are tested at least annually for impairment, usually during the third quarter, or on an interim basis if circumstances dictate. Intangible assets that have finite lives are amortized over their estimated useful lives and also are subject to impairment testing. Impairment testing requires that the fair value of each of the Company s reporting units be compared to the carrying amount of its net assets, including goodwill. The Company s reporting units were identified based on an analysis of each of its individual operating segments. If the fair value of a reporting unit is less than book value, an expense may be required to write down the related goodwill or purchased intangibles to record an impairment loss.

Deferred tax assets and liabilities are determined by applying the applicable federal and state income tax rates to 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 result from such temporary differences. A valuation allowance, if needed, reduces deferred tax assets to the expected amount most likely to be realized. Realization of deferred tax assets is dependent on the generation of a sufficient level of future taxable income, recoverable taxes paid in prior years and tax planning strategies. The Company evaluates all positive and negative evidence before determining if a valuation allowance is deemed necessary regarding the realization of deferred tax assets.

The Company measures certain financial assets and liabilities at fair value, with the measurements made on a recurring or nonrecurring basis. Significant financial instruments measured at fair value on a recurring basis are investment securities and interest rate caps. Impaired loans and other real estate owned are significant financial instruments measured at fair value on a nonrecurring basis. Fair value is defined 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. In determining fair value, the Company is required to maximize the use of observable inputs and minimize the use of unobservable inputs, reducing subjectivity.

# RECENT ACCOUNTING PRONOUNCEMENTS AND DEVELOPMENTS

Note 1 to the Consolidated Financial Statements discusses new accounting policies that the Company adopted during 2014 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.

# RESULTS OF OPERATIONS

## Net Interest Income and Net Interest Margin

Net interest income remains the most significant factor affecting our results of operations. Net interest income represents the excess of interest and fees earned on total average earning assets (loans, investment securities, federal

funds sold and interest-bearing deposits with other banks) over interest owed on average interest-bearing liabilities (deposits and borrowings). Tax-equivalent net interest income is net interest income adjusted for the tax-favored status of income from certain loans and investments. As shown in the table below, tax-equivalent net interest income for 2014 was $34.1 million. This represented an $845 thousand, or 2.4%, decrease from 2013, and a $523 thousand, or 1.5%, decrease for 2013 when compared to 2012. The decrease in both comparison periods was due to a greater decline in interest income than the decline in interest expense. When comparing 2014 to 2013, interest income decreased $3.1 million while interest expense decreased $2.2 million. When comparing 2013 to 2012, interest income decreased $4.6 million while interest expense decreased $4.1 million.

The decrease in interest expense when comparing 2014 to 2013 was mainly due to lower balances of and rates paid on time deposits, which benefitted the net interest margin. See the discussion below relating to interest expense and Note 21 in the Notes to Consolidated Financial Statements for additional information.

TABLE OF CONTENTS

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 3.43% for 2014, 5 basis points lower than the 3.48% for 2013 mainly due to the decline in the average balance of loans along with the decrease in rates. The net interest margin increased 25 basis points in 2013 when compared to 2012 primarily due to the impact of reduced average rates on deposits associated with the IND Program termination resulting in a reduction in both the money market account balances as well as the associated higher rate on this program. Additionally, there was a positive effect of decreases in average balances of lower yielding interest bearing deposits with other banks tied to the funding from the IND program. The net interest spread, which is the difference between the average yield on earning assets and the rate paid for interest-bearing liabilities, was 3.30% for 2014, 3.31% for 2013 and 3.02% for 2012.

The following table sets forth the major components of net interest income, on a tax-equivalent basis, for the years ended December 31, 2014, 2013, and 2012.

| (Dollars in thousands) | 2014 Average Balance | Interest[1] | Yield/ Rate | 2013 Average Balance | Interest[1] | Yield/ Rate | 2012 Average Balance | Interest[1] | Yield/ Rate |
|---|---|---|---|---|---|---|---|---|---|
| Earning assets | | | | | | | | | |
| Loans[2][3] | **$707,381** | **$35,225** | **4.98%** | $768,516 | $39,152 | 5.09% | $814,167 | $42,808 | 5.26% |
| Investment securities: | | | | | | | | | |
| Taxable | **198,207** | **2,957** | **1.49** | 138,701 | 2,072 | 1.49 | 134,697 | 2,815 | 2.09 |
| Tax-exempt | **432** | **18** | **4.20** | 540 | 26 | 4.84 | 2,989 | 157 | 5.25 |
| Federal funds sold | **1,883** | **1** | **0.06** | 3,850 | 4 | 0.10 | 10,185 | 10 | 0.10 |
| Interest-bearing deposits | **86,995** | **179** | **0.21** | 94,704 | 200 | 0.21 | 135,813 | 274 | 0.20 |
| Total earning assets | **994,898** | **38,380** | **3.86%** | 1,006,311 | 41,454 | 4.12% | 1,097,851 | 46,064 | 4.20% |
| Cash and due from banks | **22,973** | | | 22,603 | | | 20,256 | | |
| Other assets | **64,200** | | | 67,724 | | | 68,813 | | |
| Allowance for credit losses | **(9,449)** | | | (15,511) | | | (14,468) | | |
| Total assets | **$1,072,622** | | | $1,081,127 | | | $1,172,452 | | |
| Interest-bearing liabilities | | | | | | | | | |
| Demand deposits | **$177,828** | **247** | **0.14%** | $171,244 | 266 | 0.16% | $160,741 | 294 | 0.18% |
| Money market and savings deposits[4] | **225,616** | **275** | **0.12** | 221,808 | 1,086 | 0.49 | 279,126 | 3,279 | 1.17 |
| Certificates of deposit, $100,000 or more | **170,252** | **1,881** | **1.10** | 202,053 | 2,580 | 1.28 | 238,241 | 3,442 | 1.44 |
| Other time deposits | **180,848** | **1,826** | **1.01** | 195,045 | 2,516 | 1.29 | 204,644 | 3,486 | 1.70 |
| Interest-bearing deposits | **754,544** | **4,229** | **0.56** | 790,150 | 6,448 | 0.82 | 882,752 | 10,501 | 1.19 |
| Short-term borrowings | **8,061** | **18** | **0.22** | 10,980 | 27 | 0.24 | 14,976 | 45 | 0.30 |
| Long-term debt | | | | | | | 341 | 16 | 4.61 |
| Total interest-bearing liabilities | **762,605** | **4,247** | **0.56%** | 801,130 | 6,475 | 0.81% | 898,069 | 10,562 | 1.18% |
| | **178,002** | | | 160,182 | | | 146,057 | | |

| | | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| Noninterest-bearing deposits | | | | | | | | |
| Other liabilities | **6,921** | | | 8,370 | | | 8,967 | | |
| Stockholders equity | **125,094** | | | 111,445 | | | 119,359 | | |
| Total liabilities and stockholders equity | **$1,072,622** | | | $1,081,127 | | | $1,172,452 | | |
| Net interest spread | | **$34,133** | **3.30%** | | $34,979 | 3.31% | | $35,502 | 3.02% |
| Net interest margin | | | **3.43%** | | | 3.48% | | | 3.23% |

(1) All amounts are reported on a tax-equivalent basis computed using the statutory federal income tax rate of 34.0%, exclusive of the alternative minimum tax rate and nondeductible interest expense. The tax-equivalent adjustment amounts used in the above table to compute yields aggregated $91 thousand in 2014, $103 thousand in 2013 and $163 thousand in 2012.

(2) Average loan balances include nonaccrual loans.

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

33

TABLE OF CONTENTS

(4) Interest on money market and savings deposits includes an adjustment to expense related to interest rate caps and the hedged deposits from the Promontory Insured Network Deposits Program associated with them. This adjustment increased interest expense by $0 for 2014, $695 thousand for 2013 and $2.0 million for 2012. The interest rate caps were terminated in June of 2013.

On a tax-equivalent basis, total interest income was $38.3 million for 2014, compared to $41.5 million for 2013 and $46.1 million for 2012. The decline in interest income for 2014 and 2013 was primarily due to lower average balances of and yields earned on loans. During 2014 and 2013, average loans decreased $61.1 million and $45.7 million, respectively, and the yield earned on loans decreased 11 and 17 basis points, respectively. Excluding average nonaccrual loans, the yield on loans would have been 5.07%, 5.30% and 5.57% for 2014, 2013, and 2012, respectively. Other earning assets impacting the change in interest income for 2014 included taxable investment securities, which increased $59.5 million while the related yield remained unchanged, which increased interest income $885 thousand. The increase in taxable investment securities was the result of the capital raise in the second quarter of 2014, which allowed management to utilize the proceeds for investment. Federal funds sold and tax-exempt investment securities declined $2.0 million and $108 thousand, respectively. The yield on federal funds sold decreased 4 basis points, while the yield on tax-exempt securities decreased 64 basis points. The changes in the balances and yields of these earning assets reduced interest income a combined $11 thousand. Although the yield on interest-bearing deposits with other banks remained unchanged, the average balance declined $7.7 million, which reduced interest income $21 thousand when comparing 2014 to 2013. The decline in these earning assets reflected a reduction in excess liquidity.

When comparing 2013 to 2012, the changes in other average earning assets resulting in the decrease in interest income included an increase in taxable investment securities, which increased $4.0 million while the related yield declined 60 basis points, which reduced interest income $743 thousand. The yield on taxable investment securities decreased due to the sale of higher yielding taxable investment securities in 2013 when compared to 2012. The average balance on interest-bearing deposits with other banks declined $41.1 million, which reduced interest income by $74 thousand, reflecting a reduction in excess liquidity. The remaining earning assets, federal funds sold and tax-exempt investment securities, declined $6.3 million and $2.4 million, respectively. The yield on tax-exempt securities decreased 41 basis points while the yield on federal funds sold remained the same. The changes in the balances and yields of these earning assets reduced interest income a combined $137 thousand.

As a percentage of total average earning assets, loans, investment securities, federal funds sold and interest-bearing deposits were 71.1%, 20.0%, 0.2% and 8.7%, respectively, for 2014 which reflected a decline in higher-yielding earning assets when compared to 2013. The comparable percentages for 2013 were 76.0%, 13.8%, 0.4%, and 9.4%, respectively, and for 2012 were 74.2%, 12.5%, 0.9% and 12.4%, respectively. When comparing 2014 to 2013, the overall decrease in average balances of earning assets produced $2.2 million less in interest income and the decrease in yields on earning assets produced $844 thousand less in interest income, as seen in the Rate/Volume Variance Analysis below. When comparing 2013 to 2012, the overall decrease in average balances of earning assets produced $2.6 million less in interest income and the decrease in yields on earning assets produced $2.0 million less in interest income, as seen in the Rate/Volume Variance Analysis below.

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.

| | 2014 | 2013 | 2012 | 2011 | 2010 |
|---|---|---|---|---|---|
| Loans | **71.1** % | 76.0 % | 74.2 % | 81.7 % | 84.9 % |
| Loans held for sale | | 0.4 | | | |
| Investment securities | **20.0** | 13.8 | 12.5 | 10.6 | 10.0 |

| | | | | | |
|---|---|---|---|---|---|
| Federal funds sold | **0.2** | 0.4 | 0.9 | 2.2 | 3.7 |
| Interest-bearing deposits with other banks | **8.7** | 9.4 | 12.4 | 5.5 | 1.4 |
| | **100.0 %** | 100.0 % | 100.0 % | 100.0 % | 100.0 % |

34

TABLE OF CONTENTS

Interest expense was $4.2 million for 2014, compared to $6.5 million for 2013 and $10.6 million for 2012. The decline in interest expense for 2014 was primarily due to lower expense on money market, savings deposits and time deposits. Interest expense on money market and savings deposits declined $812 thousand in 2014 when compared to 2013, even with an increase of $3.8 million in average balances, due to a decrease of 37 basis points on rates paid on these deposits. The increase in balances of money market and savings deposits was primarily due to a decline in time deposits, and the lower rates were primarily due to current market conditions which reflects depositors finding more value in liquidity as non-interest bearing deposits also increased $17.8 million. Interest expense on time deposits (certificates of deposit of $100,000 or more and other time deposits) declined $1.4 million when compared to 2013 due to a decrease of $46 million in average time deposits and a decrease of 46 basis points on rates paid on these deposits. The decrease in average time deposits reflected a decrease in the Company s liquidity needs and the lower rates reflected current market conditions.

The decline in interest expense for 2013 relative to 2012 was primarily due to lower expense on money market and savings deposits and time deposits. Interest expense on money market and savings deposits declined $2.2 million in 2013 when compared to 2012 due to a decrease of $57.3 million in average balances of these deposits and a decrease of 68 basis points on rates paid on these deposits. The decrease in balances of money market and savings deposits was primarily due to the decline in deposits associated with the IND Program, which the Company fully exited in June of 2013, and the lower rates were primarily due to terminating the interest rate caps used to hedge the interest rates on deposits associated with the IND Program. Interest expense on time deposits declined $1.8 million when compared to 2012 due to a decrease of $45.8 million in average time deposits and a decrease of 28 basis points on rates paid on these deposits.

During 2014, lower rates on interest-bearing liabilities produced $1.7 million less in interest expense and decreased volume produced $518 thousand less in interest expense, as shown in the table below. In 2013, lower rates on interest-bearing liabilities produced $2.9 million less in interest expense and decreased volume produced $1.2 million less in interest expense.

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. 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.

| | 2014 over (under) 2013 | | | 2013 over (under) 2012 | | |
|---|---|---|---|---|---|---|
| (Dollars in thousands) | Total | Caused By | | Total | Caused By | |
| | Variance | Rate | Volume | Variance | Rate | Volume |
| Interest income from earning assets: | | | | | | |
| Loans and loans held for sale | **$(3,927)** | **$(839 )** | **$(3,088)** | $(3,656) | $(1,196) | $(2,460) |
| Taxable investment securities | **885** | | **885** | (743 ) | (825 ) | 82 |
| Tax-exempt investment securities | **(8 )** | **(3 )** | **(5 )** | (131 ) | (11 ) | (120 ) |
| Federal funds sold | **(3 )** | **(2 )** | **(1 )** | (6 ) | | (6 ) |
| Interest-bearing deposits | **(21 )** | | **(21 )** | (74 ) | 13 | (87 ) |
| Total interest income | **(3,074)** | **(844 )** | **(2,230)** | (4,610) | (2,019) | (2,591) |
| Interest expense on deposits and borrowed funds: | | | | | | |
| Interest-bearing demand deposits | **(19 )** | **(31 )** | **12** | (28 ) | (41 ) | 13 |
| Money market and savings deposits | **(812 )** | **(831 )** | **19** | (2,193) | (1,620) | (573 ) |

| | | | | | | |
|---|---|---|---|---|---|---|
| Time deposits | **(1,389)** | **(847 )** | **(542 )** | (1,832) | (1,176) | (656 ) |
| Short-term borrowings | **(9 )** | **(2 )** | **(7 )** | (18 ) | (8 ) | (10 ) |
| Long-term debt | | | | (16 ) | (8 ) | (8 ) |
| Total interest expense | **(2,229)** | **(1,711)** | **(518 )** | (4,087) | (2,853) | (1,234) |
| Net interest income | **$(845 )** | **$867** | **$(1,712)** | $(523 ) | $834 | $(1,357) |

35

TABLE OF CONTENTS

# Noninterest Income

Noninterest income decreased $678 thousand, or 3.9%, in 2014 when compared to 2013 and increased $1.7 million, or 10.8%, in 2013 when compared to 2012. The decrease in noninterest income in 2014 when compared to 2013 was primarily due to the loss of wholesale insurance commissions and fees of $1.9 million from the formerly owned Tri-State General Insurance Agency and a gain on investment securities of $913 thousand in 2013. Partially offsetting the decreases were increases in retail commissions of $493 thousand, the gain on sale of Tri-State of $114 thousand and increased trust and fee income of $247 thousand. In addition, during 2013, the Company incurred a loss of $1.3 million related to the termination of a cash flow hedge. As a result of the termination in 2013, no loss was incurred in 2014.

The increase in noninterest income in 2013 when compared to 2012 was mainly due to higher insurance agency commissions of $833 thousand, gains on sales of investment securities of $635 thousand, and fewer losses on sales of other real estate owned of $452 thousand which are included in other noninterest income. Partially offsetting the increase were lower service charges on deposit accounts of $180 thousand.

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

| | Years Ended | | | Change from Prior Year | | | |
|---|---|---|---|---|---|---|---|
| | | | | 2014/13 | | 2013/12 | |
| (Dollars in thousands) | 2014 | 2013 | 2012 | Amount | Percent | Amount | Percent |
| Service charges on deposit accounts | **$2,407** | $2,371 | $2,551 | **$36** | **1.5 %** | $(180 ) | (7.1 )% |
| Trust and investment fee income | **1,860** | 1,613 | 1,644 | **247** | **15.3** | (31 ) | (1.9 ) |
| Gains on sales of investment securities | **23** | 913 | 278 | **(890 )** | **(97.5 )** | 635 | 228.4 |
| Insurance agency commissions income | **9,525** | 10,647 | 9,814 | **(1,122)** | **(10.5 )** | 833 | 8.5 |
| Loss on termination of cash flow hedge | | (1,306 ) | (1,339 ) | **1,306** | **100.0** | 33 | 2.5 |
| Other noninterest income | **2,966** | 3,221 | 2,810 | **(255 )** | **(7.9 )** | 411 | 14.6 |
| Total | **$16,781** | $17,459 | $15,758 | **$(678 )** | **(3.9 )** | $1,701 | 10.8 |

# Noninterest Expense

Noninterest expense decreased $1.3 million, or 3.3%, in 2014 when compared to 2013 and increased $1.1 million, or 2.9%, in 2013 when compared to 2012. The decrease in noninterest expense in 2014 when compared to 2013 was primarily due to lower write-downs of other real estate owned of $660 thousand and insurance agency commission expense of $892 thousand, associated with the Tri-State Sale, which were partially offset by increases in salary and wage expense of $254 thousand, data processing of $106 thousand, and directors fees of $120 thousand.

The increase in noninterest expense in 2013 when compared to 2012 was primarily due to higher marketing expenses of $510 thousand included in other noninterest expenses, FDIC insurance premiums of $433 thousand and insurance agency commissions expense of $407 thousand. The increased marketing costs were mainly related to a branding project for the Company and its subsidiaries.

We had 292 full-time equivalent employees at December 31, 2014 and 312 full-time equivalent employees at both December 31, 2013 and December 31, 2012.

36

TABLE OF CONTENTS

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

| | Years Ended | | | Change from Prior Year | | | |
|---|---|---|---|---|---|---|---|
| | | | | 2014/13 | | 2013/12 | |
| (Dollars in thousands) | 2014 | 2013 | 2012 | Amount | Percent | Amount | Percent |
| Salaries and wages | **$17,600** | $17,346 | $17,418 | **$254** | **1.5 %** | $(72 ) | (0.4 )% |
| Employee benefits | **4,092** | 4,094 | 3,994 | **(2 )** | **(0.0 )** | 100 | 2.5 |
| Occupancy expense | **2,339** | 2,344 | 2,559 | **(5 )** | **(0.2 )** | (215 ) | (8.4 ) |
| Furniture and equipment expense | **975** | 1,020 | 963 | **(45 )** | **(4.4 )** | 57 | 5.9 |
| Data processing | **3,006** | 2,900 | 2,717 | **106** | **3.7** | 183 | 6.7 |
| Directors fees | **474** | 354 | 474 | **120** | **33.9** | (120 ) | (25.3) |
| Amortization of intangible assets | **201** | 296 | 392 | **(95 )** | **(32.1)** | (96 ) | (24.5) |
| Insurance agency commissions expense | **906** | 1,798 | 1,391 | **(892 )** | **(49.6)** | 407 | 29.3 |
| FDIC insurance premium expense | **1,636** | 1,813 | 1,380 | **(177 )** | **(9.8 )** | 433 | 31.4 |
| Write-downs of other real estate owned | **658** | 1,318 | 1,328 | **(660 )** | **(50.1)** | (10 ) | (0.8 ) |
| Other noninterest expenses | **7,474** | 7,403 | 6,939 | **71** | **1.0** | 464 | 6.7 |
| Total | **$39,361** | $40,686 | $39,555 | **$(1,325)** | **(3.3 )** | $1,131 | 2.9 |

## Income Taxes

The Company reported an income tax expense of $3.1 million for 2014, compared to an income tax benefit of $6.5 million for 2013 and $6.6 million for 2012. The effective tax rate was 37.8% for 2014, 40.3% for 2013 and 40.5% for 2012. In 2014, the Company was able to utilize a portion of their Federal and State Net Operating Loss (NOL) carryforwards which reduced income taxes payable for the year. The Company believes it will be able to continue utilizing its NOL s without the need for a valuation allowance. See the discussion below relating to the positive and negative evidence evaluated by management at Note 15, Income Taxes, in the Notes to Consolidated Financial Statements for additional information.

# REVIEW OF FINANCIAL CONDITION

Asset and liability composition, capital resources, asset quality, market risk, interest sensitivity and liquidity are all factors that affect our financial condition. The following sections discuss each of these factors.

## Assets

## Interest-Bearing Deposits with Other Banks and Federal Funds Sold

We invest excess cash balances (i.e., the excess cash remaining after funding loans and investing in securities with deposits and borrowings) in interest-bearing accounts and federal funds sold offered by our correspondent banks. These liquid investments are maintained at a level that management believes is necessary to meet current liquidity needs. Total interest-bearing deposits with other banks and federal funds sold decreased $37.8 million from $109.9 million at December 31, 2013 to $72.0 million at December 31, 2014. Average interest-bearing deposits with other

banks and federal funds sold decreased $9.7 million in 2014 and decreased $47.4 million in 2013. The decline in both the 2014 and 2013 period-end and average balances for these assets reflected a reduction in excess liquidity.

## 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 prices and 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, 2014, 98% of the portfolio was classified as available for sale and 2% as held to maturity, similar to the 97% and 3%, respectively, at December 31, 2013. The percentage of securities designated as available for sale reflects the amount that management believes is 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. We do not typically invest in structured notes or other derivative securities. Total investment securities increased $88.4 million from $152.3 million at December 31, 2013 to $240.7 million at December 31, 2014. Average investment securities increased $59.4 million in 2014, much more than the $1.6 million in 2013 due to proceeds from the second quarter of 2014 capital raise which were primarily invested in available for sale investment securities.

Investment securities available for sale were $236.1 million at the end of 2014 and $147.1 million at the end of 2013. Investment activity for 2014 included purchases of $96.1 million in mortgage-backed securities, $36.9 million in purchases of U.S. Government agencies, and $12 thousand in equity securities while investment activity for 2013 included sales of $10.3 million in U.S. Government agencies and $29.1 million in mortgage-backed securities which, in aggregate, generated a gain of $913 thousand. At year-end 2014, 31.7% of the securities in the portfolio were U.S. Government agencies and 65.8% of the securities were mortgage-backed securities, compared to 39.7% and 52.9%, respectively, at year-end 2013, reflecting a shift in the composition of the portfolio to mortgage-backed securities which provide higher yields. As seen in the table below, 32% of the available-for-sale portfolio will mature in over one through five years and 63% will mature in over ten years based on contractual maturities. The comparable amounts for 2013 were 43% and 53%, respectively. Our investments in mortgage-backed securities are issued or guaranteed by U.S. Government agencies or government-sponsored agencies.

Investment securities held to maturity, which consisted of one U.S. Government agency bond and tax-exempt municipal bonds, totaled $4.6 million at December 31, 2014. The comparable amount was $5.2 million at December 31, 2013. The lower amount at the end of 2014 reflected only maturities and no purchases of investment securities held to maturity.

The following table sets forth the maturities and weighted average yields of the bond investment portfolio as of December 31, 2014.

| | 1 Year or Less | | 1 5 Years | | 5 10 Years | | Over 10 Years | |
|---|---|---|---|---|---|---|---|---|
| (Dollars in thousands) | Carrying Amount | Average Yield | Carrying Amount | Average Yield | Carrying Amount | Average Yield | Carrying Amount | Average Yield |
| Available for sale: | | | | | | | | |
| U.S. Treasury and Government agencies | $2,002 | 0.42% | $74,895 | 0.95% | $399 | 4.34% | $2,879 | 1.43% |
| Mortgage-backed | | | 86 | 4.47 | 11,006 | 1.68 | 144,211 | 1.99 |
| Total available for sale | $2,002 | 0.42 | $74,981 | 0.95 | $11,405 | 1.77 | $147,090 | 1.98 |
| Held to maturity: | | | | | | | | |
| U.S. Government agencies | $ | % | $ | % | $ | % | $2,791 | 2.04% |
| States and political subdivisions(1) | 221 | 3.07 | 712 | 4.60 | 403 | 5.00 | 503 | 5.38 |
| Total held to maturity | $221 | 3.07 | $712 | 4.60 | $403 | 5.00 | $3,294 | 2.55 |

(1) Yields have been adjusted to reflect a tax equivalent basis assuming a federal tax rate of 34.0%.

# Loans

The loan portfolio is the primary source of our income. Loans totaled $710.7 million at December 31, 2014, a decrease of $1.2 million, or 0.2%, from 2013. Loans included deferred costs net of deferred fees of $380 thousand at year-end 2014 and $341 thousand at year-end 2013. Loans remained relatively flat for 2014 when compared to 2013 primarily due to loan charge offs slightly outpacing new loan growth as a few large problem credits were resolved at the end of 2014. Most of our loans are secured by real estate and are classified as construction, residential or commercial real estate loans. Total real estate loans decreased $338 thousand, or 0.1%, from year-end 2014 to year-end 2013. The decrease in loans was due to declines in

residential real estate loans of $1.5 million and commercial loans, which include financial and agricultural loans, of $4.5 million, or 7.9%, which were offset by increases in construction loans of $4.6 million, or 7.1%, commercial real estate loans of $1.2 million, or 0.4%. Consumer loans, which consist of a small percentage of the overall loan portfolio, decreased $877 thousand, or 8.2%, from the end of 2014 to the end of 2013.

At December 31, 2014, the real estate loan portfolio was comprised of 9.7% construction, 38.5% residential real estate and 43.0% commercial real estate. That compares to 9.1%, 38.6% and 42.8%, respectively, at December 31, 2013. Commercial and consumer loans were 7.4% and 1.4%, respectively, of the portfolio at December 31, 2014 and 8.0% and 1.5%, respectively, at December 31, 2013. At December 31, 2014, 71.3% of the loan portfolio had fixed interest rates and 28.7% had adjustable interest rates, compared to 68.9% and 31.1%, respectively, at December 31, 2013. See the discussion below under the caption Asset Quality Provision for Credit Losses and Risk Management and Note 3, Loans and Allowance for Credit Losses , in the Notes to Consolidated Financial Statements for additional information. At December 31, 2014 and 2013, the Company did not have any 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).

| | December 31, | | | | |
|---|---|---|---|---|---|
| (Dollars in thousands) | 2014 | 2013 | 2012 | 2011 | 2010 |
| Construction | **$ 69,157** | $ 64,591 | $ 108,051 | $ 119,883 | $ 143,952 |
| Residential real estate | **273,336** | 274,857 | 288,011 | 321,604 | 333,738 |
| Commercial real estate | **305,788** | 304,605 | 314,941 | 315,439 | 318,726 |
| Commercial | **52,671** | 57,195 | 60,786 | 69,485 | 82,787 |
| Consumer | **9,794** | 10,671 | 13,293 | 14,639 | 16,201 |
| Total | **$ 710,746** | $ 711,919 | $ 785,082 | $ 841,050 | $ 895,404 |

The table below sets forth the maturities and interest rate sensitivity of the loan portfolio at December 31, 2014.

| (Dollars in thousands) | Maturing within one year | Maturing after one but within five years | Maturing after five years | Total |
|---|---|---|---|---|
| Construction | $ 34,873 | $ 31,468 | $ 2,816 | $ 69,157 |
| Residential real estate | 56,631 | 111,311 | 105,394 | 273,336 |
| Commercial real estate | 58,553 | 210,713 | 36,522 | 305,788 |
| Commercial | 20,170 | 26,649 | 5,852 | 52,671 |
| Consumer | 5,499 | 3,509 | 786 | 9,794 |
| Total | $ 175,726 | $ 383,650 | $ 151,370 | $ 710,746 |
| Rate terms: | | | | |
| Fixed-interest rate loans | $ 121,199 | $ 345,341 | $ 40,049 | $ 506,589 |
| Adjustable-interest rate loans | 54,527 | 38,309 | 111,321 | 204,157 |
| Total | $ 175,726 | $ 383,650 | $ 151,370 | $ 710,746 |

# Liabilities

## Deposits

We use core deposits primarily to fund loans and to purchase investment securities. Total deposits increased from $933.5 million at December 31, 2013 to $949.0 million at December 31, 2014. As previously mentioned, the increase in deposits was mainly due to an increase in noninterest-bearing deposits of $21 million as well as an increase in interest-bearing transaction accounts of $22 million, partially offset by a decline in time deposits of $25 million. The increases in noninterest-bearing and interest-bearing deposits reflected continuing growth in our customer base and a shift from time deposits providing lower yields than in 2013. Average deposits decreased $17.8 million, or 1.9%, in 2014, compared to a 7.6% decrease in 2013. Average time deposits decreased $46 million, or 11.6%, for the same reasons as the decline in the period-end

39

TABLE OF CONTENTS

amounts. Partially offsetting this decrease, average money market and savings deposits, noninterest-bearing and interest-bearing demand deposits increased in aggregate $28.2 million, or 0.05%, during 2014. Deposits provided funding for approximately 93.7%, 94.4% and 93.7% of average earning assets for 2014, 2013 and 2012, respectively.

Average deposits declined for 2013 primarily in money market and savings deposits and time deposits which decreased in aggregate $103.1 million, or 14.3%. The decrease in money market deposit accounts was due to the Company exiting the IND Program, and the decrease in time deposits reflected management s effort to reduce excess liquidity.

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.

| | Average Balances | | | | | |
|---|---|---|---|---|---|---|
| (Dollars in thousands) | 2014 | | 2013 | | 2012 | |
| Noninterest-bearing demand | **$178,002** | **19.1** % | $160,182 | 16.9 % | $146,057 | 14.2 % |
| Interest-bearing deposits | | | | | | |
| Demand | **177,828** | **19.1** | 171,244 | 18.0 | 160,741 | 15.6 |
| Money market and savings | **225,616** | **24.2** | 221,808 | 23.3 | 279,126 | 27.1 |
| Certificates of deposit, $100,000 or more | **170,252** | **18.2** | 202,053 | 21.3 | 238,241 | 23.2 |
| Other time deposits | **180,848** | **19.4** | 195,045 | 20.5 | 204,644 | 19.9 |
| Total | $932,546 | 100.0% | $950,332 | 100.0% | $1,028,809 | 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, 2014.

| (Dollars in thousands) | |
|---|---|
| Three months or less | $ 38,151 |
| Over three through 6 months | 13,425 |
| Over 6 through 12 months | 41,753 |
| Over 12 months | 66,599 |
| Total | $ 159,928 |

## Short-Term Borrowings

Short-term borrowings generally 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. At December 31, 2014 and 2013, short-term borrowings included only repurchase agreements.

The average balance of short-term borrowings decreased $2.9 million, or 26.6%, in 2014, while the average balance decreased $4.0 million, or 26.7%, in 2013. The need for short-term borrowings declined due to fewer funding requirements for loans during 2014 and 2013.

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

| (Dollars in thousands) | 2014 Balance | 2014 Interest Rate | 2013 Balance | 2013 Interest Rate | 2012 Balance | 2012 Interest Rate |
|---|---|---|---|---|---|---|
| Average outstanding for the year | **$ 8,061** | **0.22 %** | $ 10,980 | 0.24 % | $ 14,976 | 0.30 % |
| Outstanding at year end | **4,808** | **0.23** | 10,140 | 0.23 | 13,761 | 0.26 |
| Maximum outstanding at any month end | **10,836** | | 12,662 | | 18,879 | |

40

TABLE OF CONTENTS

## Long-Term Debt

We use long-term borrowings to meet longer term liquidity needs, specifically to fund loan growth where liquidity from deposit growth is not sufficient. The Company had no long-term debt at the end of 2014 and 2013.

## Capital Resources Management

Total stockholders equity for the Company was $140.5 million at December 31, 2014, compared to $103.3 million at December 31, 2013. The increase in stockholders equity in 2014 was primarily due to the capital raise in the second quarter of 2014 which generated net proceeds of $31.3 million.

In 2012, the Board of Directors of the Company voted to suspend quarterly cash dividends on common stock until further notice. For both 2014 and 2013, the Company continued to maintain capital at levels in excess of the risk-based capital guidelines adopted by the federal banking agencies, as seen in the table below.

In May 2013, Talbot Bank entered into the Consent Agreements and the Acknowledgement with the FDIC and the Commissioner and the FDIC and the Commissioner issued the related Order. Among the requirements, Talbot Bank must meet and maintain the following minimum capital levels, (i) a leverage ratio (the ratio of Tier 1 capital to total assets) of at least 8%, and (ii) a total risk-based capital ratio (the ratio of qualifying total capital to risk-weighted assets) of at least 12%. As of December 31, 2014, the leverage ratio and total risk-based capital ratio were 8.91% and 14.16%, respectively, for Talbot Bank. For additional information regarding the Consent Agreements, the Order and the Acknowledgement along with Talbot Bank s progress with the related requirements, see Business-Regulatory Enforcement Actions and Note 1 to the Consolidated Financial Statements under the caption Regulatory Enforcement Actions.

During the second quarter of 2014, the Company sold 4,140,000 shares of its common stock for a price of $8.25 per share (the stock sale ). The Company received $31.3 million in net proceeds after deducting certain direct costs related to the stock sale, primarily underwriting discounts and commissions. The Company contributed $20.0 million of the net proceeds to Talbot Bank, to satisfy regulatory capital requirements, with the remaining proceeds used for general corporate purposes.

We record unrealized holding gains (losses), net of tax, on investment securities available for sale and on cash flow hedging activities as accumulated other comprehensive income (loss), a separate component of stockholders equity. At December 31, 2014, the portion of the investment portfolio designated as available for sale had net unrealized holding gains, net of tax, of $316 thousand compared to net unrealized holding losses, net of tax, of $437 thousand at December 31, 2013. There were no net unrealized holding gains or losses on cash flow hedging activities at the end of 2014 and 2013.

The following table compares the Company s capital ratios to the minimum regulatory requirements as of December 31, 2014, 2013 and 2012.

| (Dollars in thousands) | 2014 | 2013 | 2012 | Minimum Regulatory Requirements |
|---|---|---|---|---|
| Tier 1 capital | **$112,511** | $72,370 | $97,049 | |
| Tier 2 capital | **7,999** | 8,971 | 10,159 | |

| | | | | |
|---|---|---|---|---|
| Total risk-based capital | **120,510** | 81,341 | 107,208 | |
| Net risk-weighted assets | **736,763** | 717,129 | 805,108 | |
| Adjusted average total assets | **1,075,674** | 1,028,957 | 1,166,865 | |
| Risk-based capital ratios: | | | | |
| Tier 1 | **15.27** % | 10.09 % | 12.05 % | 4.0 % |
| Total capital | **16.36** | 11.34 | 13.32 | 8.0 |
| Tier 1 leverage ratio | **10.46** | 7.03 | 8.32 | 4.0 |

See Note 17 to the Consolidated Financial Statements for further information about the regulatory capital positions of the Company and the Banks.

41

TABLE OF CONTENTS

In July 2013, U.S. federal banking agencies published the Basel III Capital Rules establishing a new comprehensive capital framework for U.S. banking organizations. The Basel III Capital Rules are effective for the Company on January 1, 2015 and will be fully phased in on January 1, 2019. When fully phased in on January 1, 2019, the Basel III Capital Rules will require the Company to maintain (i) a minimum ratio of CET1 to risk-weighted assets of at least 4.5%, plus a 2.5% capital conservation buffer, (ii) a minimum ratio of Tier 1 capital to risk-weighted assets of at least 6.0% (increased from 4.0%), plus the capital conservation buffer, (iii) a minimum ratio of Total capital to risk-weighted assets of at least 8.0% (unchanged from current rules), plus the capital conservation buffer and (iv) a minimum leverage ratio of 4% (unchanged from current rules), calculated as the ratio of Tier 1 capital to average assets. The Basel III Capital Rules eliminate the inclusion of certain instruments, such as trust preferred securities, from Tier 1 capital. Instruments issued prior to May 19, 2010 will be grandfathered for companies with consolidated assets of $15 billion or less.

The capital conservation buffer is designed to absorb losses during periods of economic stress. Banking institutions with a ratio of CET1 to risk-weighted assets above the minimum but below the conservation buffer will face constraints on dividends, equity repurchases and compensation based on the amount of the shortfall. The implementation of the capital conservation buffer will begin on January 1, 2016 at 0.625% and be phased in over a four-year period, increasing by that amount on each January 1, until it reaches 2.5% on January 1, 2019.

The Basel III Capital Rules also revise the prompt corrective action regulations by (i) introducing a CET1 ratio requirement at each level (other than critically undercapitalized), with the required CET1 ratio being 6.5% for well-capitalized status and (ii) increasing the minimum Tier 1 capital ratio requirement for each category (other than critically undercapitalized), with the minimum Tier 1 capital ratio for well-capitalized status being 8% (as compared to the current 6%). The Basel III Capital Rules do not change the total risk-based capital requirement for any prompt corrective action category.

The Company currently meets all capital adequacy requirements under the Basel III Capital Rules as they became effective for the Company on January 1, 2015. For additional information regarding the Basel III Capital Rules, see Business Supervision and Regulation Capital Requirements.

# Asset Quality Allowance 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 terms of the loans, the quality of the collateral for the loans, 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 the Company s and Banks Asset/Liability Management Committees and the Company s Audit Committee, the Board actively reviews critical risk positions, including credit, market, 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 through a systematic process, enabling timely and appropriate action to avoid and mitigate risk.

Credit risk is mitigated through loan portfolio diversification, limiting exposure to any single industry or customer, collateral protection, and prudent 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 (nonaccrual and delinquent 90 days or more), TDRs and loan charge-offs and describes the methodologies used to develop the allowance for credit losses, including the specific, formula and unallocated components (also discussed below). Management believes the policies governing nonperforming loans, TDRs 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. Loans, or portions thereof, are charged off when considered uncollectible by management. Provisions for credit losses are made to bring the allowance for credit losses within the range of balances that are considered appropriate.

TABLE OF CONTENTS

The adequacy of the allowance for credit losses is determined based on 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 current allowance is adequate to provide for probable losses inherent in our loan portfolio; 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 on 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: (i) the specific allowance; (ii) the formula allowance; and (iii) the unallocated allowance. The specific allowance is established against impaired loans until charge offs are made. Loans are considered impaired (i.e., nonaccrual loans and accruing TDRs) when it is probable that the Company will not collect all principal and interest payments according to the loan s contractual terms. 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 unallocated 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 involve deficiencies in the borrower s overall financial condition, payment history, support available from financial guarantors and/or the fair market value of collateral. If it is determined that there is a loss associated with an impaired loan, a specific allowance is established until a charge off is made. Impaired loans, or portions thereof, are charged off when deemed uncollectible.

The formula allowance is used to estimate the loss on internally risk-rated loans, exclusive of those identified as impaired. Loans are grouped by type (construction, residential real estate, commercial real estate, commercial or consumer). Each loan type is assigned allowance factors based on management s estimate of the risk, complexity and size of individual loans within a particular category. Loans that are identified as special mention, substandard and doubtful are adversely rated. These loans are assigned higher allowance factors than favorably rated loans due to management s concerns regarding collectability or management s knowledge of particular elements regarding the borrower.

The unallocated allowance is used to estimate the loss on 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.

Because most of our loans are secured by real estate, the lack of a meaningful upturn in real estate related activities in our local real estate market and construction industry and slow improvement in general economic conditions have had a material adverse effect on the performance of our loan portfolio and the value of the collateral securing that portfolio since 2009. Factors impeding our loan performance and overall financial performance included our levels of loan charge-offs and provisions for credit losses**.** However, with a substantial portion of our credit problems behind us due to the Asset Sale, we have the opportunity to focus on reducing charge-offs as well as improving earnings.

As seen in the table below, the provision for credit losses was $3.4 million for 2014, $27.8 million for 2013 and $27.7 million for 2012. The decrease in the level of provision for credit losses in 2014 was primarily due to a reduction in charge-offs as the result of the improved local economy compared to 2013, which included $19.6 million to replenish the allowance for the charge-off of real estate loans associated with the Asset Sale. Net loan charge-offs totaled $6.4 million in 2014, $33.1 million in 2013 and $26.0 million in 2012. Real estate loans were 65%, 98% and 77% of total loans charged off during 2014, 2013 and 2012, respectively.

TABLE OF CONTENTS

The allowance for credit losses was $7.7 million, or 1.09% of average outstanding loans at December 31, 2014, compared to an allowance of $10.7 million, or 1.40% of average outstanding loans at December 31, 2013. The lower allowance at the end of 2014 when compared to the end of 2013 reflected improved credit in the portfolio, including decreased charge-offs. At December 31, 2012, the allowance for credit losses was $16.0 million, or 1.96% of average outstanding loans. The ratio of net charge-offs to average loans was 0.90% in 2014, 4.32% in 2013 and 3.20% in 2012.

The overall credit quality dramatically improved in 2014 compared to 2013 primarily due to the Asset Sale that occurred at the end of 2013 in which a significant amount of problem loans at Talbot Bank were sold. The improved local economic environment allowed the Company to continue work out efforts on outstanding problem loans, many of which were TDRs and nonperforming assets while at the same time generating positive earnings throughout the entire year of 2014. Management will continue to monitor and charge off nonperforming assets as rapidly as possible, and focus on the generation of healthy loan growth and new business development opportunities.

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

| (Dollars in thousands) | 2014 | 2013 | 2012 | 2011 | 2010 |
|---|---|---|---|---|---|
| Balance, beginning of year | **$10,725** | $15,991 | $14,288 | $14,227 | $10,876 |
| Loans charged off | | | | | |
| Construction | **(725)** | (20,695) | (7,826) | (4,236) | (7,910) |
| Residential real estate | **(2,407)** | (7,163) | (9,838) | (7,693) | (5,818) |
| Commercial real estate | **(1,648)** | (6,162) | (2,954) | (5,037) | (492) |
| Commercial | **(2,389)** | (665) | (5,451) | (3,388) | (3,710) |
| Consumer | **(163)** | (113) | (576) | (202) | (589) |
| Total | **(7,332)** | (34,798) | (26,645) | (20,556) | (18,519) |
| Recoveries | | | | | |
| Construction | **149** | 161 | 6 | 49 | 14 |
| Residential real estate | **376** | 545 | 102 | 120 | 215 |
| Commercial real estate | **58** | 161 | 166 | 361 | 108 |
| Commercial | **341** | 839 | 304 | 549 | 214 |
| Consumer | **28** | 42 | 25 | 68 | 200 |
| Total | **952** | 1,748 | 603 | 1,147 | 751 |
| Net loans charged off | **(6,380)** | (33,050) | (26,042) | (19,409) | (17,768) |
| Provision for credit losses | **3,350** | 27,784 | 27,745 | 19,470 | 21,119 |
| Balance, end of year | **$7,695** | $10,725 | $15,991 | $14,288 | $14,227 |
| Average loans outstanding | **$707,381** | $764,659 | $814,167 | $873,155 | $906,732 |
| Percentage of net charge-offs to average loans outstanding during the year | **0.90%** | 4.32% | 3.20% | 2.22% | 1.96% |
| Percentage of allowance for credit losses at year end to average loans | **1.09%** | 1.40% | 1.96% | 1.64% | 1.57% |

During 2014, there was no significant change in the processes or assumptions affecting the allowance methodology. Included in the balance of the allowance for credit losses were specific reserves of $1.3 million and $783 thousand primarily for real estate loans at the end of 2014 and 2013, respectively. As seen in the table below, the unallocated portion of the allowance for credit losses has historically been a fairly small amount of the total allowance.

TABLE OF CONTENTS

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) | 2014 Amount | 2014 % of Loans | 2013 Amount | 2013 % of Loans | 2012 Amount | 2012 % of Loans | 2011 Amount | 2011 % of Loans | 2010 Amount | 2010 % of Loans |
|---|---|---|---|---|---|---|---|---|---|---|
| Construction | **$1,303** | **16.9 %** | $1,960 | 9.1 % | $4,387 | 13.8 % | $3,745 | 14.3 % | $3,327 | 16.1 % |
| Residential real estate | **2,834** | **36.8** | 3,854 | 38.6 | 5,194 | 36.7 | 5,014 | 38.2 | 4,833 | 37.3 |
| Commercial real estate | **2,379** | **30.9** | 3,029 | 42.8 | 4,134 | 40.1 | 3,415 | 37.5 | 3,665 | 35.6 |
| Commercial | **448** | **5.8** | 1,266 | 8.0 | 1,682 | 7.7 | 1,498 | 8.3 | 1,422 | 9.2 |
| Consumer | **229** | **3.1** | 243 | 1.5 | 407 | 1.7 | 594 | 1.7 | 637 | 1.8 |
| Unallocated | **502** | **6.5** | 373 | | 187 | | 22 | | 343 | |
| Total | **$7,695** | **100.0 %** | $10,725 | 100.0 % | $15,991 | 100.0 % | $14,288 | 100.0 % | $14,227 | 100.0 % |

At December 31, 2014, nonperforming assets, excluding nonaccrual loans held for sale, were $17.2 million, a decrease of $1.4 million, or 7.7%, when compared to December 31, 2013. Similarly, accruing TDRs were $16.7 million at December 31, 2014, a decrease of $9.4 million, or 36.1%, when compared to December 31, 2013. At December 31, 2014, the ratio of nonaccrual loans excluding nonaccrual loans held for sale to total assets was 1.22%, improving from 1.39% at December 31, 2013. Likewise, the ratio of accruing TDRs to total assets at December 31, 2014 was 1.52%, decreasing from 2.47% at December 31, 2013. When comparing December 31, 2014 to December 31, 2013, the positive trend in nonperforming assets and TDRs, as well as the corresponding asset quality ratios, was mainly accomplished with the Asset Sale in 2013 and loan charge-offs.

The Company continues to focus on the resolution of its nonperforming and problem loans. The efforts to accomplish this goal include frequently contacting borrowers until the delinquency is cured or until an acceptable payment plan has been agreed upon; obtaining updated appraisals; provisioning for credit losses; charging off loans; transferring loans to other real estate owned; aggressively marketing other real estate owned; and selling loans. The reduction of nonperforming and problem loans is and will continue to be a high priority for the Company.

The following table summarizes our nonperforming assets and accruing TDRs as of December 31.

| (Dollars in thousands) | 2014 | 2013 | 2012 | 2011 | 2010 |
|---|---|---|---|---|---|
| Nonperforming assets | | | | | |
| Nonaccrual loans excluding nonaccrual loans held for sale ( hfs ) | | | | | |
| Construction | **$6,046** | $3,949 | $9,694 | $15,555 | $17,261 |
| Residential real estate | **4,035** | 5,166 | 11,532 | 20,106 | 9,969 |
| Commercial real estate | **3,121** | 4,671 | 14,567 | 14,012 | 5,133 |
| Commercial | **141** | 792 | 594 | 1,669 | 3,845 |
| Consumer | **123** | 48 | 87 | 28 | 30 |
| Total nonaccrual loans excluding nonaccrual loans hfs | **13,466** | 14,626 | 36,474 | 51,370 | 36,238 |
| Loans 90 days or more past due and still accruing | | | | | |
| Construction | | | | 325 | |
| Residential real estate | **83** | 20 | 290 | 2,331 | 3,454 |
| Commercial real estate | | | 165 | | 986 |
| Commercial | | 250 | | 66 | 174 |
| Consumer | **4** | | 5 | 1 | 88 |

| | | | | | |
|---|---|---|---|---|---|
| Total loans 90 days or more past due and still accruing | **87** | 270 | 460 | 2,723 | 4,702 |

45

TABLE OF CONTENTS

| (Dollars in thousands) | 2014 | | 2013 | | 2012 | | 2011 | | 2010 | |
|---|---|---|---|---|---|---|---|---|---|---|
| Other real estate owned | **3,691** | | 3,779 | | 7,659 | | 9,385 | | 3,702 | |
| Total nonperforming assets excluding nonaccrual loans hfs | **17,245** | | 18,675 | | 44,593 | | 63,478 | | 44,642 | |
| Nonaccrual loans hfs | | | 3,521 | | | | | | | |
| Total nonperforming assets including nonaccrual loans hfs | **$17,245** | | $22,196 | | $44,593 | | $63,478 | | $44,642 | |
| Accruing TDRs | | | | | | | | | | |
| Construction | **$4,022** | | $1,620 | | $27,335 | | $11,781 | | $10,914 | |
| Residential real estate | **6,368** | | 14,582 | | 7,017 | | 3,792 | | 5,367 | |
| Commercial real estate | **6,237** | | 9,791 | | 17,880 | | 9,566 | | 8,147 | |
| Commercial | **47** | | 95 | | 121 | | 69 | | 529 | |
| Consumer | | | | | | | | | | |
| Total accruing TDRs | **$16,674** | | $26,088 | | $52,353 | | $25,208 | | $24,957 | |
| As a percent of total loans: | | | | | | | | | | |
| Nonaccrual loans excluding nonaccrual loans hfs | **1.89** | **%** | 2.05 | % | 4.65 | % | 6.11 | % | 4.05 | % |
| Accruing TDRs | **2.35** | **%** | 3.66 | % | 6.67 | % | 3.00 | % | 2.79 | % |
| Nonaccrual loans and accruing TDRs excluding nonaccrual loans hfs | **4.24** | **%** | 5.71 | % | 11.32 | % | 9.11 | % | 6.84 | % |
| As a percent of total loans and other real estate owned: | | | | | | | | | | |
| Nonperforming assets excluding nonaccrual loans hfs | **2.41** | **%** | 2.61 | % | 5.63 | % | 7.46 | % | 4.97 | % |
| Nonperforming assets and accruing TDRs excluding nonaccrual loans hfs | **4.75** | **%** | 6.25 | % | 12.23 | % | 10.43 | % | 7.74 | % |
| As a percent of total assets: | | | | | | | | | | |
| Nonaccrual loans excluding nonaccrual loans hfs | **1.22** | **%** | 1.39 | % | 3.08 | % | 4.44 | % | 3.21 | % |
| Nonaccrual loans including nonaccrual loans hfs | **1.22** | **%** | 1.72 | % | 3.08 | % | 4.44 | % | 3.21 | % |
| Nonperforming assets excluding nonaccrual loans hfs | **1.57** | **%** | 1.77 | % | 3.76 | % | 5.48 | % | 3.95 | % |
| Nonperforming assets including nonaccrual loans hfs | **1.57** | **%** | 2.11 | % | 3.76 | % | 5.48 | % | 3.95 | % |
| Accruing TDRs | **1.52** | **%** | 2.47 | % | 4.41 | % | 2.18 | % | 2.21 | % |
| Nonperforming assets and accruing TDRs excluding nonaccrual loans hfs | **3.08** | **%** | 4.25 | % | 8.18 | % | 7.66 | % | 6.16 | % |
| Nonperforming assets and accruing TDRs including nonaccrual loans hfs | **3.08** | **%** | 4.58 | % | 8.18 | % | 7.66 | % | 6.16 | % |

# Market Risk Management and Interest Sensitivity

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 results of operations are driven by 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 Company s and 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 asset mix, volume guidelines, and liquidity and capital planning.

TABLE OF CONTENTS

Because we are not exposed to market risk from trading activities and do not use off-balance sheet management strategies, the Asset/Liability Management Committees of the Company and the Banks rely on gap analysis as a 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. During a period of rising interest rates, a negative gap would tend to decrease net interest income, while a positive gap would tend to increase net interest income. During a period of falling interest rates, a negative gap would tend to increase net interest income, while a positive gap would tend to decrease net interest income. At December 31, 2014, as shown in the table below, 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 $188.5 million, or 17.1% of total assets. The negative gap position within the one-year interval at December 31, 2013 totaled $86.2 million, or 8.2% of total assets. The $102.3 million increase in the one-year negative gap for 2014 when compared to 2013 was primarily due to the increase in investment securities of $89.0 million and total deposits of $15.5 million.

The following table summarizes our interest sensitivity at December 31, 2014. Loans, federal funds sold, time deposits and short-term borrowings are classified based on 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.

| cember 31, 2014 | Within 3 Months | 3 Months through 6 Months | 6 Months through 1 Year | 1 Year through 3 Years | 3 Years through 5 Years | After 5 Years | Non-Sensitive Funds | Total |
|---|---|---|---|---|---|---|---|---|
| llars in thousands) | | | | | | | | |
| SETS | | | | | | | | |
| ans, net | $257,821 | $22,189 | $46,321 | $149,447 | $195,268 | $39,700 | $(7,695 ) | $703,051 |
| estment securities | 10,646 | 474 | 12,288 | 77,092 | 115,568 | 24,670 | | 240,738 |
| leral funds sold | 3,552 | | | | | | | 3,552 |
| erest-bearing osits with other ks | 68,460 | | | | | | | 68,460 |
| ner assets | | | | | | | 84,601 | 84,601 |
| al assets | 340,479 | 22,663 | 58,609 | 226,539 | 310,836 | 64,370 | 76,906 | 1,100,402 |
| ABILITIES | | | | | | | | |
| ninterest-bearing nand deposits | | | | | | | 193,814 | 193,814 |
| erest-bearing nand deposits | 190,955 | | | | | | | 190,955 |
| ney market and ings deposits | 232,609 | | | | | | | 232,609 |
| rtificates of deposit, 00,000 or more | 38,141 | 16,081 | 39,097 | 46,354 | 20,245 | | | 159,918 |
| ner time deposits | 23,692 | 20,629 | 44,206 | 55,457 | 27,724 | | | 171,708 |
| ort-term rowings | 4,808 | | | | | | | 4,808 |
| ner liabilities | | | | | | | 6,121 | 6,121 |
| | | | | | | | 140,469 | 140,469 |

| | | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| OCKHOLDERS UITY | | | | | | | | |
| al Liabilities and ckholders Equity | 490,205 | 36,710 | 83,303 | 101,811 | 47,969 | | 340,404 | 1,100,402 |
| cess (deficit) | $(149,726) | $(14,047 ) | $(24,694 ) | $124,728 | $262,867 | $64,370 | $(263,498) | $ |
| mulative excess ficit) | $(149,726) | $(163,773) | $(188,467) | $(63,739 ) | $199,128 | $263,498 | $ | $ |
| mulative excess ficit) as percent of al assets | (13.6 )% | (14.9 )% | (17.1 )% | (5.8 )% | 18.1 % | 23.9 % | % | |

In addition to gap analysis, the Banks use simulation models to quantify the effect a hypothetical immediate plus or minus 100, 200 and 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. Although the GAP table above considers deposits for immediate re-pricing, the model below has incorporated a re-pricing schedule to account for the lag in rate changes based on our experience, as measured by the amount of those deposit rate changes relative to the amount of rate change in assets. In addition, non-maturity deposits (demand deposits in

47

particular), are recognized by the Bank s regulatory agencies to have different sensitivities to interest rate environments. Consequently, the results reflected in the chart below will differ from those reflected in the GAP table where non-maturity deposits are reflected as immediately repricing because the model spreads these deposits over defined time periods in order to capture that sensitivity. The chart below summarizes the forecasted results provided by the simulation model for net interest income and the fair value of capital as of year-end 2014 and 2013. For example, the model projects that compared with net interest income under stable rates, net interest income would increase 0.9% if interest rates increased 100 basis points. Conversely, net interest income would decrease 4.6% if interest rates decreased 100 basis points. 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. Due to the low interest-rate environment, we believe the results of the minus 300 basis point change in rates are not meaningful.

| | Immediate Change in Rates | | | | | |
|---|---|---|---|---|---|---|
| | -300 Basis Points | -200 Basis Points | -100 Basis Points | +100 Basis Points | +200 Basis Points | +300 Basis Points |
| 2014 | | | | | | |
| % Change in Net Interest Income | **N/A** | **(13.3 )%** | **(4.6 )%** | **0.9 %** | **1.9 %** | **2.4 %** |
| % Change in Value of Capital | **N/A** | **3.6 %** | **(0.6 )%** | **7.4 %** | **14.8 %** | **20.7 %** |
| 2013 | | | | | | |
| % Change in Net Interest Income | N/A | (12.1 )% | (4.8 )% | 2.5 % | 4.0 % | 5.1 % |
| % Change in Value of Capital | N/A | (2.3 )% | (5.7 )% | 9.4 % | 18.6 % | 26.4 % |

# 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 22 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 $15.5 million available in

48

TABLE OF CONTENTS

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 FHLB, which provides another source of liquidity, and had credit availability of approximately $70.9 million from the FHLB as of December 31, 2014.

At December 31, 2014, our loan to deposit ratio was approximately 74.9%, which represents a more liquid position than the 76.3% at year-end 2013. Investment securities available for sale totaling $236.1 million at the end of 2014 were available for the management of liquidity and interest rate risk. The comparable amount was $147.1 million at December 31, 2013. Cash and cash equivalents were $96.2 million at December 31, 2014, a decline of $34.9 million, or 26.6%, compared to the $131.1 million at year-end 2013, which reflects management s efforts to reduce excess liquidity by investing in mortgage-backed securities. 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 following table presents significant fixed and determinable contractual obligations to third parties by payment date as of December 31, 2014.

| (Dollars in thousands) | Within one year | One to three years | Three to five years | Over five years | Total |
|---|---|---|---|---|---|
| Operating leases | $ 625 | $ 826 | $ 658 | $ 889 | $ 2,998 |
| Purchase obligations | 3,134 | 5,147 | 3,495 | 1,503 | 13,279 |
| Total | $ 3,759 | $ 5,973 | $ 4,153 | $ 2,392 | $ 16,277 |

## 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 annual report under the caption Market Risk Management and Interest Sensitivity , which is incorporated herein by reference.

## Item 8. Financial Statements and Supplementary Data.

# INDEX TO CONSOLIDATED FINANCIAL STATEMENTS


| | |
|---|---|
| Management s Report on Internal Control over Financial Reporting | 50 |
| Report of Independent Registered Public Accounting Firm | 51 |
| Consolidated Balance Sheets | 53 |
| Consolidated Statements of Operations | 54 |
| Consolidated Statements of Comprehensive Income (loss) | 55 |
| Consolidated Statements of Changes in Stockholders Equity | 56 |
| Consolidated Statements of Cash Flows | 57 |
| Notes to Consolidated Financial Statements | 59 |

TABLE OF CONTENTS

# 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, 2014 based upon criteria set forth in Internal Control Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (1992 COSO Framework).

Based on this assessment and on the foregoing criteria, management has concluded that, as of December 31, 2014, 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 13, 2015

| | |
|---|---|
| /s/ Lloyd L. Beatty, Jr. | /s/ George S. Rapp |
| Lloyd L. Beatty, Jr.<br>President and Chief Executive Officer<br>(Principal Executive Officer) | George S. Rapp<br>Vice President and Chief Financial Officer<br>(Principal Financial Officer) |

50

TABLE OF CONTENTS

# 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, 2014 and 2013, and the consolidated statements of operations, comprehensive loss, changes in stockholders equity and cash flows for each of the years in the three-year period ended December 31, 2014. We also have audited the Company s internal control over financial reporting as of December 31, 2014, based on criteria established in *Internal Control Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (1992 COSO Framework). 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.

TABLE OF CONTENTS

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, 2014 and 2013, and the results of its operations and its cash flows for each of the years in the three-year period ended December 31, 2014 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, 2014, based on criteria established in *Internal Control Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (1992 COSO Framework).

Baltimore, Maryland
March 13, 2015

TABLE OF CONTENTS

# SHORE BANCSHARES, INC.

# CONSOLIDATED BALANCE SHEETS
# December 31,

| (In thousands, except share data) | 2014 | 2013 |
|---|---|---|
| ASSETS | | |
| Cash and due from banks | **$24,211** | $21,238 |
| Interest-bearing deposits with other banks | **68,460** | 109,384 |
| Federal funds sold | **3,552** | 468 |
| Investment securities: | | |
| Available for sale, at fair value | **236,108** | 147,101 |
| Held to maturity, at amortized cost fair value of $4,694 (2014) and $5,062 (2013) | **4,630** | 5,185 |
| Loans held for sale | | 3,521 |
| Loans | **710,746** | 711,919 |
| Less: allowance for credit losses | **(7,695)** | (10,725) |
| Loans, net | **703,051** | 701,194 |
| Premises and equipment, net | **16,275** | 15,198 |
| Goodwill | **11,931** | 12,454 |
| Other intangible assets, net | **1,331** | 3,520 |
| Other real estate owned, net | **3,691** | 3,779 |
| Other assets | **27,162** | 31,082 |
| Total assets | **$1,100,402** | $1,054,124 |
| LIABILITIES | | |
| Deposits: | | |
| Noninterest-bearing | **$193,814** | $172,797 |
| Interest-bearing | **755,190** | 760,671 |
| Total deposits | **949,004** | 933,468 |
| Short-term borrowings | **4,808** | 10,140 |
| Other liabilities | **6,121** | 7,217 |
| Total liabilities | **959,933** | 950,825 |
| STOCKHOLDERS EQUITY | | |
| Common stock, par value $.01, authorized 35,000,000 shares; shares issued and outstanding 12,618,513 (2014) and 8,471,289 (2013) | **126** | 85 |
| Additional paid in capital | **63,532** | 32,207 |
| Retained earnings | **76,495** | 71,444 |
| Accumulated other comprehensive income (loss) | **316** | (437) |
| Total stockholders equity | **140,469** | 103,299 |
| Total liabilities and stockholders equity | **$1,100,402** | $1,054,124 |

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

53

TABLE OF CONTENTS

# SHORE BANCSHARES, INC.

# CONSOLIDATED STATEMENTS OF OPERATIONS For the Years Ended December 31,

| (Dollars in thousands, except per share data) | 2014 | 2013 | 2012 |
|---|---|---|---|
| INTEREST INCOME | | | |
| Interest and fees on loans | **$ 35,140** | $ 39,058 | $ 42,698 |
| Interest and dividends on investment securities: | | | |
| Taxable | **2,957** | 2,072 | 2,815 |
| Tax-exempt | **12** | 17 | 104 |
| Interest on federal funds sold | **1** | 4 | 10 |
| Interest on deposits with other banks | **179** | 200 | 274 |
| Total interest income | **38,289** | 41,351 | 45,901 |
| INTEREST EXPENSE | | | |
| Interest on deposits | **4,229** | 6,448 | 10,501 |
| Interest on short-term borrowings | **18** | 27 | 45 |
| Interest on long-term debt | | | 16 |
| Total interest expense | **4,247** | 6,475 | 10,562 |
| NET INTEREST INCOME | **34,042** | 34,876 | 35,339 |
| Provision for credit losses | **3,350** | 27,784 | 27,745 |
| NET INTEREST INCOME AFTER PROVISION FOR CREDIT LOSSES | **30,692** | 7,092 | 7,594 |
| NONINTEREST INCOME | | | |
| Service charges on deposit accounts | **2,407** | 2,371 | 2,551 |
| Trust and investment fee income | **1,860** | 1,613 | 1,644 |
| Gains on sales of investment securities | **23** | 913 | 278 |
| Insurance agency commissions income | **9,525** | 10,647 | 9,814 |
| Loss on termination of cash flow hedge | | (1,306 ) | (1,339 ) |
| Other noninterest income | **2,966** | 3,221 | 2,810 |
| Total noninterest income | **16,781** | 17,459 | 15,758 |
| NONINTEREST EXPENSE | | | |
| Salaries and wages | **17,600** | 17,346 | 17,418 |
| Employee benefits | **4,092** | 4,094 | 3,994 |
| Occupancy expense | **2,339** | 2,344 | 2,559 |
| Furniture and equipment expense | **975** | 1,020 | 963 |
| Data processing | **3,006** | 2,900 | 2,717 |
| Directors fees | **474** | 354 | 474 |
| Amortization of other intangible assets | **201** | 296 | 392 |
| Insurance agency commissions expense | **906** | 1,798 | 1,391 |
| FDIC insurance premium expense | **1,636** | 1,813 | 1,380 |
| Write-downs of other real estate owned | **658** | 1,318 | 1,328 |
| Other noninterest expenses | **7,474** | 7,403 | 6,939 |

| | | | |
|---|---|---|---|
| Total noninterest expense | **39,361** | 40,686 | 39,555 |
| INCOME (LOSS) BEFORE INCOME TAXES | **8,112** | (16,135 ) | (16,203 ) |
| Income tax expense (benefit) | **3,061** | (6,501 ) | (6,565 ) |
| NET INCOME (LOSS) | **$ 5,051** | $ (9,634 ) | $ (9,638 ) |
| Basic income (loss) per common share | **$ 0.46** | $ (1.14 ) | $ (1.14 ) |
| Diluted income (loss) per common share | **$ 0.46** | $ (1.14 ) | $ (1.14 ) |
| Cash dividends paid per common share | **$** | $ | $ 0.01 |

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

TABLE OF CONTENTS

# SHORE BANCSHARES, INC.

# CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (LOSS)
# For the Years Ending December 31,

| (Dollars in thousands) | 2014 | 2013 | 2012 |
|---|---|---|---|
| Net income (loss) | **$ 5,051** | $ (9,634 ) | $ (9,638 ) |
| Other comprehensive income (loss) | | | |
| Securities available for sale: | | | |
| Unrealized holding gains (losses) on available-for-sale securities | **1,285** | (2,995 ) | 1,155 |
| Tax effect | **(518 )** | 1,209 | (465 ) |
| Reclassification of gains recognized in net income (loss) | **(23 )** | (913 ) | (278 ) |
| Tax effect | **9** | 368 | 112 |
| Net of tax amount | **753** | (2,331 ) | 524 |
| Cash flow hedging activities: | | | |
| Unrealized holding gains on cash flow hedging activities | | 681 | 1,801 |
| Tax effect | | (274 ) | (727 ) |
| Reclassification of losses recognized in net loss | | 1,306 | 1,339 |
| Tax effect | | (527 ) | (540 ) |
| Net of tax amount | | 1,186 | 1,873 |
| Total other comprehensive income (loss) | **753** | (1,145 ) | 2,397 |
| Comprehensive income (loss) | **$ 5,804** | $ (10,779 ) | $ (7,241 ) |

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

TABLE OF CONTENTS

# SHORE BANCSHARES, INC.

# CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS EQUITY For the Years Ended December 31, 2014, 2013, and 2012

| (Dollars in thousands, except per share data) | Common Stock | Warrant | Additional Paid In Capital | Retained Earnings | Accumulated Other Comprehensive Income (Loss) | Total Stockholders Equity |
|---|---|---|---|---|---|---|
| Balances, January 1, 2012 | $ 85 | $ | $ 32,052 | $ 90,801 | $ (1,689 ) | $ 121,249 |
| Net loss | | | | (9,638 ) | | (9,638 ) |
| Unrealized gains on available-for-sale securities, net of reclassification adjustment, net of taxes | | | | | 524 | 524 |
| Unrealized losses on cash flow hedging activities, net of reclassification adjustment, net of taxes | | | | | 1,873 | 1,873 |
| Stock-based compensation | | | 103 | | | 103 |
| Cash dividends paid ($0.01 per share) | | | | (85 ) | | (85 ) |
| Balances, December 31, 2012 | 85 | | 32,155 | 81,078 | 708 | 114,026 |
| Net loss | | | | (9,634 ) | | (9,634 ) |
| Unrealized gains on available-for-sale securities, net of reclassification adjustment, net of taxes | | | | | (2,331 ) | (2,331 ) |
| Unrealized gains on cash flow hedging activities, net of reclassification adjustment, net of taxes | | | | | 1,186 | 1,186 |
| Stock-based compensation | | | 52 | | | 52 |
| Balances, December 31, 2013 | 85 | | 32,207 | 71,444 | (437 ) | 103,299 |
| Net income | | | | 5,051 | | 5,051 |
| Unrealized losses on available-for-sale securities, net of reclassification adjustment, net of taxes | | | | | 753 | 753 |
| Issuance of common stock through public offering, net | 41 | | 31,238 | | | 31,279 |
| Stock-based compensation | | | 87 | | | 87 |
| Balances, December 31, 2014 | **$ 126** | **$** | **$ 63,532** | **$ 76,495** | **$ 316** | **$ 140,469** |

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

TABLE OF CONTENTS

# SHORE BANCSHARES, INC.

# CONSOLIDATED STATEMENTS OF CASH FLOWS For the Years Ended December 31,

| (Dollars in thousands) | 2014 | 2013 | 2012 |
|---|---|---|---|
| CASH FLOWS FROM OPERATING ACTIVITIES: | | | |
| Net income (loss) | **$5,051** | $(9,634) | $(9,638) |
| Adjustments to reconcile net loss to net cash provided by operating activities: | | | |
| Provision for credit losses | **3,350** | 27,784 | 27,745 |
| Depreciation and amortization | **2,312** | 2,392 | 2,648 |
| Discount accretion on debt securities | **(60)** | (43) | (70) |
| Stock-based compensation expense | **87** | 78 | 209 |
| Excess tax benefit from stock-based arrangements | | (26) | (106) |
| Deferred income tax expense (benefit) | **2,836** | (6,132) | (4,768) |
| Gains on sales of investment securities | **(23)** | (913) | (278) |
| Losses (gains) on disposals of premises and equipment | **82** | | (192) |
| Losses on sales and write-downs of other real estate owned | **687** | 1,669 | 2,015 |
| Gain on sale of wholesale insurance subsidiary | **(114)** | | |
| Loss on termination of cash flow hedge | | 1,306 | 1,339 |
| Net changes in: | | | |
| Accrued interest receivable | **(102)** | 235 | 1,137 |
| Other assets | **170** | 4,703 | 1,351 |
| Accrued interest payable | **(53)** | (114) | (230) |
| Other liabilities | **(1,044)** | (1,458) | 224 |
| Net cash provided by operating activities | **13,179** | 19,847 | 21,386 |
| CASH FLOWS FROM INVESTING ACTIVITIES: | | | |
| Proceeds from maturities and principal payments of investment securities available for sale | **43,418** | 38,512 | 47,854 |
| Proceeds from sales of investment securities available for sale | **988** | 40,351 | 6,275 |
| Proceeds from sales of investment securities held to maturity | **113** | | |
| Purchases of investment securities available for sale | **(133,006)** | (87,243) | (69,491) |
| Proceeds from maturities and principal payments of investment securities held to maturity | **443** | 439 | 3,810 |
| Net change in loans | **(3,982)** | 12,957 | 23,896 |
| Proceeds from sale of loans | | 20,565 | |
| Purchases of premises and equipment | **(2,077)** | (545) | (2,202) |
| Proceeds from sales of premises and equipment | | 4 | 317 |
| Proceeds from sales of other real estate owned | **1,697** | 5,325 | 5,742 |
| Proceeds from sale of subsidiary | **2,878** | | |
| Return of investment (investment in) unconsolidated subsidiary | | 85 | |

| | | | |
|---|---|---|---|
| Net cash (used in) provided by investing activities | **(89,528)** | 30,450 | 16,201 |
| CASH FLOWS FROM FINANCING ACTIVITIES: | | | |
| Net changes in: | | | |
| Noninterest-bearing deposits | **21,017** | 18,805 | 20,191 |
| Interest-bearing deposits | **(5,482)** | (134,610) | 19,163 |
| Short-term borrowings | **(5,332)** | (3,621) | (4,056) |
| Proceeds from issuance of common stock | **31,279** | | |
| Excess tax benefit from stock-based arrangements | | 26 | 106 |
| Repayment of long-term debt | | | (455) |
| Common stock dividends paid | | | (85) |
| Net cash provided by (used in) financing activities | **41,482** | (119,400) | 34,864 |

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

TABLE OF CONTENTS

# SHORE BANCSHARES, INC.

# CONSOLIDATED STATEMENTS OF CASH FLOWS (continued)
# For the Years Ended December 31,

| (Dollars in thousands) | 2014 | 2013 | 2012 |
|---|---|---|---|
| NET (DECREASE) INCREASE IN CASH AND CASH EQUIVALENTS | **(34,867 )** | (69,103 ) | 72,451 |
| CASH AND CASH EQUIVALENTS AT BEGINNING OF YEAR | **131,090** | 200,193 | 127,742 |
| CASH AND CASH EQUIVALENTS AT END OF YEAR | **$96,223** | $131,090 | $200,193 |
| Supplemental cash flow information: | | | |
| Interest paid | **$4,300** | $6,589 | $10,792 |
| Income taxes paid | **$243** | $265 | $163 |
| Transfers from loans to other real estate owned | **$2,295** | $3,071 | $6,031 |
| Transfers from loans to loans held for sale | **$** | $23,635 | $ |
| Transfers from loans held for sale to loans | **$3,521** | $ | $ |

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

TABLE OF CONTENTS

# SHORE BANCSHARES, INC.

# NOTES TO CONSOLIDATED FINANCIAL STATEMENTS For the Years Ended December 31, 2014, 2013, and 2012

## 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 ( GAAP ). 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 engages in the banking business through CNB, a Maryland commercial bank with trust powers, and The Talbot Bank of Easton, Maryland, a Maryland commercial bank ( Talbot Bank ). Through December 31, 2010, the Company also engaged in the banking business through The Felton Bank, a Delaware commercial bank ( Felton Bank and, together with CNB and Talbot Bank, the Banks ), which was merged into CNB on January 1, 2011. The Company s primary source of revenue is interest earned on commercial, real estate and consumer loans made to customers located on the Delmarva Peninsula. 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; a insurance premium finance company, Mubell Finance, LLC, a Maryland limited liability company (all of the foregoing insurance entities are collectively referred to as the Insurance Subsidiaries ).

### Use of Estimates

The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and the 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 Company s current 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 prices. They represent those securities which management may sell as part of its asset/liability management 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 downgrade of the security by a rating agency, a significant deterioration in the financial condition of the issuer, or a determination that management has the intent to sell the security or will be required to sell the security before recovery of its amortized cost.

TABLE OF CONTENTS

# SHORE BANCSHARES, INC.

# NOTES TO CONSOLIDATED FINANCIAL STATEMENTS For the Years Ended December 31, 2014, 2013, and 2012

## NOTE 1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)

### 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 downgrade of the security by a rating agency, a significant deterioration in the financial condition of the issuer, or a determination that management has the intent to sell the security or will be required to sell the security before recovery of its amortized cost.

### 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 (i.e., interest income is no longer accrued) when it is specifically determined to be impaired or when principal or interest is delinquent for 90 days or more, unless the loan is well secured and in the process of collection. Any unpaid interest previously accrued on those loans is reversed from income. Interest payments received on nonaccrual loans are applied as a reduction of the loan principal balance unless collectability of the principal amount is reasonably assured, in which case interest is recognized on a cash basis. Loans are returned to accrual status when all principal and interest amounts contractually due are brought current and future payments are reasonably assured.

A loan is considered impaired if it is probable that the Company will not collect all principal and interest payments according to the loan s contractual terms. An impaired loan may show deficiencies in the borrower s overall financial condition, payment history, support available from financial guarantors and/or the fair market value of collateral. The impairment of a loan is measured at the present value of expected future cash flows using the loan s effective interest rate, or at the loan s observable market price or the fair value of the collateral if the loan is collateral dependent. Generally, the Company measures impairment on such loans by reference to the fair value of the collateral. Once the amount of impairment has been determined, the uncollectible portion is charged off. Income on impaired loans is recognized on a cash basis, and payments are first applied against the principal balance outstanding (i.e., placing impaired loans on nonaccrual status). Generally, interest income is not recognized on impaired loans unless the

likelihood of further loss is remote. The allowance for credit losses may include specific reserves related to impaired loans. Specific reserves remain until charge offs are made. 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 on historical loss ratios and are included in the formula portion of the allowance for credit losses. See additional discussion below under the section, Allowance for Credit Losses .

A loan is considered a troubled debt restructuring ( TDR ) if a borrower is experiencing financial difficulties and a creditor has granted a concession. Concessions may include interest rate reductions or below market interest rates, principal forgiveness, restructuring amortization schedules and other actions intended to minimize potential losses. Loans are identified to be restructured when signs of impairment arise such as borrower interest rate reduction request, slowness to pay, or when an inability to repay becomes evident. The terms being offered are evaluated to determine if they are more liberal than those that would be indicated by policy or industry standards for similar, untroubled credits. In those situations where the terms or the interest rates are considered to be more favorable than industry standards or the current underwriting guidelines of the Company s banking subsidiaries, the loan is classified as a TDR. All loans designated as TDRs are considered

# SHORE BANCSHARES, INC.

# NOTES TO CONSOLIDATED FINANCIAL STATEMENTS For the Years Ended December 31, 2014, 2013, and 2012

## NOTE 1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)

impaired loans and may be on either accrual or nonaccrual status. In instances where the loan has been placed on nonaccrual status, six consecutive months of timely payments are required prior to returning the loan to accrual status.

All loans classified as TDRs which are restructured and accrue interest under revised terms require a full and comprehensive review of the borrower s financial condition, capacity for repayment, realistic assessment of collateral values, and the assessment of risk entered into any workout agreement. Current financial information on the borrower, guarantor, and underlying collateral is analyzed to determine if it supports the ultimate collection of principal and interest. For commercial loans, the cash flows are analyzed, both for the underlying project and globally. For consumer loans, updated salary, credit history and cash flow information is obtained. Current market conditions are also considered. Following a full analysis, the determination of the appropriate loan structure is made. The Company does not participate in any specific government or Company sponsored loan modification programs. All TDR loan agreements are contracts negotiated with each of the borrowers.

On October 28, 2013, Talbot Bank entered into agreements to sell assets with an aggregate book value of $45.0 million for a price of $25.2 million. The assets consisted of $11.1 million of nonaccrual loans, $30.4 million of accruing TDRs, $1.8 million of adversely classified performing loans and $1.7 million of other real estate owned. The execution of these agreements was consummated in the fourth quarter of 2013.

## 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. Loans, or portions thereof, that are considered uncollectible 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) Accounting Standards Codification ( ASC ) Topic 450, Contingencies , which requires that losses be accrued when they are probable of occurring and estimable; and (ii) ASC Topic 310, Receivables, which requires that losses be accrued based on the differences between the loan balance and the value of collateral, present value of future cash flows or values that are observable in the secondary market. Management uses many factors to estimate the inherent loss that may be present in our loan portfolio, including economic conditions and trends, the value and adequacy of collateral, the volume and mix of the loan portfolio, and our internal loan processes. Actual losses could differ significantly from management s estimates. In addition, GAAP itself may change from one previously acceptable method to another. Although the economics of transactions would be the same, the timing of events that would impact the transactions could change.

# SHORE BANCSHARES, INC.

# NOTES TO CONSOLIDATED FINANCIAL STATEMENTS For the Years Ended December 31, 2014, 2013, and 2012

## NOTE 1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)

The allowance for credit losses is comprised of three parts: (i) the specific allowance; (ii) the formula allowance; and (iii) the unallocated allowance. The specific allowance is established against impaired loans (i.e., nonaccrual loans and accruing TDRs) until charge offs are made. The formula allowance, described below, 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 unallocated allowance captures losses that have impacted the portfolio but have yet to be recognized in either the specific or formula allowance.

The formula allowance is used to estimate the loss on internally risk-rated loans, exclusive of those identified as impaired. Loans are grouped by type (construction, residential real estate, commercial real estate, commercial or consumer). Each loan type is assigned allowance factors based on management s estimate of the risk, complexity and size of individual loans within a particular category. Loans that are identified as special mention, substandard and doubtful are adversely rated. These loans are assigned higher allowance factors than favorably rated loans due to management s concerns regarding collectability or management s knowledge of particular elements regarding the borrower. A special mention loan has potential weaknesses that could result in a future loss to the Company if the weaknesses are realized. A substandard loan has certain deficiencies that could result in a future loss to the Company if these deficiencies are not corrected. A doubtful loan has enough risk that there is a high probability that the Company will sustain a loss.

## 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 10 years for furniture, fixtures and equipment; three to five years for computer hardware and data handling equipment; and 10 to 40 years for buildings and building improvements. Land improvements are amortized over a period of 15 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. Goodwill and other intangible assets with indefinite lives are tested at least annually for impairment, usually during the third quarter, or on an interim basis if circumstances dictate. Intangible assets that have finite lives are amortized over their estimated useful lives and also are subject to impairment testing. The Company s other intangible assets that have finite lives are amortized on a straight-line basis over varying periods not exceeding 21 years.

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

# SHORE BANCSHARES, INC.

# NOTES TO CONSOLIDATED FINANCIAL STATEMENTS For the Years Ended December 31, 2014, 2013, and 2012

## NOTE 1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)

During the third quarter of 2014 and 2013, goodwill and other intangible assets were subjected to the annual assessment for impairment. As a result of the assessment, it was determined that it was not more likely than not that the fair values of the Company s reporting units were less than their carrying amounts so no impairment was recorded.

## 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 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.

## Income Taxes

Shore Bancshares, Inc. and its subsidiaries file a consolidated federal income tax return. The Company accounts for income taxes using the liability method in accordance with required accounting guidance. Under this method, deferred tax assets and liabilities are determined by applying the applicable federal and state income tax rates to 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 result from 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. A valuation allowance, if needed, reduces deferred tax assets to the expected amount most likely to be realized. Realization of deferred tax assets is dependent on the generation of a sufficient level of future taxable income, recoverable taxes paid in prior years and tax planning strategies.

The Company recognizes accrued interest and penalties as a component of tax expense. The Company does not have any uncertain tax positions and did not recognize any adjustments for unrecognized tax benefits. The Company remains subject to examination for income tax returns ending after December 31, 2011.

## Basic and Diluted Earnings Per Common Share

Basic earnings (loss) per share is calculated by dividing net income (loss) 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 (loss) per share is calculated by dividing net income (loss) by the weighted-average number of shares outstanding, adjusted for the effect of any potentially dilutive common stock equivalents. There is no dilutive effect on the loss per share during loss periods.

TABLE OF CONTENTS

# SHORE BANCSHARES, INC.

# NOTES TO CONSOLIDATED FINANCIAL STATEMENTS For the Years Ended December 31, 2014, 2013, and 2012

## NOTE 1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)

### 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 (i) the assets have been isolated from the Company, (ii) 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 (iii) 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

Accounting guidance for stock-based compensation requires that expense relating to such transactions be recognized as compensation cost in the income statement. Stock-based compensation expense is recognized ratably over the requisite service period for all awards and is based on the grant date fair value. See Note 12 for a further discussion.

### Derivative Instruments and Hedging Activities

Under accounting guidance for derivative instruments and hedging activities, all derivatives are recorded as other assets or other liabilities on the balance sheet at their respective fair values. When the purpose of a derivative is to hedge the variability of a floating rate asset or liability, the derivative is considered a cash flow hedge. To account for the effective portion of a cash flow hedge, unrealized gains and losses due to changes in the fair value of the derivative designated as a cash flow hedge are recorded in other comprehensive income. Ineffectiveness resulting from differences between the cash flows of the hedged item and changes in fair value of the derivative is recognized as other noninterest income. The net interest settlement on a derivative designated as a cash flow hedge is treated as an adjustment of the interest income or interest expense of the hedged asset or liability.

## Fair Value

The Company measures certain financial assets and liabilities at fair value. Significant financial instruments measured at fair value on a recurring basis are investment securities and interest rate caps. Impaired loans and other real estate owned are significant financial instruments measured at fair value on a nonrecurring basis. See Note 20 for a further discussion of fair value.

## Advertising Costs

Advertising costs are generally expensed as incurred. The Company incurred advertising costs of approximately $428 thousand, $848 thousand and $338 thousand for the years ended December 31, 2014, 2013 and 2012, respectively.

## Subsequent Events

The Company has evaluated the accompanying consolidated financial statements for subsequent events and transactions through the date of the auditor s report, which is the date these financial statements were available for issue, and have determined the no material subsequent events have occurred that would affect the information presented in the accompanying consolidated financial statements or require additional disclosure.

TABLE OF CONTENTS

# SHORE BANCSHARES, INC.

# NOTES TO CONSOLIDATED FINANCIAL STATEMENTS For the Years Ended December 31, 2014, 2013, and 2012

## NOTE 1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)

## Recent Accounting Standards

*ASU 2013-04, Liabilities (ASC Topic 405) Obligations Resulting from Joint and Several Liability Arrangements for Which the Total Amount of the Obligation Is Fixed at the Reporting Date.* ASU 2013-04 provides guidance for the recognition, measurement and disclosure of obligations resulting from joint and several liability arrangements for which the total amount of the obligation is fixed at the reporting date. This guidance requires an entity to measure the obligation as the sum of the amount the reporting entity agreed to pay on the basis of its arrangement among its co-obligors, and any additional amount the reporting entity expects to pay on behalf of its co-obligors. This guidance also requires an entity to disclose the nature and amount of the obligation as well as other information about those obligations. ASU 2013-04 was effective for the Company beginning January 1, 2014 and did not have a significant impact on the Company s financial statements.

*ASU 2014-04, Receivables (ASC Topic 310) Troubled Debt Restructurings by Creditors, Reclassification of Residential Real Estate Collateralized Consumer Mortgage Loans upon Foreclosure.* ASU 2014-04 clarifies when an in substance repossession or foreclosure occurs which is defined as when a creditor should be considered to have received physical possession of residential real estate property collateralizing a consumer mortgage loan such that the loan receivable should be derecognized and the real estate property recognized. The ASU requires that the real property be recognized upon obtaining legal title to the real estate collateral, or the borrower voluntarily conveying all interest in the real estate property to the lender to satisfy the loan through a deed in lieu of foreclosure or similar legal agreement. ASU 2014-04 is effective for the Company for interim and annual periods beginning after December 15, 2014 and is not expected to have a significant impact on the Company s financial statements.

*Accounting Standards Update ( ASU ) 2014-14, Receivables Troubled Debt Restructurings by Creditors (Accounting Standards Codification ( ASC ) Subtopic 310-40) Classification of Certain Government-Guaranteed Mortgage Loans upon Foreclosure.* ASU 2014-14 the Financial Accounting Standards Board ( FASB ) issued an amendment to clarify how creditors are to classify certain government-guaranteed mortgage loans upon foreclosure. This amendment requires that a mortgage loan be derecognized and a separate other receivable be recognized upon foreclosure if the following conditions are met: (1) The loan has a government guarantee that is not separate from the loan before foreclosure and (2) at the time of foreclosure, the creditor has the intent to convey the real estate property to the guarantor and make a claim on the guarantee, and the creditor has the ability to recover under the claim and (3) at the time of foreclosure, any amount of the claim that is determined on the basis of the fair value of the real estate is fixed. Upon foreclosure, the separate other receivable should be measured based on the amount of the loan balance (principal and interest) expected to be recovered from the guarantor. This amendment is effective for annual reporting

periods, including interim periods within those annual periods, beginning after December 15, 2014. Early adoption is permitted. Entities may apply the amendments in this Update either (a) prospectively to foreclosures that occur after the date of adoption or (b) modified retrospective transition using a cumulative-effect adjustment (through a reclassification to a separate other receivable) as of the beginning of the annual period of adoption. Prior periods should not be adjusted. The Company intends to adopt the accounting standard during the first quarter of 2015, as required, and is currently evaluating the impact on its results of operations, financial position, and liquidity.

*ASU 2014-09, Revenue from Contracts with Customers (Topic 606)* ASU 2014-09 amendment requires entities to recognize revenue to depict the transfer of promised goods or services to customers in amounts that reflect the consideration to which the entity expects to be entitled in exchange for those goods or services. ASU 2014-09 is effective for periods beginning after January 1, 2017. The Company is evaluating the impact that the adoption of this amendment will have on our consolidated financial statements.

65

TABLE OF CONTENTS

# SHORE BANCSHARES, INC.

# NOTES TO CONSOLIDATED FINANCIAL STATEMENTS For the Years Ended December 31, 2014, 2013, and 2012

## NOTE 1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)

## Regulatory Enforcement Actions

Talbot Bank entered into a Stipulation and Consent to the Issuance of a Consent Order (the Consent Agreement ) with the Federal Deposit Insurance Corporation ( FDIC ), a Stipulation and Consent to the Issuance of a Consent Order (the Maryland Consent Agreement and together with the Consent Agreement, the Consent Agreements ) with the Maryland Commissioner of Financial Regulation (the Commissioner ) and an Acknowledgement of Adoption of the Order by the Commissioner (the Acknowledgement ). The FDIC and the Commissioner issued the related Consent Order (the Order ), effective May 24, 2013. The description of the Consent Agreements, the Order and the Acknowledgement along with Talbot Bank s progress with the requirements, are set forth below.

***Management.*** Talbot Bank is required to have and retain experienced, qualified management, and to assess management s ability to (1) comply with the requirements of the Order; (2) operate Talbot Bank in a safe and sound manner; (3) comply with all applicable laws, rules and regulations; and (4) restore all aspects of Talbot Bank to a safe and sound condition, including capital adequacy, asset quality, and management effectiveness. Talbot Bank has implemented certain changes to comply with the Order which include expanding our credit administration and loan workout units with the addition of experienced new staff members, in an effort to accelerate the resolution of our credit issues and position Talbot Bank for future growth. Additionally, Talbot Bank has appointed a chief financial officer.

***Board Participation.*** Talbot Bank s board of directors is required to increase its participation in the affairs of Talbot Bank, assuming full responsibility for the approval of sound policies and objectives and for the supervision of all Talbot Bank activities, including comprehensive, documented meetings to be held no less frequently than monthly. The board of directors must also develop a program to monitor Talbot Bank s compliance with the Order. Talbot Bank has completed a plan to increase the participation of its board of directors which includes increasing the frequency of board meetings from monthly to biweekly and establishing a risk management committee of the board which is responsible for monitoring Talbot Bank s compliance with the Order.

***Loss Charge-Offs.*** The Order requires that Talbot Bank eliminate from its books, by charge-off or collection, all assets or portions of assets classified Loss by the FDIC or the Commissioner. Talbot Bank has eliminated from its books all such classified assets.

***Classified Assets Reduction.*** Within 60 days of the effective date of the Order, Talbot Bank was required to submit a Classified Asset Plan to the FDIC and the Commissioner to reduce the risk position in each asset in excess of

$750,000 which was classified Substandard and Doubtful by the FDIC or the Commissioner. Talbot Bank revised its existing Classified Asset Plan to address the terms of the Order and submitted the updated plan to the FDIC and the Commissioner in accordance with the Order.

***Allowance for Loan and Lease Losses.*** Within 60 days of the effective date of the Order, the board of directors was required to review the adequacy of the allowance for loan and lease losses (the ALLL ), establish a policy for determining the adequacy of the ALLL and submit such ALLL policy to the FDIC and the Commissioner. Talbot Bank amended its ALLL policy to comply with the terms of the Order and submitted the updated policy to the FDIC and the Commissioner in accordance with the Order.

***Loan Policy.*** Within 60 days from the effective date of the Order, Talbot Bank was required to (i) review its loan policies and procedures ( Loan Policy ) for adequacy, (ii) make all appropriate revisions to the Loan Policy to address the lending deficiencies identified by the FDIC, and (iii) submit the Loan Policy to the FDIC and the Commissioner. Talbot Bank completed its review of and made the required revisions to the Loan Policy. The updated Loan Policy was submitted to the FDIC and the Commissioner in accordance with the terms of the Order.

TABLE OF CONTENTS

# SHORE BANCSHARES, INC.

# NOTES TO CONSOLIDATED FINANCIAL STATEMENTS For the Years Ended December 31, 2014, 2013, and 2012

## NOTE 1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)

***Loan Review Program.*** Within 30 days from the effective date of the Order, the Board was required to establish a program of independent loan review that will provide for a periodic review of Talbot Bank s loan portfolio and the identification and categorization of problem credits (the Loan Review Program ) and submit the Loan Review Program to the FDIC and the Commissioner. Talbot Bank enhanced its existing Loan Review Program and submitted it to the FDIC and the Commissioner in accordance with the terms of the Order.

***Capital Requirements.*** Within 90 days from the effective date of the Order, Talbot Bank must meet and maintain the following minimum capital levels, after establishing an appropriate ALLL, (i) a leverage ratio (the ratio of Tier 1 capital to total assets) of at least 8%, and (ii) a total risk-based capital ratio (the ratio of qualifying total capital to risk-weighted assets) of at least 12%. As of December 31, 2014, the leverage ratio and total risk-based capital ratio were 8.91% and 14.16%, respectively, for Talbot Bank, which exceeded the Order s minimum capital requirements.

***Profit and Budget Plan.*** Within 60 days from the effective date of the Order and within 30 days of each calendar year-end thereafter, Talbot Bank was and will be required to submit a profit and budget plan to the FDIC and the Commissioner consisting of goals and strategies, consistent with sound banking practices, and taking into account Talbot Bank s other plans, policies or other actions required by the Order. In accordance with the Order, Talbot Bank developed a profit and budget plan which was submitted to the FDIC and Commissioner within 60 days from the effective date of the Order and one which was submitted within 30 days of the end of 2014. The profit and budget plan was approved by the FDIC; additionally the FDIC approved the Talbot Bank capital plan.

***Dividend Restriction.*** While the Order is in effect, Talbot Bank cannot declare or pay dividends or fees to the Company without the prior written consent of the FDIC and the Commissioner. Talbot Bank is in compliance with this provision of the Order.

***Brokered Deposits.*** The Order provides that Talbot Bank may not accept, renew, or rollover any brokered deposits unless it is in compliance with the requirements of the FDIC regulations governing brokered deposits. Talbot Bank is in compliance with this provision of the Order.

***Oversight Committee.*** Within 30 days from the effective date of the Order, Talbot Bank must establish a board committee to monitor and coordinate compliance with the Order. Talbot Bank has established a board committee to comply with this provision of the Order.

***Progress Reports.*** Within 45 days from the end of each calendar quarter following the effective date of the Order, Talbot Bank must furnish the FDIC and the Commissioner with progress reports detailing the form, manner and

results of any actions taken to secure compliance with the Order. Talbot Bank has and will continue to submit progress reports to comply with this provision of the Order.

The Order will remain in effect until modified or terminated by the FDIC and the Commissioner.

TABLE OF CONTENTS

# SHORE BANCSHARES, INC.

# NOTES TO CONSOLIDATED FINANCIAL STATEMENTS For the Years Ended December 31, 2014, 2013, and 2012

## NOTE 2. INVESTMENT SECURITIES

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

| (Dollars in thousands) | Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses | Estimated Fair Value |
|---|---|---|---|---|
| Available-for-sale securities: | | | | |
| December 31, 2014: | | | | |
| U.S. Treasury | **$ 5,210** | **$ 5** | **$** | **$ 5,215** |
| U.S. Government agencies | **75,220** | **87** | **347** | **74,960** |
| Mortgage-backed | **154,525** | **1,230** | **452** | **155,303** |
| Equity | **624** | **6** | | **630** |
| Total | **$ 235,579** | **$ 1,328** | **$ 799** | **$ 236,108** |
| December 31, 2013: | | | | |
| U.S. Treasury | $ 5,342 | $ 1 | $ | $ 5,343 |
| U.S. Government agencies | 60,754 | 62 | 372 | 60,444 |
| Mortgage-backed | 81,130 | 520 | 937 | 80,713 |
| Equity | 609 | | 8 | 601 |
| Total | $ 147,835 | $ 583 | $ 1,317 | $ 147,101 |
| Held-to-maturity securities: | | | | |
| December 31, 2014: | | | | |
| U.S. Government agencies | **$ 2,791** | **$** | **$ 83** | **$ 2,708** |
| States and political subdivisions | **1,839** | **147** | | **1,986** |
| Total | **$ 4,630** | **$ 147** | **$ 83** | **$ 4,694** |
| December 31, 2013: | | | | |
| U.S. Government agencies | $ 2,975 | $ | $ 222 | $ 2,753 |
| States and political subdivisions | 2,210 | 99 | | 2,309 |
| Total | $ 5,185 | $ 99 | $ 222 | $ 5,062 |

The following table provides information about gross unrealized losses and fair value by length of time that the individual securities have been in a continuous unrealized loss position at December 31, 2014.

| | Less than 12 Months | More than 12 Months | Total |
|---|---|---|---|
| (Dollars in thousands) | | | |

| | Fair Value | Unrealized Losses | Fair Value | Unrealized Losses | Fair Value | Unrealized Losses |
|---|---|---|---|---|---|---|
| Available-for-sale securities: | | | | | | |
| December 31, 2014 | | | | | | |
| U.S. Government agencies | **$ 41,574** | **$ 138** | **$ 6,954** | **$ 209** | **$ 48,528** | **$ 347** |
| Mortgage-backed | **12,933** | **44** | **26,828** | **408** | **39,761** | **452** |
| Equity | | | **630** | | **630** | |
| Total | **$ 54,507** | **$ 182** | **$ 34,412** | **$ 617** | **$ 88,919** | **$ 799** |
| Held-to-maturity securities: | | | | | | |
| December 31, 2014 | | | | | | |
| U.S. Government agencies | **$** | **$** | **$ 2,708** | **$ 83** | **$ 2,708** | **$ 83** |

68

# SHORE BANCSHARES, INC.

# NOTES TO CONSOLIDATED FINANCIAL STATEMENTS For the Years Ended December 31, 2014, 2013, and 2012

## NOTE 2. INVESTMENT SECURITIES (continued)

| (Dollars in thousands) | Less than 12 Months | | More than 12 Months | | Total | |
|---|---|---|---|---|---|---|
| | Fair Value | Unrealized Losses | Fair Value | Unrealized Losses | Fair Value | Unrealized Losses |
| Available-for-sale securities: | | | | | | |
| December 31, 2013 | | | | | | |
| U.S. Government agencies | $ 33,004 | $ 372 | $ | $ | $ 33,004 | $ 372 |
| Mortgage-backed | 28,694 | 416 | 19,121 | 521 | 47,815 | 937 |
| Equity | 601 | 8 | | | 601 | 8 |
| Total | $ 62,299 | $ 796 | $ 19,121 | $ 521 | $ 81,420 | $ 1,317 |
| Held-to-maturity securities: | | | | | | |
| December 31, 2013 | | | | | | |
| U.S. Government agencies | $ 2,753 | $ 222 | $ | $ | $ 2,753 | $ 222 |

All of the securities with unrealized losses in the portfolio have modest duration risk, low credit risk, and minimal losses when compared to total amortized cost. The unrealized losses on debt securities that exist are the result of market changes in interest rates since original purchase. Because the Company does not intend to sell these securities and it is not more likely than not that the Company will be required to sell these securities before recovery of their amortized cost bases, which may be at maturity for debt securities, the Company considers the unrealized losses to be temporary.

The following table provides information on the amortized cost and estimated fair values of investment securities by maturity date at December 31, 2014.

| (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 | $ 2,001 | $ 2,002 | $ 221 | $ 223 |
| Due after one year through five years | 75,099 | 74,981 | 712 | 764 |
| Due after five years through ten years | 11,361 | 11,405 | 403 | 459 |
| Due after ten years | 146,494 | 147,090 | 3,294 | 3,248 |
| | 234,955 | 235,478 | 4,630 | 4,694 |
| Equity securities | 624 | 630 | | |
| Total | $ 235,579 | $ 236,108 | $ 4,630 | $ 4,694 |

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

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, 2014 | | December 31, 2013 | |
|---|---|---|---|---|
| | Amortized Cost | Estimated Fair Value | Amortized Cost | Estimated Fair Value |
| Pledged available-for-sale securities | **$ 115,162** | **$ 115,458** | $ 101,070 | $ 100,507 |

There were no obligations of states or political subdivisions with carrying values, as to any issuer, exceeding 10% of stockholders equity at December 31, 2014 or 2013.

69

TABLE OF CONTENTS

# SHORE BANCSHARES, INC.

# NOTES TO CONSOLIDATED FINANCIAL STATEMENTS For the Years Ended December 31, 2014, 2013, and 2012

## NOTE 2. INVESTMENT SECURITIES (continued)

Proceeds from sales of investment securities were $988 thousand, $40.4 million, and $6.3 million for the years ended December 31, 2014, 2013, and 2012, respectively. Gross gains from sales of investment securities were $23 thousand, $913 thousand and $278 thousand for the years ended December 31, 2014, 2013, and 2012, respectively. There were no gross losses in 2014, 2013 and 2012.

## NOTE 3. LOANS AND ALLOWANCE FOR CREDIT LOSSES

The Company makes residential mortgage, commercial and consumer loans to customers primarily in Talbot County, Queen Anne s County, Kent County, Caroline County and Dorchester County in Maryland and in Kent County, Delaware. The following table provides information about the principal classes of the loan portfolio at December 31, 2014 and 2013.

| (Dollars in thousands) | 2014 | 2013 |
|---|---|---|
| Construction | **$ 69,157** | $ 64,591 |
| Residential real estate | **273,336** | 274,857 |
| Commercial real estate | **305,788** | 304,605 |
| Commercial | **52,671** | 57,195 |
| Consumer | **9,794** | 10,671 |
| Total loans | **710,746** | 711,919 |
| Allowance for credit losses | **(7,695 )** | (10,725 ) |
| Total loans, net | **$ 703,051** | $ 701,194 |

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 persons who are not related to the Company and are not considered to involve more than the normal risk of collectibility. As of December 31, 2014 and 2013, such loans outstanding, both direct and indirect (including guarantees), to directors, their associates and policy-making officers, totaled approximately $18.7 million and $23.2 million, respectively. During 2014 and 2013, loan additions were approximately $1.8 million and $1.0 million, respectively, and loan repayments were approximately $6.2 million and $3.8 million, respectively.

The following tables include impairment information relating to loans and the allowance for credit losses as of December 31, 2014 and 2013.

| (Dollars in thousands) | Construction | Commercial | Consumer | Unallocated | Total |
|---|---|---|---|---|---|

| | | Residential real estate | Commercial real estate | | | | |
|---|---|---|---|---|---|---|---|
| December 31, 2014 | | | | | | | |
| Loans individually evaluated for impairment | $ 10,067 | $ 10,403 | $ 9,359 | $ 188 | $ 124 | $ | $ 30,141 |
| Loans collectively evaluated for impairment | 59,090 | 262,933 | 296,429 | 52,483 | 9,670 | | 680,605 |
| Total loans | $ 69,157 | $ 273,336 | $ 305,788 | $ 52,671 | $ 9,794 | $ | $ 710,746 |
| Allowance for credit losses allocated to: | | | | | | | |
| Loans individually evaluated for impairment | $ 41 | $ 1,099 | $ 129 | $ 1 | $ 3 | $ | $ 1,273 |
| Loans collectively evaluated for impairment | 1,262 | 1,735 | 2,250 | 447 | 226 | 502 | 6,422 |
| Total allowance for credit losses | $ 1,303 | $ 2,834 | $ 2,379 | $ 448 | $ 229 | $ 502 | $ 7,695 |

70

TABLE OF CONTENTS

# SHORE BANCSHARES, INC.

# NOTES TO CONSOLIDATED FINANCIAL STATEMENTS For the Years Ended December 31, 2014, 2013, and 2012

## NOTE 3. LOANS AND ALLOWANCE FOR CREDIT LOSSES (continued)

| (Dollars in thousands) | Construction | Residential real estate | Commercial real estate | Commercial | Consumer | Unallocated | Total |
|---|---|---|---|---|---|---|---|
| December 31, 2013 | | | | | | | |
| Loans individually evaluated for impairment | $ 5,569 | $ 19,748 | $ 14,462 | $ 887 | $ 48 | $ | $ 40,714 |
| Loans collectively evaluated for impairment | 59,022 | 255,109 | 290,143 | 56,308 | 10,623 | | 671,205 |
| Total loans | $ 64,591 | $ 274,857 | $ 304,605 | $ 57,195 | $ 10,671 | $ | $ 711,919 |
| Allowance for credit losses allocated to: | | | | | | | |
| Loans individually evaluated for impairment | $ 204 | $ 285 | $ 44 | $ 245 | $ 5 | $ | $ 783 |
| Loans collectively evaluated for impairment | 1,756 | 3,569 | 2,985 | 1,021 | 238 | 373 | 9,942 |
| Total allowance for credit losses | $ 1,960 | $ 3,854 | $ 3,029 | $ 1,266 | $ 243 | $ 373 | $ 10,725 |

The following tables provide information on impaired loans and any related allowance by loan class as of December 31, 2014 and 2013. The difference between the unpaid principal balance and the recorded investment is the amount of partial charge-offs that have been taken.

| (Dollars in thousands) | Unpaid principal balance | Recorded investment with no allowance | Recorded investment with an allowance | Related allowance | Average recorded investment | Interest income recognized |
|---|---|---|---|---|---|---|
| December 31, 2014 | | | | | | |
| Impaired nonaccrual loans: | | | | | | |
| Construction | **$ 9,277** | **$ 6,045** | **$** | **$** | **$ 7,739** | **$** |
| Residential real estate | **4,664** | **1,053** | **2,982** | **799** | **3,322** | |
| Commercial real estate | **4,703** | **2,842** | **280** | **100** | **3,889** | |
| Commercial | **1,372** | **136** | **5** | **1** | **437** | |
| Consumer | **129** | **99** | **25** | **3** | **79** | |
| Total | **20,145** | **10,175** | **3,292** | **903** | **15,466** | |

| | | | | | | |
|---|---|---|---|---|---|---|
| Impaired accruing TDRs: | | | | | | |
| Construction | **4,022** | **3,196** | **826** | **41** | **2,743** | **68** |
| Residential real estate | **6,368** | **668** | **5,700** | **300** | **15,123** | **372** |
| Commercial real estate | **6,237** | **4,774** | **1,463** | **29** | **6,574** | **254** |
| Commercial | **47** | **47** | | | **55** | **2** |
| Consumer | | | | | | |
| Total | **16,674** | **8,685** | **7,989** | **370** | **24,495** | **696** |
| Total impaired loans: | | | | | | |
| Construction | **13,299** | **9,241** | **826** | **41** | **10,482** | **68** |
| Residential real estate | **11,032** | **1,721** | **8,682** | **1,099** | **18,445** | **372** |
| Commercial real estate | **10,940** | **7,616** | **1,743** | **129** | **10,463** | **254** |
| Commercial | **1,419** | **183** | **5** | **1** | **492** | **2** |
| Consumer | **129** | **99** | **25** | **3** | **79** | |
| Total | **$ 36,819** | **$ 18,860** | **$ 11,281** | **$ 1,273** | **$ 39,961** | **$ 696** |

71

TABLE OF CONTENTS

# SHORE BANCSHARES, INC.

# NOTES TO CONSOLIDATED FINANCIAL STATEMENTS For the Years Ended December 31, 2014, 2013, and 2012

## NOTE 3. LOANS AND ALLOWANCE FOR CREDIT LOSSES (continued)

| (Dollars in thousands) | Unpaid principal balance | Recorded investment with no allowance | Recorded investment with an allowance | Related allowance | Average recorded investment | Interest income recognized |
|---|---|---|---|---|---|---|
| December 31, 2013 | | | | | | |
| Impaired nonaccrual loans: | | | | | | |
| Construction | $ 6,787 | $ 3,709 | $ 240 | $ 203 | $ 7,270 | $ |
| Residential real estate | 7,692 | 3,862 | 1,304 | 225 | 10,240 | |
| Commercial real estate | 5,218 | 4,261 | 410 | 38 | 7,829 | |
| Commercial | 1,801 | 547 | 245 | 245 | 619 | |
| Consumer | 56 | 43 | 5 | 5 | 48 | |
| Total | 21,554 | 12,422 | 2,204 | 716 | 26,006 | |
| Impaired accruing TDRs: | | | | | | |
| Construction | 1,620 | 1,527 | 93 | 1 | 14,405 | |
| Residential real estate | 14,582 | 13,177 | 1,405 | 60 | 11,101 | |
| Commercial real estate | 9,791 | 9,006 | 785 | 6 | 13,308 | |
| Commercial | 95 | 95 | | | 105 | |
| Consumer | | | | | | |
| Total | 26,088 | 23,805 | 2,283 | 67 | 38,919 | |
| Total impaired loans: | | | | | | |
| Construction | 8,407 | 5,236 | 333 | 204 | 21,675 | |
| Residential real estate | 22,274 | 17,039 | 2,709 | 285 | 21,341 | |
| Commercial real estate | 15,009 | 13,267 | 1,195 | 44 | 21,137 | |
| Commercial | 1,896 | 642 | 245 | 245 | 724 | |
| Consumer | 56 | 43 | 5 | 5 | 48 | |
| Total | $ 47,642 | $ 36,227 | $ 4,487 | $ 783 | $ 64,925 | $ |

The following tables provide a roll-forward for troubled debt restructurings as of December 31, 2014 and December 31, 2013.

| (Dollars in thousands) | 12/31/13 TDR Balance | New TDRs | Disbursements (Payments) | Charge offs | Reclassification/ Transfers In/(Out) | Loan Sale | Payoffs | 12/31/14 TDR Balance | Related Allowance |
|---|---|---|---|---|---|---|---|---|---|

| For the year ended 12/31/2014 | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|
| Accruing TDRs | | | | | | | | | |
| Construction | **$1,620** | **$** | **$(186 )** | **$(538 )** | **$3,396** | **$** | **$(270 )** | **$4,022** | **$41** |
| Residential Real Estate | **14,582** | | **(1,150 )** | **(3,614)** | **(3,136 )** | | **(314 )** | **6,368** | **300** |
| Commercial Real Estate | **9,791** | | **(99 )** | **(549 )** | **(1,805 )** | | **(1,101)** | **6,237** | **29** |
| Commercial | **95** | | **(24 )** | | | | **(24 )** | **47** | |
| Consumer | | | | | | | | | |
| Total | **$26,088** | **$** | **$(1,459 )** | **$(4,701)** | **$(1,545 )** | **$** | **$(1,709)** | **$16,674** | **$370** |
| Nonaccrual TDRs | | | | | | | | | |
| Construction | **$3,561** | **$** | **$(12 )** | **$(235 )** | **$7** | **$** | **$** | **$3,321** | **$** |
| Residential Real Estate | **1,884** | | **(50 )** | **(203 )** | **1,874** | | **(123 )** | **3,382** | **724** |
| Commercial Real Estate | **842** | | **(95 )** | **(65 )** | **(336 )** | | | **346** | **100** |
| Commercial | | | | | | | | | |
| Consumer | **26** | | **(1 )** | | | | | **25** | **3** |
| Total | **$6,313** | **$** | **$(158 )** | **$(503 )** | **$1,545** | **$** | **$(123 )** | **$7,074** | **$827** |
| Total TDRs | **$32,401** | **$** | **$(1,617 )** | **$(5,204)** | **$** | **$** | **$(1,832)** | **$23,748** | **$1,197** |

72

TABLE OF CONTENTS

# SHORE BANCSHARES, INC.

# NOTES TO CONSOLIDATED FINANCIAL STATEMENTS For the Years Ended December 31, 2014, 2013, and 2012

## NOTE 3. LOANS AND ALLOWANCE FOR CREDIT LOSSES (continued)

| (Dollars in thousands) | 12/31/12 TDR Balance | New TDRs | Disbursements (Payments) | Charge offs | Reclassification/ Transfers In/(Out) | 9/30/13 Loan Sale | Payoffs | 12/31/13 TDR Balance | Related Allowance |
|---|---|---|---|---|---|---|---|---|---|
| For the year ended 12/31/2013 | | | | | | | | | |
| Accruing TDRs | | | | | | | | | |
| Construction | **$27,335** | **$95** | **$228** | **$(13,557)** | **$(3,521)** | **$(7,908 )** | **$(1,052)** | **$1,620** | **$1** |
| Residential Real Estate | **7,017** | **10,433** | **(86 )** | **(632 )** | **(1,755)** | **(395 )** | | **14,582** | **60** |
| Commercial Real Estate | **17,880** | **1,738** | **(39 )** | **(2,108 )** | **(410 )** | **(7,162 )** | **(108 )** | **9,791** | **6** |
| Commercial | **121** | | **(26 )** | | | | | **95** | |
| Consumer | | | | | | | | | |
| Total | **$52,353** | **$12,266** | **$77** | **$(16,297)** | **$(5,686)** | **$(15,465)** | **$(1,160)** | **$26,088** | **$67** |
| Nonaccrual TDRs | | | | | | | | | |
| Construction | **$1,448** | **$** | **$(64 )** | **$(639 )** | **$3,521** | **$(57 )** | **$(648 )** | **$3,561** | **$25** |
| Residential Real Estate | **2,169** | **258** | **(90 )** | **(1,253 )** | **1,755** | **(759 )** | **(196 )** | **1,884** | |
| Commercial Real Estate | **2,970** | | **(281)** | **(866 )** | **410** | | **(1,391)** | **842** | |
| Commercial | | | | | | | | | |
| Consumer | **27** | | **(1 )** | | | | | **26** | **26** |
| Total | **$6,614** | **$258** | **$(436)** | **$(2,758 )** | **$5,686** | **$(816 )** | **$(2,235)** | **$6,313** | **$51** |
| Total TDRs | **$58,967** | **$12,524** | **$(359)** | **$(19,055)** | **$** | **$(16,281)** | **$(3,395)** | **$32,401** | **$118** |

The following tables provide information on loans that were modified and considered TDRs during 2014 and 2013.

| (Dollars in thousands) | Number of contracts | Premodification outstanding recorded investment | Postmodification outstanding recorded investment | Related allowance |
|---|---|---|---|---|
| TDRs: | | | | |
| For the year ended December 31, 2014 | | | | |

| | | | | |
|---|---|---|---|---|
| Construction | | $ | $ | $ |
| Residential real estate | | | | |
| Commercial real estate | | | | |
| Commercial | | | | |
| Consumer | | | | |
| Total | | $ | $ | $ |
| For the year ended December 31, 2013 | | | | |
| Construction | 3 | $ 218 | $ 218 | $ |
| Residential real estate | 7 | 12,485 | 12,494 | 38 |
| Commercial real estate | 4 | 2,212 | 2,211 | 82 |
| Commercial | | | | |
| Consumer | | | | |
| Total | 14 | $ 14,915 | $ 14,923 | $ 120 |

73

TABLE OF CONTENTS

# SHORE BANCSHARES, INC.

# NOTES TO CONSOLIDATED FINANCIAL STATEMENTS For the Years Ended December 31, 2014, 2013, and 2012

## NOTE 3. LOANS AND ALLOWANCE FOR CREDIT LOSSES (continued)

The following tables provide information on TDRs that defaulted during 2014 and 2013. Generally, a loan is considered in default when principal or interest is past due 90 days or more.

| (Dollars in thousands) | Number of contracts | Recorded investment | Related allowance |
|---|---|---|---|
| TDRs that subsequently defaulted: | | | |
| For the year ended December 31, 2014 | | | |
| Construction | | $ | $ |
| Residential real estate | | | |
| Commercial real estate | | | |
| Commercial | | | |
| Consumer | | | |
| Total | | $ | $ |
| TDRs that subsequently defaulted[1]: | | | |
| For the year ended December 31, 2013 | | | |
| Construction | | $ | $ |
| Residential real estate | 6 | 1,918 | |
| Commercial real estate | 2 | 2,151 | 74 |
| Commercial | | | |
| Consumer | | | |
| Total | 8 | $ 4,069 | $ 74 |

(1) These loans were classified as TDRs during 2012.

Management uses risk ratings as part of its monitoring of the credit quality in the Company s loan portfolio. Loans that are identified as special mention, substandard or doubtful are adversely rated. They are assigned higher risk ratings than favorably rated loans in the calculation of the formula portion of the allowance for credit losses. At December 31, 2014, there were no nonaccrual loans classified as special mention, $13.4 million of nonaccrual loans were identified as substandard and $89 thousand were doubtful. The comparable amounts at December 31, 2013 were $152 thousand, $13.0 million and $1.4 million, respectively.

The following tables provide information on loan risk ratings as of December 31, 2014 and 2013.

| (Dollars in thousands) | Pass/Performing | Special mention | Substandard | Doubtful | Total |
|---|---|---|---|---|---|
| December 31, 2014 | | | | | |
| Construction | **$ 52,241** | **$ 5,643** | **$ 11,273** | **$** | **$ 69,157** |
| Residential real estate | **252,643** | **6,675** | **14,018** | | **273,336** |
| Commercial real estate | **275,573** | **20,040** | **10,175** | | **305,788** |
| Commercial | **50,583** | **1,885** | **114** | **89** | **52,671** |
| Consumer | **9,658** | **13** | **123** | | **9,794** |
| Total | **$ 640,698** | **$ 34,256** | **$ 35,703** | **$ 89** | **$ 710,746** |

74

TABLE OF CONTENTS

# SHORE BANCSHARES, INC.

# NOTES TO CONSOLIDATED FINANCIAL STATEMENTS For the Years Ended December 31, 2014, 2013, and 2012

## NOTE 3. LOANS AND ALLOWANCE FOR CREDIT LOSSES (continued)

| (Dollars in thousands) | Pass/Performing | Special mention | Substandard | Doubtful | Total |
|---|---|---|---|---|---|
| December 31, 2013 | | | | | |
| Construction | $ 39,268 | $ 15,884 | $ 9,439 | $ | $ 64,591 |
| Residential real estate | 235,054 | 22,638 | 17,114 | 51 | 274,857 |
| Commercial real estate | 255,280 | 30,105 | 19,210 | 10 | 304,605 |
| Commercial | 52,032 | 3,691 | 972 | 500 | 57,195 |
| Consumer | 10,451 | 48 | 172 | | 10,671 |
| Total | $ 592,085 | $ 72,366 | $ 46,907 | $ 561 | $ 711,919 |

The following tables provide information on the aging of the loan portfolio as of December 31, 2014 and 2013.

| | Accruing | | | | | | |
|---|---|---|---|---|---|---|---|
| (Dollars in thousands) | Current | 30 59 days past due | 60 89 days past due | 90 days or more past due | Total past due | Non-accrual | Total |
| December 31, 2014 | | | | | | | |
| Construction | **$61,325** | **$1,786** | **$** | **$** | **$1,786** | **$6,046** | **$69,157** |
| Residential real estate | **263,165** | **3,351** | **2,702** | **83** | **6,136** | **4,035** | **273,336** |
| Commercial real estate | **301,695** | **459** | **513** | | **972** | **3,121** | **305,788** |
| Commercial | **52,352** | **47** | **131** | | **178** | **141** | **52,671** |
| Consumer | **9,619** | **11** | **37** | **4** | **52** | **123** | **9,794** |
| Total | **$688,156** | **$5,654** | **$3,383** | **$ 87** | **$9,124** | **$13,466** | **$710,746** |
| Percent of total loans | **96.8** % | **0.8** % | **0.5** % | % | **1.3** % | **1.9** % | |

| | Accruing | | | | | | |
|---|---|---|---|---|---|---|---|
| (Dollars in thousands) | Current | 30 59 days past due | 60 89 days past due | 90 days or more past due | Total past due | Non-accrual | Total |

| | | | | | | | |
|---|---|---|---|---|---|---|---|
| December 31, 2013 | | | | | | | |
| Construction | $60,642 | $ | $ | $ | $ | $3,949 | $64,591 |
| Residential real estate | 265,182 | 2,765 | 1,724 | 20 | 4,509 | 5,166 | 274,857 |
| Commercial real estate | 299,295 | 639 | | | 639 | 4,671 | 304,605 |
| Commercial | 55,576 | 330 | 247 | 250 | 827 | 792 | 57,195 |
| Consumer | 10,469 | 23 | 131 | | 154 | 48 | 10,671 |
| Total | $691,164 | $3,757 | $2,102 | $270 | $6,129 | $14,626 | $711,919 |
| Percent of total loans | 97.1 % | 0.5 % | 0.3 % | % | 0.8 % | 2.1 % | |

The following tables provide a summary of the activity in the allowance for credit losses allocated by loan class for 2014 and 2013. Allocation of a portion of the allowance to one loan class does not preclude its availability to absorb losses in other loan classes.

| (Dollars in thousands) | Construction | Residential real estate | Commercial real estate | Commercial | Consumer | Unallocated | Total |
|---|---|---|---|---|---|---|---|
| 2014 | | | | | | | |
| Allowance for credit losses: | | | | | | | |
| Beginning balance | **$ 1,960** | **$ 3,854** | **$ 3,029** | **$ 1,266** | **$ 243** | **$ 373** | **$ 10,725** |
| Charge-offs | **(725 )** | **(2,407 )** | **(1,648 )** | **(2,389 )** | **(163 )** | | **(7,332 )** |
| Recoveries | **149** | **376** | **58** | **341** | **28** | | **952** |
| Net charge-offs | **(576 )** | **(2,031 )** | **(1,590 )** | **(2,048 )** | **(135 )** | | **(6,380 )** |
| Provision | **(81 )** | **1,011** | **940** | **1,230** | **121** | **129** | **3,350** |
| Ending balance | **$ 1,303** | **$ 2,834** | **$ 2,379** | **$ 448** | **$ 229** | **$ 502** | **$ 7,695** |

75

TABLE OF CONTENTS

# SHORE BANCSHARES, INC.

# NOTES TO CONSOLIDATED FINANCIAL STATEMENTS For the Years Ended December 31, 2014, 2013, and 2012

## NOTE 3. LOANS AND ALLOWANCE FOR CREDIT LOSSES (continued)

| (Dollars in thousands) | Construction | Residential real estate | Commercial real estate | Commercial | Consumer | Unallocated | Total |
|---|---|---|---|---|---|---|---|
| 2013 | | | | | | | |
| Allowance for credit losses: | | | | | | | |
| Beginning balance | $4,387 | $5,194 | $4,134 | $1,682 | $407 | $187 | $15,991 |
| Charge-offs | (20,695) | (7,163) | (6,162) | (665) | (113) | | (34,798) |
| Recoveries | 161 | 545 | 161 | 839 | 42 | | 1,748 |
| Net charge-offs | (20,534) | (6,618) | (6,001) | 174 | (71) | | (33,050) |
| Provision | 18,107 | 5,278 | 4,896 | (590) | (93) | 186 | 27,784 |
| Ending balance | $1,960 | $3,854 | $3,029 | $1,266 | $243 | $373 | $10,725 |

## NOTE 4. PREMISES AND EQUIPMENT

The following table provides information on premises and equipment at December 31, 2014 and 2013.

| (Dollars in thousands) | 2014 | 2013 |
|---|---|---|
| Land | **$ 5,818** | $ 5,818 |
| Buildings and land improvements | **13,537** | 13,459 |
| Furniture and equipment | **9,273** | 7,650 |
| | **28,628** | 26,927 |
| Accumulated depreciation | **(12,353)** | (11,729) |
| Total | **$ 16,275** | $ 15,198 |

Depreciation expense totaled $867 thousand, $936 thousand and $1.1 million for 2014, 2013 and 2012, respectively.

The Company leases facilities under operating leases. Rental expense for the years ended December 31, 2014, 2013, and 2012 was $700 thousand, $744 thousand and $777 thousand, respectively. Future minimum annual rental payments are approximately as follows:

| (Dollars in thousands) | |
|---|---|
| 2015 | $ 625 |

| | |
|---|---|
| 2016 | 474 |
| 2017 | 352 |
| 2018 | 327 |
| 2019 | 331 |
| Thereafter | 889 |
| Total minimum lease payments | $ 2,998 |

# NOTE 5. INVESTMENT IN UNCONSOLIDATED SUBSIDIARIES

The Avon-Dixon Agency, LLC ( Avon-Dixon ), a wholly-owned insurance subsidiary of the Company, owns a 40% interest in a segregated portfolio of Eastern Re Ltd., SPC ( Eastern ), a specialty reinsurance company. This investment is carried at cost, adjusted for Avon-Dixon s equity ownership in Eastern s net income or loss. At December 31, 2014 and 2013, the carrying value of the investment in Eastern was $432 thousand and $328 thousand, respectively. During 2014 and 2013, income recognized from the investment in Eastern was $104 thousand and $328 thousand, respectively.

During 2012, the Company terminated its mortgage brokerage activities which were conducted through a minority series investment in an unrelated Delaware limited liability company under the name Wye Mortgage Group . This investment was carried at cost, adjusted for the Company s 49.0% equity ownership in Wye Mortgage Group s net income or loss. At December 31, 2014 and 2013, the carrying value of the investment in Wye Mortgage Group was $0 and $0, respectively. The Company recognized no income or loss in 2014 from its investment in Wye Mortgage Group, and a loss of $9 thousand in 2013.

TABLE OF CONTENTS

# SHORE BANCSHARES, INC.

# NOTES TO CONSOLIDATED FINANCIAL STATEMENTS For the Years Ended December 31, 2014, 2013, and 2012

## NOTE 6. GOODWILL AND OTHER INTANGIBLE ASSETS

The following table provides information on the significant components of goodwill and other acquired intangible assets at December 31, 2014 and 2013. The Community Banking segment had goodwill of $2.5 million at the end of both 2014 and 2013. The Insurance segment had goodwill of $9.4 million and $9.9 million at the end of 2014 and 2013. The decrease of $500 thousand was the result of the sale of the assets and liabilities of Tri-State General Insurance, LTD on June 6, 2014. See Note 26 for further information regarding the Company s business segments.

The aggregate amortization expense was $201 thousand, $296 thousand, and $392 thousand for the years ended December 31, 2014, 2013, and 2012 respectively.

The following table provides information on current period and estimated future amortization expense for amortizable other intangible assets.

| (Dollars in thousands) | Amortization Expense |
|---|---|
| Estimate for years ended December 31, 2015 | 133 |
| 2016 | 133 |
| 2017 | 85 |
| 2018 | 42 |
| 2019 | 42 |

## NOTE 7. OTHER ASSETS

The Company had the following other assets at December 31, 2014 and 2013.

| (Dollars in thousands) | 2014 | 2013 |
|---|---|---|
| Nonmarketable investment securities | **$ 1,586** | $ 2,058 |
| Accrued interest receivable | **2,663** | 2,561 |
| Deferred income taxes[(1)] | **15,744** | 19,090 |
| Prepaid expenses | **750** | 700 |
| Other assets | **6,419** | 6,673 |
| Total | **$ 27,162** | $ 31,082 |

(1) See Note 15 for further discussion.

77

NOTE 7. OTHER ASSETS

# SHORE BANCSHARES, INC.

# NOTES TO CONSOLIDATED FINANCIAL STATEMENTS For the Years Ended December 31, 2014, 2013, and 2012

## NOTE 8. OTHER LIABILITIES

The Company had the following other liabilities at December 31, 2014 and 2013.

| (Dollars in thousands) | 2014 | 2013 |
|---|---|---|
| Accrued interest payable | **$ 172** | $ 225 |
| Other accounts payable | **2,435** | 3,543 |
| Deferred compensation liability | **1,503** | 1,505 |
| Other liabilities | **2,011** | 1,944 |
| Total | **$ 6,121** | $ 7,217 |

## NOTE 9. DEPOSITS

The approximate amount of certificates of deposit of $100,000 or more was $159.9 million and $185.0 million at December 31, 2014 and 2013, respectively.

The following table provides information on the approximate maturities of total time deposits at December 31, 2014 and 2013.

| (Dollars in thousands) | 2014 | 2013 |
|---|---|---|
| Due in one year or less | **$ 181,847** | $ 184,836 |
| Due in one to three years | **101,811** | 121,403 |
| Due in three to five years | **47,969** | 66,565 |
| Total | **$ 331,627** | $ 372,804 |

## NOTE 10. SHORT-TERM BORROWINGS

The following table summarizes certain information on short-term borrowings for the years ended December 31, 2014 and 2013.

| | 2014 | | 2013 | |
|---|---|---|---|---|
| (Dollars in thousands) | Amount | Rate | Amount | Rate |
| Average for the Year | | | | |
| Retail repurchase agreements | **$ 8,061** | **0.22 %** | $ 10,980 | 0.24 % |
| At Year End | | | | |

| Retail repurchase agreements | **$ 4,808** | **0.23 %** | $ 10,140 | 0.23 % |
|---|---|---|---|---|

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. 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 $545 thousand, $520 thousand, and $513 thousand for 2014, 2013, and 2012, respectively.

TABLE OF CONTENTS

# SHORE BANCSHARES, INC.

# NOTES TO CONSOLIDATED FINANCIAL STATEMENTS For the Years Ended December 31, 2014, 2013, and 2012

## NOTE 12. STOCK-BASED COMPENSATION

As of December 31, 2014, the Company maintained the Shore Bancshares, Inc. 2006 Stock and Incentive Compensation Plan ( 2006 Equity Plan ) under which Shore Bancshares, Inc. may issue shares of its common stock or grant other equity-based awards. Under the 2006 Equity Plan, stock-based awards may be granted periodically to the Company s directors, executive officers, and key employees at the discretion of the Compensation Committee of the Board of Shore Bancshares, Inc. 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. Stock-based compensation expense is recognized ratably over the requisite service period for all awards, is based on the grant date fair value and reflects forfeitures as they occur. The 2006 Equity Plan originally reserved 631,972 shares of common stock for grant, and 503,048 shares remained available for grant at December 31, 2014.

The following tables provide information on stock-based compensation expense for 2014, 2013 and 2012.

| (Dollars in thousands) | 2014 | 2013 | 2012 |
|---|---|---|---|
| Stock-based compensation expense | **$ 87**[(1)] | $ 78 | $ 209 |
| Excess tax expense related to stock-based compensation | | 26 | 106 |

| | December 31, | | |
|---|---|---|---|
| (Dollars in thousands) | 2014 | 2013 | 2012 |
| Unrecognized stock-based compensation expense | **$59** | $136 | $143 |
| Weighted average period unrecognized expense is expected to be recognized | **0.8 years** | 1.7 years | 2.1 years |

The following table summarizes restricted stock award activity for the Company under the 2006 Equity Plan for the two years ended December 31, 2014.

| | Year Ended December 31, 2014 | | Year Ended December 31, 2013 | | Year Ended December 31, 2012 | |
|---|---|---|---|---|---|---|
| | Number of Shares | Weighted Average Grant Date Fair Value | Number of Shares | Weighted Average Grant Date Fair Value | Number of Shares | Weighted Average Grant Date Fair Value |
| Nonvested at beginning of year | **13,930** | **$ 8.33** | 6,548 | $ 14.89 | 45,779 | $ 13.20 |

| | | | | | | |
|---|---|---|---|---|---|---|
| Granted[1] | **3,654** | **9.57** | 13,930 | 8.33 | | |
| Vested | **(3,333 )** | **8.93** | (6,548 ) | 14.89 | (39,231 ) | 12.92 |
| Cancelled | | | | | | |
| Nonvested at end of year | **14,251** | **$ 8.51** | 13,930 | $ 8.33 | 6,548 | $ 14.89 |

The total fair value of restricted stock awards that vested was $30 thousand in 2014, $36 thousand in 2013, and $245 thousand in 2012.

79

# SHORE BANCSHARES, INC.

# NOTES TO CONSOLIDATED FINANCIAL STATEMENTS For the Years Ended December 31, 2014, 2013, and 2012

## NOTE 12. STOCK-BASED COMPENSATION (continued)

The following table summarizes stock option activity for the Company under the 2006 Equity Plan for the two years ended December 31, 2014.

| | Year Ended December 31, 2014 | | Year Ended December 31, 2013 | | Year Ended December 31, 2012 | |
|---|---|---|---|---|---|---|
| | Number of shares | Weighted Average Exercise Price | Number of shares | Weighted Average Exercise Price | Number of shares | Weighted Average Exercise Price |
| Outstanding at beginning of year | **40,662** | **$ 6.64** | 54,216 | $ 6.64 | | $ 6.64 |
| Granted[1] | | | | | 54,216 | |
| Exercised | **(3,593 )** | **6.64** | | | | |
| Expired/Cancelled | **(9,961 )** | **6.64** | (13,554) | 6.64 | | |
| Outstanding at end of year | **27,108** | **$ 6.64** | 40,662 | $ 6.64 | 54,216 | $ 6.64 |
| Exercisable at end of year | | **$** | | $ | | $ |

(1) On January 7, 2015 restricted stock and options were granted to executive officers in the amount of $62 thousand in restricted stock awards and $117 thousand in option awards. The restricted stock and options immediately vested 50% on the grant date of January 7, 2015, in which the amount of $90 thousand was accrued at December 31, 2014 and recorded as an other liability. On January 7, 2015 the liability for the restricted shares and the options was reclassified to additional paid-in-capital. The January 7, 2015 awarded grants are excluded from the tables above because including them would not properly reflect the outstanding shares at December 31, 2014.

The weighted average fair value of stock options granted during 2012 was $3.44. The Company estimates the fair value of options using the Black-Scholes valuation model with weighted average assumptions for dividend yield, expected volatility, risk-free interest rate and expected lives (in years). The expected dividend yield is calculated by dividing the total expected annual dividend payout by the average stock price. The expected volatility is based on historical volatility of the underlying securities. The risk-free interest rate is based on the Federal Reserve Bank s constant maturities daily interest rate in effect at grant date. The expected contract life of the options represents the period of time that the Company expects the awards to be outstanding based on historical experience with similar awards. The following weighted average assumptions were used as inputs to the Black-Scholes valuation model for options granted in 2012.

| | |
|---|---|
| Dividend yield | 0.60 % |

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

At December 31, 2014, the aggregate intrinsic value of the options outstanding under the 2006 Equity Plan was $73 thousand based on the $9.34 market value per share of Shore Bancshares, Inc. s common stock at December 31, 2014. There were 3,593 shares exercised in 2014 through a cashless exchange of stock options, which required the forfeiture of 9,961 options on October 27, 2014. The intrinsic value on the options exercised in 2014 was $8 thousand based on the $8.99 market value per share of Shore Bancshares Inc. s common stock at October 27, 2014. Since there were no options exercised during 2013, there was no intrinsic value associated with stock options exercised and no cash received on exercise of options. For 2014 and 2013 the amount of stock options vested totaled 13,554 and 0, respectively. At December 31, 2014, the weighted average remaining contract life of options outstanding was 7.2 years.

TABLE OF CONTENTS

# SHORE BANCSHARES, INC.

# NOTES TO CONSOLIDATED FINANCIAL STATEMENTS For the Years Ended December 31, 2014, 2013, and 2012

## NOTE 13. DEFERRED COMPENSATION

The Shore Bancshares, Inc. Executive Deferred Compensation Plan (the Plan ) is for members of management and highly compensated employees of Shore Bancshares, Inc. 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 are credited to an account maintained on behalf of the participant and are invested at the discretion of each participant in certain deemed investment options selected from time to time by the Compensation Committee of the Board of Shore Bancshares, Inc. Shore Bancshares, Inc. 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 Shore Bancshares, Inc. will vest over a five-year period. There were no elective deferrals made by plan participants during 2014, 2013 or 2012.

The following table provides information on Shore Bancshares, Inc. s contributions to the Plan for 2014, 2013 and 2012 and the related deferred compensation liability at December 31, 2014 and 2013.

| (Dollars in thousands) | 2014 | 2013 | 2012 |
|---|---|---|---|
| Deferred compensation contribution | **$** | $ 9 | $ 20 |

| | December 31, | |
|---|---|---|
| (Dollars in thousands) | 2014 | 2013 |
| Deferred compensation liability | **$ 445** | $ 404 |

CNB 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 CNB, 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 following table includes information on the cash surrender value and the accrued benefit obligation included in other assets and other liabilities at December 31, 2014 and 2013.

| (Dollars in thousands) | 2014 | 2013 |
|---|---|---|
| Cash surrender value | **$ 3,360** | $ 3,256 |
| Accrued benefit obligation | **1,058** | 1,101 |

# NOTE 14. OTHER EXPENSES

The following table summarizes the Company s other noninterest expenses for the years ended December 31:

| (Dollars in thousands) | 2014 | 2013 | 2012 |
|---|---|---|---|
| Advertising and marketing | **$ 428** | $ 848 | $ 338 |
| Legal and professional | **2,048** | 1,539 | 1,516 |
| Other customer expense | **396** | 414 | 372 |
| Other expense | **2,070** | 2,152 | 2,302 |
| Other loan expense | **894** | 934 | 1,086 |
| Software expense | **664** | 613 | 518 |
| Travel and entertainment expense | **288** | 287 | 265 |
| Trust professional fees | **686** | 616 | 542 |
| Total noninterest expense | **$ 7,474** | $ 7,403 | $ 6,939 |

81

TABLE OF CONTENTS

# SHORE BANCSHARES, INC.

# NOTES TO CONSOLIDATED FINANCIAL STATEMENTS For the Years Ended December 31, 2014, 2013, and 2012

## NOTE 15. INCOME TAXES

The following table provides information on components of income tax expense for each of the three years ended December 31.

| (Dollars in thousands) | 2014 | 2013 | 2012 |
|---|---|---|---|
| Current tax expense (benefit): | | | |
| Federal | **$** | $ (459 ) | $ (2,007 ) |
| State | **225** | 90 | 210 |
| | **225** | (369 ) | (1,797 ) |
| Deferred income tax expense (benefit): | | | |
| Federal | **2,516** | (4,592 ) | (3,110 ) |
| State | **320** | (1,540 ) | (1,658 ) |
| | **2,836** | (6,132 ) | (4,768 ) |
| Total income tax expense (benefit) | **$ 3,061** | $ (6,501 ) | $ (6,565 ) |

The following table provides a reconciliation of tax computed at the statutory federal tax rate of 34.0% to the actual tax expense (benefit) for each of the three years ended December 31.

| (Dollars in thousands) | 2014 | 2013 | 2012 |
|---|---|---|---|
| Tax at federal statutory rate | **34.0 %** | (34.0 )% | (34.0 )% |
| Tax effect of: | | | |
| Tax-exempt income | **(0.9 )** | (0.4 ) | (0.6 ) |
| Other non-deductible expenses | **0.3** | 0.2 | 0.2 |
| State income taxes, net of federal benefit | **4.4** | (5.9 ) | (5.9 ) |
| Other | **(0.1 )** | (0.2 ) | (0.2 ) |
| Actual income tax expense (benefit) rate | **37.7 %** | (40.3 )% | (40.5 )% |

The following table provides information on significant components of the Company s deferred tax assets and liabilities as of December 31.

| (Dollars in thousands) | 2014 | 2013 |
|---|---|---|
| Deferred tax assets: | | |
| Allowance for credit losses | **$ 3,072** | $ 4,298 |
| Reserve for off-balance sheet commitments | **121** | 180 |
| Net operating loss carry forward | **13,265** | 14,430 |

| | | |
|---|---|---|
| Write-downs of other real estate owned | **355** | 400 |
| Deferred income | **1,132** | 1,108 |
| Accrued expenses | **918** | 936 |
| Unrealized losses on available-for-sale securities | | 296 |
| Other | **80** | 83 |
| Total deferred tax assets | **18,943** | 21,731 |
| Deferred tax liabilities: | | |
| Depreciation | **372** | 463 |
| Purchase accounting adjustments | **1,751** | 1,305 |
| Deferred capital gain on branch sale | **425** | 438 |
| Unrealized gains on available-for-sale securities | **214** | |
| Other | **437** | 435 |
| Total deferred tax liabilities | **3,199** | 2,641 |
| Net deferred tax assets | **$ 15,744** | $ 19,090 |

82

TABLE OF CONTENTS

# SHORE BANCSHARES, INC.

# NOTES TO CONSOLIDATED FINANCIAL STATEMENTS For the Years Ended December 31, 2014, 2013, and 2012

## NOTE 15. INCOME TAXES (continued)

The Company s deferred tax assets primarily consist of net operating loss carryovers that will be used to offset taxable income in future periods through their statutory period of 20 years for federal tax purposes. No valuation allowance on these deferred tax assets was recorded at December 31, 2014 and December 31, 2013 as management believes it is more likely than not that all deferred tax assets will be realized based on the following positive material assumptions: 1) The Company was profitable for three of the four quarters in 2013 on a GAAP basis. The loss experienced in the third quarter of 2013 was solely attributable to the Asset Sale which is considered non-recurring. 2) The Company had pre-tax income of $8.1 million for the year ended December 31, 2014, providing further evidence that the Asset Sale was producing positive results and confirming the expectation of utilizing the deferred tax assets. 3) As a contingent opportunity, the Company has had discussions with certain investors about entering into a sales leaseback transaction for some of its branch locations which would generate a material taxable gain. The decision to act on this has been deferred; however, it would become a very viable option as a tax planning strategy if there was a risk that the net operating loss carryovers would expire before they were fully utilized. Alternatively, the Company has reviewed negative factors which would influence the conclusion of realizing the deferred tax assets which include the following: The Company could be subject to Section 382 of the Internal Revenue Code ( IRC ), which could further limit the realization of the net operating loss-related deferred tax asset ( NOL-DTA ). Although the local economy of the market in which the Company operates has been showing continued signs of improvement over the past two years, if this trend flattens or reverses, there is a potential that this negative evidence could outweigh the prevailing positive factors.

Based on the aforementioned considerations, the preponderance of positive factors, mitigation of negative factors, and no intensions of planned material non-routine transactions, the Company concluded that the predominance of observable positive evidence outweighs the future potential of negative evidence and therefore it is more likely than not that the Company will be able to realize in the future all of the net deferred income taxes.

## NOTE 16. EARNINGS/(LOSS) PER COMMON SHARE

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

| (In thousands, except per share data) | 2014 | 2013 | 2012 |
|---|---|---|---|
| Net income (loss) | **$ 5,051** | $ (9,634 ) | $ (9,638 ) |
| Weighted average shares outstanding basic | **10,945** | 8,461 | 8,457 |
| Dilutive effect of common stock equivalents | **8** | | |
| Weighted average shares outstanding diluted | **10,953** | 8,461 | 8,457 |
| Income (loss) per common share basic | **$ 0.46** | $ (1.14 ) | $ (1.14 ) |
| Income (loss) per common share diluted | **$ 0.46** | $ (1.14 ) | $ (1.14 ) |

The calculations of diluted income (loss) per share excluded weighted average common stock equivalents of $0 for 2014, $51 thousand for 2013, and $46 thousand for 2012 because the effect of including them would have been antidilutive.

TABLE OF CONTENTS

# SHORE BANCSHARES, INC.

# NOTES TO CONSOLIDATED FINANCIAL STATEMENTS For the Years Ended December 31, 2014, 2013, and 2012

## NOTE 17. REGULATORY CAPITAL REQUIREMENTS

Shore Bancshares, Inc. 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). As of December 31, 2014, management believes that Shore Bancshares, Inc. and CNB met all capital adequacy requirements to which they are subject. Per the Order, Talbot Bank submitted a capital plan to the FDIC and Commissioner which describes the methods and timing by which it will increase and maintain its capital ratios up to or in excess of required minimums (leverage ratio of 8%, total capital ratio of 12%). These methods include earnings from operations, capital infusions from the Company, and other capital-raising alternatives such as equity issuances.

As of December 31, 2014, the most recent notification from the Federal Deposit Insurance Corporation categorized Talbot Bank as adequately capitalized and CNB as well capitalized under the regulatory framework for prompt corrective action. To be categorized as adequately or well capitalized, the Banks must maintain minimum Tier 1 risk-based and total risk-based capital ratios, and Tier 1 leverage ratios, which are described below. The Talbot Bank would be considered well capitalized based on its capital ratios at year ended December 31, 2014, however must remain in the adequately capitalized category until the consent order is terminated by the FDIC and the Commissioner.

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.

The following tables present the capital amounts and ratios for Shore Bancshares, Inc., Talbot Bank and CNB as of December 31, 2014 and 2013.

| December 31, 2014 (Dollars in thousands) | Tier 1 Capital | Total Risk-Based Capital | Net Risk-Weighted Assets | Adjusted Average Total Assets | Tier 1 Risk-Based Capital Ratio | Total Risk-Based Capital Ratio | Tier 1 Leverage Ratio |
|---|---|---|---|---|---|---|---|
| Company | **$112,511** | **$120,510** | **$736,763** | **$1,075,674** | **15.27 %** | **16.36 %** | **10.46 %** |
| Talbot Bank | 51,637 | 55,910 | 394,788 | 579,781 | 13.08 | 14.16 | 8.91 |
| CNB | 44,869 | 48,594 | 331,089 | 485,042 | 13.55 | 14.68 | 9.25 |

| December 31, 2013 (Dollars in thousands) | Tier 1 Capital | Total Risk-Based Capital | Net Risk-Weighted Assets | Adjusted Average Total Assets | Tier 1 Risk-Based Capital Ratio | Total Risk-Based Capital Ratio | Tier 1 Leverage Ratio |
|---|---|---|---|---|---|---|---|
| Company | $72,370 | $81,341 | $717,129 | $1,028,957 | 10.09 % | 11.34 % | 7.03 % |
| Talbot Bank | 28,395 | 33,554 | 410,547 | 569,689 | 6.92 | 8.17 | 4.98 |
| CNB | 42,186 | 45,998 | 305,278 | 460,747 | 13.82 | 15.07 | 9.16 |

# SHORE BANCSHARES, INC.

# NOTES TO CONSOLIDATED FINANCIAL STATEMENTS For the Years Ended December 31, 2014, 2013, and 2012

## NOTE 17. REGULATORY CAPITAL REQUIREMENTS (continued)

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 Shore Bancshares, Inc. Talbot Bank is currently prohibited from paying dividends to Shore Bancshares, Inc. without the prior consent of its banking regulators. CNB paid dividends of $200 thousand to Shore Bancshares, Inc. during 2014. At December 31, 2014, CNB could have paid additional dividends to Shore Bancshares, Inc. of approximately $4.5 million without the prior consent and approval of its regulatory agencies. Shore Bancshares, Inc. had no outstanding receivables from subsidiaries at December 31, 2014 or 2013.

## NOTE 18. ACCUMULATED OTHER COMPREHENSIVE INCOME

The Company records unrealized holding gains (losses), net of tax, on investment securities available for sale and on cash flow hedging activities as accumulated other comprehensive income (loss), a separate component of stockholders equity. The following table provides information on the changes in the components of accumulated other comprehensive income (loss) for 2014 and 2013.

| (Dollars in thousands) | Accumulated net unrealized holding gains (losses) on available for sale securities | Accumulated net unrealized holding gains (losses) on cash flow hedging activities | Accumulated other comprehensive income (loss) |
|---|---|---|---|
| Balance, December 31, 2013 | **$ (437 )** | **$** | **$ (437 )** |
| Other comprehensive (loss) income | **767** | | **767** |
| Reclassification of (gains) losses recognized | **(14 )** | | **(14 )** |
| Balance, December 31, 2014 | **$ 316** | **$** | **$ 316** |
| Balance, December 31, 2012 | $ 1,894 | $ (1,186 ) | $ 708 |
| Other comprehensive income | (1,786 ) | 407 | (1,379 ) |
| Reclassification of (gains) losses recognized | (545 ) | 779 | 234 |
| Balance, December 31, 2013 | $ (437 ) | $ | $ (437 ) |

The following table presents the amounts reclassified out of each component of accumulated comprehensive income (loss) for the years ended December 31, 2014 and 2013.

| Details about Accumulated Other Comprehensive Income Components (dollars in thousands) | Amount Reclassified from Accumulated Other Comprehensive Income (Loss) Year Ended December 31, | | | Affected Line Item in the Statement Where Net Income is Presented |
|---|---|---|---|---|
| | 2014 | 2013 | 2012 | |
| Realized gain on sale of investment securities | **$ 14** | $ 545 | $ 166 | Gain on sale of investment securities |
| Total Reclassification for the Period | **$ 14** | $ 545 | $ 166 | |

# NOTE 19. LINES OF CREDIT

The Banks had $15.5 million in federal funds lines of credit and a reverse repurchase agreement available on a short-term basis from correspondent banks at both December 31, 2014 and 2013. In addition, the Banks had credit availability of approximately $70.9 million and $46.9 million from the Federal Home Loan Bank at December 31, 2014 and 2013, respectively. These lines of credit are paid for monthly on a fee basis of 0.09%. The Banks have pledged as collateral, under a blanket lien, all qualifying residential loans under borrowing agreements with the Federal Home Loan Bank. The Banks had no short-term borrowings from the Federal Home Loan Bank at December 31, 2014 or 2013.

TABLE OF CONTENTS

# SHORE BANCSHARES, INC.

# NOTES TO CONSOLIDATED FINANCIAL STATEMENTS For the Years Ended December 31, 2014, 2013, and 2012

## NOTE 20. FAIR VALUE MEASUREMENTS

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

The Company uses fair value measurements to record fair value adjustments to certain assets and liabilities 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 impaired loans, loans held for sale and other real estate owned (foreclosed assets). These nonrecurring fair value adjustments typically involve application of lower of cost or market accounting or write-downs of individual assets.

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

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

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

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

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

Investment Securities Available for Sale

Fair value measurement for investment securities available for sale is based on quoted prices from an independent pricing service. The fair value measurements consider observable data that may include present value of future cash flows, prepayment assumptions, credit loss assumptions and other factors. The Company classifies its investments in

U.S. Treasury securities as Level 1 in the fair value hierarchy, and it classifies its investments in U.S. Government agencies securities and mortgage-backed securities issued or guaranteed by U.S. Government sponsored entities as Level 2.

The tables below present the recorded amount of assets measured at fair value on a recurring basis at December 31, 2014 and 2013. No assets were transferred from one hierarchy level to another during 2014 or 2013.

| (Dollars in thousands) | Fair Value | Quoted Prices (Level 1) | Significant Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) |
|---|---|---|---|---|
| December 31, 2014 | | | | |
| Securities available for sale: | | | | |
| U.S. Treasury | **$5,215** | **$ 5,215** | **$** | **$** |
| U.S. Government agencies | **74,960** | | **74,960** | |
| Mortgage-backed | **155,303** | | **155,303** | |
| Equity | **630** | | **630** | |
| Total | **$236,108** | **$ 5,215** | **$ 230,893** | **$** |

86

TABLE OF CONTENTS

# SHORE BANCSHARES, INC.

# NOTES TO CONSOLIDATED FINANCIAL STATEMENTS For the Years Ended December 31, 2014, 2013, and 2012

## NOTE 20. FAIR VALUE MEASUREMENTS (continued)

| (Dollars in thousands) | Fair Value | Quoted Prices (Level 1) | Significant Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) |
|---|---|---|---|---|
| December 31, 2013 | | | | |
| Securities available for sale: | | | | |
| U.S. Treasury | $5,343 | $ 5,343 | $ | $ |
| U.S. Government agencies | 60,444 | | 60,444 | |
| Mortgage-backed | 80,713 | | 80,713 | |
| Equity | 601 | | 601 | |
| Total | $147,101 | $ 5,343 | $ 141,758 | $ |

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

Loans

The Company does not record loans at fair value on a recurring basis; however, from time to time, a loan is considered impaired and a valuation allowance may be established if there are losses associated with the loan. Loans are considered impaired if it is probable that payment of interest and principal will not be made in accordance with contractual terms. The fair value of impaired loans can be estimated using one of several methods, including the collateral value, market value of similar debt, liquidation value and discounted cash flows. At December 31, 2014 and 2013, substantially all impaired loans were evaluated based on the fair value of the collateral and were classified as Level 2 in the fair value hierarchy.

Loans held for sale

Loans held for sale are adjusted for fair value upon transfer of loans to loans held for sale. Subsequently, loans held for sale are carried at the lower of carrying value and fair value. Fair value is based on independent market prices, appraised value of the collateral or management s estimation of the value of the collateral. At December 31, 2014, the Company had no loans held for sale. At December 31, 2013 loans held for sale were classified as Level 2 in the fair value hierarchy.

Other Real Estate Owned (Foreclosed Assets)

Foreclosed assets are adjusted for fair value upon transfer of loans to foreclosed assets. Subsequently, foreclosed assets are carried at the lower of carrying value and fair value. Fair value is based on independent market prices, appraised value of the collateral or management s estimation of the value of the collateral. At December 31, 2014 and 2013, foreclosed assets were classified as Level 2 in the fair value hierarchy.

The tables below present the recorded amount of assets measured at fair value on a nonrecurring basis at December 31, 2014 and 2013. No assets were transferred from one hierarchy level to another during 2014 or 2013.

| (Dollars in thousands) | Fair Value | Quoted Prices (Level 1) | Significant Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) |
|---|---|---|---|---|
| December 31, 2014 | | | | |
| Impaired loans | | | | |
| Construction | **$ 10,026** | **$** | **$ 10,026** | **$** |
| Residential real estate | **9,304** | | **9,304** | |
| Commercial real estate | **9,230** | | **9,230** | |
| Commercial | **187** | | **187** | |
| Consumer | **121** | | **121** | |
| Total impaired loans | **28,868** | | **28,868** | |
| Other real estate owned | **3,691** | | **3,691** | |
| Total assets measured at fair value on a nonrecurring basis | **$ 32,559** | **$** | **$ 32,559** | **$** |

TABLE OF CONTENTS

# SHORE BANCSHARES, INC.

# NOTES TO CONSOLIDATED FINANCIAL STATEMENTS For the Years Ended December 31, 2014, 2013, and 2012

## NOTE 20. FAIR VALUE MEASUREMENTS (continued)

| (Dollars in thousands) | Fair Value | Quoted Prices (Level 1) | Significant Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) |
|---|---|---|---|---|
| December 31, 2013 | | | | |
| Impaired loans | | | | |
| Construction | $ 5,365 | $ | $ 5,365 | $ |
| Residential real estate | 19,463 | | 19,463 | |
| Commercial real estate | 14,418 | | 14,418 | |
| Commercial | 642 | | 642 | |
| Consumer | 43 | | 43 | |
| Total impaired loans | 39,931 | | 39,931 | |
| Loans held for sale | 3,521 | | 3,521 | |
| Other real estate owned | 3,779 | | 3,779 | |
| Total assets measured at fair value on a nonrecurring basis | $ 47,231 | $ | $ 47,231 | $ |

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

Cash and Cash Equivalents

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

Investment Securities Held to Maturity

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

Loans

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

Financial Liabilities

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

Commitments to Extend Credit and Standby Letters of Credit

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

TABLE OF CONTENTS

# SHORE BANCSHARES, INC.

# NOTES TO CONSOLIDATED FINANCIAL STATEMENTS For the Years Ended December 31, 2014, 2013, and 2012

## NOTE 20. FAIR VALUE MEASUREMENTS (continued)

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

| (Dollars in thousands) | December 31, 2014 | | December 31, 2013 | |
|---|---|---|---|---|
| | Carrying Amount | Estimated Fair Value | Carrying Amount | Estimated Fair Value |
| Financial assets | | | | |
| Level 2 inputs | | | | |
| Cash and cash equivalents | **$ 96,223** | **$ 96,223** | $ 131,090 | $ 131,090 |
| Investment securities held to maturity | **4,630** | **4,694** | 5,185 | 5,062 |
| Loans, net | **703,051** | **724,771** | 701,194 | 721,688 |
| Financial liabilities | | | | |
| Level 2 inputs | | | | |
| Deposits | **$ 949,004** | **$ 948,605** | $ 933,468 | $ 934,943 |
| Short-term borrowings | **4,808** | **4,808** | 10,140 | 10,140 |

## NOTE 21. DERIVATIVE INSTRUMENTS AND HEDGING ACTIVITIES

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

During the second quarter of 2009, the Company purchased interest rate caps for $7.1 million to effectively fix the interest rate at 2.97% for five years on $70 million of the Company s money market deposit accounts related to our participation in the IND Program. In the fourth quarter of 2012, the Company decided to partially exit the IND Program in an effort to reduce its excess liquidity and a portion of the interest rate caps used to hedge the interest rates on these deposits was terminated. In the second quarter of 2013, the Company fully exited the IND Program and the remainders of the interest rate caps were terminated. Because the interest rate caps qualified for hedge accounting, a

$1.3 million loss on the ineffective portion of the cash flow hedge was recognized in both the second quarter of 2013 and the fourth quarter of 2012.

The aggregate fair value of the interest rate caps was $14 thousand at December 31, 2012. The adjustments that reduced the balance to $0 at December 31, 2013 included an increase of $681 thousand to reflect unrealized holding gains on the interest rate caps and a decrease of $695 thousand to reflect the charge to interest expense associated with the hedged money market deposit accounts. Interest expense for 2014 did not reflect this adjustment because the interest rate caps were terminated in June of 2013.

By entering into derivative instrument contracts, the Company exposes itself, from time to time, to counterparty credit risk. Counterparty credit risk is the risk that the counterparty will fail to perform under the terms of the derivative contract. When the fair value of a derivative contract is in an asset position, the counterparty has a liability to the Company, which creates credit risk for the Company. The Company attempts to minimize this risk by selecting counterparties with investment grade credit ratings, limiting its

TABLE OF CONTENTS

# SHORE BANCSHARES, INC.

# NOTES TO CONSOLIDATED FINANCIAL STATEMENTS For the Years Ended December 31, 2014, 2013, and 2012

## NOTE 21. DERIVATIVE INSTRUMENTS AND HEDGING ACTIVITIES (continued)

exposure to any single counterparty and regularly monitoring its market position with each counterparty. Collateral required by the counterparties, recorded in other liabilities, was $0 at December 31, 2014 and 2013, respectively.

## NOTE 22. 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 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.

The following table provides information on commitments outstanding as of December 31, 2014 and 2013.

| (Dollars in thousands) | 2014 | 2013 |
|---|---|---|
| Commitments to extend credit | **$ 127,080** | $ 116,596 |
| Letters of credit | **7,347** | 10,477 |
| Total | **$ 134,427** | $ 127,073 |

# NOTE 23. CONTINGENCIES

In the normal course of business, Shore Bancshares, Inc. 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.

# SHORE BANCSHARES, INC.

# NOTES TO CONSOLIDATED FINANCIAL STATEMENTS For the Years Ended December 31, 2014, 2013, and 2012

## NOTE 24. PARENT COMPANY FINANCIAL INFORMATION

The following tables provide condensed financial information for Shore Bancshares, Inc. (Parent Company Only).

Condensed Balance Sheets
December 31,

| (Dollars in thousands) | 2014 | 2013 |
|---|---|---|
| Assets | | |
| Cash | **$ 2,101** | $ 987 |
| Investment securities | **9,723** | |
| Investment in subsidiaries | **126,857** | 102,815 |
| Premises and equipment, net | **3,158** | 2,726 |
| Other assets | **1,329** | 1,284 |
| Total assets | **$ 143,168** | $ 107,812 |
| Liabilities | | |
| Accrued interest payable | **$ 1** | $ |
| Deferred tax liability | | 1,628 |
| Other liabilities | **855** | 542 |
| Long-term debt | **1,843** | 2,343 |
| Total liabilities | **2,699** | 4,513 |
| Stockholders equity | | |
| Common stock | **126** | 85 |
| Additional paid in capital | **63,532** | 32,207 |
| Retained earnings | **76,495** | 71,444 |
| Accumulated other comprehensive income (loss) | **316** | (437 ) |
| Total stockholders equity | **140,469** | 103,299 |
| Total liabilities and stockholders equity | **$ 143,168** | $ 107,812 |

TABLE OF CONTENTS

# SHORE BANCSHARES, INC.

# NOTES TO CONSOLIDATED FINANCIAL STATEMENTS For the Years Ended December 31, 2014, 2013, and 2012

## NOTE 24. PARENT COMPANY FINANCIAL INFORMATION (continued)

Condensed Statements of Operations
For the Years Ended December 31,

| (Dollars in thousands) | 2014 | 2013 | 2012 |
|---|---|---|---|
| Income | | | |
| Dividends from subsidiaries | **$ 200** | $ 2,163 | $ 3,154 |
| Management and other fees from subsidiaries | **7,933** | 6,226 | 5,692 |
| Other income | **110** | 31 | 180 |
| Total income | **8,243** | 8,420 | 9,026 |
| Expenses | | | |
| Interest expense | **80** | 88 | 107 |
| Salaries and employee benefits | **5,321** | 4,447 | 4,188 |
| Occupancy and equipment expense | **541** | 508 | 463 |
| Other operating expenses | **2,387** | 1,853 | 1,529 |
| Total expenses | **8,329** | 6,896 | 6,287 |
| (Loss) income before income tax benefit and equity in undistributed net income (loss) of subsidiaries | **(86)** | 1,524 | 2,739 |
| Income tax benefit | **(107)** | (61) | (58) |
| Income before equity in undistributed net income (loss) of subsidiaries | **21** | 1,585 | 2,797 |
| Equity in undistributed net income (loss) of subsidiaries | **5,030** | (11,219) | (12,435) |
| Net income (loss) | **$ 5,051** | $ (9,634) | $ (9,638) |

# SHORE BANCSHARES, INC.

# NOTES TO CONSOLIDATED FINANCIAL STATEMENTS For the Years Ended December 31, 2014, 2013, and 2012

## NOTE 24. PARENT COMPANY FINANCIAL INFORMATION (continued)

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

| (Dollars in thousands) | 2014 | 2013 | 2012 |
|---|---|---|---|
| Cash flows from operating activities: | | | |
| Net income (loss) | **$5,051** | $(9,634) | $(9,638) |
| Adjustments to reconcile net (income) loss to cash provided by operating activities: | | | |
| Equity in undistributed net (income) loss of subsidiaries | **(5,030)** | 11,219 | 12,435 |
| Depreciation and amortization | **379** | 386 | 367 |
| Stock-based compensation expense | **87** | 78 | 209 |
| Excess tax benefit from stock-based arrangements | | (26) | (106) |
| Net (increase) decrease in other assets | **(121)** | 128 | (246) |
| Net increase (decrease) in other liabilities | **271** | (53) | (423) |
| Net cash provided by operating activities | **637** | 2,098 | 2,598 |
| Cash flows from investing activities: | | | |
| Proceeds from sale of securities | **442** | | |
| Purchases of securities | **(10,112)** | | |
| Purchases of premises and equipment | **(632)** | (307) | (108) |
| Investment in subsidiaries | **(20,000)** | (1,650) | (2,000) |
| Net cash used in investing activities | **(30,302)** | (1,957) | (2,108) |
| Cash flows from financing activities: | | | |
| Repayment of long-term debt | **(500)** | | (1,007) |
| Excess tax benefit from stock-based arrangements | | 26 | 106 |
| Proceeds from issuance of common stock | **31,279** | | |
| Common stock dividends paid | | | (85) |
| Net cash provided by (used in) financing activities | **30,779** | 26 | (986) |
| Net increase (decrease) in cash and cash equivalents | **1,114** | 167 | (496) |
| Cash and cash equivalents at beginning of year | **987** | 820 | 1,316 |
| Cash and cash equivalents at end of year | **$2,101** | $987 | $820 |

93

TABLE OF CONTENTS

# SHORE BANCSHARES, INC.

# NOTES TO CONSOLIDATED FINANCIAL STATEMENTS For the Years Ended December 31, 2014, 2013, and 2012

## NOTE 25. QUARTERLY FINANCIAL RESULTS (unaudited)

The following table provides a summary of selected consolidated quarterly financial data for the two years ended December 31, 2014.

| (In thousands, except per share data) | First Quarter | Second Quarter | Third Quarter | Fourth Quarter |
|---|---|---|---|---|
| 2014 | | | | |
| Interest income | **$ 9,455** | **$ 9,523** | **$ 9,686** | **$ 9,625** |
| Net interest income | **8,323** | **8,447** | **8,636** | **8,636** |
| Provision for credit losses | **975** | **950** | **775** | **650** |
| Income (loss) before income taxes | **2,021** | **2,108** | **2,036** | **1,947** |
| Net income (loss) | **1,258** | **1,305** | **1,262** | **1,226** |
| Basic earnings (loss) per common share | **$ 0.15** | **$ 0.13** | **$ 0.10** | **$ 0.10** |
| Diluted earnings (loss) per common share | **$ 0.15** | **$ 0.13** | **$ 0.10** | **$ 0.10** |
| 2013 | | | | |
| Interest income | $ 10,607 | $ 10,755 | $ 10,182 | $ 9,807 |
| Net interest income | 8,477 | 9,001 | 8,828 | 8,570 |
| Provision for credit losses | 2,150 | 2,700 | 22,460 | 474 |
| (Loss) income before income taxes | 326 | 504 | (18,808 ) | 1,843 |
| Net (loss) income | 222 | 361 | (11,392 ) | 1,175 |
| Basic (loss) earnings per common share | $ 0.03 | $ 0.04 | $ (1.35 ) | $ 0.14 |
| Diluted (loss) earnings per common share | $ 0.03 | $ 0.04 | $ (1.35 ) | $ 0.14 |
| 2012 | | | | |
| Interest income | $ 11,856 | $ 11,692 | $ 11,393 | $ 10,960 |
| Net interest income | 9,195 | 9,033 | 8,730 | 8,381 |
| Provision for credit losses | 8,370 | 3,525 | 6,200 | 9,650 |
| (Loss) income before income taxes | (5,099 ) | 422 | (3,178 ) | (8,348 ) |
| Net (loss) income | (3,036 ) | 293 | (1,821 ) | (5,074 ) |
| Basic (loss) earnings per common share | $ (0.36 ) | $ 0.03 | $ (0.22 ) | $ (0.60 ) |
| Diluted (loss) earnings per common share | $ (0.36 ) | $ 0.03 | $ (0.22 ) | $ (0.60 ) |

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

# NOTE 26. 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.

TABLE OF CONTENTS

# SHORE BANCSHARES, INC.

# NOTES TO CONSOLIDATED FINANCIAL STATEMENTS For the Years Ended December 31, 2014, 2013, and 2012

## NOTE 26. SEGMENT REPORTING (continued)

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

| (Dollars in thousands) | Community Banking | Insurance Products and Services | Parent Company | Total |
|---|---|---|---|---|
| 2014 | | | | |
| Interest income | **$ 38,202** | **$** | **$ 87** | **$ 38,289** |
| Interest expense | **(4,247 )** | | | **(4,247 )** |
| Provision for credit losses | **(3,350 )** | | | **(3,350 )** |
| Noninterest income | **6,482** | **10,305** | **(6 )** | **16,781** |
| Noninterest expense | **(22,776 )** | **(8,527 )** | **(8,058 )** | **(39,361 )** |
| Net intersegment (expense) income | **(7,010 )** | **(680 )** | **7,690** | |
| (Loss) income before income taxes | **7,301** | **1,098** | **(287 )** | **8,112** |
| Income tax benefit (expense) | **(2,755 )** | **(414 )** | **108** | **(3,061 )** |
| Net (loss) income | **$ 4,546** | **$ 684** | **$ (179 )** | **$ 5,051** |
| Total assets | **$ 1,074,638** | **$ 10,824** | **$ 14,940** | **$ 1,100,402** |
| 2013 | | | | |
| Interest income | $ 41,310 | $ 41 | $ | $ 41,351 |
| Interest expense | (6,475 ) | | | (6,475 ) |
| Provision for credit losses | (27,784 ) | | | (27,784 ) |
| Noninterest income | 5,716 | 11,737 | 6 | 17,459 |
| Noninterest expense | (23,676 ) | (10,350 ) | (6,660 ) | (40,686 ) |
| Net intersegment (expense) income | (5,359 ) | (655 ) | 6,014 | |
| (Loss) income before income taxes | (16,268 ) | 773 | (640 ) | (16,135 ) |
| Income tax benefit (expense) | 6,556 | (313 ) | 258 | 6,501 |
| Net (loss) income | $ (9,712 ) | $ 460 | $ (382 ) | $ (9,634 ) |
| Total assets | $ 1,036,098 | $ 15,759 | $ 2,267 | $ 1,054,124 |
| 2012 | | | | |
| Interest income | $ 45,822 | $ 79 | $ | $ 45,901 |
| Interest expense | (10,546 ) | | (16 ) | (10,562 ) |
| Provision for credit losses | (27,745 ) | | | (27,745 ) |
| Noninterest income | 5,197 | 10,422 | 139 | 15,758 |
| Noninterest expense | (23,702 ) | (9,820 ) | (6,033 ) | (39,555 ) |

| | | | | |
|---|---|---|---|---|
| Net intersegment (expense) income | (4,993) | (503) | 5,496 | |
| (Loss) income before income taxes | (15,967) | 178 | (414) | (16,203) |
| Income tax benefit (expense) | 6,467 | (70) | 168 | 6,565 |
| Net (loss) income | $ (9,500) | $ 108 | $ (246) | $ (9,638) |
| Total assets | $ 1,166,468 | $ 16,809 | $ 2,530 | $ 1,185,807 |

95

TABLE OF CONTENTS

# 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 principal executive officer (the PEO ) 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, 2014 was carried out under the supervision and with the participation of the Company s management, including the PEO 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 2014, 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, 2013. 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.

TABLE OF CONTENTS

# 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) 763-7800.

All other information required by this item is incorporated herein by reference to the following sections of the Company s definitive proxy statement to be filed in connection with the 2015 Annual Meeting of Stockholders:

Election of Directors (Proposal 1);
Continuing Directors;
Executive Officers;
Qualifications of Director Nominees and Continuing Directors;
Section 16(a) Beneficial Ownership Reporting Compliance; and
Corporate Governance Matters (under the heading, Board Committees ).

## Item 11. Executive Compensation.

The information required by this item is incorporated herein by reference to the following sections of the Company s definitive proxy statement to be filed in connection with the 2015 Annual Meeting of Stockholders:

Executive Compensation
Director Compensation

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

The Company maintains the Shore Bancshares, Inc. 2006 Stock and Incentive Compensation Plan (the 2006 Plan ) under which it may issue shares of common stock or grant other equity-based awards (stock options, stock appreciation rights, stock awards, stock units, and performance units) to directors, executive officers, and key employees at the discretion of the Compensation Committee of the Board of Shore Bancshares, Inc. The plan 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, 2014.

| Plan Category | Number of securities to be issued upon exercise of | Weighted-average exercise price of outstanding options, | Number of securities remaining available for future issuance |
|---|---|---|---|

| | outstanding options, warrants and rights (a) | warrants, and rights (b) | under equity compensation plans [excluding securities reflected in column (a)] (c) |
|---|---|---|---|
| Equity compensation plans approved by security holders[1] | 27,108 | $ 6.64 | 503,048 |
| Equity compensation plans not approved by security holders | | | |
| Total | 27,108 | $ 6.64 | 503,048 |

(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

97

TABLE OF CONTENTS

(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, 2014, the Company has granted 88,262 shares of restricted stock that are not reflected in column (a) of this table.

All other information required by this item is incorporated herein by reference to the section of the Company s definitive proxy statement to be filed in connection with the 2015 Annual Meeting of Stockholders entitled Beneficial Ownership of Common Stock .

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

The information required by this item is incorporated herein by reference to the sections of the Company s definitive proxy statement to be filed in connection with the 2015 Annual Meeting of Stockholders entitled Certain Relationships and Related Transactions and Corporate Governance Matters (under the heading, Director Independence ).

# Item 14. Principal Accounting Fees and Services.

The information required by this item is incorporated herein by reference to the section of the Company s definitive proxy statement to be filed in connection with the 2015 Annual Meeting of Stockholders entitled Audit Fees and Services .

TABLE OF CONTENTS

# 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 | 51 |
| Consolidated Balance Sheets at December 31, 2014 and 2013 | 53 |
| Consolidated Statements of Operations Years Ended December 31, 2014, 2013, and 2012 | 54 |
| Consolidated Statements of Comprehensive Loss Years Ended December 31, 2014, 2013, and 2012 | 55 |
| Consolidated Statements of Changes in Stockholders Equity Years Ended December 31, 2014, 2013, and 2012 | 56 |
| Consolidated Statements of Cash Flows Years Ended December 31, 2014, 2013, and 2012 | 57 |
| Notes to Consolidated Financial Statements for the years ended December 31, 2014, 2013, and 2012 | 59 |


(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.

99

TABLE OF CONTENTS

# SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the Registrant has caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

Shore Bancshares, Inc.
By:

Date: March 13, 2015

/s/ Lloyd L. Beatty, Jr.

Lloyd L. Beatty, Jr.
*President and Chief Executive Officer*

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the Registrant and in the capacities and on the dates indicated.

/s/ Blenda W. Armistead

Blenda W. Armistead, Director
March 13, 2015

/s/ David J. Bates

David J. Bates, Director
March 13, 2015

/s/ James A. Judge

James A. Judge, Director
March 13, 2015

/s/ Frank E. Mason, III

Frank E. Mason, III, Director
March 13, 2015

/s/ David W. Moore

David W. Moore, Director
March 13, 2015

/s/ John H. Wilson

John H. Wilson, Director
March 13, 2015

/s/ Lloyd L. Beatty, Jr.

Lloyd L. Beatty, Jr.,
Director, President, and Chief Executive Officer
(Principal Executive Officer)
March 13, 2015

/s/ Christopher F. Spurry

Christopher F. Spurry, Director
March 13, 2015

/s/ W. Moorhead Vermilye

W. Moorhead Vermilye, Director
March 13, 2015

/s/ George S. Rapp

George S. Rapp
Vice President and Chief Financial Officer
(Principal Accounting Officer)
March 13, 2015

TABLE OF CONTENTS

# 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) |
| 3.1(iii) | Articles Supplementary relating to the reclassification of Fixed Rate Cumulative Perpetual Preferred Stock, Series A, as common stock (incorporated by reference Exhibit 3.1(i) of the Company s Form 8-K filed on June 17, 2009) |
| 3.2(i) | Amended and Restated By-Laws (incorporated by reference to Exhibit 3.2(i) of the Company s Form 10-K for the year ended December 31, 2010) |
| 3.2(ii) | First Amendment to Amended and Restated By-Laws (incorporated by reference to Exhibit 3.2(ii) of the Company s Form 10-K for the year ended December 31, 2010) |
| 3.2(iii) | Second Amendment to Amended and Restated By-Laws (incorporated by reference to Exhibit 3.2(iii) of the Company s Form 10-K for the year ended December 31, 2010) |
| 3.2(iv) | Third Amendment to Amended and Restated By-Laws (incorporated by reference to Exhibit 3.2(iv) of the Company s Form 10-K for the year ended December 31, 2010) |
| 10.1 | Amended and Restated Employment Agreement, dated June 16, 2011, between the Company and W. Moorhead Vermilye (incorporated by reference to Exhibit 10.1 to the Company s Form 10-Q/A for the quarter ended June 30, 2011 filed on November 14, 2011). |
| 10.2 | Employment Agreement, dated June 16, 2011, between the Company and Lloyd L. Beatty, Jr. (incorporated by reference to Exhibit 10.2 of the Company s Form 10-Q/A for the quarter ended June 30, 2011 filed on November 14, 2011) |
| 10.3 | 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) |
| 10.4 | 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) |
| 10.5 | 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) |
| 10.6 | Shore Bancshares, Inc. Management Incentive Plan (incorporated by reference to Exhibit 10.1 of the Company s Form 8-K filed on April 21, 2010) |
| 10.7 | 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) |
| 10.8 | 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) |
| 10.9 | Form of Centreville National Bank of Maryland Director Indexed Fee Continuation Plan Agreement with Messrs. Freestate and Pierson (incorporated by reference to Exhibit 10.2 to the |

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| | Company s Form 8-K filed on December 12, 2006) |
| 10.10 | Form of Amended and Restated Director Indexed Fee Continuation Plan Agreement between Centreville National Bank and Messrs. 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) |

101

TABLE OF CONTENTS

| Exhibit No. | Description |
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| 10.11 | Form of Centreville National Bank Life Insurance Endorsement Split Dollar Plan Agreement with Messrs. Freestate and Pierson (incorporated by reference to Exhibit 10.3 to the Company s Form 8-K filed on December 12, 2006) |
| 10.12 | 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) |
| 10.13 | 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) |
| 10.14 | 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) |
| 10.15 | 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)) |
| 10.16 | 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)) |
| 10.17 | 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) |
| 10.18 | 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) |
| 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) |
| 31.1 | Certifications of the PEO 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) |