

Howard Bancorp Inc  
Form 10-Q  
November 13, 2014

**UNITED STATES**

**SECURITIES AND EXCHANGE COMMISSION**

**Washington, D.C. 20549**

**FORM 10-Q**

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

For the quarterly period ended September 30, 2014

OR

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

Commission File Number: 001-35489

**HOWARD BANCORP, INC.**

(Exact name of registrant as specified in its charter)

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**Maryland**

**20-3735949**

(State or other jurisdiction of incorporation or organization) (I.R.S. Employer Identification No.)

**6011 University Blvd. Suite 370, Ellicott City, MD 21043**

(Address of principal executive offices) (Zip Code)

**(410) 750-0020**

(Registrant's telephone number, including area code)

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

Indicate by check mark whether the registrant 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 during to preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes  No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a small reporting company. See the definitions of "large accelerated filer," "accelerated filer" and "small reporting company" in Rule 12b-2 of the Exchange Act.

Large accelerated filer  Accelerated filer   
Non-accelerated filer  Small reporting company

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

The number of outstanding shares of common stock outstanding as of October 31, 2014.

Common Stock, \$0.01 par value – 4,140,189 shares



HOWARD BANCORP, INC.

TABLE OF CONTENTS

	Page
PART I <u>Financial Information</u>	4
Item 1. <u>Financial Statements</u>	4
<u>Consolidated Balance Sheet (Unaudited)</u>	4
<u>Consolidated Statements of Operations (Unaudited)</u>	5
<u>Consolidated Statements of Comprehensive Income (Unaudited)</u>	5
<u>Consolidated Statements of Changes in Shareholders' Equity (Unaudited)</u>	6
<u>Consolidated Statements of Cash Flows (Unaudited)</u>	7
<u>Notes to Consolidated Financial Statements (Unaudited)</u>	8
Item 2. <u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	24
Item 3. <u>Quantitative and Qualitative Disclosure about Market Risk</u>	39
Item 4. <u>Controls and Procedures</u>	39
PART II <u>Other Information</u>	39
Item 1. <u>Legal Proceeding</u>	39
Item 1A. <u>Risk Factors</u>	39
Item 2. <u>Unregistered Sales of Equity Securities and Use of Proceeds</u>	39
Item 3. <u>Defaults upon Senior Securities</u>	40
Item 4. <u>Mine Safety Disclosures</u>	40
Item 5. <u>Other Information</u>	40
Item 6. <u>Exhibits</u>	40
<u>Signature</u>	41

As used in this report, "Bancorp" refers to Howard Bancorp, Inc., references to the "Company," "we," "us," and "ours" refer to Howard Bancorp, Inc. and its subsidiaries, collectively, and references to the "Bank" refer to Howard Bank.

This report contains forward-looking statements, which can be identified by the use of words such as "estimate," "project," "believe," "intend," "anticipate," "plan," "seek," "expect," "will," "may," "should" and words of similar meaning. You can also identify them by the fact that they do not relate strictly to historical or current facts.

These forward-looking statements include, but are not limited to:

- statements of our goals, intentions and expectations, particularly our business plans and strategies, increasing originations of residential mortgage loans, increasing our portfolio of mortgage lending and selling loans into the secondary market;
- the impact of [a] new accounting pronouncement[s];
- statements regarding our intentions in our investment portfolio and the status of unrealized losses in such portfolios;
- statements with respect to our allowance for credit losses, and the adequacy thereof;
- statements with respect to anticipated losses on nonperforming loans;
- future cash requirements relating to commitments to extend credit, and that we do not anticipate any material losses in connection therewith;
- our ability to retain maturing certificates of deposits;
- our statement with respect to adequate liquidity; and
- the impact on us of pending legal proceedings.

These forward-looking statements are based on our current beliefs and expectations and are inherently subject to significant business, economic and competitive uncertainties and contingencies, many of which are beyond our control. In addition, these forward-looking statements are subject to assumptions with respect to future business strategies and decisions that are subject to change. We are under no duty to and do not undertake any obligation to update any forward-looking statements after the date of this report.

The following factors, among others, could cause actual results to differ materially from the anticipated results or other expectations expressed in the forward-looking statements:

- general economic conditions, either nationally or in our market area, that are worse than expected;
- competition among depository and other financial institutions;
- inflation and changes in the interest rate environment that reduce our margins or reduce the fair value of financial instruments;
- adverse changes in the securities markets;

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changes in laws or government regulations or policies affecting financial institutions, including changes in regulatory fees and capital requirements;

our ability to enter new markets successfully and capitalize on growth opportunities, and to otherwise implement our growth strategy;

- our ability to successfully integrate acquired entities, if any
- changes in consumer spending, borrowing and savings habits;

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

- changes in our organization, compensation and benefit plans
- loss of key personnel; and

other risk discussed in this report, in our annual report on Form 10-K for the year ended December 31, 2013, as filed with the SEC, and in other reports we may file.

Because of these and a wide variety of other uncertainties, our actual future results may be materially different from the results indicated by these forward-looking statements. You should not put undue reliance on any forward-looking statements.

**PART I****Item 1. Financial Statements****Howard Bancorp, Inc. and Subsidiary****Consolidated Balance Sheets**

(in thousands)	Unaudited September 30, 2014	December 31, 2013
<b>ASSETS</b>		
Cash and due from banks	\$ 17,361	\$ 23,282
Federal funds sold	310	12,454
Total cash and cash equivalents	17,671	35,736
Securities available-for-sale, at fair value	27,112	28,688
Nonmarketable equity securities	2,700	2,282
Loans held for sale, at fair value	38,669	3,298
Loans and leases, net of unearned income	461,232	403,875
Allowance for credit losses	(3,018)	(2,506)
Net loans and leases	458,214	401,369
Bank premises and equipment, net	11,521	10,842
Core deposit intangible	798	342
Bank owned life insurance	11,563	11,282
Other real estate owned	2,472	2,377
Deferred income taxes	1,018	1,125
Interest receivable and other assets	2,630	2,577
Total assets	\$ 574,368	\$ 499,918
<b>LIABILITIES</b>		
Noninterest-bearing deposits	\$ 106,237	\$ 89,759
Interest-bearing deposits	345,673	299,190
Total deposits	451,910	388,949
Short-term borrowings	51,956	45,658
Long-term borrowings	19,000	16,000
Accrued expenses and other liabilities	1,123	687
Total liabilities	523,989	451,294
<b>COMMITMENTS AND CONTINGENCIES</b>		
<b>SHAREHOLDERS' EQUITY</b>		
Preferred stock—par value \$0.01 (liquidation preference of \$1,000 per share) authorized 5,000,000; shares issued and outstanding 12,562 series AA at September 30, 2014	12,562	12,562

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and December 31, 2013, net of issuance cost

Common stock - par value of \$0.01 authorized 10,000,000 shares; issued and outstanding 4,140,189 shares at September 30, 2014 and 4,095,650 December 31, 2013	41		41	
Capital surplus	38,217		37,607	
Accumulated deficit	(445	)	(1,590	)
Accumulated other comprehensive income	4		4	
Total shareholders' equity	50,379		48,624	
Total liabilities and shareholders' equity	\$ 574,368		\$ 499,918	

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



**Consolidated Statements of Operations**

(in thousands)	Unaudited		Three months ended	
	September 30, 2014	September 30, 2013	September 30, 2014	September 30, 2013
<b>INTEREST INCOME</b>				
Interest and fees on loans	\$ 16,038	\$ 12,713	\$ 5,776	\$ 4,627
Interest and dividends on securities	86	57	28	16
Other interest income	30	35	9	12
Total interest income	16,154	12,805	5,813	4,655
<b>INTEREST EXPENSE</b>				
Deposits	1,485	1,208	560	422
Short-term borrowings	84	83	28	26
Long-term borrowings	162	90	60	49
Total interest expense	1,731	1,381	648	497
<b>NET INTEREST INCOME</b>	14,423	11,424	5,165	4,158
Provision for credit losses	2,570	666	2,068	140
Net interest income after provision for credit losses	11,853	10,758	3,097	4,018
<b>NONINTEREST INCOME</b>				
Service charges on deposit accounts	425	275	118	106
Realized and unrealized gains on mortgage banking activity	2,864	195	1,388	35
Loss on the sale of other real estate owned	-	(37 )	-	-
Income from bank owned life insurance	281	210	95	72
Other operating income	1,287	319	574	106
Total noninterest income	4,857	962	2,175	319
<b>NONINTEREST EXPENSE</b>				
Compensation and benefits	8,456	5,260	2,790	1,905
Occupancy and equipment	1,545	1,154	489	406
Amortization of core deposit intangible	58	14	17	14
Marketing and business development	1,120	464	400	153
Professional fees	869	634	298	246
Data processing fees	488	387	174	148
FDIC Assessment	301	242	101	87
Provision for other real estate owned	-	347	-	347
Other operating expense	1,966	1,006	692	401
Total noninterest expense	14,803	9,508	4,961	3,707
<b>INCOME BEFORE INCOME TAXES</b>	1,907	2,212	311	630
Income tax expense	668	808	75	223
<b>NET INCOME</b>	1,239	1,404	236	407

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Preferred stock dividends	94	134	31	31
Net income available to common shareholders	\$1,145	\$1,270	\$ 205	\$ 376
NET INCOME PER COMMON SHARE				
Basic	\$0.28	\$0.31	\$ 0.05	\$ 0.09
Diluted	\$0.28	\$0.31	\$ 0.05	\$ 0.09

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

**Consolidated Statements of Comprehensive Income**

(in thousands) (Unaudited)	<b>Nine months ended September 30,</b>	
	2014	2013
Net Income	\$ 1,239	\$ 1,404
Other comprehensive income		
Investments available-for-sale:		
Unrealized holding losses	(1 )	(21 )
Related income tax benefit	1	9
Comprehensive income	\$ 1,239	\$ 1,392

(in thousands) (Unaudited)	<b>Three months ended September 30,</b>	
	2014	2013
Net Income	\$ 236	\$ 407
Other comprehensive income		
Investments available-for-sale:		
Unrealized holding losses	(2 )	(1 )
Related income tax benefit	1	-
Comprehensive income	\$ 235	\$ 406

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

**Consolidated Statements of Changes in Shareholders' Equity**

(dollars in thousands, except per share data) (Unaudited)	Preferred stock	Number of shares	Common stock	Capital Surplus	Accumulated deficit	Accumulated other comprehensive gain/loss	Total
Balances at January 1, 2013	\$ 12,562	4,040,471	\$ 40	\$ 37,484	\$ (3,386 )	\$ 21	\$ 46,721
Net income	-	-	-	-	1,404	-	1,404
Net unrealized loss on securities	-	-	-	-	-	(12 )	(12 )
Dividends paid on preferred stock	-	-	-	-	(134 )	-	(134 )
Stock based compensation	-	-	-	57	-	-	57
Balances at September 30, 2013	\$ 12,562	4,040,471	\$ 40	\$ 37,541	\$ (2,116 )	\$ 9	\$ 48,036

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Balances at January 1, 2014	\$ 12,562	4,095,650	\$ 41	\$ 37,607	\$ (1,590 )	\$ 4	\$ 48,624
Net income	-	-	-	-	1,239	-	1,239
Net unrealized gains on securities	-	-	-	-	-	-	-
Dividends paid on preferred stock	-	-	-	-	(94 )	-	(94 )
Forfeited restricted shares	-	(6,668 )	-	(34 )	-	-	(34 )
Stock based compensation	-	-	-	133	-	-	133
Issuance of common stock:							
Exercise of warrants	-	47,068	-	470	-	-	470
Stock awards	-	4,139	-	41	-	-	41
Balances at September 30, 2014	\$ 12,562	4,140,189	\$ 41	\$ 38,217	\$ (445 )	\$ 4	\$ 50,379

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

**Consolidated Statements of Cash Flows**

(in thousands)	Unaudited Nine months ended September 30,	
	2014	2013
<b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>		
Net income	\$1,239	\$1,404
Adjustments to reconcile net income to net cash provided by operating activities:		
Provision for credit losses	2,570	666
Deferred income taxes (benefit)	108	(289 )
Provision for other real estate owned	-	347
Depreciation	537	441
Stock-based compensation	141	57
Net accretion of investment securities	-	16
Net amortization of intangible asset	58	14
Loans originated for sale	(201,462)	(9,827 )
Proceeds from sales of loans	168,956	10,856
Realized and unrealized gains on mortgage banking activity	(2,864 )	(195 )
Loss on sales of other real estate owned, net	-	37
Cash surrender value of BOLI	(281 )	(210 )
Decrease in interest receivable	(148 )	(16 )
Increase in interest payable	53	36
Increase in other assets	(186 )	(477 )
Increase (Decrease) in other liabilities	372	(86 )
Net cash (used in) provided by operating activities	(30,907 )	2,774
<b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>		
Purchases of investment securities available-for-sale	(31,997 )	(34,997)
Proceeds from maturities of investment securities available-for-sale	33,571	40,631
Net increase in loans and leases outstanding	(43,604 )	(42,389)
Purchase of bank owned life insurance	-	(8,000 )
Proceeds from the sale of other real estate owned	-	141
Purchase of premises and equipment	(1,213 )	(416 )
Branch acquisition (net of cash received)	2,096	(3,195 )
Net cash used in investing activities	(41,147 )	(48,225)
<b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>		
Net increase in noninterest-bearing deposits	16,477	(4,685 )
Net increase in interest-bearing deposits	27,837	14,376
Net increase in short-term borrowings	6,299	12,947
Proceeds from issuance of long-term debt	5,000	14,000
Repayment of long-term debt	(2,000 )	(8,000 )
Net proceeds from exercise of warrants	470	-
Cash dividends on preferred stock	(94 )	(134 )
Net cash provided by financing activities	53,989	28,504

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Net decrease in cash and cash equivalents	(18,065 )	(16,947)
Cash and cash equivalents at beginning of period	35,736	36,361
Cash and cash equivalents at end of period	\$17,671	\$19,414

SUPPLEMENTAL INFORMATION

Cash payments for interest	\$1,678	\$848
Cash payments for income taxes	370	707
Transferred from loans to other real estate owned	95	-

BRANCH PURCHASE

Tangible assets acquired (net of cash received)	\$16,328	\$38,159
Identifiable intangible assets acquired	513	376
Liabilities assumed	18,826	35,340

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

**Notes to Consolidated Financial Statements** (unaudited)

**Note 1: Summary of Significant Accounting Policies**

**Nature of Operations**

On December 15, 2005, Howard Bancorp, Inc. (“Bancorp”) acquired all of the stock and became the holding company of Howard Bank (the “Bank”) pursuant to the Plan of Reorganization approved by the shareholders of the Bank and by federal and state regulatory agencies. Each share of Bank common stock was converted into two shares of Bancorp common stock effected by the filing of Articles of Exchange on that date, and the shareholders of the Bank became the shareholders of Bancorp. The Bank has four subsidiaries, three of which hold foreclosed real estate and the other owns and manages real estate that is used as a branch location and has office and retail space. The accompanying consolidated financial statements of Bancorp and its wholly-owned subsidiary bank (collectively the “Company”) have been prepared in accordance with accounting principles generally accepted in the United States of America (“GAAP”). These consolidated financial statements included herein are unaudited; however in the opinion of management, present a fair representation of the Company’s financial condition, results of operations, and cash flows for the periods presented. The Company believes that the disclosures are adequate to make the information presented not misleading. The balances as of December 31, 2013 have been derived from audited financial statements. Other than the application of the fair value option to loans held for sale there have been no significant changes to the Company’s accounting policies as disclosed in Bancorp’s Annual Report on Form 10-K for the year ended December 31, 2013. The results of operations for the three and nine months ended September 30, 2014 are not necessarily indicative of the results of operations to be expected for the remainder of the year or any other period.

Bancorp was incorporated in April of 2005 under the laws of the State of Maryland and is a bank holding company registered under the Bank Holding Company Act of 1956. Bancorp is a single bank holding company with one subsidiary, Howard Bank, which operates as a state trust company with commercial banking powers regulated by the Maryland Office of the Commissioner of Financial Regulation (the “Commissioner”).

The Company is a diversified financial services company providing commercial banking, mortgage banking and consumer finance through banking branches, the internet and other distribution channels to businesses, business owners, professionals and other consumers located primarily in the Greater Baltimore Metropolitan Area.

The following is a description of the Company’s significant accounting policies.

### **Principles of Consolidation**

The consolidated financial statements include the accounts of Bancorp, its subsidiary bank and the Bank's subsidiaries. All significant intercompany accounts and transactions have been eliminated. Certain reclassifications may have been made to the prior year's consolidated financial statements to conform to current period presentation.

### **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 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. Material estimates that are particularly susceptible to significant changes in the near-term relate to the determination of the allowance for credit losses, other-than-temporary impairment of investment securities, determination of fair value for financial instruments, deferred income taxes and share-based compensation.

### **Loans Held for Sale**

During the quarter ended September 30, 2014 the Company elected to apply the fair value option under Financial Accounting Standards Board ("FASB") Accounting Standards Codification ("ASC") 825-10 "*Recognition and Measurement of Financial Assets and Financial Liabilities*" to loans held for sale. As such, mortgage loans originated and intended for sale into the secondary market are carried at fair value. Fair value is determined based on outstanding investor commitments, and in the absence of such commitments, on current investor yield requirements or third party pricing models. This election was made in order to better align the timing and recognition of the revenues generated with the related costs associated with mortgage loans originated with the intent to sell at the measurement date. Prior to this election, loans were originated and recorded at cost as of the measurement date, and related gains or losses were not recorded until the loan was sold. The effect of implementing the fair value for mortgage loans held for sale during the second quarter accelerated mortgage related revenues by \$836 thousand through September 30, 2014.



The Company sells its mortgage loans to third party investors servicing released. Upon sale and delivery, loans are legally isolated from the Company and the Company has no ability to restrict or constrain the ability of third party investors to pledge or exchange the mortgage loans. The Company does not have the entitlement or ability to repurchase the mortgage loans or unilaterally cause third party investors to put the mortgage loans back to the Company. Unrealized and realized gains on loan sales are determined using the specific identification method and are recognized through mortgage banking activity in the Consolidated Statement of Operations.

### **Segment Information**

The Company has one reportable segment, “Community Banking.” All of the Company’s activities are interrelated, and each activity is dependent and assessed based on how each of the activities of the Company supports the others. For example, lending is dependent upon the ability of the Bank to fund itself with deposits and other borrowings and manage interest rate and credit risk. Accordingly, all significant operating decisions are based upon analysis of the Company as one segment or unit.

### **New Accounting Pronouncements**

ASU No. 2014-04, *Receivables – Troubled Debt Restructurings by Creditors (Subtopic 310-40): Reclassification of Residential Real Estate Collateralized Consumer Mortgage Loans upon Foreclosure (a consensus of the FASB Emerging Issues Task Force)*. The guidance clarifies when an “in substance repossession or foreclosure” occurs, that is, when a creditor should be considered to have received physical possession of residential real estate property collateralizing a consumer mortgage loan, such that all or a portion of the loan should be derecognized and the real estate property recognized. ASU 2014-04 states that a creditor is considered to have received physical possession of residential real estate property collateralizing a consumer mortgage loan, upon either the creditor obtaining legal title to the residential real estate property upon completion of a foreclosure, or the borrower conveying all interest in the residential real estate property to the creditor to satisfy that loan through completion of a deed in lieu of foreclosure or through a similar legal agreement. The amendments of ASU 2014-04 also require interim and annual disclosure of both the amount of foreclosed residential real estate property held by the creditor and the recorded investment in consumer mortgage loans collateralized by residential real estate property that are in the process of foreclosure. The amendments of ASU 2014-04 are effective for interim and annual periods beginning after December 15, 2014, and may be applied using either a modified retrospective transition method or a prospective transition method as described in ASU 2014-04. The Company will evaluate these amendments but does not believe they will have an impact on its financial position or results of operations.

ASU No. 2014-09, *Revenue from Contracts with Customers (Topic 606)*. This guidance states an entity should recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. The guidance in this Update affects any entity that either enters into contracts with customers to transfer goods or services or enters into

contracts for the transfer of nonfinancial assets unless those contracts are within the scope of other standards. The amendments in this Update are effective for annual reporting periods beginning after December 15, 2016. The adoption of this guidance is not expected to have a material impact on its financial position or results of operations.

ASU No. 2014-11, *Transfers and Servicing (Topic 860): Repurchase-to-Maturity Transactions, Repurchase Financings, and Disclosures*. The amendments in this Update change the accounting for repurchase-to-maturity transactions to secured borrowing accounting and for repurchase financing arrangements; require separate accounting for a transfer of a financial asset executed contemporaneously with a repurchase agreement with the same counterparty, which will result in secured borrowing accounting for the repurchase agreement. The amendments in this Update require two new disclosures for certain transactions. First to disclose information about certain transactions accounted for as a sale in which the transferor retains substantially all of the exposure to the economic return on the transferred financial assets through an agreement with the same counterparty. Secondly to disclose information about repurchase agreements, securities lending transactions, and repurchase-to-maturity transactions that are accounted for as secured borrowings. The amendments of ASU 2014-11 are effective for interim and annual periods beginning after December 15, 2014. The Company will evaluate these amendments but does not believe they will have an impact on its financial position or results of operations

ASU No. 2014-12, *Compensation—Stock Compensation (Topic 718): Accounting for Share-Based Payments When the Terms of an Award Provide That a Performance Target Could Be Achieved after the Requisite Service Period (a consensus of the FASB Emerging Issues Task Force)*. The amendments require that a performance target that affects vesting and that could be achieved after the requisite service period be treated as a performance condition. Guidance in Topic 718 as it relates to awards with performance conditions that affect vesting should be applied to account for such awards. As such, the performance target should not be reflected in estimating the grant-date fair value of the award. Compensation cost should be recognized in the period in which it becomes probable that the performance target will be achieved and should represent the compensation cost attributable to the period(s) for which the requisite service has already been rendered. If the performance target becomes probable of being achieved before the end of the requisite service period, the remaining unrecognized compensation cost should be recognized prospectively over the remaining requisite service period. The total amount of compensation cost recognized during and after the requisite service period should reflect the number of awards that are expected to vest and should be adjusted to reflect those awards that ultimately vest. The requisite service period ends when the employee can cease rendering service and still be eligible to vest in the award if the performance target is achieved. As indicated in the definition of vest, the stated vesting period (which includes the period in which the performance target could be achieved) may differ from the requisite service period. The amendments of ASU 2014-12 are effective for interim and annual periods beginning after December 15, 2014.

**Note 2: Investment Securities**

The amortized cost and estimated fair values of investments available for sale are as follows:

(in thousands)	September 30, 2014				December 31, 2013			
	Amortized Cost	Gross Gains	Gross Unrealized Losses	Estimated Fair Value	Amortized Cost	Gross Gains	Gross Unrealized Losses	Estimated Fair Value
U.S. Government Agencies	\$22,998	\$ 1	\$ -	\$ 22,999	\$28,522	\$ 1	\$ 2	\$ 28,521
Treasuries	3,999	-	-	3,999	-	-	-	-
Mortgage-backed	108	6	-	114	157	10	-	167
	\$27,105	\$ 7	\$ -	\$ 27,112	\$28,679	\$ 11	\$ 2	\$ 28,688

There have not been any individual securities with an unrealized loss position for a period greater than one year as of either September 30, 2014 or December 31, 2013. Gross unrealized losses and fair value by investment category and length of time the individual securities have been in a continuous unrealized loss position at December 31, 2013 are presented below:

December 31, 2013 (in thousands)	Less than 12 months		12 months or more		Total	
	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses
U.S. Government agencies	\$ 15,994	\$ 2	\$ -	\$ -	\$ 15,994	\$ 2
Mortgage-backed	-	-	-	-	-	-
	\$ 15,994	\$ 2	\$ -	\$ -	\$ 15,994	\$ 2

As of September 30, 2014, there were no gross unrealized losses.

The unrealized losses that existed were a result of market changes in interest rates since the original purchase. Management systematically evaluates investment securities for other-than-temporary declines in fair value on a quarterly basis. This analysis requires management to consider various factors, which include (1) duration and magnitude of the decline in value, (2) the financial condition of the issuer or issuers and (3) structure of the security.

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An impairment loss is recognized in earnings if any of the following are true: (1) the Company intends to sell the debt security; (2) it is more likely than not that the Company will be required to sell the security before recovery of its amortized cost basis; or (3) the Company does not expect to recover the entire amortized cost basis of the security. In situations where the Company intends to sell or when it is more likely than not that the Company will be required to sell the security, the entire impairment loss must be recognized in earnings. In all other situations, only the portion of the impairment loss representing the credit loss must be recognized in earnings, with the remaining portion being recognized in shareholders' equity as a component of other comprehensive income, net of deferred tax.

The amortized cost and estimated fair values of investments available for sale by contractual maturity are shown below:

(in thousands)	September 30, 2014		December 31, 2013	
	Amortized Cost	Estimated Fair Value	Amortized Cost	Estimated Fair Value
Amounts maturing:				
One year or less	\$ 26,998	\$ 26,999	\$ 28,522	\$ 28,521
After one through five years	22	23	51	54
After five through ten years	85	90	106	113
After ten years	-	-	-	-
	\$ 27,105	\$ 27,112	\$ 28,679	\$ 28,688

There were no sales of investment securities during the nine months ended September 30, 2014 or in 2013. At September 30, 2014 and December 31, 2013, \$19.7 million and \$20.7 million fair value of securities, respectively, were pledged as collateral for repurchase agreements. The outstanding balance of no single issuer, except for U. S. Government and U. S. Government agency securities, exceeded ten percent of shareholders' equity at either September 30, 2014 or December 31, 2013.

### Note 3: Loans and Leases

The Company makes loans to customers primarily in the Greater Baltimore Maryland metropolitan area, and surrounding communities. A substantial portion of the Company's loan portfolio consists of loans to businesses secured by real estate and/or other business assets.

The loan portfolio segment balances at September 30, 2014 and December 31, 2013 are presented in the following table:

(in thousands)	September 30, 2014	% of Total	December 31, 2013	% of Total	
Real estate					
Construction and land	\$ 62,649	13.6	% \$ 50,884	12.6	%
Residential - first lien	61,560	13.3	39,249	9.7	
Residential - junior lien	11,881	2.6	8,266	2.0	
Total residential real estate	73,441	15.9	47,515	11.7	
Commercial - owner occupied	94,517	20.5	90,333	22.4	
Commercial - non-owner occupied	116,820	25.3	113,559	28.1	
Total commercial real estate	211,337	45.8	203,892	50.5	
Total real estate loans	347,427	75.3	302,291	74.8	
Commercial loans and leases	112,357	24.4	100,410	24.9	
Consumer	1,448	0.3	1,174	0.3	
Total loans	\$ 461,232	100.0	% \$ 403,875	100.0	%

There were \$38.7 million and \$3.3 million in loans held for sale at September 30, 2014 and at December 31, 2013, respectively.

**Note 4: Credit Quality Assessment****Allowance for Credit Losses**

The following table provides information on the activity in the allowance for credit losses by the respective loan portfolio segment for the nine months and three months ended September 30, 2014 and September 30, 2013:

(in thousands)	<b>September 30, 2014</b>							
	Construction and land	Residential first lien	Residential junior lien	Commercial owner occupied	Commercial non-owner occupied	Commercial loans and leases	Commercial Consumer loans	Total
Allowance for credit losses:								
Nine months ended								
Beginning balance	\$ 122	\$ 200	\$ 34	\$ 131	\$ 541	\$ 1,464	\$ 14	\$ 2,506
Charge-offs	-	-	-	-	-	(2,115 )	-	(2,115 )
Recoveries	-	-	-	-	4	53	-	57
Provision for credit losses	(13 )	5	(11 )	195	4	2,393	(3 )	2,570
Ending balance	\$ 109	\$ 205	\$ 23	\$ 326	\$ 549	\$ 1,795	\$ 11	\$ 3,018
Three months ended								
Beginning balance	\$ 159	\$ 196	\$ 17	\$ 138	\$ 661	\$ 1,871	\$ 11	\$ 3,053
Charge-offs	-	-	-	-	-	(2,115 )	-	(2,115 )
Recoveries	-	-	-	-	-	12	-	12
Provision for credit losses	(50 )	9	6	188	(112 )	2,027	-	2,068
Ending balance	\$ 109	\$ 205	\$ 23	\$ 326	\$ 549	\$ 1,795	\$ 11	\$ 3,018
Ending balance:								
individually evaluated for impairment	-	-	-	-	-	72	-	72
collectively evaluated for impairment	109	205	23	326	549	1,723	11	2,946
Loans:								
Ending balance	62,649	61,560	11,881	94,517	116,820	112,357	1,448	461,232
Ending balance:								
individually evaluated for impairment	810	314	-	-	2,702	1,649	-	5,475
collectively evaluated for impairment	61,839	61,246	11,881	94,517	114,118	110,708	1,448	455,757

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September 30, 2013

(in thousands)	Commercial							Total
	Construction and land	Residential first lien	Residential junior lien	owner occupied	non-owner occupied	Commercial loans and leases	Commercial Consumer loans	
Allowance for credit losses:								
Nine months ended								
Beginning balance	\$ 127	\$ 204	\$ 22	\$ 650	\$ 505	\$ 1,227	\$ 29	\$ 2,764
Charge-offs	-	(183 )	-	-	(2 )	(202 )	-	(387 )
Recoveries	-	-	-	-	30	72	-	102
Provision for credit losses	(20 )	138	-	(70 )	241	393	(16 )	666
Ending balance	\$ 107	\$ 159	\$ 22	\$ 580	\$ 774	\$ 1,490	\$ 13	\$ 3,145
Three months ended								
Beginning balance	\$ 122	\$ 133	\$ 22	\$ 663	\$ 502	\$ 1,482	\$ 27	\$ 2,951
Charge-offs	-	-	-	-	(2 )	-	-	(2 )
Recoveries	-	-	-	-	-	56	-	56
Provision for credit losses	(15 )	26	-	(83 )	274	(48 )	(14 )	140
Ending balance	\$ 107	\$ 159	\$ 22	\$ 580	\$ 774	\$ 1,490	\$ 13	\$ 3,145
Ending balance:								
individually evaluated for impairment	-	-	-	-	373	715	-	1,088
collectively evaluated for impairment	107	159	22	580	401	775	13	2,057
Loans:								
Ending balance	49,390	36,149	8,244	89,008	116,306	101,463	948	401,508
Ending balance:								
individually evaluated for impairment	-	-	-	-	3,098	3,403	-	6,501
collectively evaluated for impairment	49,390	36,149	8,244	89,008	113,208	98,060	948	395,007

When potential losses are identified, a specific provision and/or charge-off may be taken, based on the then current likelihood of repayment, that is at least in the amount of the collateral deficiency, and any potential collection costs, as determined by the independent third party appraisal.

All loans that are considered impaired are subject to the completion of an impairment analysis. This analysis highlights any potential collateral deficiencies. A specific amount of impairment is established based on the Company's calculation of the probable loss inherent in the individual loan. The actual occurrence and severity of losses involving impaired credits can differ substantially from estimates.

Credit risk profile by portfolio segment based upon internally assigned risk assignments are presented below:

	September 30, 2014							
	Commercial	Commercial	Commercial	Commercial	Commercial	Commercial	Commercial	
(in thousands)	Construction and land	Residential first lien	Residential junior lien	owner occupied	non-owner occupied	loans and leases	Consumer loans	Total
Credit quality indicators:								
Not classified	\$61,839	\$ 61,246	\$ 11,881	\$ 94,517	\$ 114,118	\$ 110,709	\$ 1,448	\$455,758
Special mention	-	-	-	-	-	-	-	-
Substandard	810	314	-	-	2,702	1,648	-	5,474
Doubtful	-	-	-	-	-	-	-	-
Total	\$62,649	\$ 61,560	\$ 11,881	\$ 94,517	\$ 116,820	\$ 112,357	\$ 1,448	\$461,232
	December 31, 2013							
(in thousands)	Commercial	Commercial	Commercial	Commercial	Commercial	Commercial	Commercial	
	Construction and land	Residential first lien	Residential junior lien	owner occupied	non-owner occupied	loans and leases	Consumer loans	Total
Credit quality indicators:								
Not classified	\$50,884	\$ 38,918	\$ 8,266	\$ 90,333	\$ 113,301	\$ 97,817	\$ 1,174	\$400,693
Special mention	-	-	-	-	-	-	-	-
Substandard	-	331	-	-	258	2,593	-	3,182
Doubtful	-	-	-	-	-	-	-	-
Total	\$50,884	\$ 39,249	\$ 8,266	\$ 90,333	\$ 113,559	\$ 100,410	\$ 1,174	\$403,875

**Special mention** - A special mention asset has potential weaknesses that deserve management's close attention. If left uncorrected, these potential weaknesses may result in deterioration of the repayment prospects for the asset or in the institution's credit position at some future date. Special mention assets are not adversely classified and do not expose an institution to sufficient risk to warrant adverse classification.



**Substandard** - Substandard loans are inadequately protected by the current sound worth and paying capacity of the obligor or of the collateral pledged, if any. Loans so classified must have a well defined weakness or weaknesses that jeopardize the liquidation of the debt. They are characterized by the distinct possibility that the bank will sustain some loss if the deficiencies are not corrected.

**Doubtful** - Loans classified doubtful have all the weaknesses inherent in those classified substandard with the added characteristic that the weaknesses make collection or liquidation in full, on the basis of currently known facts, conditions and values, highly questionable and improbable.

Loans classified special mention, substandard, doubtful or loss are reviewed at least quarterly to determine their appropriate classification. All commercial loan relationships are reviewed annually. Non-classified residential mortgage loans and consumer loans are not evaluated unless a specific event occurs to raise the awareness of a possible credit deterioration.

An aged analysis of past due loans is as follows:

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	September 30, 2014							
(in thousands)	Construction and land	Residential first lien	Residential junior lien	Commercial owner occupied	Commercial non-owner occupied	Commercial loans and leases	Commercial Consumer loans	Total
Analysis of past due loans:								
Accruing loans current	\$61,505	\$60,928	\$11,827	\$94,517	\$116,670	\$111,165	\$1,448	\$458,060
Accruing loans past due:								
31-59 days past due	-	-	54	-	-	120	-	174
60-89 days past due	334	318	-	-	-	-	-	652
Greater than 90 days past due	-	-	-	-	150	-	-	150
Total past due	334	318	54	-	150	120	-	976
Non-accrual loans	810	314	-	-	-	1,072	-	2,196
Total loans	\$62,649	\$61,560	\$11,881	\$94,517	\$116,820	\$112,357	\$1,448	\$461,232
	December 31, 2013							
(in thousands)	Construction and land	Residential first lien	Residential junior lien	Commercial owner occupied	Commercial non-owner occupied	Commercial loans and leases	Commercial Consumer loans	Total
Analysis of past due loans:								
Accruing loans current	\$50,884	\$38,025	\$8,266	\$90,333	\$113,142	\$97,127	\$1,174	\$398,951
Accruing loans past due:								
31-59 days past due	-	570	-	-	-	150	-	720
60-89 days past due	-	323	-	-	-	244	-	567
Greater than 90 days past due	-	-	-	-	159	296	-	455
Total past due	-	893	-	-	159	690	-	1,742
Non-accrual loans	-	331	-	-	258	2,593	-	3,182
Total loans	\$50,884	\$39,249	\$8,266	\$90,333	\$113,559	\$100,410	\$1,174	\$403,875

Total loans either in non-accrual status or in excess of ninety days delinquent totaled \$2.3 million or .51% of total loans outstanding as of September 30, 2014, which represents a decrease from \$3.6 million as of December 31, 2013.

The impaired loans at September 30, 2014 and December 31, 2013 are as follows:

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September 30, 2014

(in thousands)	Commercial							Total
	Construction & land	Residential first lien	Residential junior lien	Commercial owner occupied	Commercial non-owner occupied	Commercial loans and leases	Commercial Consumer loans	
Impaired loans:								
Recorded investment	\$810	\$ 314	\$ -	\$ -	\$ 2,702	\$ 1,649	\$ -	\$5,475
With an allowance recorded	-	-	-	-	-	188	-	188
With no related allowance recorded	810	314	-	-	2,702	1,461	-	5,287
Related allowance	-	-	-	-	-	72	-	72
Unpaid principal	1,316	314	-	-	2,701	1,703	-	6,034
Nine months ended								
Average balance of impaired loans	760	329	-	-	2,717	2,454	-	6,260
Interest income recognized	24	13	-	-	149	105	-	291
Three months ended								
Average balance of impaired loans	810	328	-	-	2,706	2,416	-	6,260
Interest income recognized	24	4	-	-	50	22	-	100

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(in thousands)	December 31, 2013							
	Commercial & land	Residential first lien	Residential junior lien	Commercial owner occupied	Commercial non-owner occupied	Commercial loans and leases	Commercial Consumer loans	Total
Impaired loans:								
Recorded investment	\$-	\$ 331	\$ -	\$ -	\$ 2,984	\$ 2,975	\$ -	\$6,290
With an allowance recorded	-	331	-	-	258	677	-	1,266
With no related allowance recorded	-	-	-	-	2,726	2,298	-	5,024
Related allowance	-	4	-	-	31	224	-	259
Unpaid principal	-	331	-	-	2,984	2,978	-	6,293
Average balance of impaired loans	-	333	-	-	2,994	3,706	-	7,033
Interest income recognized	-	15	-	-	208	120	-	343

Nonaccrual loans included in impaired loans totaled \$2.2 million and \$3.2 million at September 30, 2014 and December 31, 2013, respectively. Interest income that would have been recorded if nonaccrual loans had been current and in accordance with their original terms was \$104 thousand for the first nine months of 2014.

Management routinely evaluates other real estate owned (“OREO”) based upon periodic appraisals. For the nine months ended September 30, 2014 and 2013 there were no additional valuation allowances recorded as the current appraised value was sufficient to cover the recorded OREO amount. There were no new loans transferred to OREO during the nine months ended September 30, 2013 and one new loan was transferred to OREO during the nine months ended September 30, 2014.

For the first nine months of 2014, the Company did not sell any properties held as OREO and for the first nine months of 2013 sold one property totaling \$178 thousand.

The trouble debt restructured loans (“TDRs”) at September 30, 2014 and December 31, 2013 are as follows:

(dollars in thousands)	September 30, 2014			
	Number Non-Accrual Status	Number of Loans	Accrual Status	Total TDRs

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	of				
	Loans				
Commercial loans	6	\$ 758	1	\$ 228	\$986
Residential first liens	1	314	-	-	314
	7	\$ 1,072	1	\$ 228	\$1,300

	December 31, 2013				
	Number	Non-Accrual	Number	Accrual	Total
(dollars in thousands)	of	Status	of Loans	Status	TDRs
	Loans				
Commercial loans	6	\$ 861	-	\$ -	\$ 861

A summary of TDR modifications outstanding and performance under modified terms are as follows:

	September 30, 2014		
	Not	Performing	
	Performing		
	to	to Modified	Total
(in thousands)	Modified	Terms	TDRs
Commercial loans			
Forbearance	\$758	\$ -	\$758
Extension or other modification	-	228	228
Total commercial	758	228	986
Residential first liens			
Extension or other modification	314	-	314
Total residential first liens	314	-	314
Total trouble debt restructure loans	\$1,072	\$ 228	\$1,300

(in thousands)	December 31, 2013			Total TDRs
	Performing Terms	Not Performing to Modified Terms	Performing to Modified Terms	
Commercial loans				
Forbearance	\$ 861	\$ -	\$ -	\$ 861
Total commercial	\$ 861	\$ -	\$ -	\$ 861

There were two new loans restructured in the first nine months of 2014.

**Note 5: Derivative Financial Instruments**

The Company enters into commitments to originate residential mortgage loans whereby the interest rate on the loan is determined prior to funding (i.e. rate lock commitment). Such rate lock commitments on mortgage loans to be sold in the secondary market are considered to be derivatives. The period of time between issuance of a loan commitment and closing and sale of the loan generally ranges from 15 to 60 days. Interest rate lock commitments are recorded at fair value in accordance with ASC 815 “Derivatives and Hedging” and are recorded in other assets on the consolidated balance sheet. The Company protects itself from changes in interest rates through the use of best efforts forward delivery commitments, whereby the Company commits to sell a loan at a premium at the time the borrower commits to an interest rate with the intent that the buyer has assumed interest rate risk on the loan.

At September 30, 2014 the Bank had derivative financial instruments resulting from the issuance of \$14.3 million in interest rate lock commitments. The net fair value of these derivative instruments at September 30, 2014 was \$131 thousand included in other assets. There were no derivative instruments in 2013.

**Note 6: Intangibles**

The gross carrying amount and accumulated amortization of intangible assets is as follows:

(in thousands)	September 30, 2014		Weighted Average Remaining Life (Years)
	Gross Carrying Amount	Accumulated Amortization	
	Net Carrying Amount		

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Amortizing intangible assets:

Core deposit intangible	\$ 889	\$ 91	\$ 798	8.26
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Estimated future amortizing expense for amortization intangibles within the years ending December 31, are as follows:

(in thousands)

2014	\$45
2015	170
2016	130
2017	101
2018	81
Thereafter	271
Total amortizing intangible assets	\$798

With the acquisition of a branch location in Havre de Grace, Maryland, in the third quarter of 2014, the Company added an additional \$513 thousand in core deposit intangibles in addition to the amount previously reported.

**Note 7: Deposits**

The following table details the composition of deposits and the related percentage mix of total deposits, respectively:

(dollars in thousands)	September 30, 2014		December 31, 2013	
	Amount	% of Total	Amount	% of Total
Noninterest-bearing demand	\$ 106,237	24 %	\$ 89,759	23 %
Interest-bearing checking	34,897	7	31,443	8
Money market accounts	121,144	27	96,365	25
Savings	13,177	3	12,496	3
Certificates of deposit \$100,000 and over	121,970	27	110,516	29
Certificates of deposit under \$100,000	54,485	12	48,370	12
Total deposits	\$ 451,910	100 %	\$ 388,949	100 %

**Note 8: Stock Options, Awards and Warrants**

The Company initially raised \$4,775,000 of capital by selling to its founders investment units consisting of one share of common stock and a fully detachable warrant equal to .25 shares of common stock per unit. The warrants were issued in recognition of the financial and organizational risk undertaken by the purchasers in the organizational offering. The warrants were immediately exercisable upon issuance and expired ten (10) years from the date of issuance, which was in August 2014. The following table summarizes the warrant activity and related information for the periods ended:

	September 30, 2014		December 31, 2013	
	Shares	Weighted Average Exercise Price	Shares	Weighted Average Exercise Price
Balance at January 1, 2014	119,376	\$ 10.00	119,376	\$ 10.00
Granted	-	-	-	-
Exercised	(47,068 )	10.00	-	-
Forfeited	(72,308 )	10.00	-	-
Balance at September 30, 2014	-	\$ -	119,376	\$ 10.00
Exercisable at September 30, 2014	-	\$ -	119,376	\$ 10.00

The Company's equity incentive plan provides for awards of nonqualified and incentive stock options as well as vested and non-vested common stock awards. Employee stock options can be granted with exercise prices at the fair market



value (as defined within the plan) of the stock at the date of grant and with terms of up to ten years. Except as otherwise permitted in the plan, upon termination of employment for reasons other than retirement, permanent disability or death, the option exercise period is reduced or the options are canceled.

Stock awards may also be granted to non-employee members of the Board of Directors as compensation for attendance and participation at meetings of the Board of Directors and meetings of the various committees of the Board. For the nine months ended September 30, 2014 directors earned 3,817 shares of stock as compensation for their service.

**Stock Options**

The following table summarizes the Company's stock option activity and related information for the periods ended:

	September 30, 2014		December 31, 2013	
	Shares	Weighted Average Exercise Price	Shares	Weighted Average Exercise Price
Balance at January 1, 2014	387,101	\$ 11.19	395,351	\$ 11.16
Granted	-	-	-	-
Exercised	-	-	-	-
Forfeited	(118,310 )	10.02	(8,250 )	9.90
Balance at September 30, 2014	268,791	\$ 11.71	387,101	\$ 11.19
Exercisable at September 30, 2014	268,791	\$ 11.71	387,101	\$ 11.19
Weighted average fair value of options granted during the year		\$ -		\$ -

The intrinsic value of a stock option is the amount that the market value of the underlying stock exceeds the exercise price of the option. Based upon a fair market value of \$10.35 at September 30, 2014 the options outstanding had an aggregate intrinsic value of \$65 thousand. There have not been any stock options exercised during 2014.

**Restricted Stock**

In the second quarter of 2013, 50,000 shares of restricted stock were granted, with 30,000 of the shares subject to a three year vesting schedule with one third of the shares vesting each year on the grant date anniversary. The remaining 20,000 awarded shares also are subject to a three year vesting schedule, however they only vest if certain annual performance measures are satisfactorily achieved.

A summary of the activity for the Company's restricted stock for the periods indicated is presented in the following table:

September 30, 2014	December 31, 2013
Weighted Average Grant Date	Weighted Average Grant Date

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	Shares	Fair Value	Shares	Fair Value
Balance at January 1, 2014	50,000	\$ 6.89	-	\$ -
Granted	-	-	50,000	6.89
Vested	(10,002 )	6.91	-	-
Forfeited	(6,668 )	6.85	-	-
Balance at September 30, 2014	33,330	\$ 6.89	50,000	\$ 6.89

Of the 20,000 shares of restricted stock that were issued during 2013 with vesting subject to meeting certain performance measures, those measures were not achieved, and thus 6,668 shares were forfeited during the first nine months of 2014. At September 30, 2014, based on restricted stock awards outstanding at that time, the total unrecognized pre-tax compensation expense related to unvested restricted stock awards was \$149 thousand. This expense is expected to be recognized through 2016.

### **Restricted Stock Units**

Restricted stock units are similar to restricted stock, except the recipient does not receive the stock immediately, but instead receives it according to a vesting plan and distribution schedule after achieving required performance milestones or upon remaining with the employer for a particular length of time. Each restricted stock unit that vests entitles the recipient to receive one share of common stock on a specified issuance date. The recipient does not have any stockholder rights, including voting, dividend or liquidation rights, with respect to the shares underlying awarded restricted stock units until the recipient becomes the record holder of those shares.

During the second and third quarters of 2014, 44,500 restricted stock units were granted, with 19,500 of the units subject to a three year vesting schedule with one third of the units vesting each year on the grant date anniversary. The remaining 25,000 awarded units also are subject to a three year vesting schedule, however they only vest if certain annual performance measures are satisfactorily achieved.

A summary of the activity for the Company's restricted stock units for the periods indicated is presented in the following table:

	September 30, 2014		December 31, 2013	
	Shares	Weighted Average Grant Date Fair Value	Shares	Weighted Average Grant Date Fair Value
Balance at January 1, 2014	-	\$ -	-	\$ -
Granted	44,500	11.21	-	-
Vested	-	-	-	-
Forfeited	-	-	-	-
Balance at September 30, 2014	44,500	\$ 11.21	-	\$ -

At September 30, 2014, based on restricted stock unit awards outstanding at that time, the total unrecognized pre-tax compensation expense related to unvested restricted stock unit awards was \$431 thousand. This expense is expected to be recognized through 2017.

**Note 9: Profit Sharing Plan**

The Company sponsors a defined contribution retirement plan through a Section 401(k) profit sharing plan. Employees may contribute up to 15% of their pretax compensation. Participants are eligible for matching Company contributions up to 4% of eligible compensation dependent on the level of voluntary contributions. Company matching contributions totaled \$204 thousand for the nine months ended September 30, 2014 and \$103 thousand for the nine months ended September 30, 2013. The Company's matching contributions vest immediately. The increase in the matching contributions for the Company was due to a large increase in the number of participants in the plan. With the growth in overall staff over the last year, the number of participants in the plan has increased from 60 participants at September 30, 2013 to 95 participants at September 30, 2014.

**Note 10: Income per Common Share**

The table below shows the presentation of basic and diluted income per common share for the periods ended:

Nine months ended September 30,	Three months ended September 30,
------------------------------------	-------------------------------------

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(dollars in thousands, except per share data)	2014	2013	2014	2013
Net income	\$1,239	\$1,404	\$236	\$407
Preferred dividends	(94 )	(134 )	(31 )	(31 )
Net income available to common shareholders (numerator)	\$1,145	\$1,270	\$205	\$376
<b>BASIC</b>				
Basic average common shares outstanding (denominator)	4,061,598	4,040,105	4,081,685	4,040,471
Basic income per common share	\$0.28	\$0.31	\$0.05	\$0.09
<b>DILUTED</b>				
Average common shares outstanding	4,061,598	4,040,105	4,081,685	4,040,471
Diluted effect of common stock equivalents	75,865	34,338	91,916	51,371
Diluted average common shares outstanding (denominator)	4,137,463	4,074,443	4,173,601	4,091,842
Diluted income per common share	\$0.28	\$0.31	\$0.05	\$0.09
Common stock equivalents outstanding that are anti-dilutive and thus excluded from calculation of diluted number of shares presented above	209,347	486,422	209,347	486,422

The decrease in the anti-dilutive common stock equivalents noted above resulted from the forfeiture of stock options and warrants that expired during the third quarter of 2014.

**Note 11: Risk-Based Capital**

The Federal Deposit Insurance Corporation Improvement Act of 1991 (“FDICIA”) required that the federal regulatory agencies adopt regulations defining five capital tiers for banks: well capitalized, adequately capitalized, undercapitalized, significantly undercapitalized and critically undercapitalized. 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. Quantitative measures, established by the regulators to ensure capital adequacy, require that the Bank and Bancorp maintain minimum ratios (set forth below) of capital to risk-weighted assets. Under the guidelines, capital is compared to the relative risk related to the balance sheet. The capital amounts and classification are also subject to qualitative judgments by the regulators about components, risk weightings, and other factors.

Management believes that, as of September 30, 2014 and December 31, 2013 the Bank met all capital adequacy requirements to which it is subject.

	Actual		For capital		To be well		
(dollars in thousands)	Amount	Ratio	adequacy purposes	Ratio	capitalized under	prompt corrective	action provisions
			Amount		the FDICIA		
As of September 30, 2014:							
Total capital (to risk-weighted assets)							
Howard Bank	\$52,135	10.62 %	\$ 39,289	8.00 %	\$ 49,112	10.00 %	
Howard Bancorp	\$52,395	10.69 %	\$ 39,206	8.00 %	<b>N/A</b>		
Tier 1 capital (to risk-weighted assets)							
Howard Bank	\$49,117	10.00 %	\$ 19,645	4.00 %	\$ 29,467	6.00 %	
Howard Bancorp	\$49,377	10.08 %	\$ 19,603	4.00 %	<b>N/A</b>		
Tier 1 capital (to average assets)							
(Leverage ratio)							
Howard Bank	\$49,117	9.05 %	\$ 21,719	4.00 %	\$ 27,149	5.00 %	
Howard Bancorp	\$49,377	9.09 %	\$ 21,739	4.00 %	<b>N/A</b>		
As of December 31, 2013:							
Total capital (to risk-weighted assets)							
Howard Bank	\$49,902	11.85 %	\$ 33,684	8.00 %	\$ 42,105	10.00 %	
Howard Bancorp	\$50,700	12.05 %	\$ 33,668	8.00 %	<b>N/A</b>		
Tier 1 capital (to risk-weighted assets)							
Howard Bank	\$47,396	11.26 %	\$ 16,842	4.00 %	\$ 25,263	6.00 %	
Howard Bancorp	\$48,195	11.45 %	\$ 16,834	4.00 %	<b>N/A</b>		
Tier 1 capital (to average assets)							
(Leverage ratio)							
Howard Bank	\$47,396	9.77 %	\$ 19,406	4.00 %	\$ 24,257	5.00 %	

Howard Bancorp	\$48,195	9.93 %	\$ 19,414	4.00 %	N/A
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The Bank is currently prohibited from paying dividends without the prior approval of the Commissioner.

## Note 12: Preferred Stock

On September 22, 2011, we entered into a Securities Purchase Agreement with the Secretary of the Treasury, pursuant to which Bancorp issued and sold to the Treasury 12,562 shares of our Senior Non-Cumulative Perpetual Preferred Stock, Series AA, having a liquidation preference of \$1,000 per share, for aggregate proceeds of \$12,562,000. The issuance was pursuant to the Treasury's Small Business Lending Fund (SBLF) program, a \$30 billion fund established under the Small Business Jobs Act of 2010, which encourages lending to small businesses by providing capital to qualified community banks with assets of less than \$10 billion. The Series AA Preferred Stock holders are entitled to receive non-cumulative dividends payable quarterly on each January 1, April 1, July 1 and October 1, beginning October 1, 2011. The dividend rate, which is calculated on the aggregate Liquidation Amount, was initially set at 5% per annum based upon the current level of "Qualified Small Business Lending" ("QSBL") by the Bank and is currently set at 1%. The dividend rate for each dividend period may vary and is set based upon the percentage change in qualified lending between each dividend period and the baseline QSBL level established at the time the Agreement was entered into. Such dividend rate may vary from 1% per annum to 5% per annum for the second through tenth dividend periods and from 1% per annum to 7% per annum for the eleventh through the eighteenth dividend periods and through March 22, 2016 with respect to the nineteenth dividend period. If the Series AA Preferred Stock remains outstanding for more than four-and-one-half years, the dividend rate will be fixed at 9%. Prior to that time, in general, the dividend rate decreases as the level of the Bank's QSBL increases. Such dividends are not cumulative, but Bancorp may only declare and pay dividends on its common stock (or any other equity securities junior to the Series AA Preferred Stock) if it has declared and paid dividends for the current dividend period on the Series AA Preferred Stock, and will be subject to other restrictions on its ability to repurchase or redeem other securities. In addition, if (i) we have not timely declared and paid dividends on the Series AA Preferred Stock for six dividend periods or more, whether or not consecutive, the Treasury (or any successor holder of Series AA Preferred Stock) may designate a representative to attend all meetings of Bancorp's Board of Directors in a nonvoting observer capacity and Bancorp must give such representative copies of all notices, minutes, consents and other materials that Bancorp provide to its directors in connection with such meetings.

We may redeem the shares of Series AA Preferred Stock, in whole or in part, at any time at a redemption price equal to the sum of the Liquidation Amount per share and the per-share amount of any unpaid dividends for the then-current period, subject to any required prior approval by our primary federal banking regulator.

### **Note 13: Fair Value**

FASB ASC Topic 820 “Fair Value Measurements” 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. FASB ASC Topic 820 also establishes a fair value hierarchy, which requires an entity to maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair value.

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

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

Level 1: Valuations for assets and liabilities traded in active exchange markets. Valuations are obtained from readily available pricing sources for market transactions involving identical assets or liabilities.

Level 2: Valuations for assets and liabilities traded in less active dealer or broker markets. Valuations are obtained from third party pricing services for identical or comparable assets or liabilities which use observable inputs other than Level 1 prices, such as quoted prices for similar assets or liabilities; quoted prices in active markets that are not active; or other inputs that are observable or can be corroborated by observable market data for substantially the full term of the assets or liabilities.

Level 3: Unobservable inputs that are supported by little or no market activity and that are significant to the fair value of the assets or liabilities.



A financial instrument's level within the fair value hierarchy is based on the lowest level of input that is significant to the fair value measurement.

The types of instruments valued based on quoted market prices in active markets include most U.S. government and agency securities, liquid mortgage products, active listed equities and most money market securities. Such instruments are generally classified within Level 1 or Level 2 of the fair value hierarchy. As required by FASB ASC Topic 820, the Company does not adjust the quoted price for such instruments.

The market value of rate lock commitments and best efforts contracts are not readily ascertainable with precision because rate lock commitments and best efforts contracts are not actively traded. These are generally classified within Level 1 or Level 2 of the fair value hierarchy, in accordance with ASC 815 "Derivatives and Hedging".

The types of instruments valued based on quoted prices in markets that are not active, broker or dealer quotations, or alternative pricing sources with reasonable levels of price transparency include most investment-grade and high-yield corporate bonds, less liquid mortgage products, less liquid equities, state, municipal and provincial obligations, and certain physical commodities. Such instruments are generally classified within Level 2 of the fair value hierarchy.

Level 3 is for positions that are not traded in active markets or are subject to transfer restrictions, valuations are adjusted to reflect illiquidity and/or non-transferability, and such adjustments are generally based on available market evidence. In the absence of such evidence, management's best estimate is used.

Impaired loans are evaluated and valued at the time the loan is identified as impaired, at the lower of cost or market value. Market value is measured based on the value of the collateral securing these loans and is classified at a Level 3 in the fair value hierarchy. Collateral may be real estate and/or business assets including equipment, inventory and/or accounts receivable. The value of real estate collateral is determined based on appraisal by qualified licensed appraisers hired by the Company. The value of business equipment, inventory and accounts receivable collateral is based on the net book value on the business' financial statements and, if necessary, discounted based on management's review and analysis. Appraised and reported values may be discounted based on management's historical knowledge, changes in market conditions from the time of valuation, and/or management's expertise and knowledge of the client and client's business. Impaired loans are reviewed and evaluated on at least a quarterly basis for additional impairment and adjusted accordingly, based on the same factors identified above.

The following table sets forth the Company's financial assets and liabilities that were accounted for or disclosed at fair value on a recurring basis as of September 30, 2014 and December 31, 2013.

September 30, 2014		Quoted Price in	Significant	
	Carrying	Active Markets	Other	Significant
(in thousands)	Value	for Identical	Observable	Unobservable
	(Fair Value)	Assets	Inputs	Inputs
		(Level 1)	(Level 2)	(Level 3)
Investment securities:				
U.S. Government agencies	\$ 22,999	\$ -	\$ 22,999	\$ -
U.S. Government treasuries	3,999	-	3,999	-
Mortgage-backed securities	114	-	114	-
Loans held for sale	38,669	-	38,669	-
Rate lock commitments	131	-	131	-

December 31, 2013		Quoted Price in	Significant	
	Carrying	Active Markets	Other	Significant
(in thousands)	Value	for Identical	Observable	Unobservable
	(Fair Value)	Assets	Inputs	Inputs
		(Level 1)	(Level 2)	(Level 3)
Investment securities:				
U.S. Government agencies	\$ 28,521	\$ -	\$ 28,521	\$ -
Mortgage-backed securities	167	-	167	-

The following table sets forth the Company's financial assets and liabilities that were accounted for or disclosed at fair value on a nonrecurring basis at September 30, 2014 and December 31, 2013.

September 30, 2014		Quoted Price in	Significant	
		Active Markets	Other	Significant

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(in thousands)	Carrying Value (Fair Value)	for Identical Assets (Level 1)	Observable Inputs (Level 2)	Unobservable Inputs (Level 3)
Other real estate owned	\$ 2,472	\$ -	\$ -	\$ 2,472
Impaired loans:				
Construction and land	810	-	-	810
Residential - first lien	314	-	-	314
Residential - junior lien	-	-	-	-
Commercial - owner occupied	-	-	-	-
Commercial - non-owner occupied	2,702	-	-	2,702
Commercial loans and leases	1,461	-	-	1,461
Consumer	-	-	-	-

22

December 31, 2013	Carrying Value (Fair Value)	Quoted Price in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
(in thousands)				
Other real estate owned	\$ 2,377	\$ -	\$ -	\$ 2,377
Impaired loans:				
Construction and land	-	-	-	-
Residential - first lien	327	-	-	327
Residential - junior lien	-	-	-	-
Commercial - owner occupied	-	-	-	-
Commercial - non-owner occupied	2,953	-	-	2,953
Commercial loans and leases	2,754	-	-	2,754
Consumer	-	-	-	-

Loan impairment is measured using the present value of expected cash flows, the loan's observable market price or the fair value of the collateral (less selling costs) if the loans are collateral dependent. The value of business equipment, inventory and accounts receivable collateral is based on net book value on the business' financial statements and, if necessary, discounted based on management's review and analysis. Appraised and reported values may be discounted based on management's historical knowledge, changes in market conditions from the time of valuation, and/or management's expertise and knowledge of the client and client's business. Impaired loans are reviewed and evaluated on at least a quarterly basis for additional impairment and adjusted accordingly, based on the factors identified above. Valuation techniques are consistent with those techniques applied in prior periods.

Other real estate owned ("OREO") is adjusted to fair value upon transfer of the loans to OREO. Subsequently, OREO is carried at the lower of carrying value or fair value. The estimated fair value for other real estate owned included in Level 3 is determined by independent market based appraisals and other available market information, less cost to sell, that may be reduced further based on market expectations or an executed sales agreement. If the fair value of the collateral deteriorates subsequent to initial recognition, the Company records the OREO as a non-recurring Level 3 adjustment. Valuation techniques are consistent with those techniques applied in prior periods.

The fair value of a financial instrument is the amount at which the instrument could be exchanged in a current transaction between willing parties, other than in a forced or liquidation sale. Fair value estimates are based on quoted market prices where available or calculated using present value techniques. Since quoted market prices are not available on many of our financial instruments, estimates may be based on the present value of estimated future cash flows and estimated discount rates. These financial assets and liabilities have not been recorded at fair value.

The following methods and assumptions were used to estimate the fair value of financial instruments where it is practical to estimate fair value:

**Cash and cash equivalents:** The fair value of cash and cash equivalents is estimated to approximate the carrying amounts.

**Securities available-for-sale:** Based on quoted market prices. If quoted market price is not available fair value is estimated using quoted market prices for similar securities. See Note 2 for additional information.

**Nonmarketable equity securities:** Because these securities are not marketable, the carrying amount approximates the fair value.

**Loans held for sale:** Loans held for sale are carried at fair value. Based on outstanding investor commitments or, in absent of such commitments, based on current investor yield requirements on third party models.

**Derivative financial instruments:** The market value of rate lock commitments and best efforts contracts are not readily ascertainable with precision because rate lock commitments and best efforts contracts are not actively traded

**Loans:** For variable rate loans the carrying amount approximates the fair value. For fixed rate loans the fair value is calculated by discounting estimated cash flows using current rates at which similar loans would be made to borrowers with similar credit ratings and for the same remaining maturities. The estimated cash flows do not anticipate prepayments.

**Deposits:** The carrying amount of non-maturity deposits such as demand deposits, money market and saving deposits approximates the fair value. The fair value of deposits with predetermined maturity dates such as certificate of deposits is estimated by discounting the future cash flows using current rates of similar deposits with similar remaining maturities.

**Short-term borrowing:** Variable rate repurchase agreements carrying amounts approximate the fair values at the reporting date.

**Long-term borrowing:** Because the borrowing is a variable rate instrument, the carrying amount approximates the fair value.

Management has made estimates of fair value discount rates that it believes to be reasonable. However, because there is no market for many of these financial instruments, management has no basis to determine whether the fair value presented for loans would be indicative of the value negotiated in an actual sale.

<b>September 30, 2014</b>					
(in thousands)	Carrying Amount	Fair Value	Quoted Price in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
<b>Financial Assets</b>					
Cash and cash equivalents	\$17,671	\$17,671	\$ -	\$ 17,671	\$ -
Investment securities	27,112	27,112	-	27,112	-
Nonmarketable equity securities	2,700	2,700	-	2,700	-
Loans held for sale	38,669	38,669	-	38,669	-
Rate lock commitments	131	131	-	131	-
Loans and leases	458,214	459,445	-	-	459,445
<b>Financial Liabilities</b>					
Deposits	451,910	452,668	-	-	452,668
Short-term borrowings	51,956	51,956	-	51,956	-
Long-term borrowings	19,000	18,992	-	18,992	-

<b>December 31, 2013</b>					
(in thousands)	Carrying Amount	Fair Value	Quoted Price in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
<b>Financial Assets</b>					
Cash and cash equivalents	\$35,736	\$35,736	\$ -	\$ 35,736	\$ -
Investment securities	28,688	28,688	-	28,688	-
Nonmarketable equity securities	2,282	2,282	-	2,282	-
Loans held for sale	3,298	3,298	-	3,298	-
Loans and leases	401,369	401,652	-	-	401,652
<b>Financial Liabilities</b>					

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Deposits	388,949	389,220	-	-	389,220
Short-term borrowings	45,658	45,658	-	45,658	-
Long-term borrowings	16,000	16,008	-	16,008	-

**Note 14: Acquisition**

On August 28, 2014, the Bank purchased a branch from NBRS Financial Bank (“NBRS”) its branch located at 800 Revolution Street, Havre de Grace, MD 21078. Pursuant to the transaction, the Bank acquired \$16.1 million in loans and \$18.8 million in deposits from NBRS, as well as the branch furniture and equipment at their book value. In connection with its purchase of the branch from NBRS, the Bank received a cash payment from NBRS of \$1.98 million, which was net of a premium of approximately \$384,000.

**Note 15: Subsequent Event**

On October 17, 2014, the Bank assumed all of the deposits and acquired essentially all of the assets of NBRS from the Federal Deposit Insurance Corporation (the “FDIC”), as receiver for NBRS, pursuant to the terms of the Purchase and Assumption Agreement, dated as of October 17, 2014, by and among the FDIC, Receiver of NBRS, the FDIC and the Bank (the “Agreement”).

The Bank acquired approximately \$143.4 million in book value of deposits as well as approximately \$145.9 million in book value of assets, consisting primarily of \$100.5 million in book value of loans and \$34.6 million in book value of marketable securities. The FDIC will retain the other real estate owned and other remaining assets for later disposition. The Bank paid a premium of 1.19% to assume all of the deposits of NBRS. These amounts are based on information currently available to the Company and are subject to change as additional information relative to fair values as of October 17, 2014 becomes available. The amounts are also subject to adjustments based upon final settlement with the FDIC. The FDIC estimates that the cost to the Deposit Insurance Fund (DIF) will be \$24.3 million, as this transaction was not subject to any loss share agreement.

The Bank also acquired two bank premises from NBRS including one branch and one former (now vacant) branch, and is operating an additional five former NBRS branches; while the Bank did not commit to assume the leases on these branches it has the option to do so under the Agreement. The Bank did not acquire any of NBRS' other real estate owned. In addition, no assets were acquired or liabilities assumed from NBRS' parent entity.

The Bank has entered into an agreement with a third party to sell an aggregate of approximately \$18.4 million in book value of certain non-performing and other loans acquired from NBRS within 30 days from October 17, 2014. Assuming such sale is consummated, the Bank would retain approximately \$2.0 million in book value of non-performing loans acquired from NBRS.



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

This section is intended to help readers understand our financial performance through a discussion of the factors affecting our consolidated financial condition and results of operations. This section should be read in conjunction with the consolidated financial statements and accompanying notes.

### Overview

Bancorp is the holding company for the Bank. The Bank is a trust company chartered under Subtitle 2 of Title 3 of the Financial Institutions Article of the Annotated Code of Maryland. The Bank was formed in March 2004 and commenced banking operations on August 9, 2004. The Bank does not exercise trust powers, and our regulatory structure is the same as a Maryland-chartered commercial bank. As such, our business has consisted primarily of originating both commercial and real estate loans secured by property in our market area. Typically, commercial real estate and business loans involve a higher degree of risk and carry a higher yield than one-to-four-family residential loans. Although we plan to continue to focus on commercial customers, we intend to increase our originations of one-to-four-family residential mortgage loans going forward, increasing our portfolio of mortgage lending and also selling select loans into the secondary markets.

We are headquartered in Ellicott City, Maryland and we consider our primary market area to be The Greater Baltimore Metropolitan Area. We engage in a general commercial banking business, making various types of loans and accepting deposits. We market our financial services to small to medium sized businesses and their owners, professionals and executives, and high-net-worth individuals. Our loans are primarily funded by core deposits of customers in our market.

Our core business strategy is to deliver superior customer service that is supported by an extremely high level of banking sophistication. Our specialized community banking focus on both local markets and small business related market segments is combined with a broad array of products, new technology and seasoned banking professionals which positions the Bank differently than most competitors. Our experienced executives establish a relationship with each client and bring value to all phases of a client's business and personal banking needs. We call it Hands-On Service.

Our results of operations depend mainly on our net interest income, which is the difference between the interest income we earn on our loan and investment portfolios and the interest expense we pay on deposits and borrowings. Results of operations are also affected by provisions for credit losses, noninterest income and noninterest expense. Our noninterest expense consists primarily of compensation and employee benefits, as well as office occupancy, business development, deposit insurance and general administrative and data processing expenses. Our operations are

significantly affected by general economic and competitive conditions, particularly with respect to changes in interest rates, government policies and actions of regulatory authorities. Future changes in applicable law, regulations or government policies may materially affect our financial condition and results of operations.

Total assets increased \$74.5 million or 14.9% when comparing September 30, 2014 assets of \$574.4 million to the \$499.9 million at December 31, 2013. Total loans outstanding of \$461.2 million at the end of September 2014, showed an increase of \$57.4 million or 14.2% compared to total loans of \$403.9 million on December 31, 2013. Total deposits grew by \$63.0 million or 16.2% when comparing September 30, 2014 to December 31, 2013. These increases reflect the acquisition of our new Havre de Grace branch from NBRS, which was acquired during the third quarter of 2014, and which had balances of \$15.9 million in loans and \$17.6 million in deposits at September 30, 2014.

Net income was \$1.2 million during the first nine months of 2014 compared to \$1.4 million during the first nine months of 2013, and \$.2 million and \$.4 million, respectively, during the three months ended September 30, 2014 and 2013. Net interest income for the nine months ended September 30, 2014 was \$14.4 million versus \$11.4 million for the first nine months of 2013, an increase of approximately \$3.0 million or 26.3%. Total noninterest income was \$4.9 million for the first nine months of 2014, compared to \$1.0 million for the same period in 2013. The first nine months of 2014 noninterest income was primarily impacted by increased mortgage banking activities of \$2.7 million. Total noninterest expenses increased by \$5.3 million from \$9.5 million for the nine months ended September 30, 2013 to \$14.8 million for the same period in 2014. Most of the increase in expenses was due to additional compensation costs as we continued to expand staff and additional infrastructure to support growth.

During the first nine months of 2014, we have spent considerable financial and nonfinancial resources in putting together a highly professional team of mortgage bankers. To accommodate the mortgage banking initiative, we have leased additional office space in Annapolis, Maryland, and opened mortgage offices in Columbia, Maryland and in Timonium, Maryland. Over the twelve months from September 30, 2013 to September 30, 2014, we added three new branch locations in Towson, Bel Air, and Aberdeen, as well as acquiring our Havre de Grace location, all located in Maryland. In addition, we opened a regional office in Towson, Maryland. This dramatic increase in both branches/offices and the related staff additions geographically extends our market presence and our brand, and provides a platform for continued growth in size and revenues.

## Critical Accounting Policies

Our accounting and financial reporting policies conform to GAAP and general practice within the banking industry. Accordingly, the financial statements require management to exercise significant judgment or discretion or make significant assumptions based on the information available that have, or could have, a material impact on the carrying value of certain assets or on income. These estimates and assumptions affect the reported amounts of assets and liabilities at the date of the financial statements and the reported amounts of income and expenses during the periods presented. In reviewing and understanding financial information for us, you are encouraged to read and understand the significant accounting policies used in preparing our financial statements. We consider the allowance for credit losses to be our most significant accounting policy, which is further described in the notes to the financial statements.

The allowance for credit losses is established through a provision for credit losses charged against income. Loans are charged against the allowance for credit losses when management believes that the collectability of the principal is unlikely. Subsequent recoveries are added to the allowance. The allowance is an amount that represents the amount of probable and reasonably estimable known and inherent losses in the loan portfolio, based on evaluations of the collectability of loans. The evaluations take into consideration such factors as changes in the types and amount of loans in the loan portfolio, historical loss experience, adverse situations that may affect the borrower's ability to repay, estimated value of any underlying collateral, estimated losses relating to specifically identified loans, and current economic conditions. This evaluation is inherently subjective as it requires material estimates including, among others, exposure at default, the amount and timing of expected future cash flows on impacted loans, value of collateral, estimated losses on our loan portfolios as well as consideration of general loss experience. Based on our estimate of the level of allowance for credit losses required, we record a provision for credit losses to maintain the allowance for credit losses at an appropriate level.

We cannot predict with certainty the amount of loan charge-offs that we will incur. We do not currently determine a range of loss with respect to the allowance for credit losses. In addition, our regulatory agencies, as an integral part of their examination processes, periodically review our allowance for credit losses. Such agencies may require that we recognize additions to the allowance for credit losses based on their judgments about information available to them at the time of their examination. To the extent that actual outcomes differ from management's estimates, additional provisions to the allowance for credit losses may be required that would adversely impact earnings in future periods.

We account for income taxes under the asset/liability method. We recognize deferred tax assets for the future consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax basis, as well as operating loss and tax credit carry-forwards. We measure deferred tax assets and liabilities 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. We recognize the effect on deferred tax assets and liabilities of a change in tax rates in income in the period indicated by the enactment date. We establish a valuation allowance for deferred tax assets when, in the judgment of management, it is more likely than not that such deferred tax assets will not become realizable. The judgment about the level of future taxable income is dependent to a great extent on matters that may, at least in part, be beyond our control. It is at least reasonably possible that management's

judgment about the need for a valuation allowance for deferred tax assets could change in the near term.

We follow the provisions of ASC Topic 718 "Compensation," which requires the expense recognition over a service period for the fair value of share based compensation awards, such as stock options, restricted stock, and performance based shares. This standard allows management to establish modeling assumptions as to expected stock price volatility, option terms, forfeiture rates and dividend rates which directly impact estimated fair value. The accounting standard also allows for the use of alternative option pricing models which may impact fair value as determined. Our practice is to utilize reasonable and supportable assumptions which are reviewed with the appropriate Board committee.

### **Balance Sheet Analysis and Comparison of Financial Condition**

A comparison between September 30, 2014 and December 31, 2013 balance sheets is presented below.

#### **Assets**

Total assets increased \$74.5 million, or 14.9%, to \$574.4 million at September 30, 2014 compared to \$499.9 million at December 31, 2013. This asset growth was primarily due to growth of \$57.4 million in total loans and leases and a \$35.4 million in loans held for sale, partially offset by decreases of \$18.1 million in cash and cash equivalents and \$1.2 million in investment securities. In addition to the organic loan growth of \$41.5 million, total assets were enhanced from the Bank's purchase of loans in the Havre de Grace branch acquisition, which totaled \$15.9 million at September 30, 2014. The impact of the Bank's newly created mortgage banking division is evident by the increase in loans held for sale. The asset growth was funded primarily from increases in customer deposits, which increased from \$388.9 million at December 31, 2013 to \$451.9 million at September 30, 2014, an increase of \$63.0 million or 16.2%. In addition to our continued organic growth in deposits, additional deposits were acquired in the Havre de Grace branch acquisition, which added \$17.6 million in deposits as of September 30, 2014.

## Securities Available for Sale

We currently hold U.S. agency, U.S treasuries and mortgage backed securities in our securities portfolio, all of which are categorized as available for sale. Our securities portfolio is used to provide the required collateral for funding via commercial customer repurchase agreements as well as to provide sufficient liquidity to fund our loans and provide funds for withdrawals of deposited funds. At September 30, 2014 and December 31, 2013 we held an investment in stock of the Federal Home Loan Bank of Atlanta (“FHLB”) of \$2.7 million and \$2.3 million, respectively. This investment is required for continued FHLB membership, and is based partially upon the amount of borrowings outstanding from the FHLB. These investments are carried at cost. We have never held stock in Fannie Mae or Freddie Mac.

The following tables set forth the composition of our investment securities portfolio at the dates indicated.

(in thousands)	<b>September 30, 2014</b>		December 31, 2013	
	Amortized Cost	Estimated Fair Value	Amortized Cost	Estimated Fair Value
U.S. Government				
Agencies	\$ 22,998	\$ 22,999	\$ 28,522	\$ 28,521
Treasuries	3,999	3,999	-	-
Mortgage-backed	108	114	157	167
	\$ 27,105	\$ 27,112	\$ 28,679	\$ 28,688

We had securities available for sale of \$27.1 million and \$28.7 million at September 30, 2014 and December 31, 2013, respectively, which were recorded at fair value. This represents a decrease of \$1.6 million, or 5.5%, from the prior year end. The decrease in our securities portfolio resulted solely from scheduled maturities, and not any sales of securities during the period. We continue to maintain an appropriate amount of securities to collateralize our repurchase agreements at September 30, 2014. We did not record any gains or losses on the sales or calls of securities in either period presented.

With respect to our total portfolio of securities available for sale, we did not have any securities that had unrealized losses at September 30, 2014, and at December 31, 2013 we had certain securities that had unrealized losses of less than \$1 thousand. The minimal changes in the fair value of these securities resulted primarily from interest rate fluctuations.

## Loan and Lease Portfolio

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Total loans and leases increased by \$57.4 million or 14.2%, to \$461.2 million at September 30, 2014 from \$403.9 million at December 31, 2013. Included in this growth is \$15.9 million in loans associated with the Havre de Grace branch acquisition. At September 30, 2014, total loans were 80.3% of total assets, down from 80.8% of total assets at December 31, 2013. As the economy in our market area continues to gradually improve so has demand for certain types of credit, especially commercial real estate, commercial and construction loans. In addition, with the expansion of our mortgage banking activities, our portfolio of residential mortgages also reflected growth during the nine month period of 2014.

The following table sets forth the composition of our loan and lease portfolio at the dates indicated. In addition to the loan amounts below, we had loans held for sale of \$38.7 million at September 30, 2014, and \$3.3 million at December 31, 2013.

(in thousands)	September 30,		December 31,		
	2014	% of Total	2013	% of Total	
Real estate					
Construction and land	\$62,649	13.6	% \$50,884	12.6	%
Residential - first lien	61,560	13.3	39,249	9.7	
Residential - junior lien	11,881	2.6	8,266	2.0	
Total residential real estate	73,441	15.9	47,515	11.7	
Commercial - owner occupied	94,517	20.5	90,333	22.4	
Commercial - non-owner occupied	116,820	25.3	113,559	28.1	
Total commercial real estate	211,337	45.8	203,892	50.5	
Total real estate loans	347,427	75.3	302,291	74.8	
Commercial loans and leases	112,357	24.4	100,410	24.9	
Consumer	1,448	0.3	1,174	0.3	
Total loans	\$461,232	100.0	% \$403,875	100.0	%

## Deposits

Our deposits increased from \$388.9 million at December 31, 2013 to \$451.9 million at September 30, 2014, an increase of \$63.0 million or 16.2%. Included in this deposit growth is \$17.6 million associated with the Havre de Grace branch acquisition which consisted of the following at September 30, 2014:

\$3.5 million in non-interest bearing demand accounts  
 \$1.8 million in interest bearing demand accounts  
 \$2.5 million in money market accounts  
 \$1.6 million in saving accounts  
 \$8.2 million in certificate of deposit accounts

During 2014 every category of deposits experienced growth from the December 2013 levels. Money market account experienced the largest growth of \$24.8 million or 25.7%, followed by non-interest bearing demand account growth of \$16.4 million or 18.4%. Additionally we grew, certificate of deposits \$17.6 million or 11.1%, interest bearing demand accounts \$3.5 million or 11.0% and saving accounts \$.7 million or 5.5%.

The following tables set forth the distribution of total deposits, by account type, at the dates indicated

(dollars in thousands)	September 30, 2014		December 31, 2013	
	Amount	% of Total	Amount	% of Total
Noninterest-bearing demand	\$ 106,237	24 %	\$ 89,759	23 %
Interest-bearing checking	34,897	7	31,443	8
Money market accounts	121,144	27	96,365	25
Savings	13,177	3	12,496	3
Certificates of deposit \$100,000 and over	121,970	27	110,516	29
Certificates of deposit under \$100,000	54,485	12	48,370	12
Total deposits	\$ 451,910	100 %	\$ 388,949	100 %

## Borrowings

Customer deposits remain the primary source utilized to meet funding needs. Borrowings consist of overnight unsecured master notes, overnight securities sold under agreement to repurchase (“repurchase agreements”) and FHLB advances. Our borrowings totaled \$71.0 million at September 30, 2014 and \$61.7 million at December 31, 2013. Short-term borrowings totaled \$52.0 million at September 30, 2014 and \$45.7 million at December 31, 2013. We had

seven long-term FHLB advances outstanding totaling \$19.0 million at September 30, 2014 compared to nine FHLB advances outstanding totaling \$16 million at December 31, 2013.

### **Shareholders' Equity**

Total shareholders' equity increased by \$1.8 million, or 3.6%, from \$48.6 million at December 31, 2013 to \$50.4 million at September 30, 2014. The increase in shareholders' equity is primarily the result of the retention of the earnings for the first nine months of 2014, supplemented by approximately \$470 thousand in additional capital resulting from the exercise of warrants.

Total shareholders' equity at September 30, 2014 represents a capital to asset ratio of 8.8%, while the total shareholders' equity at December 31, 2013 represents a capital to asset ratio of 9.7%. Even though capital levels increased, the overall growth in asset levels resulted in a decline in the capital to asset ratio.



**Average Balance and Yields**

The following tables set forth average balance sheets, average yields and costs, and certain other information for the periods indicated. No tax-equivalent yield adjustments were made, as the effect thereof was not material. All average balances are daily average balances. Non-accrual loans were included in the computation of average balances, and have been reflected in the table as loans carrying a zero yield. The yields set forth below include the effect of deferred fees, discounts and premiums that are amortized or accreted to interest income or expense.

(dollars in thousands)	Nine months ended September 30,					
	<b>2014</b>			2013		
	Average Balance	Income / Expense	Yield / Rate	Average Balance	Income / Expense	Yield / Rate
<b>Earning assets</b>						
Loans and leases: <sup>1</sup>						
Commercial loans and leases	\$103,232	\$ 3,749	4.86 %	\$90,880	\$ 3,308	4.87 %
Commercial real estate	203,002	7,573	4.99	171,569	6,407	4.99
Construction and land	57,346	2,195	5.12	40,968	1,592	5.20
Residential real estate	56,889	1,924	4.52	39,325	1,336	4.54
Consumer	1,082	47	5.79	1,133	44	5.19
Total loans and leases	421,551	15,488	4.91	343,875	12,687	4.93
Loans held for sale	20,945	550	3.51	1,076	26	3.23
Federal funds sold	20,384	30	0.19	21,648	35	0.22
Securities: <sup>2</sup>						
U.S. Treasury	88	1	0.77	-	-	
U.S Gov agencies	19,636	14	0.10	15,365	21	0.18
Mortgage-backed	141	5	4.51	266	9	4.52
Other investments	2,448	66	3.63	1,680	27	2.15
Total securities	22,312	86	0.52	17,311	57	0.44
Total earning assets	485,192	16,154	4.45	383,910	12,805	4.46
Cash and due from banks	5,627			4,812		
Bank premises and equipment, net	11,345			9,589		
Other assets	17,598			14,445		
Less: allowance for credit losses	(2,818 )			(2,943 )		
Total assets	\$516,944			\$409,813		
<b>Interest-bearing liabilities</b>						
Deposits:						
Interest-bearing demand accounts	\$31,610	\$ 59	0.25 %	\$24,916	\$ 51	0.27 %
Money market	107,488	369	0.46	76,148	241	0.42
Savings	12,609	22	0.23	12,131	33	0.36
Time deposits \$100,000 and over	72,515	651	1.20	58,491	524	1.20
Other time deposits	88,646	385	0.58	64,575	359	0.74
Total interest-bearing deposits	312,868	1,485	0.63	236,261	1,208	0.68
Short-term borrowings	38,002	84	0.30	23,578	83	0.47
Long-term borrowings	20,237	162	1.07	16,029	90	0.75

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Total interest-bearing funds	371,107	1,731	0.62	275,868	1,381	0.67
Noninterest-bearing deposits	95,669			85,517		
Other liabilities and accrued expenses	911			928		
Total liabilities	467,687			362,313		
Shareholders' equity	49,257			47,500		
Total liabilities & shareholders' equity	\$516,944			\$409,813		
Net interest rate spread <sup>3</sup>		\$ 14,423	3.83 %		\$ 11,424	3.79 %
Effect of noninterest-bearing funds			0.15			0.19
Net interest margin on earning assets <sup>4</sup>			3.97 %			3.98 %

(1) *Loan fee income is included in the interest income calculation, and nonaccrual loans are included in the average loan base upon which the interest rate earned on loans is calculated.*

(2) *Available for sale securities and loans held for sale are presented at fair value.*

(3) *Net interest rate spread represents the difference between the yield on average interest-earning assets and the cost of average interest-bearing liabilities.*

(4) *Net interest margin represents net interest income divided by average total interest-earning assets.*

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(dollars in thousands)	Three months ended September 30,					
	2014			2013		
	Average Balance	Income / Expense	Yield / Rate	Average Balance	Income / Expense	Yield / Rate
Earning assets						
Loans and leases: <sup>1</sup>						
Commercial loans and leases	\$ 107,984	\$ 1,301	4.78 %	\$ 96,927	\$ 1,203	4.92 %
Commercial real estate	203,037	2,685	5.25	189,024	2,368	4.97
Construction and land	61,674	734	4.72	43,478	564	5.15
Residential real estate	66,304	754	4.51	41,875	477	4.52
Consumer	1,211	17	5.66	951	13	5.42
Total loans and leases	440,210	5,491	4.95	372,255	4,625	4.93
Loans held for sale	32,157	285	3.51	458	2	1.73
Federal funds sold	19,354	9	0.18	22,469	12	0.21
Securities: <sup>2</sup>						
U.S. Treasury	261	-	-	-	-	
U.S. Gov agencies	16,782	3	0.08	14,660	4	0.10
Mortgage-backed	123	1	4.46	211	2	3.76
Other investments	2,566	24	3.68	1,925	10	2.06
Total securities	19,732	28	0.57	16,796	16	0.37
Total earning assets	511,453	5,813	4.51	411,978	4,655	4.48
Cash and due from banks	6,242			5,018		
Bank premises and equipment, net	11,532			9,842		
Other assets	17,737			15,013		
Less: allowance for credit losses	(3,059 )			(3,056 )		
Total assets	\$ 543,905			\$ 438,795		
Interest-bearing liabilities						
Deposits:						
Interest-bearing demand accounts	\$ 31,123	\$ 20	0.25 %	\$ 24,643	\$ 16	0.26 %
Money market	118,246	158	0.53	79,169	68	0.34
Savings	12,510	7	0.21	12,406	9	0.29
Time deposits \$100,000 and over	76,394	243	1.26	64,498	192	1.18
Other time deposits	90,010	132	0.58	76,414	137	0.71
Total interest-bearing deposits	328,283	560	0.68	257,130	422	0.65
Short-term borrowings	40,755	28	0.27	25,695	26	0.40
Long-term borrowings	22,728	60	1.05	21,957	49	0.89
Total interest-bearing funds	391,766	648	0.66	304,782	497	0.65
Noninterest-bearing deposits	101,168			85,073		
Other liabilities and accrued expenses	1,168			939		
Total liabilities	494,102			390,794		
Shareholders' equity	49,803			48,001		
Total liabilities & shareholders' equity	\$ 543,905			\$ 438,795		
Net interest rate spread <sup>3</sup>		\$ 5,165	3.85 %		\$ 4,158	3.84 %
Effect of noninterest-bearing funds			0.15			0.17
Net interest margin on earning assets <sup>4</sup>			4.01 %			4.00 %

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- (1) *Loan fee income is included in the interest income calculation, and nonaccrual loans are included in the average loan base upon which the interest rate earned on loans is calculated.*
- (2) *Available for sale securities and loans held for sale are presented at fair value.*
- (3) *Net interest rate spread represents the difference between the yield on average interest-earning assets and the cost of average interest-bearing liabilities.*
- (4) *Net interest margin represents net interest income divided by average total interest-earning assets.*

**Rate/Volume Analysis**

The following table presents the effects of changing rates and volumes on our net interest income for the periods indicated. The rate column shows the effects attributable to changes in rate (changes in rate multiplied by prior volume). The volume column shows the effects attributable to changes in volume (changes in volume multiplied by prior rate). The total column is further broken down to show the impact of changes in either rates or volumes. For purposes of this table, changes attributable to both rate and volume, which cannot be segregated, have been allocated proportionately, based on the changes due to rate and the changes due to volume.

(in thousands)	Nine months ended September 30, 2014 vs. 2013			Three months ended September 30, 2014 vs. 2013		
	Total	Rates	Volumes <sup>1</sup>	Total	Rates	Volumes <sup>1</sup>
Interest earned on:						
Loans and leases:						
Commercial loans and leases	\$ 441	\$ (10 )	\$ 451	\$ 98	\$ (141 )	\$ 239
Commercial real estate	1,166	(9 )	1,175	317	522	(205 )
Construction and land	603	(32 )	635	170	(186 )	355
Residential real estate	588	(8 )	596	277	(3 )	280
Consumer	3	7	(4 )	4	2	2
Loans held for sale	524	3	521	283	8	275
Taxable securities	29	13	16	12	34	(22 )
Federal funds sold	(5 )	(4 )	(1 )	(3 )	(6 )	3
Total interest income	3,349	(40 )	3,389	1,158	231	927
Interest paid on:						
Savings deposits	(11 )	(16 )	5	(2 )	(9 )	7
Checking plus interest deposits	8	(6 )	14	4	(2 )	6
Money market accounts	128	27	101	90	151	(61 )
Time deposit \$100,000 and over	127	1	126	51	53	(2 )
Other time deposits	26	(105 )	131	(5 )	(98 )	93
Short-term borrowings	1	(41 )	42	2	(33 )	35
Long-term borrowing	72	51	21	11	37	(26 )
Total interest expense	350	(89 )	439	151	99	52
Net interest earned	\$ 2,999	\$ 49	\$ 2,950	\$ 1,007	\$ 132	\$ 874

(1) Change attributed to mix (rate and volume) are included in volume variance

**Comparison of Results of Operations**

*A comparison between the nine months ended September 30, 2014 and September 30, 2013 is presented below.*

## **General**

Net income available to common shareholders decreased \$125 thousand, or 9.9%, to \$1.1 million for the nine months ended September 30, 2014 compared to \$1.3 million for the nine months ended September 30, 2013. This decrease was primarily due to the \$2.6 million provision recorded during the third quarter of 2014, primarily relating to one loan relationship. Our two main sources of revenues, net interest income and noninterest income, on a combined basis increased by \$6.8 million or 56% when comparing the first nine months of 2014 to the same period of 2013. As detailed below, net interest income increased \$2.9 million, or 26.3%, during the nine months ended September 30, 2014 compared to the nine months ended September 30, 2013, while noninterest income was \$4.9 million for the nine months ended September 30, 2014 compared to \$1.0 million for the nine months ended September 30, 2013, a \$3.9 million increase. Partially offsetting this combined revenue increase of \$6.8 million, was an increase in noninterest expenses of \$5.3 million which is described below.

## **Interest Income**

Interest income increased \$3.3 million, or 26.2%, to \$16.2 million for the nine months ended September 30, 2014 compared to \$12.8 million for the same period in 2013. The increase was due to a \$3.3 million or 26.2% increase in interest income on loans and leases, and included \$550 thousand in interest on mortgage loans held for sale. The increase in interest income on loans was due to a nearly \$78 million or 22.6% increase in the average balance of the loan portfolio during the nine months ended September 30, 2014 compared to the nine months ended September 30, 2013. In addition to the growth in our portfolio of loans, an increase of \$19.9 million in the average balance of loans held for sale drove a \$524 thousand increase in interest income while our securities portfolio increased \$5 million on average resulting in a \$34 thousand increase in interest income.

## **Interest Expense**

Interest expense increased by \$350 thousand, or 25.3%, to \$1.7 million for the nine months ended September 30, 2014, compared to \$1.4 million for the same period in 2013. We grew average interest bearing deposits by \$76.6 million or 32.4% for the first nine months of 2014 compared to the first nine months of 2013, total interest expense on deposits only rose 22.9% as the average rates paid on deposits decreased from .68% to .63% when comparing the two periods, primarily as a result of a continuing shift in the composition of our deposits towards lower cost deposit products including noninterest-bearing deposits, the average balance of which grew \$7.1 million when comparing the nine months ended September 30, 2014 to the same period of the prior year. In addition to the growth of deposits, the average balance of borrowings increased 47.0% which also increased overall interest expense.

## **Net Interest Income**

Net interest income is our largest source of operating revenue. Net interest income is affected by various factors including changes in interest rates and the composition of interest-earning assets and interest-bearing liabilities and maturities. Net interest income is determined by the interest rate spread (i.e., the difference between the yields earned on interest-earning assets and the rates paid on interest-bearing liabilities) and the relative amounts of interest-earning assets and interest-bearing liabilities. Net interest income increased \$2.9 million, or 26.3%, during the nine months ended September 30, 2014 compared to the nine months ended September 30, 2013. As noted above, the increase in net interest income was primarily due to an increase in interest income of \$3.3 million, reduced by an increase of \$350 thousand in interest expense. The Havre de Grace branch acquisition at the end of August 2014 had a minimal effect on the average balance and increased net interest income by \$67 thousand during the nine months ended September 30, 2014.

## **Provision for Credit Losses**

We establish a provision for credit losses, which is a charge to earnings, in order to maintain the allowance for credit losses at a level we consider adequate to absorb credit losses incurred in the loan portfolio that are both probable and reasonably estimable at the balance sheet date. In determining the level of the allowance for credit losses, management considers past and current loss experience, evaluations of real estate collateral, current economic conditions, volume and type of lending, adverse situations that may affect a borrower's ability to repay a loan and the levels of nonperforming loans. The amount of the allowance is based on estimates and actual losses may vary from such estimates as more information becomes available or economic conditions change. This evaluation is inherently subjective as it requires estimates that are susceptible to significant revision as circumstances change as more information becomes available. The allowance for credit losses is assessed on a quarterly basis and provisions are made for credit losses as required in order to maintain the allowance.

Based on management's evaluation of the above factors, we had a provision for credit losses of \$2.6 million for the nine months ended September 30, 2014 compared to \$666 thousand for the same period in 2013, an increase of \$1.9 million. This substantial increase in our provision for credit losses during the 2014 period resulted primarily from one large commercial customer that closed its business during the third quarter of 2014 and did not fulfill its commitments under existing contracts. While the Bank is pursuing multiple remedies, it was deemed prudent to absorb the full loss within the quarter. The remainder of the provision for the 2014 period reflects additional general provisions that are required given our continued growth in the size of the loan portfolio, as well as any specific provisions required on loans that are individually evaluated and deemed to be impaired.

Management analyzes the allowance for credit losses as described in the section entitled "Allowance for Credit Losses." The provision that is recorded is sufficient, in management's judgment, to bring the allowance for credit losses to a level that reflects the losses inherent in our loan portfolio relative to loan mix, economic conditions and historical loss experience. Management believes, to the best of its knowledge, that all known losses as of the balance sheet dates have been recorded. However, although management uses the best information available to make determinations with respect to the provisions for credit losses, additional provisions for credit losses may be required to be established in the future should economic or other conditions change substantially. In addition, as an integral part of their examination process, the Commissioner and the FDIC will periodically review the allowance for credit losses. The Commissioner and the FDIC may require us to recognize additions to the allowance based on their analysis of information available to them at the time of their examination.

### **Noninterest Income**

Noninterest income was \$4.9 million for the nine months ended September 30, 2014 compared to \$1.0 million for the nine months ended September 30, 2013, a \$3.9 million increase. The largest increase was generated from mortgage banking activities. Realized and unrealized gains from these activities increased from \$0.2 million in the first nine months of 2013 to \$2.9 million in the first nine months of 2014, and included the effect of implementing the fair value method for mortgage loans held for sale which accelerated mortgage related revenues by \$931 thousand. Fees generated from mortgage banking, included in other operating income, increased 100% for the first nine months of 2014 compared to the comparable prior year period, representing \$859 thousand in revenues. Additionally, the approximately \$3.0 million expansion of our BOLI program since September 30, 2013 generated an increase of \$71 thousand in income from bank owned life insurance, to \$281 thousand during the first nine months of 2014 compared to \$210 thousand during the first nine months of 2013. Service charges on deposit accounts, which consist of account activity fees and other traditional banking fees, increased 54.7% to \$425 thousand for the nine months ended September 30, 2014 from \$275 thousand for the same period in 2013 due mostly to an increase in overdraft-related fees. Other operating income, besides fees generated from mortgage banking activities, consists mainly of certain loan fees and non-depository account fees. Noninterest income benefited in the first nine months of 2014 from loan fees of \$97 thousand primarily associated with letters of credit from two credit relationships. Fees for customer related services such as wire, merchant card and ATM increased \$11 thousand during the nine months ended September 30, 2014 compared to the same period of 2013 due to increased activity. The Havre de Grace branch acquisition had minimal effect on noninterest income during the nine months ended September 30, 2014.



## Noninterest Expenses

Noninterest expenses increased \$5.3 million or 55.7%, to \$14.8 million for the nine months ended September 30, 2014 from \$9.5 million for the nine months ended September 30, 2013. This increase reflects the large investments in staff and infrastructure made during the first nine months of 2014 to build the mortgage banking platform, which is also evident in the additional revenues that were generated, from continuing branch expansion efforts, and increased marketing related to our business development initiatives. Compensation and employee benefits increased \$3.2 million or 60.7% in the first nine months of 2014 compared to the same period in 2013. Full time equivalent employees at September 30, 2014 nearly doubled, up 90.8%, from September 30, 2013 as the Bank has built its mortgage banking team, added branch and other sales staff, and expanded support and compliance areas of the Bank. The increase in occupancy and equipment costs of \$391 thousand or 33.9% reflects our adding three new branch locations, a regional office, and two additional mortgage offices since September 30, 2013. Our newly established mortgage banking group had an impact on nearly all areas of our noninterest expenses relating to both start-up and ongoing operating costs when comparing the nine months ended September 30, 2014 to the nine months ended September 30, 2013. Marketing and business development expenses increased a total of \$656 thousand, of which \$429 thousand pertained to mortgage sales activities. Professional fees, which consists of legal, consulting and outside service providers, increased \$235 thousand in total, \$49 thousand relating to start-up mortgage banking legal matters and the remainder due to ongoing banking related growth initiatives. Other operating expense consists of loan related expenses (including credit reports, appraisals and collection costs) and a variety of general expenses such as phone and data lines, supplies and postage and courier services. Of the total \$960 thousand increase in other operating expenses, \$692 thousand corresponded to the development of the mortgage banking infrastructure and we incurred a 100% increase in loan related costs associated with the additional volume in processing mortgage requests.

## Net Income Available to Common Shareholders

Net income available to common shareholders during the nine months ended September 30, 2014 decreased \$125 thousand or 9.9% to \$1.1 million compared to \$1.3 million during the nine months ended September 30, 2013. This reflects an increased provision for credit losses of \$2.6 million and increased noninterest expenses. Preferred stock dividends were lower during the 2014 period because of a reduction in the dividend rate paid on our SBLF Preferred Stock given the growth in applicable loan categories in accordance with the terms of the program.

*A comparison between the three months ended September 30, 2014 and September 30, 2013 is presented below.*

## General

Net income available to common shareholders decreased \$171 thousand, or 45.5%, to \$205 thousand for the three months ended September 30, 2014 compared to \$376 thousand for the three months ended September 30, 2013. This resulted in earnings per share decrease to \$.05 for the third quarter 2014 compared to \$.09 in the same period of 2013. The primary reasons for the decrease in earnings were a single credit relationship that required the majority of the provision for credit losses of \$2.1 million in the three month period, as well as a \$1.3 million increase in noninterest expenses.

### **Interest Income**

Interest income increased \$1.2 million, or 24.9%, to \$5.8 million for the three months ended September 30, 2014 compared to \$4.7 million for the same period 2013. The increase was primarily due to a \$1.1 million, or 24.8%, increase in interest income and fees on loans. The increase in interest income on loans was due to a \$68.0 million or 18.3% increase in the average balance of the loan portfolio compared to the three months ended September 30, 2013, slightly enhanced by a two basis point increase in the average yield. In addition to the portfolio loans, the \$31.7 million increase in the average balance of loans held for sale quarter over quarter contributed to the increase in interest and fees on loans. Interest and dividends on securities increased during the first quarter of 2014 compared to the same period last year primarily as a result of a \$2.9 million increase in the average balance of investment securities quarter over quarter. Partially offsetting these increases was a decline in interest income on federal funds sold, which decreased \$3 thousand over the same period in 2013 as a result of a three basis point decrease in the average yield and a \$3.1 million decrease in the average balance of federal funds sold quarter over quarter.

### **Interest Expense**

Interest expense increased \$151 thousand, or 30.5%, to \$648 thousand for the three months ended September 30, 2014, compared to \$497 thousand for the same period 2013, primarily as a result of an increase in the rate paid on interest-bearing deposits. The average rate paid on interest-bearing deposits increased three basis points during the three months ended September 30, 2014 compared to the same period of 2013, further impacting the increase in interest expense. In addition, increases in the average balance of both interest-bearing deposits and borrowing of \$71.2 million and \$15.8 million, respectively, also contributed to the increase in interest expense.

### **Net Interest Income**

Net interest income increased \$1.0 million, or 24.0%, during the three months ended September 30, 2014 compared to the three months ended September 30, 2013. As noted above, the increase in net interest income was due to an increase of \$1.2 million in interest income coupled with only a \$0.2 million increase in interest expense during the three month period.

### **Provision for Credit Losses**

Based on management's evaluation, we had a provision for credit losses of \$2.1 million for the three months ended September 30, 2014 compared to \$140 thousand for the same period in 2013, an increase of \$1.9 million. The provision for the third quarter of 2014 was primarily due to a single credit and additional general provisions that were required given the continued growth in the size of our loan portfolio, as discussed above with respect to the provision for credit losses during the nine months ended September 30, 2014.

### **Noninterest Income**

Noninterest income was \$2.2 million for the three months ended September 30, 2014 compared to \$0.3 million for the three months ended September 30, 2013, a \$1.9 million or 581.8% increase. This increase was primarily due to the \$1.4 million of income generated from the mortgage banking activities during the third quarter of 2014 as secondary market investing expanded at the beginning of 2014. Additionally, fees collected on these activities included in other operating income totaled \$438 thousand for the third quarter of 2014.

## **Noninterest Expenses**

Noninterest expenses increased by \$1.3 million or 75.5%, during the three months ended September 30, 2014 compared to the three months ended September 30, 2013. As discussed above with respect to the nine month period ended September 30, 2014, expanding regional markets and our mortgage banking platform were the greatest factors impacting the increase in noninterest expenses. Compensation and employee benefits increased \$885 thousand or 46.5% quarter over quarter. Occupancy and equipment expenses increased \$83 thousand or 20.6%, marketing and business development increased \$247 thousand, professional fees increased \$52 thousand and data processing increased \$26 thousand, primarily resulting from support and expanded infrastructures related to growth initiatives as well as mortgage related activities. The \$291 thousand increase in other operating expense for the three months ended September 30, 2014 compared the same period of 2013 related to general increases in supplies, communication systems and postage needed to support our expand operations. Other operating expense increases were partially offset by a \$347 thousand reduction in OREO valuation expense as we had a \$347 thousand write down on OREO during the quarter ended September 30, 2013; no write-downs were necessary during the quarter ended September 30, 2014 as the current appraised values were sufficient to cover the recorded amounts.

## **Nonperforming and Problem Assets**

Management performs reviews of all delinquent loans and our loan officers contact customers to attempt to resolve potential credit issues in a timely manner. When in the best interests of the Bank and the customer, we will do a troubled debt restructure with respect to a particular loan. When not possible, we are aggressively moving loans through the legal and foreclosure process within applicable legal constraints.

Loans are generally placed on non-accrual status when payment of principal or interest is 90 days or more past due and the value of the collateral securing the loan, if any, is less than the outstanding balance of the loan. Loans are also placed on non-accrual status if management has serious doubt about further collectability of principal or interest on the loan, even though the loan is currently performing. When loans are placed on non-accrual status, unpaid accrued interest is fully reversed, and further income is recognized only to the extent received. The loan may be returned to accrual status if the loan is brought current, has performed in accordance with the contractual terms for a reasonable period of time and ultimate collectability of the total contractual principal and interest is no longer in doubt.

The table below sets forth the amounts and categories of our nonperforming assets, which consist of nonaccrual loans, troubled debt restructurings and OREO (which includes real estate acquired through, or in lieu of, foreclosure), at the dates indicated.

(in thousands)	September 30, 2014	December 31, 2013	
Non-accrual loans:			
Construction and land	\$ 810	\$ -	
Real estate loans:			
Residential - First Lien	314	331	
Commercial	-	258	
Commercial and leases	1,072	2,593	
Total non-accrual loans	2,196	3,182	
Troubled debt restructure loans:			
Accruing troubled debt restructure loans	228	-	
Total non-performing loans	2,424	3,182	
Other real estate owned:			
Land	595	595	
Commercial	1,877	1,782	
Total other real estate owned	2,472	2,377	
Total non-performing assets	\$ 4,896	\$ 5,559	
Ratios:			
Non-performing loans to total gross loans	0.53	% 0.79	%
Non-performing assets to total assets	0.85	% 1.11	%

Included in total non-accrual loans at September 30, 2014 are seven trouble debt restructured loans totaling \$1.1 million that were not performing in accordance with the modified terms, and the accrual of interest has ceased. There was one commercial real estate credit totaling \$150 thousand that was 90 days or more past due and still accruing interest at September 30, 2014. At December 31, 2013 there was one commercial real estate credit totaling \$159 thousand and one commercial credit totaling \$296 thousand 90 days or more past due and still accruing interest.

Under GAAP, we are required to account for certain loan modifications or restructurings as “troubled debt restructurings.” In general, the modification or restructuring of a debt constitutes a troubled debt restructuring if Howard Bank, for economic or legal reasons related to the borrower’s financial difficulties, grants a concession, such as a reduction in the effective interest rate, to the borrower that we would not otherwise consider. However, not all debt restructurings or loan modifications for a borrower necessarily constitute troubled debt restructurings.

Nonperforming assets amounted to \$4.9 million, or 0.85% of total assets, at September 30, 2014 compared to \$5.6 million or 1.11% of total assets at December 31, 2013. Total nonperforming assets have decreased by \$663 thousand during 2014, with one new property being transferred to OREO, no current properties were sold and no additional valuation adjustments were required on current assets. The decrease in non-accrual loans was impacted by the reductions in the balances of several non-accrual loans as principal payments were received from the borrowers and

also as funds were received from the Small Business Administration (the "SBA") for claims made under their guarantees.

The composition of our nonperforming loans at September 30, 2014 is further described below:

Seven commercial loans to two local businesses totaling \$0.86 million. These loans all have an SBA guarantee, and no further losses are anticipated.

Eleven small commercial loans totaling approximately \$0.21 million to borrowers that are in various stages of collection. Each relationship is independently evaluated, and no losses are anticipated.

One construction and land loan for \$0.81 million, which is secured by real estate. Based upon the current value of the collateral, no specific reserve has been established and no further losses are anticipated.

One residential mortgage for \$0.31 million. A specific reserve has been established and based upon current valuations, no further losses are anticipated.

## Allowance for Credit Losses

We provide for credit losses based upon the consistent application of our documented allowance for credit loss methodology. All credit losses are charged to the allowance for credit losses and all recoveries are credited to it. Additions to the allowance for credit losses are provided by charges to income based on various factors which, in our judgment, deserve current recognition in estimating probable losses. We regularly review the loan portfolio and make provisions for credit losses in order to maintain the allowance for credit losses in accordance with GAAP. The allowance for credit losses consists primarily of two components:

Specific allowances are established for loans classified as substandard or doubtful. For loans classified as impaired, the allowance is established when the net realizable value (collateral value less costs to sell) of the impaired loan is lower than the carrying amount of the loan. The amount of impairment provided for as a specific allowance is represented by the deficiency, if any, between the underlying collateral value and the carrying value of the loan. Impaired loans for which the estimated fair value of the loan, or the loan's observable market price or the fair value of the underlying collateral, if the loan is collateral dependent, exceeds the carrying value of the loan are not considered in establishing specific allowances for credit losses; and

General allowances established for credit losses on a portfolio basis for loans that do not meet the definition of impaired loans. The portfolio is grouped into similar risk characteristics, primarily loan type and regulatory classification. We apply an estimated loss rate to each loan group. The loss rates applied are based upon our loss experience adjusted, as appropriate, for the qualitative factors discussed below. This evaluation is inherently subjective, as it requires material estimates that may be susceptible to significant revisions based upon changes in economic and real estate market conditions.

The allowance for credit losses is maintained at a level to provide for losses that are probable and can be reasonably estimated. Management's periodic evaluation of the adequacy of the allowance is based on Howard Bank's past credit loss experience, known and inherent losses in the portfolio, adverse situations that may affect the borrower's ability to repay, the estimated value of any underlying collateral, composition of the loan portfolio, current economic conditions and other relevant factors. This evaluation is inherently subjective as it requires material estimates that may be susceptible to significant change, including the amounts and timing of future cash flows expected to be received on impaired loans.

A loan is considered past due or delinquent when a contractual payment is not paid on the day it is due. A loan is considered impaired when, based on current information and events, it is probable that Howard Bank will be unable to collect the scheduled payments of principal or interest when due according to the contractual terms of the loan agreement. Factors considered by management in determining impairment include payment status, collateral value and the probability of collecting scheduled principal and interest payments when due. Loans that experience insignificant payment delays and payment shortfalls generally are not classified as impaired. Management determines the significance of payment delays and payment shortfalls on a case-by-case basis, taking into consideration all of the circumstances surrounding the loan and the borrower, including the length of the delay, the reasons for the delay, the borrower's prior payment record and the amount of the shortfall in relation to the principal and interest owed. The impairment of a loan may be measured based on the present value of expected future cash flows discounted at the

loan's effective interest rate, or the fair value of the collateral if repayment is expected to be provided by the collateral. Generally, Howard Bank's impairment on such loans is measured by reference to the fair value of the collateral. Interest income on impaired loans is recognized on the cash basis.

Our loan policies state that after all collection efforts have been exhausted, and the loan is deemed to be a loss, then the remaining loan balance will be charged to the established allowance for credit losses. All loans are evaluated for loss potential once it has been determined by the Watch Committee that the likelihood of repayment is in doubt. When a loan is past due for at least 90 days or a deterioration in debt service coverage ratio, guarantor liquidity, or loan-to-value ratio has occurred that would cause concern regarding the likelihood of the full repayment of principal and interest, and the loan is deemed not to be well secured, the loan should be moved to nonaccrual status and a specific reserve is established if the net realizable value is less than the principal value of the loan balance(s). Once the actual loss value has been determined a charge-off against the allowance for credit losses for the amount of the loss is taken. Each loss is evaluated on its specific facts regarding the appropriate timing to recognize the loss.

The adjustments to historical loss experience are based on our evaluation of several qualitative factors, including:

- changes in lending policies, procedures, practices or personnel;
- changes in the level and composition of construction portfolio and related risks;
  - changes and migration of classified assets;
  - changes in exposure to subordinate collateral lien positions;
- levels and composition of existing guarantees on loans by SBA or other agencies;
- changes in national, state and local economic trends and business conditions;
- changes and trends in levels of loan payment delinquencies; and
- any other factors that managements considers relevant to the quality or performance of the loan portfolio.



We evaluate the allowance for credit losses based upon the combined total of the specific and general components. Generally when the loan portfolio increases, absent other factors, the allowance for credit loss methodology results in a higher dollar amount of estimated probable losses than would be the case without the increase. Generally when the loan portfolio decreases, absent other factors, the allowance for credit loss methodology results in a lower dollar amount of estimated probable losses than would be the case without the decrease.

Commercial and commercial real estate loans generally have greater credit risks compared to the one- to four-family residential mortgage loans we originate, as they typically involve larger loan balances concentrated with single borrowers or groups of related borrowers. In addition, the payment experience on loans secured by income-producing properties typically depends on the successful operation of the related business and thus may be subject to a greater extent to adverse conditions in the real estate market and in the general economy. Actual credit losses may be significantly more than the allowance for credit losses we have established, which could have a material negative effect on our financial results.

Generally, we underwrite commercial loans based on cash flow and business history and receive personal guarantees from the borrowers where appropriate. We generally underwrite commercial real estate loans and residential real estate loans at a loan-to-value ratio of 85% or less at origination. Accordingly, in the event that a loan becomes past due and, randomly with respect to performing loans, we will conduct visual inspections of collateral properties and/or review publicly available information, such as online databases, to ascertain property values. We will also obtain formal appraisals on a regular basis even if we are not considering liquidation of the property to repay a loan. It is our practice to obtain updated appraisals if there is a material change in market conditions or if we become aware of new or additional facts that indicate a potential material reduction in the value of any individual property collateral.

For impaired loans, we utilize the appraised value in determining the appropriate specific allowance for credit losses attributable to a loan. In addition, changes in the appraised value of multiple properties securing our loans may result in an increase or decrease in our general allowance for credit losses as an adjustment to our historical loss experience due to qualitative and environmental factors, as described above.

At September 30, 2014 and December 31, 2013, impaired loans amounted to \$5.5 million and \$6.3 million, respectively. The amount of impaired loans requiring specific reserves totaled \$.2 million and \$1.3 million, respectively. The amount of impaired loans with no specific valuation allowance totaled \$5.3 million and \$5.0 million, respectively.

Nonperforming loans are evaluated and valued at the time the loan is identified as impaired on a case by case basis, at the lower of cost or market value. Market value is measured based on the value of the collateral securing the loan. The value of real estate collateral is determined based on an appraisal by qualified licensed appraisers hired by us. Appraised values may be discounted based on management's historical experience, changes in market conditions from the time of valuation, and/or management's expertise and knowledge of the client and client's business. The difference

between the appraised value and the principal balance of the loan will determine the specific allowance valuation required for the loan, if any. Nonperforming loans are reviewed and evaluated on at least a quarterly basis for additional impairment and adjusted accordingly.

We evaluate the loan portfolio on at least a quarterly basis, more frequently if conditions warrant, and the allowance is adjusted accordingly. While we use the best information available to make evaluations, future adjustments to the allowance may be necessary if conditions differ substantially from the information used in making the evaluations. In addition, as an integral part of their examination process, the Commissioner and the FDIC will periodically review the allowance for credit losses. The Commissioner and the FDIC may require us to recognize additions to the allowance based on their analysis of information available to them at the time of their examination.

The following table sets forth activity in our allowance for credit losses for the indicated periods:

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(in thousands)	Nine months ended September 30,		Three months ended September 30,	
	2014	2013	2014	2013
Balance at beginning of period	\$ 2,506	\$ 2,764	\$ 3,053	\$ 2,951
Charge-offs:				
Real estate				
Residential first lien loans	-	(183 )	-	-
Commercial non-owner occupied loans	-	(2 )	-	(2 )
Commercial loans and leases	(2,115 )	(202 )	(2,115 )	-
	(2,115 )	(387 )	(2,115 )	(2 )
Recoveries:				
Real estate				
Commercial non-owner occupied loans	4	30	-	-
Commercial loans and leases	53	72	12	56
	57	102	12	56
Net recoveries (charge-offs)	(2,058 )	(285 )	(2,103 )	54
Provision for credit losses	2,570	666	2,068	140
Balance at end of period	\$ 3,018	\$ 3,145	\$ 3,018	\$ 3,145

**Allocation of Allowance for Credit Losses**

The following tables set forth the allowance for credit losses allocated by loan category and the percent of loans in each category to total loans at the dates indicated. The allowance for credit losses allocated to each category is not necessarily indicative of future losses in any particular category and does not restrict the use of the allowance to absorb losses in other categories.

(dollars in thousands)	September 30, 2014		December 31, 2013	
	Amount	Percent <sup>1</sup>	Amount	Percent <sup>1</sup>
Real estate				
Construction and land loans	\$ 109	13.6 %	\$ 122	12.6 %
Residential first lien loans	205	13.3	200	9.7
Residential junior lien loans	23	2.6	34	2.0
Commercial owner occupied loans	326	19.2	131	22.4
Commercial non-owner occupied loans	549	26.6	541	28.1
Commercial loans and leases	1,795	24.4	1,464	24.9
Consumer loans	11	0.3	14	0.3
Total	\$ 3,018	100.0 %	\$ 2,506	100.0 %

(1) Represents the percent of loans in each category to total loans

## Liquidity and Capital Resources

Liquidity is the ability to meet current and future financial obligations. Our primary sources of funds consist of deposit inflows, loan repayments, advances from the FHLB, principal repayments and the sale of securities available for sale. While maturities and scheduled amortization of loans and securities are predictable sources of funds, deposit flows and loan prepayments are greatly influenced by general interest rates, economic conditions and competition. Our Asset Liability Committee is responsible for establishing and monitoring our liquidity targets and strategies in order to ensure that sufficient liquidity exists for meeting the borrowing needs and deposit withdrawals of our customers as well as unanticipated contingencies. We believe that we have enough sources of liquidity to satisfy our short- and long-term liquidity needs as of September 30, 2014 and December 31, 2013. We regularly monitor and adjust our investments in liquid assets based upon our assessment of:

- 1) Expected loan demand;
- 2) Expected mortgage origination activities;
- 3) Expected deposit flows and borrowing maturities;
- 4) Yields available on interest-earning deposits and securities; and
- 5) The objectives of our asset/liability management program.

Excess liquid assets are invested generally in interest-earning deposits and short-term securities.

Our most liquid assets are cash and cash equivalents. The level of these assets is dependent on our operating, financing, lending and investing activities during any given period. At September 30, 2014 and December 31, 2013, cash and cash equivalents totaled \$17.7 million and \$35.7 million, respectively.

Our cash flows are derived from operating activities, investing activities and financing activities as reported in our statements of cash flows included in our financial statements.

At September 30, 2014 and December 31, 2013, we had \$99.5 million and \$75.8 million, respectively, in loan commitments outstanding, including commitments issued to originate loans of \$54.1 million and \$34.5 million at September 30, 2014 and December 31, 2013, respectively, and \$45.4 million and \$41.3 million in unused lines of credit to borrowers at September 30, 2014 and December 31, 2013, respectively. A large portion of the increase in the commitments to originate loans was derived from commitments for residential mortgage loans, now that our mortgage banking group is fully operational. In addition to commitments to originate loans and unused lines of credit we had \$9.9 million and \$9.8 million in letters of credit at September 30, 2014 and December 31, 2013, respectively. Certificates of deposit due within one year of September 30, 2014 totaled \$107.6 million, or 23.8% of total deposits. Should these deposits not remain with us, we may be required to seek other sources of funds, including loan and securities sales, and FHLB advances. Depending on market conditions, we may be required to pay higher rates on our deposits or other borrowings than we currently pay on the certificates of deposit. We believe, however, based on historical experience and current market interest rates that we will retain upon maturity a large portion of our certificates of deposit with maturities of one year or less.

Our primary investing activity is originating loans. During the nine months ended September 30, 2014 cash was utilized to increase our portfolio of loans by \$43.6 million and our loans held for sale portfolio by \$35.4 million. For the nine month period ended September 30, 2013, these amounts were \$42.3 million and \$0.01 million, respectively. During the first nine months of 2014 we purchased \$32.0 million in additional securities and we received \$33.6 million from security maturities; by comparison during the nine months ended September 30, 2013 we purchase \$35.0 million in additional securities while receiving \$40.1 million from security maturities. Total cash used to fund our activities totaled \$18.1 million and \$16.9 million for the nine months ended September 30, 2014 and 2013, respectively.

Financing activities consist primarily of activity in deposit accounts and FHLB advances. We experienced a net increase in deposits of \$44.3 million during the nine months ended September 30, 2014. Deposit flows are affected by the overall level of interest rates, the interest rates and products offered by us and our local competitors, and by other factors.

Liquidity management is both a daily and long-term function of business management. If we require funds beyond our ability to generate them internally, borrowing agreements exist with the FHLB, which provide an additional source of funds. FHLB advances were \$46 million at September 30, 2014 compared to \$40 million at December 31, 2013. At

September 30, 2014, we had the ability to borrow up to a total of \$106.7 million based upon our credit availability at the FHLB, subject to collateral requirements.

The Bank is subject to various regulatory capital requirements, including a risk-based capital measure. The risk-based capital guidelines include both a definition of capital and a framework for calculating risk-weighted assets by assigning balance sheet assets and off-balance sheet items to broad risk categories. At September 30, 2014 and December 31, 2013, the Bank exceeded all regulatory capital requirements. The Bank is considered “well capitalized” under regulatory guidelines.

### **Commitments, Contingent Liabilities, and Off-Balance Sheet Arrangements**

We are party to financial instruments with off-balance sheet risk in the normal course of business to meet the financial needs of our customers. These financial instruments are limited to commitments to originate loans and involve, to varying degrees, elements of credit, interest rate, and liquidity risk. These do not represent unusual risks, and management does not anticipate any losses which would have a material effect on us.

Outstanding loan commitments and lines of credit at September 30, 2014 and December 31, 2013 are as follows:

(in thousands)	September 30, 2014	December 31, 2013
Unfunded loan commitments	\$ 54,098	\$ 34,464
Unused lines of credit	45,355	41,326
Letters of credit	9,876	9,676

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. We generally require collateral to support financial instruments with credit risk on the same basis as we do for balance sheet instruments. Management generally bases the collateral required on the credit evaluation of the counterparty. Commitments generally have interest rates at current market rates, expiration dates or other termination clauses and may require payment of a fee. Available credit lines represent the unused portion of lines of credit previously extended and available to the customer so long as there is no violation of any contractual condition. These lines generally have variable interest rates. Since we expect many of the commitments to expire without being drawn upon, and since it is unlikely that all customers will draw upon their lines of credit in full at any one time, the total commitment amount or line of credit amount does not necessarily represent future cash requirements. We evaluate each customer's credit-worthiness on a case-by-case basis. Because we conservatively underwrite these facilities at inception, we have not had to withdraw any commitments. We are not aware of any loss that we would incur by funding our commitments or lines of credit.

The credit risk involved in these financial instruments is essentially the same as that involved in extending loan facilities to customers. No amount has been recognized in the statement of financial condition at September 30, 2014 or December 31, 2013 as a liability for credit loss related to these commitments.

### **Impact of Inflation and Changing Prices**

Our financial statements and related notes have been prepared in accordance with GAAP. GAAP generally requires the measurement of financial position and operating results in terms of historical dollars without consideration of changes in the relative purchasing power of money over time due to inflation. The impact of inflation is reflected in the increased cost of our operations. Unlike industrial companies, our assets and liabilities are primarily monetary in nature. As a result, changes in market interest rates have a greater impact on performance than the effects of inflation.

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

Not applicable

### **Item 4. Controls and Procedures**

As of the end of the period covered by this quarterly report on Form 10-Q Bancorp's Chief Executive Officer and Chief Financial Officer evaluated the effectiveness of Bancorp's disclosure controls and procedures as defined in Rule 13a-15(e) under the Securities Exchange Act of 1934, as amended (the "Exchange Act"). Based upon that evaluation, Bancorp's Chief Executive Officer and Chief Financial Officer concluded that Bancorp's disclosure controls and procedures are effective as of September 30, 2014. Disclosure controls and procedures are controls and other

procedures that are designed to ensure that information required to be disclosed by Bancorp in the reports that it files or submits under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms.

In addition, there were no changes in Bancorp's internal control over financial reporting (as defined in Rule 13a-15(f) under the Exchange Act) during the quarter ended September 30, 2014, that have materially affected, or are reasonably likely to materially affect Bancorp's internal control over financial reporting.

## **PART II - Other Information**

### **Item 1. Legal Proceedings**

From time to time, we may be involved in litigation relating to claims arising out of our normal course of business. As of the date of this report, we are not aware of any material pending litigation matters.

### **Item 1A. Risk Factors**

There have been no material changes in the risk factors from those disclosed in our Annual Report on Form 10-K for the year ended December 31, 2013, as filed with the SEC on March 27, 2014.

### **Item 2. Unregistered Sales of Equity Securities and Use of Proceeds**

Our registration statement on Form S-1, File Number 333-178204, with respect to our initial public offering of our common stock, was declared effective by the SEC on May 14, 2012. We sold a total of 1,396,364 shares of common stock in our initial public offering for aggregate gross proceeds of \$10.2 million.



After expenses, we raised net proceeds of approximately \$9.0 million in the public offering. During the third quarter of 2013 we provided \$8.5 million of the proceeds to the Bank, and the remainder of the proceeds were provided to the Bank in the third quarter of 2014 to increase its capital levels in order to support the Bank's continued growth.

Item 3. Defaults upon Senior Securities

None

Item 4. Mine Safety Disclosures

Not applicable

Item 5. Other Information

None

**Item 6. Exhibits**

2.1 Purchase and Assumption Agreement, dated as of October 17, 2014, by and among the Federal Deposit Insurance Corporation, Receiver of NBRS Financial Bank, the Federal Deposit Insurance Corporation and Howard Bank (incorporated by reference to Exhibit 2.1 of Bancorp's Current Report on Form 8-K filed with the SEC on October 23, 2014)

31(a) Certification of Chief Executive Officer pursuant to Rule 13a-14(a) or 15d-14(a) of the Exchange Act pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 - filed herewith

31(b) Certification of Chief Financial Officer pursuant to Rule 13a-14(a) or 15d-14(a) of the Exchange Act pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 - filed herewith

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32 Certifications pursuant to 18 U.S.C. Section 1350, pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 – filed herewith

101 Extensible Business Reporting Language (“XBRL”) – filed herewith  
101.INSXBRL Instance File  
101.SCHXBRL Schema File  
101.CALXBRL Calculation File  
101.DEF XBRL Definition File  
101.LABXBRL Label File  
101.PREXBRL Presentation File

40

**Signatures**

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

HOWARD BANCORP, INC.  
(Registrant)

November 13, 2014 /s/ Mary Ann Scully  
Date MARY ANN SCULLY  
PRESIDENT AND CEO

November 13, 2014 /s/ George C. Coffman  
Date GEORGE C. COFFMAN  
EVP AND CFO