SHORE BANCSHARES INC
Form 10-Q/A
December 30, 2013

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

FORM 10-Q/A
AMENDMENT NO. 1

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

For the Quarterly Period Ended September 30, 2013

OR

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

For the transition period from ________ to ________

Commission file number 0-22345

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

Maryland (State or Other Jurisdiction of Incorporation or Organization)	52-1974638 (I.R.S. Employer Identification No.)
28969 Information Lane, Easton, Maryland (Address of Principal Executive Offices)	21601 (Zip Code)

(410) 763-7800
Registrant's Telephone Number, Including Area Code

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

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

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

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

Large accelerated filer	¨	Accelerated filer	¨
Non-accelerated filer (Do not check if a smaller reporting company)	¨	Smaller reporting company	R

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

APPLICABLE ONLY TO CORPORATE ISSUERS

Indicate the number of shares outstanding of each of the issuer’s classes of common stock, as of the latest practicable date: 8,461,289 shares of common stock outstanding as of October 31, 2013.

Explanatory Note: This Amendment No. 1 to the Form 10-Q of Shore Bancshares, Inc. for the period ended September 30, 2013, is filed to (i) correct information originally disclosed in Item 1 of Part 1, Notes to Consolidated Financial Statements, specifically Note 5, "Other Assets", and Item 2 of Part I, Management's Discussion and Analysis of Financial Condition and Results of Operations under the captions "Liquidity and Capital Resources" and "Regulatory Enforcement Actions"; (ii) provide Note 14, "Restatement of Financial Information"; and (iii) revise management's conclusions in Item 4 of Part I with respect to the effectiveness of the Company's disclosure controls and procedures as of September 30, 2013. No other changes have been made to the Company's Form 10-Q and this amendment does not reflect events that have occurred after the November 14, 2013 filing date or modify or update the disclosure presented therein except to reflect the amendment described above. New certifications are supplied as Exhibits 31.1, 31.2 and 32.

1

INDEX

	Page
Part I. Financial Information	3
Item 1. Financial Statements	3
Consolidated Balance Sheets - September 30, 2013 (unaudited) and December 31, 2012	3
Consolidated Statements of Operations - For the three and nine months ended September 30, 2013 and 2012 (unaudited)	4
Consolidated Statements of Comprehensive Loss - For the three and nine months ended September 30, 2013 and 2012 (unaudited)	5
Consolidated Statements of Changes in Stockholders' Equity - For the nine months ended September 30, 2013 and 2012 (unaudited)	6
Consolidated Statements of Cash Flows - For the nine months ended September 30, 2013 and 2012 (unaudited)	7
Notes to Consolidated Financial Statements (unaudited)	8
Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations	30
Item 3. Quantitative and Qualitative Disclosures about Market Risk	44
Item 4. Controls and Procedures	44
Part II. Other Information	45
Item 1. Legal Proceedings	45
Item 1A. Risk Factors	45
Item 2. Unregistered Sales of Equity Securities and Use of Proceeds	45
Item 3. Defaults Upon Senior Securities	45
Item 4. Mine Safety Disclosures	45
Item 5. Other Information	45
Item 6. Exhibits	45
Signatures	45
Exhibit Index	46

PART I FINANCIAL INFORMATION

Item 1. Financial Statements.

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

	September 30, 2013 (Unaudited)	December 31, 2012
ASSETS		
Cash and due from banks	$ 26,133	$ 26,579
Interest-bearing deposits with other banks	79,165	164,864
Federal funds sold	1,624	8,750
Investment securities:		
Available for sale, at fair value	135,862	145,508
Held to maturity, at amortized cost fair value of $2,471 (2013) and $2,884 (2012)	2,357	2,657
Loans held for sale	23,635	-
Loans	718,627	785,082
Less: allowance for credit losses	(11,301)	(15,991)
Loans, net	707,326	769,091
Premises and equipment, net	15,175	15,593
Goodwill	12,454	12,454
Other intangible assets, net	3,594	3,816
Other real estate owned, net	5,776	7,659
Other assets	38,283	28,836
TOTAL ASSETS	$ 1,051,384	$ 1,185,807
LIABILITIES		
Deposits:		
Noninterest-bearing	$ 166,225	$ 153,992
Interest-bearing	764,188	895,281
Total deposits	930,413	1,049,273
Short-term borrowings	11,468	13,761
Other liabilities	7,502	8,747
TOTAL LIABILITIES	949,383	1,071,781
STOCKHOLDERS' EQUITY		
Common stock, par value $.01 per share; shares authorized 35,000,000; shares issued and outstanding 8,461,289 (2013) and 8,457,359 (2012)	85	85
Additional paid in capital	32,187	32,155
Retained earnings	70,269	81,078
Accumulated other comprehensive (loss) income	(540)	708

TOTAL STOCKHOLDERS' EQUITY		102,001		114,026
TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY	$	1,051,384	$	1,185,807

See accompanying notes to Consolidated Financial Statements.

3

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

	For the Three Months Ended September 30,		For the Nine Months Ended September 30,	
	2013	2012	2013	2012
INTEREST INCOME				
Interest and fees on loans	$ 9,767	$ 10,604	$ 29,816	$ 32,505
Interest and dividends on investment securities:				
Taxable	357	685	1,568	2,149
Tax-exempt	5	22	14	92
Interest on federal funds sold	-	3	3	7
Interest on deposits with other banks	53	79	143	188
Total interest income	10,182	11,393	31,544	34,941
INTEREST EXPENSE				
Interest on deposits	1,348	2,647	5,218	7,931
Interest on short-term borrowings	6	10	20	36
Interest on long-term debt	-	6	-	16
Total interest expense	1,354	2,663	5,238	7,983
NET INTEREST INCOME	8,828	8,730	26,306	26,958
Provision for credit losses	22,460	6,200	27,310	18,095
NET INTEREST (EXPENSE) INCOME AFTER PROVISION FOR CREDIT LOSSES	(13,632)	2,530	(1,004)	8,863
NONINTEREST INCOME				
Service charges on deposit accounts	600	628	1,772	1,898
Trust and investment fee income	401	410	1,184	1,279
Gains on sales of investment securities	-	278	913	278
Insurance agency commissions	2,724	2,427	8,170	7,522
Loss on termination of cash flow hedge	-	-	(1,306)	-
Other noninterest income	1,067	258	2,511	2,175
Total noninterest income	4,792	4,001	13,244	13,152
NONINTEREST EXPENSE				
Salaries and wages	4,420	4,386	13,010	13,178
Employee benefits	971	945	3,111	3,071
Occupancy expense	566	625	1,775	1,950
Furniture and equipment expense	275	265	768	728
Data processing	718	703	2,127	2,063
Directors' fees	86	131	262	367

Amortization of other intangible assets		74		96		222		318
Insurance agency commissions expense		409		275		1,328		1,004
FDIC insurance premium expense		467		376		1,200		993
Write-downs of other real estate owned		219		224		947		1,077
Other noninterest expenses		1,763		1,683		5,468		5,121
Total noninterest expense		9,968		9,709		30,218		29,870
LOSS BEFORE INCOME TAX BENEFIT		(18,808)		(3,178)		(17,978)		(7,855)
Income tax benefit		(7,416)		(1,357)		(7,169)		(3,291)
NET LOSS	$	(11,392)	$	(1,821)	$	(10,809)	$	(4,564)
Basic net loss per common share	$	(1.35)	$	(0.22)	$	(1.28)	$	(0.54)
Diluted net loss per common share	$	(1.35)	$	(0.22)	$	(1.28)	$	(0.54)
Dividends paid per common share	$	-	$	-	$	-	$	0.01

See accompanying notes to Consolidated Financial Statements.

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

	For the Three Months Ended September 30,		For the Nine Months Ended September 30,	
	2013	2012	2013	2012
Net loss	$ (11,392)	$ (1,821)	$ (10,809)	$ (4,564)
Other comprehensive (loss) income				
Securities available for sale:				
Unrealized holding (losses) gains on available-for-sale securities	(367)	609	(3,167)	1,524
Tax effect	148	(245)	1,278	(614)
Reclassification of gains recognized in net income	-	(278)	(913)	(278)
Tax effect	-	112	368	112
Net of tax amount	(219)	198	(2,434)	744
Cash flow hedging activities:				
Unrealized holding gains on cash flow hedging activities	-	479	681	1,259
Tax effect	-	(193)	(274)	(508)
Reclassification of losses recognized in net income	-	-	1,306	-
Tax effect	-	-	(527)	-
Net of tax amount	-	286	1,186	751
Total other comprehensive (loss) income	(219)	484	(1,248)	1,495
Comprehensive loss	$ (11,611)	$ (1,337)	$ (12,057)	$ (3,069)

See accompanying notes to Consolidated Financial Statements.

SHORE BANCSHARES, INC.
CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY (Unaudited)
For the Nine Months Ended September 30, 2013 and 2012
(Dollars in thousands, except per share amounts)

	Common Stock	Additional Paid in Capital	Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Total Stockholders' Equity
Balances, January 1, 2013	$85	$32,155	$81,078	$708	$114,026
Comprehensive loss:					
Net loss	-	-	(10,809)	-	(10,809)
Unrealized losses on available-for-sale securities, net of reclassification adjustment, net of taxes	-	-	-	(2,434)	(2,434)
Unrealized gains on cash flow hedging activities, net of reclassification adjustment, net of taxes	-	-	-	1,186	1,186
Total comprehensive loss					(12,057)
Stock-based compensation	-	32	-	-	32
Balances, September 30, 2013	$85	$32,187	$70,269	$(540)	$102,001
Balances, January 1, 2012	$85	$32,052	$90,801	$(1,689)	$121,249
Comprehensive loss:					
Net loss	-	-	(4,564)	-	(4,564)
Unrealized gains on available-for-sale securities, net of taxes	-	-	-	744	744
Unrealized gains on cash flow hedging activities, net of taxes	-	-	-	751	751
Total comprehensive loss					(3,069)
Stock-based compensation	-	68	-	-	68
Cash dividends paid ($0.01 per share)	-	-	(85)	-	(85)
Balances, September 30, 2012	$85	$32,120	$86,152	$(194)	$118,163

See accompanying notes to Consolidated Financial Statements.

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

	For the Nine Months Ended September 30,	
	2013	2012
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net loss	$ (10,809)	$ (4,564)
Adjustments to reconcile net loss to net cash provided by operating activities:		
Provision for credit losses	27,310	18,095
Depreciation and amortization	1,839	2,011
Discount accretion on debt securities	(30)	(56)
Stock-based compensation expense	58	174
Excess tax expense from stock-based arrangements	(26)	(106)
Deferred income tax expense (benefit)	286	(63)
Gains on sales of investment securities	(913)	(278)
Gains on disposals of premises and equipment	-	(214)
Losses on sales and write-downs of other real estate owned	1,188	1,549
Loss on termination of cash flow hedge	1,306	-
Net changes in:		
Accrued interest receivable	27	473
Other assets	(8,561)	(3,085)
Accrued interest payable	(68)	(66)
Other liabilities	(1,220)	(265)
Net cash provided by operating activities	10,387	13,605
CASH FLOWS FROM INVESTING ACTIVITIES:		
Proceeds from maturities and principal payments of investment securities available for sale	27,518	34,795
Proceeds from sales of investment securities available for sale	40,351	6,275
Purchases of investment securities available for sale	(62,049)	(36,717)
Proceeds from maturities and principal payments of investment securities held to maturity	294	2,395
Net change in loans	7,963	8,877
Purchases of premises and equipment	(292)	(1,842)
Proceeds from sales of premises and equipment	4	307
Proceeds from sales of other real estate owned	3,595	4,133
Return of investment in unconsolidated subsidiary	85	-
Net cash provided by investing activities	17,469	18,223
CASH FLOWS FROM FINANCING ACTIVITIES:		
Net changes in:		
Noninterest-bearing deposits	12,233	22,778
Interest-bearing deposits	(131,093)	5,817
Short-term borrowings	(2,293)	(4,738)
Excess tax expense from stock-based arrangements	26	106
Common stock dividends paid	-	(85)

Net cash (used in) provided by financing activities		(121,127)		23,878
Net (decrease) increase in cash and cash equivalents		(93,271)		55,706
Cash and cash equivalents at beginning of period		200,193		127,742
Cash and cash equivalents at end of period	$	106,922	$	183,448
Supplemental cash flows information:				
Interest paid	$	5,307	$	8,050
Income taxes paid	$	265	$	122
Transfers from loans to other real estate owned	$	2,857	$	4,715
Transfers from loans to loans held for sale	$	23,635	$	-

See accompanying notes to Consolidated Financial Statements.

Shore Bancshares, Inc.
Notes to Consolidated Financial Statements
For the Three and Nine Months Ended September 30, 2013 and 2012
(Unaudited)

Note 1 - Basis of Presentation

The consolidated financial statements include the accounts of Shore Bancshares, Inc. and its subsidiaries with all significant intercompany transactions eliminated. The consolidated financial statements conform to accounting principles generally accepted in the United States of America ("GAAP") and to prevailing practices within the banking industry. The accompanying interim financial statements are unaudited; however, in the opinion of management all adjustments necessary to present fairly the consolidated financial position at September 30, 2013, the consolidated results of operations and comprehensive loss for the three and nine months ended September 30, 2013 and 2012, and changes in stockholders' equity and cash flows for the nine months ended September 30, 2013 and 2012, have been included. All such adjustments are of a normal recurring nature. The amounts as of December 31, 2012 were derived from the 2012 audited financial statements. The results of operations for the three and nine months ended September 30, 2013 are not necessarily indicative of the results to be expected for any other interim period or for the full year. This Quarterly Report on Form 10-Q should be read in conjunction with the Annual Report of Shore Bancshares, Inc. on Form 10-K for the year ended December 31, 2012. For purposes of comparability, certain reclassifications have been made to amounts previously reported to conform with the current period presentation.

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

Recent Accounting Standards

Accounting Standards Update ("ASU") 2012-02, "Intangibles Goodwill and Other (Accounting Standards Codification ("ASC") Topic 350) Testing Indefinite-Lived Intangible Assets for Impairment." ASU 2012-02 gives entities the option to first assess qualitative factors to determine whether the existence of events or circumstances leads to a determination that it is more likely than not that an indefinite-lived intangible asset is impaired. If, after assessing the totality of events or circumstances, an entity determines it is more likely than not that an indefinite-lived intangible asset is impaired, then the entity must perform the quantitative impairment test. If, under the quantitative impairment test, the carrying amount of the intangible asset exceeds its fair value, an entity should recognize an impairment loss in the amount of that excess. Permitting an entity to assess qualitative factors when testing indefinite-lived intangible assets for impairment results in guidance that is similar to the goodwill impairment testing guidance in ASU 2011-08. ASU 2012-02 became effective for the Company on January 1, 2013, and did not have a significant impact on the Company's financial statements.

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

Note 2 Earnings/(Loss) Per Share

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

8

(In thousands, except per share data)	For the Three Months Ended September 30, 2013	2012	For the Nine Months Ended September 30, 2013	2012
Net loss	$ (11,392)	$ (1,821)	$ (10,809)	$ (4,564)
Weighted average shares outstanding - Basic	8,461	8,457	8,460	8,457
Dilutive effect of common stock equivalents	-	-	-	-
Weighted average shares outstanding - Diluted	8,461	8,457	8,460	8,457
Loss per common share - Basic	$ (1.35)	$ (0.22)	$ (1.28)	$ (0.54)
Loss per common share - Diluted	$ (1.35)	$ (0.22)	$ (1.28)	$ (0.54)

The calculations of diluted earnings/(loss) per share excluded weighted average common stock equivalents of 54 thousand for both the three and nine months ended September 30, 2013 and 54 thousand and 43 thousand for the three and nine months ended September 30, 2012, respectively, because the effect of including them would have been antidilutive.

Note 3 Investment Securities

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

(Dollars in thousands)	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
Available-for-sale securities:				
September 30, 2013:				
Obligations of U.S. Treasury	$ 5,375	$ -	$ 6	$ 5,369
Obligations of U.S. Government agencies and corporations	46,552	56	394	46,214
Mortgage-backed securities	84,234	389	952	83,671
Equity securities	606	2	-	608
Total	$ 136,767	$ 447	$ 1,352	$ 135,862
December 31, 2012:				
Obligations of U.S. Government agencies and corporations	$ 35,213	$ 903	$ 9	$ 36,107
Mortgage-backed securities	106,524	2,464	208	108,780
Equity securities	596	25	-	621
Total	$ 142,333	$ 3,392	$ 217	$ 145,508
Held-to-maturity securities:				
September 30, 2013:				
Obligations of states and political subdivisions	$ 2,357	$ 114	$ -	$ 2,471
December 31, 2012:				
Obligations of states and political subdivisions	$ 2,657	$ 227	$ -	$ 2,884

The following table provides information about gross unrealized losses and fair value by length of time that the individual available-for-sale securities have been in a continuous unrealized loss position at September 30, 2013.

(Dollars in thousands)	Less than 12 Months		More than 12 Months		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
Available-for-sale securities:						
U.S. Treasury	$ 5,369	$ 6	$ -	$ -	$ 5,369	$ 6
U.S. Gov't. agencies and corporations	30,603	394	-	-	30,603	394
Mortgage-backed securities	56,177	952	-	-	56,177	952
Total	$ 92,149	$ 1,352	$ -	$ -	$ 92,149	$ 1,352

All of the securities with unrealized losses in the available-for-sale portfolio have modest duration risk, low credit risk, and minimal losses when compared to total amortized cost. The unrealized losses on debt securities that exist are the result of market changes in interest rates since original purchase. Because the Company does not intend to sell these debt securities and it is not more likely than not that the Company will be required to sell these securities before recovery of their amortized cost bases, which may be at maturity, the Company considers the unrealized losses in the available-for-sale portfolio to be temporary. There were no unrealized losses in the held-to-maturity securities portfolio at September 30, 2013.

The following table provides information on the amortized cost and estimated fair values of investment securities by maturity date at September 30, 2013.

(Dollars in thousands)	Available for sale		Held to maturity	
	Amortized Cost	Estimated Fair Value	Amortized Cost	Estimated Fair Value
Due in one year or less	$ 6,055	$ 6,066	$ 413	$ 419
Due after one year through five years	42,500	42,372	433	454
Due after five years through ten years	3,894	3,936	1,007	1,077
Due after ten years	83,712	82,880	504	521
	136,161	135,254	2,357	2,471
Equity securities	606	608	-	-
Total	$ 136,767	$ 135,862	$ 2,357	$ 2,471

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

Note 4 Loans and allowance for credit losses

The Company makes residential mortgage, commercial and consumer loans to customers primarily in Talbot County, Queen Anne's County, Kent County, Caroline County and Dorchester County in Maryland and in Kent County, Delaware. The following table provides information about the principal classes of the loan portfolio at September 30, 2013 and December 31, 2012.

(Dollars in thousands)	September 30, 2013	December 31, 2012
Construction	$ 68,971	$ 108,051
Residential real estate	280,153	288,011
Commercial real estate	303,154	314,941

Commercial		55,101		60,786
Consumer		11,248		13,293
Total loans		718,627		785,082
Allowance for credit losses		(11,301)		(15,991)
Total loans, net	$	707,326	$	769,091

10

Loans are stated at their principal amount outstanding net of any deferred fees and costs. Interest income on loans is accrued at the contractual rate based on the principal amount outstanding. Fees charged and costs capitalized for originating loans are being amortized substantially on the interest method over the term of the loan. A loan is placed on nonaccrual (i.e., interest income is no longer accrued) when it is specifically determined to be impaired or when principal or interest is delinquent for 90 days or more, unless the loan is well secured and in the process of collection. Any unpaid interest previously accrued on those loans is reversed from income. Interest payments received on nonaccrual loans are applied as a reduction of the loan principal balance unless collectability of the principal amount is reasonably assured, in which case interest is recognized on a cash basis. Loans are returned to accrual status when all principal and interest amounts contractually due are brought current and future payments are reasonably assured.

A loan is considered impaired if it is probable that the Company will not collect all principal and interest payments according to the loan's contractual terms. An impaired loan may show deficiencies in the borrower's overall financial condition, payment history, support available from financial guarantors and/or the fair market value of collateral. The impairment of a loan is measured at the present value of expected future cash flows using the loan's effective interest rate, or at the loan's observable market price or the fair value of the collateral if the loan is collateral dependent. Generally, the Company measures impairment on such loans by reference to the fair value of the collateral. Once the amount of impairment has been determined, the uncollectible portion is charged off. Income on impaired loans is recognized on a cash basis, and payments are first applied against the principal balance outstanding (i.e., placing impaired loans on nonaccrual status). Generally, interest income is not recognized on impaired loans unless the likelihood of further loss is remote. The allowance for credit losses may include specific reserves related to impaired loans. Specific reserves remain until charge offs are made. Impaired loans do not include groups of smaller balance homogenous loans such as residential mortgage and consumer installment loans that are evaluated collectively for impairment. Reserves for probable credit losses related to these loans are based on historical loss ratios and are included in the formula portion of the allowance for credit losses. See additional discussion under the caption "Critical Accounting Policies" in Management's Discussion and Analysis of Financial Condition and Results of Operations.

A loan is considered a troubled debt restructuring if a borrower is experiencing financial difficulties and a creditor has granted a concession. Concessions may include interest rate reductions or below market interest rates, principal forgiveness, restructuring amortization schedules and other actions intended to minimize potential losses. All loans designated as troubled debt restructurings ("TDRs") are considered impaired loans and may be on either accrual or nonaccrual status.

The following tables include impairment information relating to loans and the allowance for credit losses as of September 30, 2013 and December 31, 2012.

(Dollars in thousands)	Construction	Residential real estate	Commercial real estate	Commercial	Consumer	Unallocated	Total
September 30, 2013							
Loans individually evaluated for impairment	$ 9,938	$ 22,171	$ 14,919	$ 952	$ 80	$ -	$ 48,060
Loans collectively evaluated for impairment	59,033	257,982	288,235	54,149	11,168	-	670,567
Total loans	$ 68,971	$ 280,153	$ 303,154	$ 55,101	$ 11,248	$ -	$ 718,627
Allowance for credit losses allocated to:							
Loans individually evaluated for impairment	$ 422	$ 924	$ 455	$ 305	$ 61	$ -	$ 2,167
Loans collectively evaluated for impairment	1,568	2,806	3,113	967	209	471	9,134
Total allowance for credit losses	$ 1,990	$ 3,730	$ 3,568	$ 1,272	$ 270	$ 471	$ 11,301

(Dollars in thousands)	Construction	Residential real estate	Commercial real estate	Commercial	Consumer	Unallocated	Total
December 31, 2012							
Loans individually evaluated for impairment	$ 37,029	$ 18,549	$ 32,447	$ 715	$ 87	$ -	$ 88,827
Loans collectively evaluated for impairment	71,022	269,462	282,494	60,071	13,206	-	696,255
Total loans	$ 108,051	$ 288,011	$ 314,941	$ 60,786	$ 13,293	$ -	$ 785,082
Allowance for credit losses allocated to:							
Loans individually evaluated for impairment	$ 941	$ 598	$ 614	$ -	$ 48	$ -	$ 2,201
Loans collectively evaluated for impairment	3,446	4,596	3,520	1,682	359	187	13,790
Total allowance for credit losses	$ 4,387	$ 5,194	$ 4,134	$ 1,682	$ 407	$ 187	$ 15,991

The following tables provide information on impaired loans and any related allowance by loan class as of September 30, 2013 and December 31, 2012. The difference between the unpaid principal balance and the recorded investment is the amount of partial charge-offs that have been taken.

(Dollars in thousands)	Unpaid principal balance	Recorded investment with no allowance	Recorded investment with an allowance	Related allowance	Quarter-to-date average recorded investment	Year-to-date average recorded investment
September 30, 2013						
Impaired nonaccrual loans:						
Construction	$ 11,863	$ 6,582	$ 1,457	$ 421	$ 9,672	$ 8,654
Residential real estate	7,486	4,082	1,323	309	10,825	10,921
Commercial real estate	6,287	1,825	1,517	255	7,607	9,905
Commercial	1,678	546	122	122	656	595
Consumer	54	19	28	28	43	44
Total	27,368	13,054	4,447	1,135	28,803	30,119
Impaired accruing restructured loans:						
Construction	1,899	1,804	95	1	14,462	20,834
Residential real estate	16,735	14,347	2,388	584	11,290	9,225
Commercial real estate	10,704	9,439	1,265	92	12,849	15,331
Commercial	101	101	-	-	105	112
Consumer	-	-	-	-	-	-
Total	29,439	25,691	3,748	677	38,706	45,502
Impaired adversely rated loans:						
Construction	-	-	-	-	-	-
Residential real estate	31	-	31	31	16	8
Commercial real estate	873	-	873	108	437	218
Commercial	183	-	183	183	92	46
Consumer	33	-	33	33	17	8
Total	1,120	-	1,120	355	562	280
Total impaired loans:						
Construction	13,762	8,386	1,552	422	24,134	29,488
Residential real estate	24,252	18,429	3,742	924	22,131	20,154
Commercial real estate	17,864	11,264	3,655	455	20,893	25,454
Commercial	1,962	647	305	305	853	753
Consumer	87	19	61	61	60	52
Total	$ 57,927	$ 38,745	$ 9,315	$ 2,167	$ 68,071	$ 75,901

(Dollars in thousands)	Unpaid principal balance	Recorded investment with no allowance	Recorded investment with an allowance	Related allowance	Quarter-to-date average recorded investment	Year-to-date average recorded investment
December 31, 2012						
Impaired nonaccrual loans:						
Construction	$ 14,288	$ 3,371	$ 6,323	$ 941	$ 10,600	$ 12,428
Residential real estate	17,975	9,469	2,063	598	13,294	17,472
Commercial real estate	19,515	11,838	2,729	614	13,554	12,975
Commercial	1,556	594	-	-	1,126	1,538
Consumer	92	39	48	48	50	55
Total	53,426	25,311	11,163	2,201	38,624	44,468
Impaired accruing restructured loans:						
Construction	27,335	27,335	-	-	27,907	21,193
Residential real estate	7,017	7,017	-	-	6,124	5,064
Commercial real estate	17,880	17,880	-	-	17,433	16,252
Commercial	121	121	-	-	105	87
Consumer	-	-	-	-	-	-
Total	52,353	52,353	-	-	51,569	42,596
Impaired adversely rated loans:						
Construction	-	-	-	-	-	-
Residential real estate	-	-	-	-	-	-
Commercial real estate	-	-	-	-	-	-
Commercial	-	-	-	-	-	-
Consumer	-	-	-	-	-	-
Total	-	-	-	-	-	-
Total impaired loans:						
Construction	41,623	30,706	6,323	941	38,507	33,621
Residential real estate	24,992	16,486	2,063	598	19,418	22,536
Commercial real estate	37,395	29,718	2,729	614	30,987	29,227
Commercial	1,677	715	-	-	1,231	1,625
Consumer	92	39	48	48	50	55
Total	$ 105,779	$ 77,664	$ 11,163	$ 2,201	$ 90,193	$ 87,064

The following tables provide information on loans that were modified and considered TDRs during the nine months ended September 30, 2013 and September 30, 2012.

(Dollars in thousands)	Number of contracts	Premodification outstanding recorded investment	Postmodification outstanding recorded investment	Related allowance
TDRs:				
For the nine months ended September 30, 2013				
Construction	3	$ 218	$ 218	$ -
Residential real estate	6	11,758	11,772	38
Commercial real estate	4	2,212	2,211	82
Commercial	-	-	-	-
Consumer	-	-	-	-
Total	13	$ 14,188	$ 14,201	$ 120
For the nine months ended September 30, 2012				
Construction	12	$ 17,347	$ 17,361	$ -
Residential real estate	11	3,382	3,044	-
Commercial real estate	7	7,270	7,429	-
Commercial	1	24	24	-
Consumer	-	-	-	-
Total	31	$ 28,023	$ 27,858	$ -

The following tables provide information on TDRs that defaulted during the nine months ended September 30, 2013 and September 30, 2012. Generally, a loan is considered in default when principal or interest is past due 90 days or more.

(Dollars in thousands)	Number of contracts	Recorded investment	Related allowance
TDRs that subsequently defaulted (1):			
For the nine months ended September 30, 2013			
Construction	-	$-	$-
Residential real estate	4	1,563	-
Commercial real estate	1	1,741	74
Commercial	-	-	-
Consumer	-	-	-
Total	5	$3,304	$74
TDRs that subsequently defaulted (2):			
For the nine months ended September 30, 2012			
Construction	1	$666	$-
Residential real estate	3	913	-
Commercial real estate	-	-	-
Commercial	-	-	-
Consumer	-	-	-

Total	4	$1,579	$-

(1) These loans were classified as TDRs during 2012.
(2) These loans were classified as TDRs during 2011.

15

Management uses risk ratings as part of its monitoring of the credit quality in the Company's loan portfolio. Loans that are identified as special mention, substandard or doubtful are adversely rated. They are assigned higher risk ratings than favorably rated loans in the calculation of the formula portion of the allowance for credit losses.

The following tables provide information on loan risk ratings as of September 30, 2013 and December 31, 2012.

(Dollars in thousands)	Pass/Performing	Special mention	Substandard	Doubtful	Nonaccrual	Total
September 30, 2013						
Construction	$ 38,481	$ 15,369	$ 7,082	$ -	$ 8,039	$ 68,971
Residential real estate	238,293	21,806	14,649	-	5,405	280,153
Commercial real estate	266,836	22,813	10,163	-	3,342	303,154
Commercial	50,313	3,406	714	-	668	55,101
Consumer	10,995	206	-	-	47	11,248
Total	$ 604,918	$ 63,600	$ 32,608	$ -	$ 17,501	$ 718,627

(Dollars in thousands)	Pass/Performing	Special mention	Substandard	Doubtful	Nonaccrual	Total
December 31, 2012						
Construction	$ 45,385	$ 30,817	$ 22,155	$ -	$ 9,694	$ 108,051
Residential real estate	237,299	23,657	15,090	433	11,532	288,011
Commercial real estate	257,418	21,554	21,402	-	14,567	314,941
Commercial	55,432	3,062	1,639	59	594	60,786
Consumer	13,147	-	59	-	87	13,293
Total	$ 608,681	$ 79,090	$ 60,345	$ 492	$ 36,474	$ 785,082

The following tables provide information on the aging of the loan portfolio as of September 30, 2013 and December 31, 2012.

	Accruing						
(Dollars in thousands)	Current	30-59 days past due	60-89 days past due	90 days or more past due	Total past due	Nonaccrual	Total
September 30, 2013							
Construction	$ 60,932	$ -	$ -	$ -	$ -	$ 8,039	$ 68,971
Residential real estate	272,819	1,554	375	-	1,929	5,405	280,153
Commercial real estate	297,841	-	1,971	-	1,971	3,342	303,154
Commercial	54,164	248	21	-	269	668	55,101
Consumer	11,099	48	45	9	102	47	11,248
Total	$ 696,855	$ 1,850	$ 2,412	$ 9	$ 4,271	$ 17,501	$ 718,627
Percent of total loans	97.0 %	0.3 %	0.3 %	-	0.6 %	2.4 %	

	Accruing						
(Dollars in thousands)	Current	30-59 days past due	60-89 days past due	90 days or more past due	Total past due	Nonaccrual	Total
December 31, 2012							
Construction	$ 98,221	$ 136	$ -	$ -	$ 136	$ 9,694	$ 108,051
Residential real estate	272,311	3,116	762	290	4,168	11,532	288,011
Commercial real estate	298,522	887	800	165	1,852	14,567	314,941
Commercial	59,746	380	66	-	446	594	60,786

Consumer	13,125	57	19	5	81	87	13,293
Total	$ 741,925	$ 4,576	$ 1,647	$ 460	$ 6,683	$ 36,474	$ 785,082
Percent of total loans	94.5 %	0.6 %	0.2 %	0.1 %	0.9 %	4.6 %	

Management evaluates the adequacy of the allowance for credit losses at least quarterly and adjusts the provision for credit losses based on this analysis. The following tables provide a summary of the activity in the allowance for credit losses allocated by loan class for the three months ended September 30, 2013 and 2012. Allocation of a portion of the allowance to one loan class does not preclude its availability to absorb losses in other loan classes.

(Dollars in thousands)	Construction	Residential real estate	Commercial real estate	Commercial	Consumer	Unallocated	Total
For the three months ended September 30, 2013							
Allowance for credit losses:							
Beginning balance	$ 4,346	$ 4,259	$ 5,514	$ 1,216	$ 301	$ 87	$ 15,723
Charge-offs	(18,539)	(4,225)	(4,056)	(196)	(3)	-	(27,019)
Recoveries	3	51	20	47	16	-	137
Net charge-offs	(18,536)	(4,174)	(4,036)	(149)	13	-	(26,882)
Provision	16,180	3,645	2,090	205	(44)	384	22,460
Ending balance	$ 1,990	$ 3,730	$ 3,568	$ 1,272	$ 270	$ 471	$ 11,301

(Dollars in thousands)	Construction	Residential real estate	Commercial real estate	Commercial	Consumer	Unallocated	Total
For the three months ended September 30, 2012							
Allowance for credit losses:							
Beginning balance	$ 2,845	$ 4,237	$ 3,952	$ 1,063	$ 304	$ 408	$ 12,990
Charge-offs	(3,222)	(2,323)	(742)	(73)	(31)	-	(6,391)
Recoveries	5	5	116	22	8	-	156
Net charge-offs	(3,217)	(2,318)	(626)	(51)	(23)	-	(6,235)
Provision	3,699	2,268	275	524	(158)	(408)	6,200
Ending balance	$ 3,327	$ 4,187	$ 3,601	$ 1,536	$ 304	$ -	$ 12,955

The following tables provide a summary of the activity in the allowance for credit losses allocated by loan class for the nine months ended September 30, 2013 and 2012.

(Dollars in thousands)	Construction	Residential real estate	Commercial real estate	Commercial	Consumer	Unallocated	Total
For the nine months ended September 30, 2013							
Allowance for credit losses:							
Beginning balance	$ 4,387	$ 5,194	$ 4,134	$ 1,682	$ 407	$ 187	$ 15,991
Charge-offs	(20,048)	(6,114)	(6,003)	(419)	(65)	-	(32,649)
Recoveries	5	349	113	149	33	-	649
Net charge-offs	(20,043)	(5,765)	(5,890)	(270)	(32)	-	(32,000)
Provision	17,646	4,301	5,324	(140)	(105)	284	27,310
Ending balance	$ 1,990	$ 3,730	$ 3,568	$ 1,272	$ 270	$ 471	$ 11,301

(Dollars in thousands)	Construction	Residential real estate	Commercial real estate	Commercial	Consumer	Unallocated	Total
For the nine months ended September 30, 2012							
Allowance for credit losses:							
Beginning balance	$ 3,745	$ 5,014	$ 3,415	$ 1,498	$ 594	$ 22	$ 14,288
Charge-offs	(5,008)	(7,996)	(2,177)	(4,513)	(208)	-	(19,902)
Recoveries	5	99	123	230	17	-	474
Net charge-offs	(5,003)	(7,897)	(2,054)	(4,283)	(191)	-	(19,428)
Provision	4,585	7,070	2,240	4,321	(99)	(22)	18,095
Ending balance	$ 3,327	$ 4,187	$ 3,601	$ 1,536	$ 304	$ -	$ 12,955

Note 5 Other Assets

The Company had the following other assets at September 30, 2013 and December 31, 2012.

(Dollars in thousands)	September 30, 2013	December 31, 2012
Nonmarketable investment securities	$ 2,058	$ 2,750
Accrued interest receivable	2,769	2,796
Insurance premiums receivable	719	1,089
Income taxes receivable	2,073	5,160
Deferred income taxes	20,365	9,180
Prepaid expenses	1,209	2,227
Other assets	9,090	5,634
Total	$ 38,283	$ 28,836

Note 6 Other Liabilities

The Company had the following other liabilities at September 30, 2013 and December 31, 2012.

(Dollars in thousands)	September 30, 2013	December 31, 2012
Accrued interest payable	$ 271	$ 339
Other accounts payable	3,824	3,657
Deferred compensation liability	1,481	2,431
Other liabilities	1,926	2,320
Total	$ 7,502	$ 8,747

Note 7 - Stock-Based Compensation

As of September 30, 2013, the Company maintained the Shore Bancshares, Inc. 2006 Stock and Incentive Compensation Plan (“2006 Equity Plan”) under which it may issue shares of common stock or grant other equity-based awards. Stock-based awards granted to date generally are time-based, vest in equal installments on each anniversary of the grant date over a three- to five-year period of time, and, in the case of stock options, expire 10 years from the grant date. Stock-based compensation expense is recognized ratably over the requisite service period for all awards, is based on the grant-date fair value and reflects forfeitures as they occur.

The following tables provide information on stock-based compensation expense for the three and nine months ended September 30, 2013 and 2012.

	For the Three Months Ended September 30,		For the Nine Months Ended September 30,	
(Dollars in thousands)	2013	2012	2013	2012
Stock-based compensation expense	$ 18	$ 33	$ 58	$ 174
Excess tax expense related to stock-based compensation	-	-	26	106

	September 30,	
(Dollars in thousands)	2013	2012
Unrecognized stock-based compensation expense	$ 112	$ 178
Weighted average period unrecognized expense is expected to be recognized	1.7 years	2.2 years

The following table summarizes restricted stock award activity for the Company under the 2006 Equity Plan for the nine months ended September 30, 2013.

	Number of Shares	Weighted Average Grant Date Fair Value
Nonvested at beginning of period	6,548	$ 14.89
Granted	3,930	6.81
Vested	(6,548)	14.89
Cancelled	-	-
Nonvested at end of period	3,930	$ 6.81

The following table summarizes stock option activity for the Company under the 2006 Equity Plan for the nine months ended September 30, 2013.

	Number of Shares	Weighted Average Exercise Price	Weighted Average Grant Date Fair Value
Outstanding at beginning of period	54,216	$ 6.64	$ 3.44
Granted	-	-	-
Exercised	-	-	-
Expired/Cancelled	-	-	-
Outstanding at end of period	54,216	$ 6.64	$ 3.44
Exercisable at end of period	-	$ -	$ -

The Company estimates the fair value of stock options using the Black-Scholes valuation model with weighted average assumptions for dividend yield, expected volatility, risk-free interest rate and expected contract life (in years). The expected dividend yield is calculated by dividing the total expected annual dividend payout by the average stock price. The expected volatility is based on historical volatility of the underlying securities. The risk-free interest rate is based on the Federal Reserve Bank's constant maturities daily interest rate in effect at grant date. The expected contract life of the options represents the period of time that the Company expects the awards to be outstanding based on historical experience with similar awards. The following weighted average assumptions were used as inputs to the Black-Scholes valuation model for options outstanding at September 30, 2013.

Dividend yield	0.60	%
Expected volatility	58.65	%
Risk-free interest rate	1.69	%
Expected contract life (in years)	5.83	

At the end of the third quarter of 2013, the aggregate intrinsic value of the options outstanding under the 2006 Equity Plan was $117 thousand based on the $8.80 market value per share of Shore Bancshares, Inc.'s common stock at September 30, 2013. Since there were no options exercised during the first nine months of 2013 or 2012, there was no intrinsic value associated with stock options exercised and no cash received on exercise of options. At September 30, 2013, the weighted average remaining contract life of options outstanding was 8.5 years.

Note 8 Accumulated Other Comprehensive Income

The Company records unrealized holding gains (losses), net of tax, on investment securities available for sale and on cash flow hedging activities as accumulated other comprehensive income (loss), a separate component of stockholders' equity. The following table provides information on the changes in the components of accumulated other comprehensive income (loss) for the nine months ended September 30, 2013 and 2012.

(Dollars in thousands)	Accumulated net unrealized holding gains (losses) on available for sale securities	Accumulated net unrealized holding gains (losses) on cash flow hedging activities	Accumulated other comprehensive income (loss)
Balance, December 31, 2012	$ 1,894	$ (1,186)	$ 708
Other comprehensive (loss) income	(1,889)	407	(1,482)
Reclassification of (gains) losses recognized	(545)	779	234
Balance, September 30, 2013	$ (540)	$ -	$ (540)
Balance, December 31, 2011	$ 1,370	$ (3,059)	$ (1,689)
Other comprehensive income	910	751	1,661
Reclassification of gains recognized	(166)	-	(166)
Balance, September 30, 2012	$ 2,114	$ (2,308)	$ (194)

Note 9 Fair Value Measurements

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

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

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

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

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

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

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

Investment Securities Available for Sale

Fair value measurement for investment securities available for sale is based on quoted prices from an independent pricing service. The fair value measurements consider observable data that may include present value of future cash flows, prepayment assumptions, credit loss assumptions and other factors. The Company classifies its investments in U.S. Treasury securities as Level 1 in the fair value hierarchy, and it classifies its investments in U.S. Government agencies securities and mortgage-backed securities issued or guaranteed by U.S. Government sponsored entities as Level 2.

Derivative Assets
Derivative instruments held by the Company for risk management purposes are traded in over-the-counter markets where quoted market prices are not readily available. For those derivatives, the Company measures fair value using third-party models that use primarily market observable inputs, such as yield curves and option volatilities, and include the value associated with counterparty credit risk. The Company classifies its derivative instruments held for risk management purposes as Level 2 in the fair value hierarchy and includes them in other assets in the accompanying consolidated balance sheets. As of September 30, 2013, the Company had no derivative instruments. At December 31, 2012, the Company's derivative instruments consisted solely of interest rate caps.

The tables below present the recorded amount of assets measured at fair value on a recurring basis at September 30, 2013 and December 31, 2012. No assets were transferred from one hierarchy level to another during the first nine months of 2013 or 2012.

(Dollars in thousands)	Fair Value	Quoted Prices (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
September 30, 2013				
Securities available for sale:				
U.S. Treasury	$ 5,369	$ 5,369	$ -	$ -
U.S. Government agencies	46,214	-	46,214	-
Mortgage-backed securities	83,671	-	83,671	-
Other equity securities	608	-	608	-
Total	$ 135,862	$ 5,369	$ 130,493	$ -
Interest rate caps	$ -	$ -	$ -	$ -

(Dollars in thousands)	Fair Value	Quoted Prices (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
December 31, 2012				
Securities available for sale:				
U.S. Government agencies	$ 36,107	$ -	$ 36,107	$ -
Mortgage-backed securities	108,780	-	108,780	-
Other equity securities	621	-	621	-
Total	$ 145,508	$ -	$ 145,508	$ -
Interest rate caps	$ 14	$ -	$ 14	$ -

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

Loans held for sale
Loans held for sale are adjusted for fair value upon transfer of loans to loans held for sale. Subsequently, loans held for sale are carried at the lower of carrying value and fair value. Fair value is based on independent market prices, appraised value of the collateral or management's estimation of the value of the collateral. At September 30, 2013, loans held for sale were classified as Level 3 in the fair value hierarchy.

Loans

The Company does not record loans at fair value on a recurring basis; however, from time to time, a loan is considered impaired and a valuation allowance may be established if there are losses associated with the loan. Loans are considered impaired if it is probable that payment of interest and principal will not be made in accordance with contractual terms. The fair value of impaired loans can be estimated using one of several methods, including the collateral value, market value of similar debt, liquidation value and discounted cash flows. At September 30, 2013 and December 31, 2012, substantially all impaired loans were evaluated based on the fair value of the collateral and were classified as Level 3 in the fair value hierarchy.

Other Real Estate and Other Assets Owned (Foreclosed Assets)
Foreclosed assets are adjusted for fair value upon transfer of loans to foreclosed assets. Subsequently, foreclosed assets are carried at the lower of carrying value and fair value. Fair value is based on independent market prices, appraised value of the collateral or management's estimation of the value of the collateral. At September 30, 2013 and December 31, 2012, foreclosed assets were classified as Level 3 in the fair value hierarchy.

The tables below summarize the changes in the recorded amount of assets measured at fair value on a nonrecurring basis for the nine months ended September 30, 2013 and 2012. All assets measured at fair value on a nonrecurring basis were classified as Level 3 in the fair value hierarchy for the periods presented.

(Dollars in thousands)	Construction	Residential real estate	Commercial real estate	Commercial	Consumer	Total
For the nine months ended September 30, 2013						
Impaired loans:						
Beginning balance	$ 36,088	$ 17,951	$ 31,833	$ 715	$ 39	$ 86,626
Charge-offs	(19,377)	(4,664)	(6,893)	(90)	(38)	(31,062)
Payments	(1,510)	(2,183)	(8,170)	(47)	(13)	(11,923)
Transferred to loans held for sale	(9,820)	(5,492)	(6,795)	-	-	(22,107)
Transferred to other real estate owned	(205)	(729)	(1,601)	-	-	(2,535)
Returned to performing status	-	(2,448)	(1,075)	-	-	(3,523)
Changed to nonaccrual status	-	(1,626)	(1,741)	-	-	(3,367)
Additions	3,821	20,764	8,747	374	44	33,750
Changes in allowance	519	(326)	159	(305)	(13)	34
Ending balance	$ 9,516	$ 21,247	$ 14,464	$ 647	$ 19	$ 45,893

(Dollars in thousands)	Construction	Residential real estate	Commercial real estate	Commercial	Consumer	Total
For the nine months ended September 30, 2012						
Impaired loans:						
Beginning balance	$ 27,166	$ 22,602	$ 23,578	$ 1,738	$ 28	$ 75,112
Charge-offs	(4,965)	(7,628)	(2,177)	(1,264)	-	(16,034)
Payments	(976)	(8,405)	(1,858)	(105)	(4)	(11,348)
Transferred to loans held for sale	-	-	-	-	-	-
Transferred to other real estate owned	(1,631)	(1,463)	(1,334)	(30)	-	(4,458)
Returned to performing status	-	(201)	-	(39)	-	(240)
Changed to nonaccrual status	(666)	(786)	-	-	-	(1,452)
Additions	20,856	14,256	10,693	1,346	30	47,181
Changes in allowance	151	1,296	-	-	-	1,447
Ending balance	$ 39,935	$ 19,671	$ 28,902	$ 1,646	$ 54	$ 90,208

(Dollars in thousands)	For the Nine Months Ended September 30, 2013		2012	
Other real estate owned:				
Beginning balance	$	7,659	$	9,385
Sales		(3,793)		(4,605)
Write-downs		(947)		(1,077)
Additions		2,857		4,715
Ending balance	$	5,776	$	8,418

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

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

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

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

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

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

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

	September 30, 2013		December 31, 2012	
(Dollars in thousands)	Carrying Amount	Estimated Fair Value	Carrying Amount	Estimated Fair Value
Financial assets				
Level 2 inputs				
Cash and cash equivalents	$ 106,922	$ 106,922	$ 200,193	$ 200,193
Investment securities held to maturity	2,357	2,471	2,657	2,884
Level 3 inputs				
Loans, net	707,326	728,466	769,091	798,381
Financial liabilities				
Level 2 inputs				
Deposits	$ 930,413	$ 929,587	$ 1,049,273	$ 1,052,382
Short-term borrowings	11,468	11,468	13,761	13,761

Note 10 Derivative Instruments and Hedging Activities

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

During the second quarter of 2009, the Company purchased interest rate caps for $7.1 million to effectively fix the interest rate at 2.97% for five years on $70 million of the Company's money market deposit accounts. These money market deposit accounts were associated with the Promontory Insured Network Deposits Program (the "IND Program") in which the Company participated. In December 2012, the Company decided to partially exit the IND Program in an effort to reduce its excess liquidity and, in the second quarter of 2013, the Company fully exited the IND Program. Money market deposit accounts declined from $279 million at December 31, 2012 to $204.3 million at September 30, 2013, primarily due to exiting the IND Program. When the Company fully exited the IND Program, the interest rate caps used to hedge the interest rates on these deposits were terminated. Because the interest rate caps qualified for hedge accounting, a $1.3 million loss on the ineffective portion of the cash flow hedge was recognized in the second quarter of 2013.

The aggregate fair value of the interest rate caps was $14 thousand at December 31, 2012. The adjustments that reduced the balance to $0 at September 30, 2013 included an increase of $681 thousand to reflect unrealized holding gains and a decrease of $695 thousand to reflect the charge to interest expense associated with the hedged money market deposit accounts. The comparable amounts for the first nine months of 2012 were $1.3 million and $1.5 million, respectively.

By entering into derivative instrument contracts, the Company exposes itself, from time to time, to counterparty credit risk. Counterparty credit risk is the risk that the counterparty will fail to perform under the terms of the derivative contract. When the fair value of a derivative contract is in an asset position, the counterparty has a liability to the Company, which creates credit risk for the Company. The Company attempts to minimize this risk by selecting counterparties with investment grade credit ratings, limiting its exposure to any single counterparty and regularly monitoring its market position with each counterparty. Collateral required by the counterparties, recorded in other liabilities, was $0 and $428 thousand at September 30, 2013 and December 31, 2012, respectively.

Note 11 Financial Instruments with Off-Balance Sheet Risk

In the normal course of business, to meet the financial needs of its customers, the Company's bank subsidiaries are parties to financial instruments with off-balance sheet risk. These financial instruments include commitments to extend credit and standby letters of credit. Commitments to extend credit are agreements to lend to a customer as long as there is no violation of any condition established in the contract. Letters of credit are conditional commitments issued by the Company's bank subsidiaries to guarantee the performance of a customer to a third party. Letters of credit and other commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. Because many of the letters of credit and commitments are expected to expire without being drawn upon, the total commitment amount does not necessarily represent future cash requirements.

The following table provides information on commitments outstanding at September 30, 2013 and December 31, 2012.

(Dollars in thousands)	September 30, 2013	December 31, 2012
Commitments to extend credit	$ 129,572	$ 141,518
Letters of credit	12,286	12,817
Total	$ 141,858	$ 154,335

Note 12 Segment Reporting

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

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

The following table includes selected financial information by business segments for the first nine months of 2013 and 2012.

(Dollars in thousands)	Community Banking	Insurance Products and Services	Parent Company	Consolidated Total
2013				
Interest income	$ 31,509	$ 35	$ -	$ 31,544
Interest expense	(5,238)	-	-	(5,238)
Provision for credit losses	(27,310)	-	-	(27,310)
Noninterest income	4,192	9,046	6	13,244
Noninterest expense	(17,449)	(7,638)	(5,131)	(30,218)
Net intersegment (expense) income	(3,982)	(530)	4,512	-
(Loss) income before taxes	(18,278)	913	(613)	(17,978)
Income tax benefit (expense)	7,289	(364)	244	7,169
Net (loss) income	$ (10,989)	$ 549	$ (369)	$ (10,809)
Total assets	$ 1,032,956	$ 15,973	$ 2,455	$ 1,051,384
2012				
Interest income	$ 34,882	$ 59	$ -	$ 34,941
Interest expense	(7,967)	-	(16)	(7,983)
Provision for credit losses	(18,095)	-	-	(18,095)
Noninterest income	5,089	7,974	89	13,152
Noninterest expense	(17,969)	(7,407)	(4,494)	(29,870)
Net intersegment (expense) income	(3,903)	(392)	4,295	-
(Loss) income before taxes	(7,963)	234	(126)	(7,855)
Income tax benefit (expense)	3,336	(98)	53	3,291
Net (loss) income	$ (4,627)	$ 136	$ (73)	$ (4,564)
Total assets	$ 1,159,766	$ 16,920	$ 1,947	$ 1,178,633

Note 13 Subsequent Event

After the third quarter and nine-month financial results for the Company were reported in its press release dated October 28, 2013, it was determined that the accounting and presentation in the financial statements for the losses recognized in connection with the execution of agreements by the Company's wholly owned subsidiary, The Talbot Bank of Easton (the "Bank"), to sell loans and other real estate owned (the "Asset Sale") required modification. The transaction originally was reported in noninterest income as a $19.8 million loss on the Asset Sale. The revised accounting and presentation in this Form 10-Q reflect loan charge-offs of $19.6 million on loans associated with the Asset Sale and a subsequent provision for credit losses of $19.6 million. The write-downs of $182 thousand on other real estate owned associated with the Asset Sale are reflected in noninterest expense. Net loss for the three and nine months ended September 30, 2013 was not impacted by the modification. See additional details on the Asset Sale in the following Management's Discussion and Analysis of Financial Condition and Results of Operations.

Note 14 Restatement of Financial Information

Subsequent to the filing of the Company's Form 10-Q for the third quarter of 2013, management determined that the regulatory capital ratios previously reported for the Company and Talbot Bank required modification due to a change in deferred income taxes. This adjustment to deferred income taxes was a result of a reclassification from income taxes receivable to reflect what the Company will receive through carryback claims. The change in deferred income taxes impacted the disallowed deferred tax assets ("DTA") in the calculations of the regulatory capital ratios. The following tables provide information on the originally reported and restated amounts for income taxes receivable and deferred income taxes, and regulatory capital ratios at September 30, 2013.

(Dollars in thousands)	As originally reported		Adjustment		As restated	
Income taxes receivable	$	12,698	$	(10,625)	$	2,073
Deferred income taxes		9,740		10,625		20,365

	As originally reported		Adjustment (basis points)	As restated	
The Company					
Tier 1 risk-based capital ratio	11.21	%	(189)	9.32	%
Total risk-based capital ratio	12.44	%	(187)	10.57	%
Leverage ratio	8.25	%	(143)	6.82	%
Talbot Bank					
Tier 1 risk-based capital ratio	8.44	%	(215)	6.29	%
Total risk-based capital ratio	9.70	%	(215)	7.55	%
Leverage ratio	6.59	%	(170)	4.89	%

The Company's restated capital ratios remain well in excess of regulatory minimums. Per its consent order, Talbot Bank will submit a capital plan to the FDIC and Commissioner which describes the methods and timing by which it will increase its capital ratios up to or in excess of required minimums. These methods include earnings from operations, capital infusions from the Company, tax planning strategies to reduce disallowed DTA, and other capital-raising alternatives such as debt or equity issuances.

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

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

Forward-Looking Information

Portions of this Quarterly Report on Form 10-Q contain forward-looking statements within the meaning of The Private Securities Litigation Reform Act of 1995. Statements that are not historical in nature, including statements that include the words "anticipate", "estimate", "should", "expect", "believe", "intend", and similar expressions, are expressions a our confidence, policies, and strategies, the adequacy of capital levels, and liquidity and are not guarantees of future performance. Such forward-looking statements involve certain risks and uncertainties, including economic conditions, competition in the geographic and business areas in which we operate, inflation, fluctuations in interest rates, legislation, and governmental regulation. These risks and uncertainties are described in detail in the section of the periodic reports that Shore Bancshares, Inc. files with the Securities and Exchange Commission (the "SEC") entitled "Risk Factors" (see Item 1A of Part II of this report and Item 1A of Part I of the Annual Report of Shore Bancshares, Inc. on Form 10-K for the year ended December 31, 2012). Actual results may differ materially from such forward-looking statements, and we assume no obligation to update forward-looking statements at any time except as required by law.

Introduction

The following discussion and analysis is intended as a review of significant factors affecting the Company's financial condition and results of operations for the periods indicated. This discussion and analysis should be read in conjunction with the unaudited consolidated financial statements and related notes presented elsewhere in this report, as well as the audited consolidated financial statements and related notes included in the Annual Report of Shore Bancshares, Inc. on Form 10-K for the year ended December 31, 2012.

Shore Bancshares, Inc. is the largest independent financial holding company located on the Eastern Shore of Maryland. It is the parent company of The Talbot Bank of Easton, Maryland located in Easton, Maryland ("Talbot Bank") and CNB located in Centreville, Maryland (together with Talbot Bank, the "Banks"). The Banks operate 18 full service branches in Kent County, Queen Anne's County, Talbot County, Caroline County and Dorchester County in Maryland and Kent County, Delaware. The Company engages in the insurance business through three insurance producer firms, The Avon-Dixon Agency, LLC, Elliott Wilson Insurance, LLC and Jack Martin Associates, Inc.; a wholesale insurance company, TSGIA, Inc.; and an insurance premium finance company, Mubell Finance, LLC (all of the foregoing are collectively referred to as the "Insurance Subsidiary"). Each of these entities is a wholly-owned subsidiary of Shore Bancshares, Inc. The Company engages in the trust services business through the trust department at CNB under the trade name Wye Financial & Trust.

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

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

Regulatory Enforcement Actions

Talbot Bank entered into a Stipulation and Consent to the Issuance of a Consent Order (the "Consent Agreement") with the Federal Deposit Insurance Corporation (the "FDIC"), a Stipulation and Consent to the Issuance of a Consent Order (the "Maryland Consent Agreement" and together with the Consent Agreement, the "Consent Agreements") with the Maryland Commissioner of Financial Regulation (the "Commissioner") and an Acknowledgement of Adoption of the

Order by the Commissioner (the "Acknowledgement"). The FDIC and the Commissioner issued the related Consent Order (the "Order"), effective May 24, 2013. The description of the Consent Agreements, the Order and the Acknowledgement along with Talbot Bank's progress with the requirements, are set forth below.

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

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

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

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

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

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

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

Capital Requirements. Within 90 days from the effective date of the Order, Talbot Bank must meet and maintain the following minimum capital levels, after establishing an appropriate ALLL, (i) a leverage ratio (the ratio of Tier 1 capital to total assets) of at least 8%, and (ii) a total risk-based capital ratio (the ratio of qualifying total capital to risk-weighted assets) of at least 12%. As of September 30, 2013, the leverage ratio and total risk-based capital ratio were 4.89% and 7.55%, respectively, for Talbot Bank. Talbot Bank has notified the FDIC and Commissioner of falling below the minimum capital ratios required by the Order, and is currently developing a written plan describing the means and timing by which it will increase its capital ratios up to or in excess of the required minimums including earnings from operations, capital infusions from the Company and other capital raising alternatives such as debt or equity issuances.

Profit and Budget Plan. Within 60 days from the effective date of the Order and within 30 days of each calendar year-end thereafter, Talbot Bank must submit a profit and budget plan to the FDIC and Commissioner consisting of goals and strategies, consistent with sound banking practices, and taking into account Talbot Bank's other plans, policies or other actions required by the Order. In accordance with the Order, Talbot Bank developed a profit and

budget plan which was submitted to the FDIC and Commissioner within the required timeframe.

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

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

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

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

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

Critical Accounting Policies

Our financial statements are prepared in accordance with GAAP. The financial information contained within the financial statements is, to a significant extent, financial information contained that is based on measures of the financial effects of transactions and events that have already occurred. A variety of factors could affect the ultimate value that is obtained either when earning income, recognizing an expense, recovering an asset or relieving a liability. Based on the valuation techniques used and the sensitivity of financial statement amounts to the methods, assumptions, and estimates underlying those amounts, management has determined that the accounting policy with respect to the allowance for credit losses to be the accounting area that requires the most subjective or complex judgments, and, as such, could be most subject to revision as new information becomes available. Accordingly, the allowance for credit losses is considered to be a critical accounting policy, along with goodwill and other intangible assets and fair value, as discussed below.

Allowance for Credit Losses

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

Three basic components comprise our allowance for credit losses: (i) a specific allowance; (ii) a formula allowance; and (iii) a nonspecific allowance. Each component is determined based on estimates that can and do change when the actual events occur. The specific allowance is established against impaired loans (i.e., nonaccrual loans and TDRs) based on our assessment of the losses that may be associated with the individual loans. The specific allowance remains until charge-offs are made. An impaired loan may show deficiencies in the borrower's overall financial condition, payment history, support available from financial guarantors and/or the fair market value of collateral. The formula allowance is used to estimate the loss on internally risk-rated loans, exclusive of those identified as impaired. Loans are grouped by type (construction, residential real estate, commercial real estate, commercial or consumer). Each loan type is assigned allowance factors based on management's estimate of the risk, complexity and size of individual loans within a particular category. Loans identified as special mention, substandard, and doubtful are adversely rated. These loans are assigned higher allowance factors than favorably rated loans due to management's concerns regarding collectability or management's knowledge of particular elements regarding the borrower. The nonspecific allowance captures losses that have impacted the portfolio but have yet to be recognized in either the specific or formula allowance.

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

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

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

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

Fair Value
The Company measures certain financial assets and liabilities at fair value. Investment securities and interest rate caps are significant financial assets measured at fair value on a recurring basis. Impaired loans and other real estate owned are significant financial assets measured at fair value on a nonrecurring basis. See Note 9, "Fair Value Measurements", in the Notes to Consolidated Financial Statements for a further discussion of fair value.

OVERVIEW

The Company reported a net loss of $11.4 million for the third quarter of 2013, or diluted loss per common share of $(1.35), compared to a net loss of $1.8 million, or diluted loss per common share of $(0.22), for the third quarter of 2012. For the second quarter of 2013, the Company reported net income of $361 thousand, or diluted income per common share of $0.04. The Company reported a net loss of $10.8 million or $(1.28) per diluted common share for the first nine months of 2013, compared to a net loss of $4.6 million or $(0.54) per diluted common share for the first nine months of 2012.

The losses for the three and nine months ended September 30, 2013 were due to pretax losses of $19.8 million recognized in connection with the Asset Sale by the Bank. On October 28, 2013, the Bank entered into agreements to sell assets with an aggregate book value of $45.0 million for a price of $25.2 million. The assets consisted of $11.1 million of nonaccrual loans, $30.4 million of accruing TDRs, $1.8 million of adversely classified performing loans and $1.7 million of other real estate owned. As a result, as of September 30, 2013, charge-offs of $19.6 million were taken on the $43.3 million of loans subject to the Asset Sale to reflect the value to be realized upon sale. Subsequently, the provision for credit losses was increased $19.6 million to replenish the allowance and the loans subject to the Asset Sale were transferred to loans held for sale. Other real estate owned subject to the Asset Sale was written down $182 thousand. Loans held for sale with an aggregate book value of $10.7 million were sold on November 8, 2013 and the remaining assets subject to the Asset Sale are currently scheduled to be sold in mid-December, subject to certain closing conditions.

The Company's management and board of directors made the difficult but prudent decision to sell approximately 50% of problem loans in order to accelerate the disposition of nonperforming assets and decrease the overall risk profile in the portfolio. Disposing these loans will provide the Company with the opportunity to focus more on growing healthy new business, improving and sustaining earnings, and positioning the Company for future success. The Company was

able to pursue this strategy because of its strong capital position and its continued maintenance of solid underlying capital ratios. Management believes that the economy in our region has shown some improvement as real estate pricing stabilizes and hopes to continue to work out of the remaining problem loans, many of which are TDRs which are performing.

RESULTS OF OPERATIONS

Net Interest Income

Tax-equivalent net interest income is net interest income adjusted for the tax-favored status of income from certain loans and investments. As shown in the table below, tax-equivalent net interest income for the third quarter of 2013 was $8.9 million, slightly higher than the $8.8 million for the third quarter of 2012. The increase in net interest income was due to a greater decline in interest expense than the decline in interest income. The decrease in interest expense was mainly the result of lower rates paid on and balances of money market and savings deposits due to the Company exiting the remainder of the IND Program and terminating the remainder of the interest rate caps associated with these deposits. In December 2012, the Company decided to partially exit the IND Program to reduce excess liquidity and, in June 2013, the Company fully exited the IND Program. Net interest margin is tax-equivalent net interest income (annualized) divided by average earning assets. Our net interest margin improved to 3.54% for the third quarter of 2013, compared to 3.15% for the third quarter of 2012. For the second quarter of 2013, tax-equivalent net interest income was $9.0 million and the net interest margin was 3.60%. The decrease in net interest income for the third quarter of 2013 when compared to the second quarter of 2013 was primarily due to a greater decline in interest income than the decline in interest expense. The decrease in interest income was partially the result of a $308 thousand nonrecurring adjustment to loan income related to a troubled debt restructuring in the second quarter of 2013. The decrease in interest expense was mainly due to exiting the IND Program and terminating the interest rate caps.

On a tax-equivalent basis, interest income declined $1.2 million, or 10.7%, for the third quarter of 2013 when compared to the third quarter of 2012. The decrease in interest income was due to a 10.4% decline in average balances of earning assets (i.e., loans, investment securities, federal funds sold and interest-bearing deposits with other banks) combined with a 2 basis point decrease in yields earned on average earning assets. Changes in the balances and rates related to loans had the largest impact on interest income. For the third quarter of 2013, average loans decreased 4.5% and the yield earned on loans decreased from 5.23% to 5.03% when compared to the third quarter of 2012, which reduced interest income by $842 thousand. Loans comprised 77.7% of total average earning assets for the third quarter of 2013, higher than the 72.9% for the third quarter of 2012. The yields on taxable investment securities declined from 2.01% to 1.15% when comparing the third quarter of 2013 with the third quarter of 2012, and balances declined $11.8 million, or 8.7%, which reduced interest income $328 thousand. The yields on taxable investment securities decreased because the reinvestment rates on investment securities purchased during 2013 were lower than the yields on the investment securities that matured or were sold during the period. The remaining components of average earning assets decreased $67.2 million, primarily from a reduction in interest-bearing deposits, and the yields earned on these assets declined 4 basis points, which in aggregate reduced interest income $56 thousand. The decrease in interest-bearing deposits reflected a reduction in excess liquidity. Tax-equivalent interest income decreased $576 thousand, or 5.3%, when compared to the second quarter of 2013 mainly due to a 22 basis point decrease in yields and a 1.2% decrease in average earning assets.

Interest expense decreased $1.3 million, or 49.2%, when comparing the third quarter of 2013 to the third quarter of 2012. The decrease in interest expense was due to a 48 basis point decrease in rates paid on interest-bearing liabilities (i.e., deposits and borrowings) and a 13.9% decline in average balances of interest-bearing liabilities. Changes in the rates and balances related to money market and savings deposits had the largest impact on interest expense. For the three months ended September 30, 2013, the rates paid on money market and savings deposits decreased 107 basis points and the average balances of these deposits decreased $71.8 million, or 25.7%, when compared to the same period last year, which reduced interest expense $770 thousand. The lower rates paid on money market and savings deposits were mainly due to terminating the interest rate caps associated with the IND Program while the decrease in balances was primarily due to the decline in deposits associated with the IND Program. By terminating the interest rate caps, the interest expense related to the hedged money market deposit accounts declined from $524 thousand for the third quarter of 2012 to $0 for the third quarter of 2013. See Note 10, "Derivative Instruments and Hedging Activities", in the Notes to Consolidated Financial Statements for additional information. Also contributing to the decrease in interest expense when comparing the third quarter of 2013 with the third quarter of 2012 was a 32 basis

point decline in the rates paid on time deposits (i.e., certificates of deposit $100,000 or more and other time deposits) and a $54.8 million, or 12.3%, decline in the average balances of these deposits, which reduced interest expense $523 thousand. The decrease in average time deposits reflected a reduction in the Company's liquidity needs and the lower rates reflected current market conditions. When comparing the third quarter of 2013 to the second quarter of 2013, interest expense decreased $400 thousand, or 22.8%. The decline was primarily due to lower interest rates paid on and average balances of money market and savings deposits due to terminating the interest rate caps associated with the IND Program and exiting the remainder of the IND Program during June of 2013.

The following table presents the distribution of the average consolidated balance sheets, interest income/expense, and annualized yields earned and rates paid for the three months ended September 30, 2013 and 2012.

	For the Three Months Ended September 30, 2013			For the Three Months Ended September 30, 2012		
(Dollars in thousands)	Average Balance	Income(1)/ Expense	Yield/ Rate	Average Balance	Income(1)/ Expense	Yield/ Rate
Earning assets						
Loans (2), (3)	$ 772,008	$ 9,789	5.03 %	$ 808,244	$ 10,631	5.23 %
Investment securities						
Taxable	123,499	357	1.15	135,257	685	2.01
Tax-exempt	521	7	5.27	2,614	34	5.07
Federal funds sold	1,618	-	0.07	11,971	3	0.11
Interest-bearing deposits	95,422	53	0.22	150,170	79	0.21
Total earning assets	993,068	10,206	4.08 %	1,108,256	11,432	4.10 %
Cash and due from banks	22,088			20,158		
Other assets	65,001			69,921		
Allowance for credit losses	(15,238)			(14,189)		
Total assets	$ 1,064,919			$ 1,184,146		
Interest-bearing liabilities						
Demand deposits	$ 172,143	68	0.16 %	$ 167,423	74	0.18 %
Money market and savings deposits (4)	207,162	62	0.12	279,003	832	1.19
Certificates of deposit $100,000 or more	198,495	614	1.23	238,624	875	1.46
Other time deposits	192,878	604	1.24	207,547	866	1.66
Interest-bearing deposits	770,678	1,348	0.69	892,597	2,647	1.18
Short-term borrowings	10,695	6	0.23	14,909	10	0.27
Long-term debt	-	-	-	455	6	4.58
Total interest-bearing liabilities	781,373	1,354	0.69 %	907,961	2,663	1.17 %
Noninterest-bearing deposits	162,189			148,096		
Other liabilities	7,453			8,768		
Stockholders’ equity	113,904			119,321		
Total liabilities and stockholders’ equity	$ 1,064,919			$ 1,184,146		
Net interest spread		$ 8,852	3.39 %		$ 8,769	2.93 %
Net interest margin			3.54 %			3.15 %
Tax-equivalent adjustment						
Loans		$ 22			$ 27	
Investment securities		2			12	
Total		$ 24			$ 39	

(1) All amounts are reported on a tax-equivalent basis computed using the statutory federal income tax rate of 34.0% for 2013 and 2012 exclusive of the alternative minimum tax rate and nondeductible interest expense.
(2) Average loan balances include nonaccrual loans.
(3) Interest income on loans includes amortized loan fees, net of costs, and all are included in the yield calculations.
(4)

Interest on money market and savings deposits includes an adjustment to expense related to interest rate caps and the hedged deposits associated with them. This adjustment increased interest expense $0 for the third quarter of 2013 and $524 thousand for the third quarter of 2012. The interest rate caps were terminated in June of 2013.

Tax-equivalent net interest income for the nine months ended September 30, 2013 was $26.4 million, as seen in the table below. This represented a decrease of $705 thousand, or 2.6%, when compared to the same period last year. The decrease was mainly due to lower yields earned on average earning assets and a decline in higher-yielding average loan balances. The decrease was partially offset by lower rates paid on and a decline in average balances of money market and savings deposits, and time deposits. However, the net interest margin improved to 3.48% for the first nine months of 2013 when compared to 3.31% for the first nine months of 2012.

On a tax-equivalent basis, interest income was $31.6 million for the first nine months of 2013, a decrease of $3.5 million, or 9.8%, when compared to the first nine months of 2012. Average earning assets decreased 7.3% while yields earned declined 11 basis points to 4.17% primarily due to the impact of loan activity. Average loans decreased 4.7% and the yield earned on loans declined 19 basis points. Loans comprised 77.0% and 74.8% of total average earning assets for the nine months ended September 30, 2013 and 2012, respectively.

Interest expense was $5.2 million for the nine months ended September 30, 2013, a decrease of $2.7 million, or 34.4%, when compared to the same period last year. The rates paid on average interest-bearing liabilities declined 32 basis points to 0.87% while balances decreased $88.2 million, or 9.8%, primarily due to money market and savings deposit, and time deposit activity. For the nine months ended September 30, 2013, the average rate paid on money market and savings deposits declined 55 basis points while the average balance of these deposits decreased $52.9 million, or 19.0%, when compared to the same period last year, which reduced interest expense $1.4 million. As with the quarterly results, the lower rates paid on money market and savings deposits were mainly due to terminating the interest rate caps associated with the IND Program and the decrease in these deposits was primarily due to exiting the remainder of the IND Program. By terminating the interest rate caps, the interest expense related to the hedged money market deposit accounts declined from $1.5 million for the first nine months of 2012 to $695 thousand for the first nine months of 2013. The interest expense associated with the hedged deposits will be $1.3 million less for fiscal year 2013 than for fiscal year 2012. For the first nine months of 2013, the average rate paid on time deposits decreased 26 basis points, when compared to the same period last year, and the average balance of these deposits declined $42.1 million, or 9.5%, which reduced interest expense $1.3 million.

The following table presents the distribution of the average consolidated balance sheets, interest income/expense, and annualized yields earned and rates paid for the nine months ended September 30, 2013 and 2012.

	For the Nine Months Ended September 30, 2013			For the Nine Months Ended September 30, 2012		
(Dollars in thousands)	Average Balance	Income(1)/ Expense	Yield/ Rate	Average Balance	Income(1)/ Expense	Yield/ Rate
Earning assets						
Loans (2), (3)	$ 780,359	$ 29,887	5.12 %	$ 819,088	$ 32,588	5.31 %
Investment securities						
Taxable	136,680	1,568	1.53	131,863	2,149	2.18
Tax-exempt	560	21	4.97	3,548	140	5.27
Federal funds sold	4,241	3	0.10	10,992	7	0.09
Interest-bearing deposits	92,403	143	0.21	128,756	188	0.19
Total earning assets	1,014,243	31,622	4.17 %	1,094,247	35,072	4.28 %
Cash and due from banks	23,177			19,920		
Other assets	67,036			69,514		
Allowance for credit losses	(16,306)			(14,523)		
Total assets	$ 1,088,150			$ 1,169,158		
Interest-bearing liabilities						
Demand deposits	$ 169,476	200	0.16 %	$ 157,835	216	0.18 %
Money market and savings deposits (4)	225,351	1,021	0.61	278,297	2,423	1.16
Certificates of deposit $100,000 or more	206,076	2,024	1.31	240,595	2,626	1.46
Other time deposits	197,201	1,973	1.34	204,789	2,666	1.74
Interest-bearing deposits	798,104	5,218	0.87	881,516	7,931	1.20
Short-term borrowings	11,140	20	0.25	15,448	36	0.31
Long-term debt	-	-	-	455	16	4.61
Total interest-bearing liabilities	809,244	5,238	0.87 %	897,419	7,983	1.19 %
Noninterest-bearing deposits	156,286			142,874		
Other liabilities	8,500			8,949		
Stockholders' equity	114,120			119,916		
Total liabilities and stockholders' equity	$ 1,088,150			$ 1,169,158		
Net interest spread		$ 26,384	3.30 %		$ 27,089	3.09 %
Net interest margin			3.48 %			3.31 %
Tax-equivalent adjustment						
Loans		$ 71			$ 83	
Investment securities		7			48	
Total		$ 78			$ 131	

(1) All amounts are reported on a tax-equivalent basis computed using the statutory federal income tax rate of 34.0% for 2013 and 2012 exclusive of the alternative minimum tax rate and nondeductible interest expense.

(2) Average loan balances include nonaccrual loans.

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

(4)

Interest on money market and savings deposits includes an adjustment to expense related to interest rate caps and the hedged deposits associated with them. This adjustment increased interest expense $695 thousand for the first nine months of 2013 and $1.5 million for the first nine months of 2012. The interest rate caps were terminated in June of 2013.

Noninterest Income

Total noninterest income for the third quarter of 2013 increased $791 thousand, or 19.8%, when compared to the third quarter of 2012 and $830 thousand, or 20.9%, when compared to the second quarter of 2013. The increase in noninterest income when compared to the third quarter of 2012 was due to fewer losses on sales of other real estate owned ($524 thousand), income from an insurance investment ($297 thousand), and higher insurance agency commissions ($297 thousand). Partially offsetting this increase were $278 thousand in gains on sales of investment securities during the third quarter of 2012 compared to none during the third quarter of 2013. Included in noninterest income for the second quarter of 2013 was a $1.3 million loss incurred to recognize the ineffective portion of the previously mentioned interest rate caps related to the IND Program which was substantially offset by $913 thousand in gains on sales of investment securities. These transactions, along with the $297 thousand in income from an insurance investment, improved noninterest income when compared to the second quarter of 2013.

Total noninterest income for the nine months ended September 30, 2013 increased $92 thousand, or less than 1%, when compared to the same period in 2012. Included in total noninterest income for the first nine months of 2013 were higher insurance agency commissions ($648 thousand), larger gains on sales of investment securities ($635 thousand), and the income from the insurance investment ($297 thousand). Mainly offsetting these higher amounts was the $1.3 million loss incurred to terminate the interest rate caps associated with the IND Program.

Noninterest Expense

Total noninterest expense for the third quarter of 2013 grew $259 thousand, or 2.7%, when compared to the third quarter of 2012 primarily due to higher insurance agency commissions ($134 thousand), FDIC insurance premiums ($91 thousand) and marketing costs ($95 thousand). The higher marketing costs were mainly related to a branding project for the Company and its subsidiaries. When compared to the second quarter of 2013, total noninterest expense for the third quarter of 2013 grew $209 thousand, or 2.1%, primarily due to higher write-downs of other real estate owned ($163 thousand), salaries ($113 thousand), and FDIC insurance premiums ($100 thousand) which were partially offset by lower marketing costs ($77 thousand) and professional fees ($76 thousand).

Total noninterest expense for the first nine months of 2013 increased $348 thousand, or 1.2%, when compared to the same period in 2012. Included in noninterest expense were higher marketing costs ($387 thousand), insurance agency commissions ($324 thousand) and FDIC insurance premiums ($207 thousand). Partially offsetting these amounts were lower occupancy expense ($175 thousand), salaries ($168 thousand) and write-downs of other real estate owned ($130 thousand).

Income Taxes

The Company reported an income tax benefit of $7.4 million and $1.4 million for the third quarter of 2013 and 2012, respectively, while the effective tax rate was a 39.4% and 42.7% benefit for the third quarter of 2013 and 2012, respectively. The Company reported an income tax benefit of $7.2 million and $3.3 million for the first nine months of 2013 and 2012, respectively, while the effective tax rate was a 39.9% and 41.9% benefit for the first nine months of 2013 and 2012, respectively.

ANALYSIS OF FINANCIAL CONDITION

Loans

Loans totaled $718.6 million at September 30, 2013 and $785.1 million at December 31, 2012, a decline of $66.5 million, or 8.5%. Loans included deferred costs, net of deferred fees, of $317 thousand at September 30, 2013 and $286 thousand at December 31, 2012. We do not engage in foreign or subprime lending activities. The decline in loans since the end of 2012 was mainly due to the $19.6 million in charge-offs taken on the loans associated with the Asset Sale and the subsequent transfer of these loans to loans held for sale at the value to be realized upon sale ($23.6 million). Loans have declined in all 5 principal classes with the majority of the decline in construction ($39.1 million) and commercial real estate ($11.8 million), primarily due to the Asset Sale. Residential real estate loans declined $7.9 million, while commercial and consumer loans declined $5.7 million and $2.0 million, respectively. Fewer high-quality loan opportunities and our level of loan charge-offs continue to impede overall loan growth and financial performance. However, the disposition of the problem loans in the Asset Sale will provide the opportunity to focus more on growing healthy new business and generating earnings in a slowly improving economy. See Note 4, "Loans and Allowance for Credit Losses", in the Notes to Consolidated Financial Statements and below under the caption "Allowance for Credit Losses" for additional information.

Our loan portfolio has a commercial real estate loan concentration, which is defined as a combination of construction and commercial real estate loans. Construction loans were $69.0 million, or 9.6% of total loans, at September 30, 2013, compared to $108.1 million, or 13.8% of total loans, at December 31, 2012. Commercial real estate loans were approximately $303.2 million, or 42.2% of total loans, at September 30, 2013, compared to $314.9 million, or 40.1% of total loans, at December 31, 2012. The overall decline in these 2 principal loan classes was $50.9 million while the

combined percent of total loans was 51.8% at September 30, 2013, declining from the 53.9% at the end of 2012, primarily due to the Asset Sale. Because most of our loans are secured by real estate, the slow upturn in real estate related activities in our local real estate market and construction industry, and the soft economy on the Delmarva Peninsula in general, have had a material adverse effect on the performance of our loan portfolio and the value of the collateral securing that portfolio. However, we are cautiously optimistic that the real estate values driving our regional economy are beginning to stabilize.

Allowance for Credit Losses

We have established an allowance for credit losses, which is increased by provisions charged against earnings and recoveries of previously charged-off debts and is decreased by current period charge-offs of uncollectible debts. Management evaluates the adequacy of the allowance for credit losses at least quarterly and adjusts the provision for credit losses based on this analysis. The evaluation of the adequacy of the allowance for credit losses is based primarily on a risk rating system of individual loans, as well as on a collective evaluation of smaller balance homogenous loans, each grouped by loan type. Each loan type is assigned allowance factors based on criteria such as past credit loss experience, local economic and industry trends, and other measures which may impact collectibility. Please refer to the discussion above under the caption “Critical Accounting Policies” for an overview of the underlying methodology management employs to maintain the allowance.

The provision for credit losses was $22.5 million for the third quarter of 2013, $6.2 million for the third quarter of 2012 and $2.7 million for the second quarter of 2013. The provision for credit losses was $27.3 million for the first nine months of 2013 and $18.1 million for the first nine months of 2012. The provision for credit losses for the third quarter of 2013 and for the first nine months of 2013 included $19.6 million to replenish the allowance for the charge-off of loans associated with the Asset Sale. Credit quality has been negatively impacted by soft economic conditions and as problem loans are identified, management takes prompt action to quantify and minimize losses in its focused efforts to dispose of existing problem loans such as with the Asset Sale. Management expects to continue to work out of the remaining problem loans, many of which are performing TDRs, and to charge off nonperforming assets as rapidly as possible, to enable the Company to improve its overall credit quality and reduce problem loans.

Net charge-offs were $26.9 million for the third quarter of 2013 and $6.2 million for the third quarter of 2012, as shown in the following table. Net charge-offs were $2.7 million for the second quarter of 2013. Net charge-offs were $32 million and $19.4 million for the first nine months of 2013 and 2012, respectively. The charge-offs in all periods discussed were mainly real estate related loans. As previously mentioned, the higher charge-offs for the third quarter of 2013 and for the first nine months of 2013 were mainly due to the $19.6 million in charge-offs related to the loans associated with the Asset Sale. The allowance for credit losses as a percentage of average loans was 1.46% for the third quarter of 2013 and 1.60% for the third quarter of 2012. The allowance for credit losses as a percentage of average loans was 1.45% for the first nine months of 2013, compared to 1.58% for the same period in 2012. Management believes that the provision for credit losses and the resulting allowance were adequate to provide for probable losses inherent in our loan portfolio at September 30, 2013.

The following table presents a summary of the activity in the allowance for credit losses for the three and nine months ended September 30, 2013 and 2012.

(Dollars in thousands)	For the Three Months Ended September 30, 2013	2012	For the Nine Months Ended September 30, 2013	2012
Allowance balance beginning of period	$ 15,723	$ 12,990	$ 15,991	$ 14,288
Charge-offs:				
Construction	(18,539)	(3,222)	(20,048)	(5,008)
Residential real estate	(4,225)	(2,323)	(6,114)	(7,996)
Commercial real estate	(4,056)	(742)	(6,003)	(2,177)
Commercial	(196)	(73)	(419)	(4,513)
Consumer	(3)	(31)	(65)	(208)
Totals	(27,019)	(6,391)	(32,649)	(19,902)
Recoveries:				
Construction	3	5	5	5
Residential real estate	51	5	349	99
Commercial real estate	20	116	113	123
Commercial	47	22	149	230
Consumer	16	8	33	17
Totals	137	156	649	474
Net charge-offs	(26,882)	(6,235)	(32,000)	(19,428)
Provision for credit losses	22,460	6,200	27,310	18,095
Allowance balance end of period	$ 11,301	$ 12,955	$ 11,301	$ 12,955
Average loans outstanding during the period	$ 772,008	$ 808,244	$ 780,359	$ 819,088
Net charge-offs (annualized) as a percentage of	13.81 %	3.07 %	5.48 %	3.17 %

average loans outstanding during the period								
Allowance for credit losses at period end as a percentage of average loans	1.46	%	1.60	%	1.45	%	1.58	%

39

Nonperforming Assets and Accruing TDRs

Nonperforming assets, excluding nonaccrual loans held for sale, declined $21.3 million to $23.3 million at September 30, 2013 from $44.6 million at December 31, 2012, as shown in the following table. Accruing TDRs, excluding accruing TDRs held for sale, declined $23.0 million to $29.4 million at September 30, 2013 from $52.4 million at December 31, 2012. Partially offsetting the decline in accruing TDRs was the addition of a $9.6 million favorably-rated credit from one loan relationship. At September 30, 2013, the ratio of nonaccrual loans, excluding nonaccrual loans held for sale, to total assets was 1.66%, improving from 3.08% at December 31, 2012. Likewise, the ratio of accruing TDRs, excluding accruing TDRs held for sale, to total assets at September 30, 2013 was 2.80%, decreasing from 4.41% at December 31, 2012. The positive trend in nonperforming assets and TDRs, as well as the corresponding asset quality ratios, was due primarily to the impact of the Asset Sale.

Gross interest income of $1.5 million, $2.9 million and $2.2 million for the first nine months of 2013, fiscal year 2012 and the first nine months of 2012, respectively, would have been recorded if nonaccrual loans had been current and performing in accordance with their original terms. No interest was recorded on these loans during the first nine months of 2013 or 2012.

The Company continues to focus on the resolution of its nonperforming and problem loans. The efforts to accomplish this goal include the following:

- frequently contacting borrowers until the delinquency is cured or until an acceptable payment plan has been agreed upon;
- obtaining updated appraisals;
- provisioning for credit losses;
- charging off loans;
- transferring loans to other real estate owned;
- aggressively marketing other real estate owned; and
- sale of loans.

The reduction of nonperforming and problem loans is and will continue to be a high priority for the Company.

The following table summarizes our nonperforming assets and accruing TDRs at September 30, 2013 and December 31, 2012.

(Dollars in thousands)	September 30, 2013	December 31, 2012
Nonperforming assets		
Nonaccrual loans excluding nonaccrual loans held for sale		
Construction	$ 8,039	$ 9,694
Residential real estate	5,405	11,532
Commercial real estate	3,342	14,567
Commercial	668	594
Consumer	47	87
Total nonaccrual loans excluding nonaccrual loans held for sale	17,501	36,474
Loans 90 days or more past due and still accruing		
Construction	-	-
Residential real estate	-	290
Commercial real estate	-	165
Commercial	-	-
Consumer	9	5
Total loans 90 days or more past due and still accruing	9	460
Other real estate owned	5,776	7,659
Total nonperforming assets excluding nonaccrual loans held for sale	23,286	44,593
Nonaccrual loans held for sale	7,265	-
Total nonperforming assets including nonaccrual loans held for sale	$ 30,551	$ 44,593
Accruing TDRs excluding accruing TDRs held for sale		
Construction	$ 1,899	$ 27,335
Residential real estate	16,735	7,017
Commercial real estate	10,704	17,880
Commercial	101	121
Consumer	-	-
Total accruing TDRs excluding accruing TDRs held for sale	29,439	52,353
Accruing TDRs held for sale	14,842	-
Total accruing TDRs including TDRs held for sale	$ 44,281	$ 52,353
As a percent of total loans:		
Nonaccrual loans	2.44 %	4.65 %
Accruing TDRs	4.10 %	6.67 %
Nonaccrual loans and accruing TDRs	6.53 %	11.31 %
As a percent of total loans and other real estate owned:		
Nonperforming assets	3.21 %	5.63 %
Nonperforming assets and accruing TDRs	7.28 %	12.23 %
As a percent of total assets:		
Nonaccrual loans excluding nonaccrual loans held for sale	1.66 %	3.08 %
Nonaccrual loans including nonaccrual loans held for sale	2.36 %	3.08 %
Nonperforming assets excluding nonaccrual loans held for sale	2.21 %	3.76 %
Nonperforming assets including nonaccrual loans held for sale	2.91 %	3.76 %
Accruing TDRs excluding accruing TDRs held for sale	2.80 %	4.41 %

Accruing TDRs including accruing TDRs held for sale	4.21	%	4.41	%
Nonperforming assets and accruing TDRs excluding nonaccrual loans and accruing TDRs held for sale	5.01	%	8.18	%
Nonperforming assets and accruing TDRs including nonaccrual loans and accruing TDRs held for sale	7.12	%	8.18	%

41

Investment Securities
The investment portfolio is comprised of securities that are either available for sale or held to maturity. Investment securities available for sale are stated at estimated fair value based on quoted market prices. They represent securities which may be sold as part of the asset/liability management strategy or which may be sold in response to changing interest rates. Net unrealized holding gains and losses on these securities are reported net of related income taxes as accumulated other comprehensive income, a separate component of stockholders' equity. Investment securities in the held to maturity category are stated at cost adjusted for amortization of premiums and accretion of discounts. We have the intent and current ability to hold such securities until maturity. At September 30, 2013, 98% of the portfolio was classified as available for sale and 2% as held to maturity, the same as at December 31, 2012. With the exception of municipal securities, our general practice is to classify all newly-purchased securities as available for sale. See Note 3, "Investment Securities", in the Notes to Consolidated Financial Statements for additional details on the composition of our investment portfolio.

Investment securities totaled $138.2 million at September 30, 2013, a $9.9 million, or 6.7%, decrease since December 31, 2012. Included in the decrease were sales of $39.4 million in investment securities which generated a gain of $913 thousand during the second quarter of 2013. At the end of September 2013, 60.5% of the securities in the portfolio were mortgage-backed securities, 33.4% were U.S. Government agencies and 3.9% were U.S. Treasuries, compared to 73.4%, 24.4% and 0%, respectively, at year-end 2012. Our investments in mortgage-backed securities are issued or guaranteed by U.S. Government agencies or government-sponsored agencies.

Deposits
Total deposits at September 30, 2013 were $930.4 million, a $118.9 million, or 11.3%, decrease when compared to the $1.049 billion at December 31, 2012. The decrease in deposits was mainly due to a decline in money market deposit accounts associated with the IND Program. As previously mentioned, the Company decided to exit the IND Program to decrease its excess liquidity. Also contributing to the decrease in deposits was a $41.1 million decline in time deposits reflecting a reduction in the Company's liquidity needs and a $15.7 million decline in interest-bearing demand deposits primarily from a decrease in deposits of a large municipal customer. Noninterest-bearing deposits increased $12.2 million, or 7.9%, from the end of 2012.

Short-Term Borrowings
Short-term borrowings at September 30, 2013 and December 31, 2012 were $11.5 million and $13.8 million, respectively. Short-term borrowings generally consist of securities sold under agreements to repurchase which are issued in conjunction with cash management services for commercial depositors, overnight borrowings from correspondent banks and short-term advances from the Federal Home Loan Bank (the "FHLB"). Short-term advances are defined as those with original maturities of one year or less. At September 30, 2013 and December 31, 2012, short-term borrowings included only repurchase agreements.

Liquidity and Capital Resources
We derive liquidity through increased customer deposits, maturities in the investment portfolio, loan repayments and income from earning assets. To the extent that deposits are not adequate to fund customer loan demand, liquidity needs can be met in the short-term funds markets through arrangements with correspondent banks. The Banks had $15.5 million in federal funds lines of credit and a reverse repurchase agreement available on a short-term basis from correspondent banks at September 30, 2013 and December 31, 2012. The Banks are also members of the FHLB, which provides another source of liquidity. Through the FHLB, the Banks had credit availability of approximately $53.7 million and $58.0 million at September 30, 2013 and December 31, 2012, respectively. The Banks have pledged, under a blanket lien, all qualifying residential loans under borrowing agreements with the FHLB. Management is not aware of any demands, commitments, events or uncertainties that are likely to materially affect our future ability to maintain liquidity at satisfactory levels.

Total stockholders’ equity was $102.0 million at September 30, 2013, compared to $114.0 million at December 31, 2012. The decrease since the end of 2012 was due to the net loss of $10.8 million and unrealized losses on available-for-sale securities of $2.4 million which was partially offset by unrealized gains on cash flow hedging activities of $1.2 million relating to the interest rate caps. On May 3, 2012, the Company’s board of directors voted to suspend quarterly cash dividends until further notice in order to mitigate declines in capital and capital ratios.

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

Risk-based capital standards have been supplemented with requirements for a minimum Tier 1 capital to average assets ratio (leverage ratio). In addition, regulatory agencies consider the published capital levels as minimum levels and may require a financial institution to maintain capital at higher levels. At September 30, 2013, the Company’s capital ratios were well in excess of regulatory minimums.

The table below presents a comparison of the Company's capital ratios to the minimum regulatory requirements as of September 30, 2013 and December 31, 2012.

	September 30, 2013		December 31, 2012		Minimum Regulatory Requirements	
Tier 1 risk-based capital ratio	9.32	%	12.05	%	4.00	%
Total risk-based capital ratio	10.57	%	13.32	%	8.00	%
Leverage ratio	6.82	%	8.32	%	4.00	%

In July 2013, the U.S. Federal banking regulators published final rules (the "Basel III Capital Rules") establishing a new comprehensive capital framework for U.S. banking organizations. The rules implement the Basel Committee's December 2010 framework known as "Basel III" for strengthening international capital standards as well as certain provisions of the Dodd-Frank Act. The Basel III Capital Rules substantially revise the risk-based capital requirements applicable to bank holding companies and depository institutions compared to the current U.S. risk-based capital rules. The Basel III Capital Rules define the components of capital and address other issues affecting the numerator in banking institutions' regulatory capital ratios. The Basel III Capital Rules also address risk weights and other issues affecting the denominator in banking institutions' regulatory capital ratios and replace the existing risk-weighting approach with a more risk-sensitive approach. The Basel III Capital Rules are effective for the Company on January 1, 2015 and will be fully phased in on January 1, 2019.

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

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

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

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

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

Applying a 150% risk weight instead of a 100% risk weight for certain high volatility commercial real estate acquisition, development and construction loans.

Assigning a 150% risk weight to loans (other than residential mortgage) that are 90 days past due.

Providing for a 20% credit conversion factor for the unused portion of a commitment with an original maturity of one year or less that is not unconditionally cancellable, currently at 0%.

Management is currently reviewing the Basel III Capital Rules to determine the impact that they could have on the Company.

Item 3. Quantitative and Qualitative Disclosures about Market Risk.

Our primary market risk is interest rate fluctuation and management has procedures in place to evaluate and mitigate this risk. This risk and these procedures are discussed in Item 7 of Part II of the Annual Report of Shore Bancshares, Inc. on Form 10-K for the year ended December 31, 2012 under the caption "Market Risk Management". Management believes that there have been no material changes in our market risks, the procedures used to evaluate and mitigate these risks, or our actual and simulated sensitivity positions since December 31, 2012.

Item 4. Controls and Procedures.

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

Prior to November 14, 2013, an evaluation of the effectiveness of these disclosure controls as of September 30, 2013 was carried out under the supervision and with the participation of management, including the CEO and the PAO. Based on that evaluation, management, including the CEO and the PAO, concluded and disclosed in the original report to which this amendment relates that our disclosure controls and procedures were, in fact, effective at the reasonable assurance level. As discussed in the Explanatory Note to this amended report and in Note 14 to the financial statements presented herein, however, management subsequently became aware that income taxes receivable did not reflect what the Company would receive through carryback claims. In light of this discovery, our disclosure controls and procedures as of September 30, 2013 have since been re-evaluated under the supervision and with the participation of management, including the CEO and the PAO. Based on such re-evaluation, such officers have now determined that our disclosure controls and procedures were not, in fact, effective at the reasonable assurance level as of September 30, 2013. Management has taken steps which it believes will ensure, to the extent reasonably possible, that this type of error will not occur in the future.

There was no change in our internal control over financial reporting during the third quarter of 2013 that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

PART II OTHER INFORMATION

Item 1. Legal Proceedings

From time to time the Company may become involved in legal proceedings. At the present time, there are no proceedings which the Company believes will have a material adverse impact on the financial condition or earnings of the Company.

Item 1A. Risk Factors

The risks and uncertainties to which our financial condition and operations are subject are discussed in detail in Item 1A of Part I of the Annual Report of Shore Bancshares, Inc. on Form 10-K for the year ended December 31, 2012. Management does not believe that any material changes in our risk factors have occurred since they were last disclosed.

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

None

Item 3. Defaults Upon Senior Securities

None

Item 4. Mine Safety Disclosures

Not Applicable

Item 5. Other Information

None

Item 6. Exhibits.

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

SIGNATURES

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

SHORE BANCSHARES, INC.

Date: December 30, 2013	By:	/s/ Lloyd L. Beatty, Jr. Lloyd L. Beatty, Jr. President & Chief Executive Officer (Principal Executive Officer)
Date: December 30, 2013	By:	/s/ George S. Rapp George S. Rapp Vice President & Chief Financial Officer

(Principal Accounting Officer)

EXHIBIT INDEX

Exhibit Number	Description
10.1	Stipulation and Consent to the Issuance of a Consent Order with the FDIC[1]
10.2	Stipulation and Consent to the Issuance of a Consent Order with the Maryland Commissioner of Financial Regulation[1]
10.3	Consent Order issued by the Federal Deposit Insurance Corporation[1]
10.4	Acknowledgement of Adoption of the Order by the Maryland Commissioner of Financial Regulation[1]
31.1	Certifications of the Principal Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act (filed herewith).
31.2	Certifications of the Principal Accounting Officer pursuant to Section 302 of the Sarbanes-Oxley Act (filed herewith).
32	Certification pursuant to Section 906 of the Sarbanes-Oxley Act (furnished herewith).
101	Interactive Data File

---

1. Incorporated by reference from the Company's Current Report on Form 8-K dated May 24, 2013.