

Howard Bancorp Inc  
Form 10-Q  
November 09, 2012

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**UNITED STATES**

**SECURITIES AND EXCHANGE COMMISSION**

**Washington, D.C. 20549**

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**FORM 10-Q**

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

For the quarterly period ended September 30, 2012

OR

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

Commission File Number: 001-35489

**HOWARD BANCORP, INC.**

(Exact name of registrant as specified in its charter)

Maryland  
(State or other jurisdiction of incorporation or organization)

20-3735949  
(I.R.S. Employer Identification No.)

6011 University Blvd. Suite 370, Ellicott City, MD 21043  
(Address of principal executive offices) (Zip Code)

**(410) 750-0020**

(Registrant's telephone number, including area code)

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

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

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

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

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

The number of outstanding shares of common stock outstanding as of October 31, 2012.

Common Stock, \$0.01 par value – 4,036,628 shares

HOWARD BANCORP, INC.

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

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

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

- statements of our goals, intentions and expectations, particularly increasing originations of residential mortgage loans, our portfolio of mortgage loans and our selling of loans into the secondary market;
- the expected impact of our recently-completed initial public offering and concurrent private placement;
- statements regarding our intentions to not sell securities in our investment portfolio and the status of unrealized losses in such portfolios;
- our statement regarding anticipated changes in expenses;
- statements with respect to our allowance for credit losses, and the adequacy thereof;
- future cash requirements relating to commitments to extend credit, and that we do not anticipate any material losses in connection therewith;
- our statement with respect to expected retention of maturing certificates of deposits; and
- our statement with respect to adequate liquidity and future liquidity intentions.

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

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

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

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

- changes in consumer spending, borrowing and savings habits;
- changes in accounting policies and practices, as may be adopted by the bank regulatory agencies, the Financial Accounting Standards Board, the Securities and Exchange Commission (“SEC”) and the Public Company Accounting Oversight Board;
- changes in our organization, compensation and benefit plans
- loss of key personnel; and

other risk discussed in this report, in our final prospectus dated May 21, 2012 as filed with the SEC on May 23, 2012 and in other reports we may file.

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

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

## Consolidated Balance Sheets

(in thousands)	Unaudited September 30, 2012	December 31, 2011
<b>ASSETS</b>		
Cash and due from banks	\$ 11,858	\$ 17,926
Federal funds sold	6,478	279
Total cash and cash equivalents	18,336	18,205
Securities available-for-sale	35,952	13,376
Nonmarketable equity securities	1,205	1,313
Loans held for sale	573	646
Loans and leases, net of unearned income	298,814	276,531
Allowance for credit losses	(2,733 )	(3,433 )
Net loans Net loans and leases	296,081	273,098
Bank premises and equipment, net	9,659	9,484
Other real estate owned	2,903	1,885
Deferred income taxes	1,208	1,679
Interest receivable and other assets	2,564	3,396
Total assets	\$ 368,481	\$ 323,082
<b>LIABILITIES</b>		
Noninterest-bearing deposits	\$ 79,934	\$ 62,044
Interest-bearing deposits	207,492	200,598
Total deposits	287,426	262,642
Short-term borrowings	27,619	12,984
Long-term borrowings	6,000	10,000
Accrued expenses and other liabilities	1,114	826
Total liabilities	322,159	286,452
<b>COMMITMENTS AND CONTINGENCIES</b>		
<b>SHAREHOLDERS' EQUITY</b>		
Preferred stock—par value \$0.01 (liquidation preference of \$1,000 per share) authorized 5,000,000; shares issued and outstanding 12,562 series AA at September 30, 2012 and December 31, 2011, net of issuance cost	12,562	12,562
	40	26

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Common stock - par value of \$0.01 authorized 5,000,000 shares; issued and outstanding 4,036,628 shares at September 30, 2012 and 2,640,264 shares at December 31, 2011

Capital surplus	37,379	28,413
Accumulated deficit	(3,681 )	(4,391 )
Accumulated other comprehensive income	22	20
Total shareholders' equity	46,322	36,630
Total liabilities and shareholders' equity	\$ 368,481	\$ 323,082

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

## Consolidated Statements of Operations

(in thousands)	Unaudited Nine months ended		Three months ended	
	September 30, 2012	2011	September 30, 2012	2011
<b>INTEREST INCOME</b>				
Interest and fees on loans and leases	\$11,386	\$10,728	\$ 3,854	\$ 3,666
Interest and dividends on securities	74	82	29	30
Other interest income	46	17	15	6
Total interest income	11,506	10,827	3,898	3,702
<b>INTEREST EXPENSE</b>				
Deposits	1,371	1,300	432	441
Short-term borrowings	125	137	40	50
Long-term borrowings	53	72	14	18
Total interest expense	1,549	1,509	486	509
<b>NET INTEREST INCOME</b>	9,957	9,318	3,412	3,193
Provision for credit losses	650	740	308	558
Net interest income after provision for credit losses	9,307	8,578	3,104	2,635
<b>NONINTEREST INCOME</b>				
Service charges on deposit accounts	235	229	87	75
Gains on the sale of loans	111	18	31	4
Loss on the sale of other real estate owned	(131 )	-	-	-
Other operating income	334	256	98	60
Total noninterest income	549	503	216	139
<b>NONINTEREST EXPENSE</b>				
Compensation and benefits	4,291	3,752	1,491	1,256
Occupancy and equipment	1,124	1,061	381	341
Marketing and business development	435	368	145	109
Professional fees	445	250	134	79
Data processing fees	331	257	116	92
FDIC Assessment	228	258	83	42
Provision for OREO	48	393	-	-
Other operating expense	940	1,018	309	293
Total noninterest expense	7,843	7,357	2,659	2,212
<b>INCOME BEFORE INCOME TAXES</b>	2,013	1,724	661	561
Income tax expense	831	693	274	224
<b>NET INCOME</b>	\$1,182	\$1,031	\$ 387	\$ 337
Preferred stock dividends	471	278	157	115
Net income available to common shareholders	\$711	\$753	\$ 230	\$ 222
<b>NET INCOME PER COMMON SHARE AVAILABLE</b>				
Basic	\$0.24	\$0.29	\$ 0.06	\$ 0.08
Diluted	\$0.24	\$0.29	\$ 0.06	\$ 0.08



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

Consolidated Statements of Comprehensive Income

(in thousands)	Unaudited			
	Nine months ended		Three months ended	
	September 30,		September 30,	
	2012	2011	2012	2011
Net Income	\$1,182	\$1,031	\$ 387	\$ 337
Other comprehensive income				
Investments available-for-sale:				
Unrealized holding (losses) gains	3	(1 )	15	(37 )
Related income tax benefit (expense)	(1 )	-	(5 )	15
Comprehensive income	\$1,184	\$1,030	\$ 397	\$ 315

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

Consolidated Statements of Changes in Shareholders' Equity

(dollars in thousands, except per share data)	Preferred stock	Number of shares	Common stock	Capital Surplus	Accumulated deficit	Accumulated other comprehensive gain/(loss)	Total
(Unaudited)							
Balances at January 1, 2011	\$6,272	2,636,837	\$ 26	\$28,285	\$ (5,325 )	\$ 30	\$29,288
Net income	-	-	-	-	1,031	-	1,031
Net unrealized gain/(loss) on securities	-	-	-	-	-	-	-
Issuance of series AA preferred stock	12,562						12,562
Dividends paid on preferred stock	-	-	-	-	(278 )	-	(278 )
Repurchase of series A and B preferred stock	(6,272 )	-	-	-	-	-	(6,272 )
Issuance of common stock:							
Stock awards	-	3,427	-	21	-	-	21
Stock-based compensation	-	-	-	80	-	-	80
Balances at September 30, 2011	\$12,562	2,640,264	\$ 26	\$28,386	\$ (4,572 )	\$ 30	\$36,432
Balances at January 1, 2012	\$12,562	2,640,264	\$ 26	\$28,413	\$ (4,391 )	\$ 20	\$36,630
Net income	-	-	-	-	1,182	-	1,182
Net unrealized gain/(loss) on securities	-	-	-	-	-	2	2
Issuance of series AA preferred stock	-						-
Dividends paid on preferred stock	-	-	-	-	(471 )	-	(471 )
Issuance of common stock:							
Stock offering	-	1,396,364	14	8,966	-	-	8,980
Balances at September 30, 2012	\$12,562	4,036,628	\$ 40	\$37,379	\$ (3,681 )	\$ 22	\$46,322

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

## Consolidated Statements of Cash Flows

	Unaudited Nine months ended September 30,	
(in thousands)	2012	2011
<b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>		
Net income	\$1,182	\$1,031
Adjustments to reconcile net income to net cash provided by operating activities:		
Provision for credit losses	650	740
Deferred income taxes	470	605
Provision for other real estate owned	48	393
Depreciation	381	343
Stock-based compensation	-	101
Net accretion of investment securities	32	172
Loans originated for sale	(8,658 )	(1,655 )
Proceeds from loans originated for sale	8,841	2,745
Gains on sales of loans	(111 )	(18 )
Loss on sales of other real estate owned, net	131	-
Decrease in interest receivable	(62 )	(161 )
Increase (decrease) in interest payable	10	(19 )
Decrease in other assets	1,003	358
Increase in other liabilities	278	191
Net cash provided by operating activities	4,195	4,826
<b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>		
Purchases of investment securities available-for-sale	(44,018)	(39,185)
Proceeds from maturities of investment securities available-for-sale	21,413	36,545
Net increase in loans and leases outstanding	(25,358)	(16,963)
Proceeds from the sale of other real estate owned	527	-
Purchase of premises and equipment	(555 )	(415 )
Net cash used in investing activities	(47,991)	(20,018)
<b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>		
Net increase in noninterest-bearing deposits	17,890	8,985
Net increase in interest-bearing deposits	6,893	2,673
Net increase (decrease) in short-term borrowings	14,635	(1,843 )
Proceeds from issuance of long-term debt	-	4,000
Repayment of long-term debt	(4,000 )	-
Net proceeds from issuance of common stock, net of cost	8,980	-
Net proceeds from issuance of preferred stock, net of cost	-	6,290
Cash dividends on preferred stock	(471 )	(278 )
Net cash provided by financing activities	43,927	19,827
Net increase in cash and cash equivalents	131	4,635
Cash and cash equivalents at beginning of period	18,205	11,754

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Cash and cash equivalents at end of period	\$18,336	\$16,389
SUPPLEMENTAL INFORMATION		
Cash payments for interest	\$1,539	\$1,319
Cash payments for income taxes	\$475	\$50

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

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## Notes to Consolidated Financial Statements

### Note 1: Summary of Significant Accounting Policies

#### Nature of Operations

On December 15, 2005, Howard Bancorp, Inc. (“Bancorp”) acquired all of the stock and became the holding company of Howard Bank (the “Bank”) pursuant to the Plan of Reorganization approved by the shareholders of the Bank and by federal and state regulatory agencies. Each share of Bank common stock was converted into two shares of Bancorp common stock effected by the filing of Articles of Exchange on that date, and the shareholders of the Bank became the shareholders of Bancorp. The Bank has three subsidiaries, two of which hold foreclosed real estate and the other owns and manages real estate that is used as a branch location and has office and retail space. The accompanying consolidated financial statements of Bancorp and its wholly-owned subsidiary bank (collectively the “Company”) have been prepared in accordance with accounting principles generally accepted in the United States of America. These consolidated financial statements included herein are unaudited, however they reflect all adjustments consisting only of normal recurring accruals that, in the opinion of management, are necessary to present fairly the Company’s financial condition, results of operations, and cash flows for the periods presented. Certain information and note disclosures normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States of America have been condensed or omitted pursuant to the rules and regulations of the Securities and Exchange Commission. The Company believes that the disclosures are adequate to make the information presented not misleading. The balances as of December 31, 2011 have been derived from audited financial statements. There have been no significant changes to the Company’s accounting policies as disclosed in the 2011 Annual Report. The results of operations for the three and nine months ended September 30, 2012 are not necessarily indicative of the results of operations to be expected for the remainder of the year or any other period.

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

The Company is a diversified financial services company providing commercial banking, mortgage banking and consumer finance through banking branches, the internet and other distribution channels to businesses, business owners, professionals and other consumers located primarily in Howard County Maryland, Anne Arundel County Maryland and their contiguous counties.

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

### **Principles of Consolidation**

The consolidated financial statements include the accounts of Bancorp, its subsidiary bank and the bank's subsidiaries. All significant intercompany accounts and transactions have been eliminated.

Certain reclassifications may have been made to the prior year's consolidated financial statements to conform to current period presentation.

### **Use of Estimates**

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America ("GAAP") requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates. Material estimates that are particularly susceptible to significant changes in the near-term relate to the determination of the allowance for credit losses, other-than-temporary impairment of investment securities, deferred income taxes and share-based compensation.

### **Segment Information**

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

### **New Accounting Pronouncements**

ASU No. 2011-11, "Disclosures about Offsetting Assets and Liabilities." ASU No. 2011-11 requires an entity to disclose both gross information and net information about both instruments and transactions eligible for offset in the statement of financial position and instruments and transactions subject to an agreement similar to a master netting arrangement. This scope would include derivatives, sale and repurchase agreements and reverse sale and repurchase agreements, and securities borrowing and securities lending arrangements. The guidance is effective for annual

reporting periods beginning on or after January 1, 2013, and interim periods within those annual periods and is not expected to have a significant impact on the financial statements.



ASU No. 2011-12, "Deferral of Effective Date for Amendments to the Presentation of Reclassifications of Items Out of Accumulated Other Comprehensive Income in Accounting Standards Update No. 2011-05." ASU No. 2011-12 defer the effective date pertaining to reclassification adjustments out of accumulated other comprehensive income in Accounting Standards Update 2011-05, Comprehensive Income (Topic 220): Presentation of Comprehensive Income, until the Board is able to reconsider those paragraphs. While the Board is considering the concerns entities should continue to report reclassifications out of accumulated other comprehensive income consistent with the presentation requirements in effect before Update 2011-05. ASU No. 2011-12 became effective January 1, 2012 and did not have a significant impact on the financial statements.

**Note 2: Investments Securities**

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

(in thousands)	September 30, - Unaudited 2012				December 31, 2011			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
U.S. Federal agencies	\$35,536	\$ 10	\$ 2	\$ 35,544	\$12,774	\$ 1	\$ 2	\$ 12,773
Mortgage-backed	380	28	-	408	568	35	-	603
	\$35,916	\$ 38	\$ 2	\$ 35,952	\$13,342	\$ 36	\$ 2	\$ 13,376

There have not been any individual securities with an unrealized loss position for a period greater than one year as of either September 30, 2012 or December 31, 2011. Gross unrealized losses and fair value by investment category and length of time the individual securities have been in a continuous unrealized loss position at September 30, 2012 and December 31, 2011 are presented below:

**September 30, 2012 -Unaudited**

(in thousands)	Less than 12 months		12 months or more		Total	
	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses
U.S. Federal agencies	\$ 12,999	\$ 2	\$ -	\$ -	\$12,999	\$ 2
Mortgage-backed	-	-	-	-	-	-
	\$ 12,999	\$ 2	\$ -	\$ -	\$12,999	\$ 2

December 31, 2011

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(in thousands)	Less than 12 months		12 months or more		Total	
	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses
U.S. Federal agencies	\$ 9,722	\$ 2	\$ -	\$ -	\$9,722	\$ 2
Mortgage-backed	-	-	-	-	-	-
	\$ 9,722	\$ 2	\$ -	\$ -	\$9,722	\$ 2

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

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

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

(in thousands)	September 30, - Unaudited 2012		December 31, 2011	
	Amortized Cost	Estimated Fair Value	Amortized Cost	Estimated Fair Value
Amounts maturing:				
One year or less	\$ 30,566	\$ 30,567	\$6,000	\$ 6,000
After one through five years	5,144	5,163	7,021	7,036
After five through ten years	109	117	168	177
After ten years	97	105	153	163
	\$ 35,916	\$ 35,952	\$13,342	\$ 13,376

There were no sales of investment securities during the nine months ended September 30, 2012 or in 2011. At September 30, 2012 and December 31, 2011, \$16.2 million and \$5.8 million fair value of securities was pledged as collateral for repurchase agreements, respectively. The outstanding balance of no single issuer, except for U. S. Government and U. S. Government agency securities, exceeded ten percent of shareholders' equity at either period.

### Note 3: Loans and Leases

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

The loan portfolio segment balances at September 30, 2012 and December 31, 2011 are presented in the following table:

(in thousands)	Unaudited September 30,		December 31,	
	2012	% of Total	2011	% of Total
Real estate				
Construction and land	\$35,889	<b>12.0</b>	% \$39,268	14.2 %
Residential - first lien	23,074	7.7	22,087	8.0
Residential - junior lien	8,162	2.7	9,242	3.3
Total residential real estate	31,236	10.5	31,329	11.3
Commercial - owner occupied	58,793	19.7	46,588	16.8

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Commercial - non-owner occupied	86,116	28.8	76,880	27.8
Total commercial real estate	144,909	48.5	123,468	44.6
Total real estate loans	212,034	71.0	194,065	70.2
Commercial loans and leases	85,409	28.6	81,243	29.4
Consumer	1,371	0.5	1,223	0.4
Total loans and leases	\$298,814	<b>100.0</b>	% \$276,531	100.0 %

There were \$573 thousand in loans held for sale at September 30, 2012 and \$646 thousand at December 31, 2011.

**Note 4: Credit Quality Assessment**

**Allowance for Credit Losses**

Summary information on the allowance for credit loss activity for the nine months ended September 30, 2012 and September 30, 2011 is provided in the following table:

(in thousands)	Unaudited Nine months ended September 30,	
	2012	2011
Balance at beginning of year	\$ 3,433	\$ 3,523
Provision for credit losses	650	740
Loan and lease charge-offs	(1,480 )	(553 )
Loan and lease recoveries	130	306
Balance at period end	\$ 2,733	\$ 4,016

The following tables provides information on the activity in the allowance for credit losses by the respective loan portfolio segment for the three months and nine months ended September 30, 2012 and September 30, 2011, and for the year ended December 31, 2011:

(in thousands)	September 30, 2012 - Unaudited							
	Construction and land	Residential first lien	Residential junior lien	Commercial owner occupied	Commercial non-owner occupied	Commercial loans and leases	Commercial Consumer loans	Total
Allowance for credit losses:								
<u>Nine months ended September 30, 2012</u>								
Beginning balance	\$ 174	\$ 111	\$ 64	\$ 611	\$ 197	\$ 2,233	\$ 43	\$ 3,433
Charge-offs	-	(23 )	(44 )	-	(268 )	(1,130 )	(15 )	(1,480 )
Recoveries	-	-	-	-	63	65	2	130
Provision for credit losses	18	17	2	40	357	215	1	650
Ending balance	\$ 192	\$ 105	\$ 22	\$ 651	\$ 349	\$ 1,383	\$ 31	\$ 2,733

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Three months ended  
September 30, 2012

Beginning balance	\$99	\$ 65	\$ 42	\$ 553	\$ 532	\$ 1,744	\$ 41	\$3,076
Charge-offs	-	-	-	-	(268 )	(463 )	-	(731 )
Recoveries	-	-	-	-	63	16	1	80
Provision for credit losses	93	40	(20 )	98	22	86	(11 )	308
Ending balance	\$192	\$105	\$ 22	\$ 651	\$ 349	\$ 1,383	\$ 31	\$2,733

Ending balance:

individually evaluated for impairment	103	73	-	-	-	257	-	433
collectively evaluated for impairment	89	32	22	651	349	1,126	31	2,300

Loans:

Ending balance	35,889	23,074	8,162	58,793	86,116	85,409	1,371	298,814
Ending balance:								
individually evaluated for impairment	432	471	-	-	3,146	1,978	-	6,027
collectively evaluated for impairment	35,457	22,603	8,162	58,793	82,970	83,431	1,371	292,787

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September 30, 2011 - Unaudited

(in thousands)	Construction and land	Residential first lien	Residential junior lien	Commercial owner occupied	Commercial non-owner occupied	Commercial loans and leases	Commercial Consumer loans	Total
Allowance for credit losses:								
Nine months ended September 30, 2011								
Beginning balance	\$ 143	\$ 16	\$ 20	\$ 892	\$ 124	\$ 2,294	\$ 34	\$ 3,523
Charge-offs	-	-	-	-	-	(531 )	(21 )	(552 )
Recoveries	-	-	-	-	-	304	1	305
Provision for credit losses	26	1	-	229	12	443	29	740
Ending balance	\$ 169	\$ 17	\$ 20	\$ 1,121	\$ 136	\$ 2,510	\$ 43	\$ 4,016
Three months ended September 30, 2011								
Beginning balance	\$ 160	\$ 17	\$ 20	\$ 1,146	\$ 123	\$ 2,366	\$ 36	\$ 3,868
Charge-offs	-	-	-	-	-	(394 )	(16 )	(410 )
Recoveries	-	-	-	-	-	-	-	-
Provision for credit losses	9	-	-	(25 )	13	538	23	558
Ending balance	\$ 169	\$ 17	\$ 20	\$ 1,121	\$ 136	\$ 2,510	\$ 43	\$ 4,016
Ending balance: individually evaluated for impairment	-	-	-	1,033	-	112	-	1,145
collectively evaluated for impairment	169	17	20	88	136	2,398	43	2,871
Loans:								
Ending balance	36,809	23,365	10,089	46,513	70,816	82,405	1,212	271,209
Ending balance: individually evaluated for impairment	-	475	-	2,122	-	1,243	-	3,840
collectively evaluated for impairment	36,809	22,890	10,089	44,391	70,816	81,162	1,212	267,369

December 31, 2011

(in thousands)	Construction and land	Residential first lien	Residential junior lien	Commercial owner occupied	Commercial non-owner occupied	Commercial loans and leases	Commercial Consumer loans	Total
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Allowance for credit losses:

Beginning balance	\$ 143	\$ 16	\$ 20	\$ 892	\$ 124	\$ 2,294	\$ 34	\$ 3,523
Charge-offs	-	-	-	(1,033 )	-	(562 )	(21 )	(1,616 )
Recoveries	-	-	-	-	-	361	1	362
Provision for credit losses	31	95	44	752	73	140	29	1,164
Ending balance	\$ 174	\$ 111	\$ 64	\$ 611	\$ 197	\$ 2,233	\$ 43	\$ 3,433

Ending balance:

individually evaluated for impairment	-	68	44	-	-	1,161	-	1,273
collectively evaluated for impairment	174	43	20	611	197	1,072	43	2,160

Loans:

Ending balance	39,268	22,087	9,242	46,588	76,880	81,243	1,223	276,531
Ending balance:								
individually evaluated for impairment	-	611	44	1,988	2,783	3,498	9	8,933
collectively evaluated for impairment	39,268	21,476	9,198	44,600	74,097	77,745	1,214	267,598

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

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



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

September 30, 2012 - Unaudited								
	Construction and land	Residential first lien	Residential junior lien	Commercial owner occupied	Commercial non-owner occupied	Commercial loans and leases	Commercial Consumer loans	Total
(in thousands)								
Credit quality indicators:								
Not classified	\$35,457	\$22,841	\$8,162	\$58,793	\$85,726	\$83,867	\$1,371	\$296,217
Special mention	-	-	-	-	-	-	-	-
Substandard	432	233	-	-	390	1,542	-	2,597
Doubtful	-	-	-	-	-	-	-	-
Total	\$35,889	\$23,074	\$8,162	\$58,793	\$86,116	\$85,409	\$1,371	\$298,814

December 31, 2011								
	Construction and land	Residential first lien	Residential junior lien	Commercial owner occupied	Commercial non-owner occupied	Commercial loans and leases	Commercial Consumer loans	Total
(in thousands)								
Credit quality indicators:								
Not classified	\$39,268	\$21,476	\$9,198	\$44,600	\$76,880	\$78,014	\$1,214	\$270,650
Special mention	-	-	-	-	-	-	-	-
Substandard	-	611	44	1,988	-	3,229	9	5,881
Doubtful	-	-	-	-	-	-	-	-
Total	\$39,268	\$22,087	\$9,242	\$46,588	\$76,880	\$81,243	\$1,223	\$276,531

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

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

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

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

possible credit deterioration.

An aged analysis of past due loans are as follows:

(in thousands)	September 30, 2012 - Unaudited							Total
	Construction and land	Residential first lien	Residential junior lien	Commercial owner occupied	Commercial non-owner occupied	Commercial loans and leases	Consumer loans	
Analysis of past due loans:								
Accruing loans current	\$35,457	\$22,395	\$8,121	\$58,793	\$85,726	\$83,757	\$1,371	\$295,620
Accruing loans past due:								
31-59 days past due	-	238	41	-	-	110	-	389
60-89 days past due	-	208	-	-	-	-	-	208
Greater than 90 days past due	-	-	-	-	-	-	-	-
Total past due	\$-	\$446	\$41	\$-	\$-	\$110	\$-	\$597
Non-accrual loans	432	233	-	-	390	1,542	-	2,597
Total loans	\$35,889	\$23,074	\$8,162	\$58,793	\$86,116	\$85,409	\$1,371	\$298,814

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(in thousands)	December 31, 2011							Total
	Construction & land	Residential first lien	Residential junior lien	Commercial owner occupied	Commercial non-owner occupied	Commercial loans and leases	Commercial Consumer loans	
Analysis of past due loans:								
Accruing loans current	\$39,268	\$21,719	\$9,198	\$44,600	\$75,790	\$77,951	\$1,214	\$269,740
Accruing loans past due:								
31-59 days past due	-	-	-	-	-	-	-	-
60-89 days past due	-	-	-	-	1,000	63	-	1,063
Greater than 90 days past due	-	-	-	-	90	-	-	90
Total past due	\$-	\$-	\$-	\$-	\$1,090	\$63	\$-	\$1,153
Non-accrual loans	-	368	44	1,988	-	3,229	9	5,638
Total loans	\$39,268	\$22,087	\$9,242	\$46,588	\$76,880	\$81,243	\$1,223	\$276,531

Total loans either in non-accrual status or in excess of ninety days delinquent totaled \$2.6 million or .87% of total loans outstanding as of September 30, 2012 compared to \$5.7 million or 2.07% of total loans outstanding as of December 31, 2011.

The impaired loans for the nine months ended September 30, 2012 and the year ended December 31, 2011 are as follows:

(in thousands)	September 30, 2012 - Unaudited							Total
	Construction & land	Residential first lien	Residential junior lien	Commercial owner occupied	Commercial non-owner occupied	Commercial loans and leases	Commercial Consumer loans	
Impaired loans:								
Recorded investment	\$432	\$471	\$-	\$-	\$3,146	\$1,978	\$-	\$6,027
With an allowance recorded	432	233	-	-	-	584	-	1,249
With no related allowance recorded	-	238	-	-	3,146	1,394	-	4,778
Related allowance	103	73	-	-	-	257	-	433
Un-paid principal Nine months ended September 30, 2012	432	471	-	-	3,081	2,134	-	6,118

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Average balance of impaired loans	441	472	-	-	3,517	2,418	-	6,848
Interest income recognized	18	7	-	-	155	88	-	268
Three months ended September 30, 2012								
Average balance of impaired loans	432	472	-	-	3,510	2,265	-	6,679
Interest income recognized	\$18	\$ -	\$ -	\$ -	\$ 48	\$ 69	\$ -	\$135

December 31, 2011

(in thousands)	Residential		Commercial		Commercial		Commercial	
	Consumer & land	Residential first lien	Residential junior lien	owner occupied	non-owner occupied	loans and leases	Consumer loans	Total
Impaired loans:								
Recorded investment	\$-	\$ 611	\$ 44	\$ 1,988	\$ 2,783	\$ 3,498	\$ 9	\$8,933
With an allowance recorded	-	368	44	-	-	1,884	-	2,296
With no related allowance recorded	-	243	-	1,988	2,783	1,614	9	6,637
Related allowance	-	68	44	-	-	1,161	-	1,273
Un-paid principal	-	611	44	3,021	2,783	3,533	9	10,001
Average balance of impaired loans	-	609	44	3,044	2,778	3,593	9	10,078
Interest income recognized	\$-	\$ 23	\$ 2	\$ 52	\$ 114	\$ 157	\$ -	\$348

Nonaccrual loans included in impaired loans totaled \$2.6 million and \$5.6 million at September 30, 2012 and December 31, 2011, respectively. Interest income that would have been recorded if nonaccrual loans had been current and in accordance with their original terms was \$68 thousand for the first nine months of 2012.

Management routinely evaluates other real estate owned (“OREO”) based upon periodic appraisals. For the nine months ended September 30, 2012 the Bank transferred two properties into OREO totaling \$1.7 million, one of which was a residential property for \$112 thousand that was also sold in 2012. During 2011, the Bank transferred two loans totaling \$1.8 million, net of reserves, to OREO. For the nine months ended September 30, 2012 the Bank recorded an additional valuation allowance of \$48 thousand in non-interest expense for two properties whose current appraised value was less than the recorded OREO amount. For 2011 the Bank recorded a valuation allowance of \$393 thousand during the same nine month period.

The trouble debt restructured loans (“TDRs”) for September 30, 2012 and December 31, 2011 are as follows:

(dollars in thousands)	September 30, 2012 - Unaudited				
	Number of Loans	Non-Accrual Status	Number of Loans	Accrual Status	Total TDR's
Residential real estate - first lien	-	\$ -	-	\$ -	\$ -
Commercial real estate non-owner occupied	-	-	-	-	-
Commercial loans	3	637	-	-	637
	3	\$ 637	-	\$ -	\$ 637

(dollars in thousands)	December 31, 2011				
	Number of Loans	Non-Accrual Status	Number of Loans	Accrual Status	Total TDR's
Residential real estate - first lien	-	\$ -	1	\$ 240	\$ 240
Commercial real estate non-owner occupied	-	-	-	-	-
Commercial loans	5	751	-	-	751
	5	\$ 751	1	\$ 240	\$ 991

There have not been any defaults on loans classified as a TDR for the periods presented. One loan for \$387 thousand was restructured during the three months ended September 30, 2012.

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

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September 30, 2012 - Unaudited

	Not Performing to Modified Terms	Performing to Modified Terms	Total TDR's
(in thousands)			
Residential real estate - first lien			
Interest only payments	\$ -	\$ -	\$ -
Rate modification	-	-	-
Forbearance	-	-	-
Extension or other modification	-	-	-
Total residential real estate	-	-	-
Commercial loans			
Interest only payments	\$ -	\$ -	\$ -
Rate modification	-	-	-
Forbearance	-	-	-
Extension or other modification	637	-	637
Total commercial	637	-	637
Total TDR's	\$ 637	\$ -	\$ 637

(in thousands)	December 31, 2011		
	Not Performing to Modified Terms	Performing to Modified Terms	Total TDR's
Residential real estate - first lien			
Interest only payments	\$-	\$ -	\$ -
Rate modification	-	-	-
Forbearance	-	-	-
Extension or other modification	-	240	240
Total residential real estate	-	240	240
Commercial loans			
Interest only payments	\$-	\$ -	\$ -
Rate modification	-	-	-
Forbearance	353	-	353
Extension or other modification	398	-	398
Total commercial	751	-	751
Total TDR's	\$751	\$ 240	\$ 991

#### Note 5: Deposits

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

(dollars in thousands)	Unaudited		December 31,		
	September 30, 2012	% of Total	2011	% of Total	
Noninterest-bearing demand	\$79,934	28	% \$62,044	24	%
Interest-bearing checking	18,946	7	17,687	7	
Money market accounts	66,707	23	61,267	23	
Savings	12,262	4	10,644	4	
Certificates of deposit \$100,000 and over	74,844	26	79,718	30	
Certificates of deposit under \$100,000	34,733	12	31,282	12	
Total deposits	\$287,426	100	% \$262,642	100	%

#### Note 6: Stock Options, Awards and Warrants

The Company initially raised \$4,775,000 of capital by selling to its founders investment units consisting of one share of common stock and a fully detachable warrant equal to .25 shares of common stock per unit. The warrants were issued in recognition of the financial and organizational risk undertaken by the purchasers in the organizational

offering. The warrants are immediately exercisable and will expire ten (10) years from the date of issuance on August 8, 2014. As of September 30, 2012 there have not been any exercises of these warrants and the Company has outstanding warrants to purchase 119,376 shares at the price of \$10.00 per share.

The Company's stock incentive plans provide for awards of nonqualified and incentive stock options as well as vested and non-vested common stock awards. Employee stock options can be granted with exercise prices at the fair market value (as defined within the plan) of the stock at the date of grant and with terms of up to ten years. Except as otherwise permitted in the plan, upon termination of employment for reasons other than retirement, permanent disability or death, the option exercise period is reduced or the options are canceled.

Stock options and stock awards may also be granted to non-employee members of the Board of Directors as compensation for attendance and participation at meetings of the Board of Directors and meetings of the various committees of the Board. The Company previously maintained an Advisory Board, for which non-employee members were compensated via stock options for meeting attendance. These nonqualified stock options can be granted with terms up to ten years, vest immediately, and are fully exercisable at time of grant. Stock awards granted to directors are based on the fair value of the awards, which is generally the market price of the common stock on the measurement date, and vest immediately. For the nine months ended September 30, 2012 the Company's granted 6,211 shares of stock to directors as compensation for their service.



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

	Unaudited September 30, 2012	
	Shares	Weighted Average Exercise Price
Balance at January 1, 2012	395,351	\$ 11.16
Granted	-	-
Exercised	-	-
Forfeited		
Balance at September 30, 2012	395,351	\$ 11.16
Exercisable at September 30, 2012	394,751	\$ 11.17
Weighted average fair value of options granted during the year		\$ -

The intrinsic value of a stock option is the amount that the market value of the underlying stock exceeds the exercise price of the option. Based upon a fair market value of \$7.15 at September 30, 2012 the options outstanding had no aggregate intrinsic value. There have not been any exercises of options during the first nine months of 2012.

#### **Note 7: Profit Sharing Plan**

The Company sponsors a defined contribution retirement plan through a Section 401(k) profit sharing plan. Employees may contribute up to 15% of their pretax compensation. Participants are eligible for matching Company contributions up to 4% of eligible compensation dependent on the level of voluntary contributions. Company matching contributions totaled \$79.7 thousand for the nine months ended September 30, 2012 and \$72.8 thousand for the same period in 2011. The Company's matching contributions vest immediately.

#### **Note 8: Income per Common Share**

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

Unaudited	Unaudited
Nine months ended	Three months ended
September 30,	September 30,

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(dollars in thousands, except per share data)	2012	2011	2012	2011
Net income	\$1,182	\$1,031	\$387	\$337
Preferred dividends	(471 )	(278 )	(157 )	(115 )
Net income available to common shareholders (numerator)	\$711	\$753	\$230	\$222
<b>BASIC</b>				
Average common shares outstanding (denominator)	3,012,288	2,637,829	3,748,248	2,639,780
Basic income per common share	\$0.24	\$0.29	\$0.06	\$0.08
<b>DILUTED</b>				
Average common shares outstanding	3,012,288	2,637,829	3,748,248	2,639,780
Diluted effect of stock options and warrants	-	-	-	-
Diluted average common shares outstanding (denominator)	3,012,288	2,637,829	3,748,248	2,639,780
Diluted income per common share	\$0.24	\$0.29	\$0.06	\$0.08
Stock options and warrants outstanding that are anti-dilutive and thus excluded from calculation of diluted number of shares presented above	514,127	491,576	514,127	491,576

**Note 9: Risk-Based Capital**

The Federal Deposit Insurance Corporation Improvement Act of 1991 (“FDICIA”) required that the federal regulatory agencies adopt regulations defining five capital tiers for banks: well capitalized, adequately capitalized, undercapitalized, significantly undercapitalized and critically undercapitalized. Failure to meet minimum capital requirements can initiate certain mandatory and possibly additional discretionary actions by regulators that, if undertaken, could have a direct material effect on the Company’s financial statements. Quantitative measures, established by the regulators to ensure capital adequacy, require that the Bank and Bancorp maintain minimum ratios (set forth below) of capital to risk-weighted assets. Under the guidelines, capital is compared to the relative risk related to the balance sheet. The capital amounts and classification are also subject to qualitative judgments by the regulators about components, risk weightings, and other factors.

Management believes that, as of September 30, 2012 and December 31, 2011 the Bank met all capital adequacy requirements to which it is subject.

(dollars in thousands)	Actual		For capital adequacy purposes		To be well capitalized under the FDICIA prompt corrective action provisions	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
<b>As of September 30, 2012: (unaudited)</b>						
Total capital (to risk-weighted assets)						
Howard Bank	\$39,196	12.79%	\$24,525	8.00 %	\$30,656	10.00 %
Howard Bancorp	\$48,974	15.83%	\$24,742	8.00 %	N/A	
Tier 1 capital (to risk-weighted assets)						
Howard Bank	\$36,466	11.90%	\$12,262	4.00 %	\$18,394	6.00 %
Howard Bancorp	\$46,241	14.95%	\$12,371	4.00 %	N/A	
Tier 1 capital (to average assets) (Leverage ratio)						
Howard Bank	\$36,466	10.10%	\$14,448	4.00 %	\$18,060	5.00 %
Howard Bancorp	\$46,241	12.79%	\$14,457	4.00 %	N/A	
<b>As of December 31, 2011:</b>						
Total capital (to risk-weighted assets)						
Howard Bank	\$38,172	13.75%	\$22,214	8.00 %	\$27,768	10.00 %
Howard Bancorp	\$40,127	14.36%	\$22,349	8.00 %	N/A	
Tier 1 capital (to risk-weighted assets)						
Howard Bank	\$34,739	12.51%	\$11,107	4.00 %	\$16,661	6.00 %
Howard Bancorp	\$36,694	13.14%	\$11,174	4.00 %	N/A	
Tier 1 capital (to average assets) (Leverage ratio)						
Howard Bank	\$34,739	10.92%	\$12,725	4.00 %	\$15,907	5.00 %

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Howard Bancorp                                      \$36,694    11.52%    \$ 12,737            4.00 %    N/A

The Bank is currently prohibited from paying dividends without the prior approval of the Commissioner.

**Note 10: Common Stock Offering**

On July 20, 2012, Bancorp closed its previously announced common stock offering, pursuant to an effective registration statement, and concurrent private placement of its common stock. Bancorp raised \$10.2 million of additional capital and issued 1,396,364 shares of its common stock as of the closing date of the offerings. The following table represents the additional capital raised and the number of shares issued under each segment of the offerings:

	Gross Proceeds \$	Shares Issued #
Rights Offering	1,778,039	243,567
Public Offer	4,264,616	584,194
Private Placement	4,150,802	568,603
Total	10,193,457	1,396,364

### **Note 11: Preferred Stock**

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

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

### **Note 12: Fair Value**

FASB ASC Topic 820 "Fair Value Measurements" defines fair value as the exchange price that would be received for an asset or paid to transfer a liability (an exit price) in the principal or most advantageous market for the asset or liability in an orderly transaction between market participants on the measurement date. FASB ASC Topic 820 also establishes a fair value hierarchy, which requires an entity to maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair value.

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

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

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

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

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

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

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

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

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

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

The following table sets forth the Company's financial assets and liabilities that were accounted for or disclosed at fair value on a recurring basis as of September 30, 2012 and December 31, 2011.

<b>September 30, 2012</b> (unaudited)	Carrying Value (Fair Value)	Quoted Price in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
(in thousands)				
Investment securities:				
U.S. Federal agencies	\$ 35,544	\$ -	\$ 35,544	\$ -
Mortgage-backed securities	408	-	408	-
Loans held for sale	573	-	573	-

The following table sets forth the Company's financial assets and liabilities that were accounted for or disclosed at fair value on a nonrecurring basis as of September 30, 2012 and December 31, 2011.

<b>September 30, 2012</b> - (unaudited)	Quoted Price in	Significant
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(in thousands)	Carrying Value (Fair Value)	Active Markets for Identical Assets (Level 1)	Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Other real estate owned	\$ 2,903	\$ -	\$ -	\$ 2,903
Impaired loans:				
Construction and land	432	-	-	432
Residential - first lien	471	-	-	471
Residential - junior lien	-	-	-	-
Commercial - owner occupied	-	-	-	-
Commercial - non-owner occupied	3,144	-	-	3,144
Commercial loans and leases	1,980	-	-	1,980
Consumer	-	-	-	-



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December 31, 2011	Carrying Value (Fair Value)	Quoted Price in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
(in thousands)				
Other real estate owned	\$ 1,885	\$ -	\$ -	\$ 1,885
Impaired loans:				
Construction and land	-	-	-	-
Residential - first lien	611	-	-	611
Residential - junior lien	44	-	-	44
Commercial - owner occupied	1,988	-	-	1,988
Commercial - non-owner occupied	2,783	-	-	2,783
Commercial loans and leases	3,498	-	-	3,498
Consumer	9	-	-	9

The following table provides a reconciliation of all assets measured at fair value on a nonrecurring basis using significant unobservable inputs for the nine months ended September 30, 2012 and the twelve months ended December 31, 2011.

(in thousands)	Foreclosed Properties	Impaired Loans
Balance at December 31, 2011	\$ 1,885	\$ 8,933
Total net gain (losses) for the year included in:		
Gain (loss) on sale of foreclosed properties	(131 )	-
Other comprehensive gain (loss)	-	-
Purchase and sales, net	(422 )	-
Net transfers in (out)	1,598	(2,906 )
Valuation allowance	(27 )	-
<b>Balance at September 30, 2012 - Unaudited</b>	<b>\$ 2,903</b>	<b>\$ 6,027</b>

(in thousands)	Foreclosed Properties	Impaired Loans
Balance at December 31, 2010	\$ 3,024	\$ 9,433
Total net gain (losses) for the year included in:		
Gain on sale of foreclosed properties	459	-
Other comprehensive gain (loss)	-	-
Purchase and sales, net	(2,625 )	-
Net transfers in (out)	1,804	218
Valuation allowance	(777 )	(718 )
Balance at December 31, 2011	\$ 1,885	\$ 8,933

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The following table presents required information in accordance with ASC Topic 825 “Financial Instruments” at September 30, 2012 and December 31, 2011. The fair value of a financial instrument is the amount at which the instrument could be exchanged in a current transaction between willing parties, other than in a forced or liquidation sale. Fair value estimates are based on quoted market prices where available or calculated using present value techniques. Since quoted market prices are not available on many of our financial instruments, estimates may be based on the present value of estimated future cash flows and estimated discount rates. These financial assets and liabilities have not been recorded at fair value,

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

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

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

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

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

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

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

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

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

**September 30, 2012** - Unaudited  
Quoted Significant  
Price

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(in thousands)	Carrying Amount	Fair Value	December 31, 2011		
			in Active Markets for Identical Assets (Level 1)	Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
<b>Financial Assets</b>					
Cash and cash equivalents	\$ 18,336	\$ 18,336	\$ -	\$ 18,336	0
Nonmarketable equity securities	1,205	1,205	-	1,205	0
Loans	299,387	304,950	-	-	304,950
<b>Financial Liabilities</b>					
Deposits	287,426	286,789	-	286,789	0
Short-term borrowings	27,619	27,619	-	27,619	0
Long-term borrowings	6,000	6,028	-	6,028	0

(in thousands)	Carrying Amount	Fair Value	December 31, 2011		
			Quoted Price in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
<b>Financial Assets</b>					
Cash and cash equivalents	\$ 18,205	\$ 18,205	\$ -	\$ 18,205	0
Nonmarketable equity securities	1,313	1,313	-	1,313	0
Loans	277,177	280,653	-	-	280,653
<b>Financial Liabilities</b>					
Deposits	262,642	262,412	-	262,412	0
Short-term borrowings	12,984	12,984	-	12,984	0
Long-term borrowings	10,000	10,052	-	10,052	0

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

This section is intended to help potential investors understand our financial performance through a discussion of the factors affecting our consolidated financial condition. This section should be read in conjunction with the Consolidated Financial Statements and notes to the consolidated financial statements.

### **Overview**

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

We are headquartered in Ellicott City, Maryland and we consider our primary market area to be Howard County, Maryland and Anne Arundel County, Maryland. Our secondary market area, primarily for commercial lending, includes the Maryland counties of Baltimore, Carroll, Frederick, Montgomery and Prince George's as well as Baltimore City. We engage in a general commercial banking business, making various types of loans and accepting deposits. We market our financial services to small to medium sized businesses and their owners, professionals and executives, and high-net-worth individuals. Our loans are primarily funded by core deposits of customers in our market.

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

Our results of operations depend mainly on our net interest income, which is the difference between the interest income we earn on our loan and investment portfolios and the interest expense we pay on deposits and borrowings. Results of operations are also affected by provisions for credit losses, noninterest income and noninterest expense.

Our noninterest expense consists primarily of compensation and employee benefits, as well as office occupancy, deposit insurance and general administrative and data processing expenses. Our operations are significantly affected by general economic and competitive conditions, particularly with respect to changes in interest rates, government policies and actions of regulatory authorities. Future changes in applicable law, regulations or government policies may materially affect our financial condition and results of operations.

Bancorp's total assets increased by over \$45 million or 14.1% when comparing September 30, 2012 assets of \$368.5 million to the \$323.1 million at December 31, 2011. Total loans outstanding of \$298.8 million at the end of September 2012, showed an increase of 8.1% compared to total loans of \$276.5 million on December 31, 2011. Demand deposits, which not only represent the lowest cost source of funding available to a bank, but also are most reflective of the core customer relationships targeted by the Bank, grew from \$62.0 million at December 31, 2011 to \$79.9 million at the end of the third quarter of 2012, representing growth in this highly coveted deposit category of \$17.9 million or 28.8%. Total deposits grew by \$24.8 million or 9.4% when comparing September 30, 2012 to December 31, 2011. Because of the significant increases in deposits, even after funding the 8.1% loan growth, the Bank was able to utilize the additional deposits to increase our balance sheet liquidity measures.

Through the end of the third quarter of 2012 net income was \$1.2 million, which represents an increase of 14.6% over net income for the nine months ended September 30, 2011. Net interest income for the first nine months of 2012 was \$10.0 million versus \$9.3 million for the first nine months of 2011, an increase of approximately \$639 thousand or 6.9%. Noninterest income for the first nine months of 2012 compared to the first nine months of 2011 increased \$46 thousand or 9.2% while noninterest expense increased \$486 thousand or 6.6%. Total noninterest income was \$549 thousand for the nine months ended September 30, 2012, compared to a total of \$503 thousand for the same period in 2011. For 2012, noninterest income would have reflected a \$177 thousand or 35.2% increase over the prior year, but 2012 was impacted by a loss on the sale of one property classified as other real estate owned ("OREO") of \$131 thousand in the first quarter of 2012. Total noninterest expenses for the nine months ended September 30, 2012 was \$7.8 million compared to \$7.4 million for the same period in 2011. This represent a \$486 thousand or a 6.6% increase.

We closed our initial public offering and a concurrent private placement, pursuant to which we issued a total of 1,396,364 shares of our common stock, for total gross proceeds of \$10.2 million on July 20, 2012. The net proceeds of the offering increased our capital levels, which will permit additional growth in our loan levels and asset size. This growth may be either organic growth, which could take a longer time to occur, or growth that could come more quickly via merger or acquisition of other financial institutions. As such growth is realized, our operating results will reflect the additional income generated from the higher levels of earning assets.

## Critical Accounting Policies

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

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

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

We account for income taxes under the asset/liability method. We recognize deferred tax assets for the future consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax basis, as well as operating loss and tax credit carry-forwards. We measure deferred tax assets and liabilities using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. We recognize the effect on deferred tax assets and liabilities of a change in tax rates in income in the period indicated by the enactment date. We establish a valuation allowance for deferred tax assets when, in the judgment of management, it is more likely than not that such deferred tax assets will not become realizable. The judgment about the level of future taxable income is dependent to a great

extent on matters that may, at least in part, be beyond our control. It is at least reasonably possible that management's judgment about the need for a valuation allowance for deferred tax assets could change in the near term.

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

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

A comparison between September 30, 2012 and December 31, 2011 balance sheets are presented below.

#### **Assets**

Total assets increased \$45.4 million, or 14.1%, to \$368.5 million at September 30, 2012 compared to \$323.1 million at December 31, 2011. This asset growth was primarily due to a \$22.6 million increase in investment securities and growth of \$22.3 million in total loans. The asset growth was funded primarily from increases in customer deposits and commercial customers overnight sweep agreements. Deposits increased from \$262.6 million at December 31, 2011 to \$287.4 million at September 30, 2012, an increase of \$24.8 million or 9.4%. From a funding perspective, most important was the growth in noninterest-bearing deposits of \$17.9 million or 28.8% from \$62.0 million at December 31, 2011 to \$79.9 million at September 30, 2012. Additional funding for asset growth came from securities sold under agreement to repurchase and other short term borrowings which increased \$14.6 million to \$27.6 million at September 30, 2012 from \$13.0 million at December 31, 2011.



## Securities Available for Sale

We currently hold both U.S. agency securities and mortgage backed securities in our securities portfolio, all of which are classified as available for sale. Our securities portfolio is used to provide the required collateral for funding via commercial customer repurchase agreements as well as to provide sufficient liquidity to fund our loans and provide funds for withdrawals of deposited funds. At September 30, 2012 we held an investment in stock of the Federal Home Loan Bank of Atlanta (“FHLB”) of \$1.2 million compared to \$1.3 million held at December 31, 2011. This investment, which is required for continued membership, is based partially upon the dollar amount of borrowings outstanding from the FHLB. These investments are carried at cost. We have never held stock in Fannie Mae or Freddie Mac.

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

(in thousands)	September 30, 2012		December 31, 2011	
	Amortized Cost	Estimated Fair Value	Amortized Cost	Estimated Fair Value
U.S. Federal agencies	\$ 35,536	\$ 35,544	\$ 12,774	\$ 12,773
Mortgage-backed	380	408	568	603
Total	\$ 35,916	\$ 35,952	\$ 13,342	\$ 13,376

We had securities available for sale of \$36.0 million and \$13.4 million at September 30, 2012 and December 31, 2011, respectively, which were recorded at fair value. This represents an increase of \$22.6 million, or 168.8%, from the prior year end. We did not record any gains or losses on the sales or calls of securities or mortgage backed securities in either period presented. At September 30, 2012 and December 31, 2011, \$16.2 million and \$5.8 million fair value of securities, respectively, was pledged as collateral for repurchase agreements.

With respect to our total portfolio of securities available for sale, we held certain securities that had unrealized losses of \$2 thousand at both September 30, 2012 and December 31, 2011. The minimal changes in the fair value of these securities resulted primarily from interest rate fluctuations. We do not intend to sell these securities nor is it more likely than not that we would be required to sell these securities before their anticipated recovery, and we believe the collection of the investment and related interest is probable. Based on this analysis, we consider all of the unrealized losses to be temporary impairment losses.

## Loan and Lease Portfolio

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Total loans and leases increased by \$22.3 million or 8.1%, to \$298.8 million at September 30, 2012 from \$276.5 million at December 31, 2011. At September 30, 2012, total loans and leases were 81.1% of total assets, down slightly compared to 85.6% of total assets at December 31, 2011. Loan and leases growth throughout the banking industry has been impacted by decreased loan demand resulting from uncertain economic conditions.

The following table sets forth the composition of our loan and lease portfolio at the dates indicated. We had loans held for sale of \$573 thousand at September 30, 2012, and \$646 thousand at December 31, 2011.

(in thousands)	Unaudited					
	September 30, 2012	% of Total	December 31, 2011	% of Total		
Real estate						
Construction and land	\$35,889	12.0	% \$39,268	14.2	%	
Residential - first lien	23,074	7.7	22,087	8.0		
Residential - junior lien	8,162	2.7	9,242	3.3		
Total residential real estate	31,236	10.5	31,329	11.3		
Commercial - owner occupied	58,793	19.7	46,588	16.8		
Commercial - non-owner occupied	86,116	28.8	76,880	27.8		
Total commercial real estate	144,909	48.5	123,468	44.6		
Total real estate loans	212,034	71.0	194,065	70.2		
Commercial loans and leases	85,409	28.6	81,243	29.4		
Consumer	1,371	0.5	1,223	0.4		
Total loans and leases	\$298,814	100.0	% \$276,531	100.0	%	

## Deposits

Our deposits increased from \$262.6 million at December 31, 2011 to \$287.4 million at September 30, 2012, an increase of \$24.8 million or 9.4%. The increase resulted primarily from a \$17.9 million or 28.8% increase in noninterest-bearing checking accounts, which increased from \$62.0 million at December 31, 2011 to \$79.9 million at September 30, 2012. In addition, with the exception of certificates of deposit all other interest bearing accounts increased \$8.3 million or 9.3% from December 31, 2011 to September 30, 2012. Certificates of deposits declined \$1.4 million or 1.3% to \$109.6 million at September 30, 2012 from \$111.0 million at December 31, 2011. The growth in the non-maturity deposits and other sources was more than sufficient to fund the growth in loans and assets during the nine month period.

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

(dollars in thousands)	September 30,		December 31,		
	2012	% of Total	2011	% of Total	%
Noninterest-bearing demand	\$79,934	<b>28</b>	% \$62,044	24	%
Interest-bearing checking	18,946	7	17,687	7	
Money market accounts	66,707	23	61,267	23	
Savings	12,262	4	10,644	4	
Certificates of deposit \$100,000 and over	74,844	26	79,718	30	
Certificates of deposit under \$100,000	34,733	12	31,282	12	
Total deposits	\$287,426	<b>100</b>	% \$262,642	100	%

## Borrowings

Customer deposits remain the primary source utilized to meet funding needs. Borrowings consist of overnight unsecured master notes, overnight securities sold under agreement to repurchase (“repurchase agreements”) and FHLB advances. Our borrowings totaled \$33.6 million at September 30, 2012 and \$23.0 million at December 31, 2011, respectively. Short-term borrowings totaled \$27.6 million at September 30, 2012 and \$13.0 million at December 31, 2011. Short term borrowing at September 30, 2012 consisted of master notes, repurchase agreements and FLHB advances totaling \$1.5 million, \$16.1 million and \$10.0 million, respectively compared to these borrowings at December 31, 2011 totaling \$1.2 million, \$5.8 million and \$6.0 million, respectively. We had three long-term FHLB advances outstanding totaling \$6.0 million at September 30, 2012 compared to five FHLB advances outstanding totaling \$10 million at December 31, 2011.

## Shareholders' Equity

Total shareholders' equity increased by \$9.7 million or 26.5% from \$36.6 million at December 31, 2011 to \$46.3 million at September 30, 2012. The increase in shareholders' equity is primarily the result of the common stock offering and retention of the earnings for the first nine months of 2012, net of preferred dividends paid. On July 20, 2012, Bancorp closed its previously announced common stock offering, pursuant to an effective registration statement, and concurrent private placement of its common stock. Bancorp raised \$10.2 million in gross proceeds and issued 1,396,364 shares of its common stock as of the closing date of the offerings.

Total shareholders' equity at September 30, 2012 represents a capital to asset ratio of 12.57%, while the total shareholders' equity at December 31, 2011 represents a capital to asset ratio of 11.34%. Even though capital levels increased, the overall growth in asset levels resulted in a decline in the capital to asset ratio.

### **Average Balance and Yields**

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

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(dollars in thousands)	Nine months ended September 30,					
	2012			2011		
	Average Balance	Income / Expense	Yield / Rate	Average Balance	Income / Expense	Yield / Rate
<b>Earning assets</b>						
<b>Loans and leases: <sup>1</sup></b>						
Commercial loans and leases	\$79,080	\$3,226	<b>5.45 %</b>	\$85,156	\$3,595	5.64 %
Commercial real estate	131,227	5,412	5.51	104,857	4,604	5.87
Construction and land	38,107	1,544	5.41	33,164	1,240	5.00
Residential real estate	31,138	1,147	4.92	33,101	1,242	5.02
Consumer	1,679	58	4.62	1,266	47	4.96
Total loans and leases	281,231	11,386	5.41	257,544	10,728	5.57
Federal funds sold	27,827	46	0.22	11,484	17	0.20
<b>Securities: <sup>2</sup></b>						
U.S Gov agencies	21,835	39	0.24	13,399	36	0.36
Mortgage-backed	504	18	4.69	865	32	4.95
Other investments	1,190	18	1.98	1,489	14	1.26
Total securities	23,529	74	0.42	15,753	82	0.70
Total earning assets	332,586	11,506	4.62	284,781	10,827	5.08
Cash and due from banks	3,690			3,040		
Bank premises and equipment, net	9,664			9,201		
Other assets	6,445			9,369		
Less: allowance for credit losses	(3,269 )			(3,840 )		
Total assets	\$349,116			\$302,551		
<b>Interest-bearing liabilities</b>						
<b>Deposits:</b>						
Interest-bearing demand accounts	\$17,678	47	0.36	\$16,024	52	0.43
Money market	64,321	280	0.58	62,725	329	0.70
Savings	11,576	47	0.54	12,340	61	0.66
Time deposits \$100,000 and over	61,815	554	1.20	57,911	530	1.22
Other time deposits	51,747	442	1.14	40,548	328	1.08
Total interest-bearing deposits	207,137	1,371	0.88	189,548	1,300	0.92
Short-term borrowings	23,303	125	0.72	24,219	137	0.76
Long-term borrowings	7,248	53	0.97	6,872	72	1.40
Total interest-bearing funds	237,689	1,549	0.87	220,639	1,509	0.91
Noninterest-bearing deposits	71,017			51,050		
Other liabilities and accrued expenses	842			807		
Total liabilities	309,547			272,496		
Shareholders' equity	39,569			30,055		
Total liabilities & shareholders' equity	\$349,116			\$302,551		
Net interest rate spread <sup>3</sup>		\$9,957	<b>3.75 %</b>		\$9,318	4.17 %
Effect of noninterest-bearing funds			0.25			0.21
Net interest margin on earning assets <sup>4</sup>			<b>4.00 %</b>			4.37 %

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

(2) *Available for sale securities are presented at amortized cost*

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

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

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(dollars in thousands)	Three months ended September 30,					
	2012			2011		
	Average Balance	Income / Expense	Yield / Rate	Average Balance	Income / Expense	Yield / Rate
<b>Earning assets</b>						
<b>Loans and leases: <sup>1</sup></b>						
Commercial loans and leases	\$81,412	\$ 1,084	<b>5.30</b> %	\$85,734	\$ 1,172	5.42 %
Commercial real estate	136,046	1,861	5.44	106,898	1,605	5.96
Construction and land	37,577	510	5.40	34,839	453	5.16
Residential real estate	31,296	381	4.84	33,476	421	4.99
Consumer	1,615	18	4.43	1,196	15	4.98
Total loans and leases	287,946	3,854	5.32	262,143	3,666	5.55
Federal funds sold	25,944	15	0.22	11,482	6	0.21
<b>Securities: <sup>2</sup></b>						
U.S. Gov agencies	29,198	18	0.24	13,879	13	0.37
Mortgage-backed	434	5	4.64	779	9	4.58
Other investments	1,051	6	2.18	1,451	8	2.19
Total securities	30,683	29	0.37	16,109	30	0.74
Total earning assets	344,573	3,897	4.50	289,734	3,702	5.07
Cash and due from banks	3,762			3,469		
Bank premises and equipment, net	9,740			9,192		
Other assets	6,244			9,569		
Less: allowance for credit losses	(2,831 )			(3,966 )		
Total assets	\$361,488			\$307,998		
<b>Interest-bearing liabilities</b>						
<b>Deposits:</b>						
Interest-bearing demand accounts	\$17,887	13	0.29	\$15,171	17	0.44
Money market	65,418	77	0.47	60,177	107	0.71
Savings	12,164	13	0.43	11,328	18	0.63
Time deposits \$100,000 and over	60,557	181	1.19	62,286	187	1.19
Other time deposits	50,737	147	1.16	42,507	112	1.05
Total interest-bearing deposits	206,763	432	0.83	191,469	441	0.91
Short-term borrowings	26,341	40	0.60	23,638	50	0.84
Long-term borrowing	6,000	14	0.96	6,587	18	1.09
Total interest-bearing funds	239,104	486	0.81	221,694	509	0.91
Noninterest-bearing deposits	77,121			54,685		
Other liabilities and accrued expenses	708			888		
Total liabilities	316,934			277,267		
Shareholders' equity	44,554			30,731		
Total liabilities & shareholders' equity	\$361,488			\$307,998		
Net interest rate spread <sup>3</sup>		\$ 3,411	<b>3.69</b> %		\$ 3,193	4.16 %
Effect of noninterest-bearing funds			0.25			0.21
Net interest margin on earning assets <sup>4</sup>			<b>3.94</b> %			4.37 %

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

(2) Available for sale securities are presented at amortized cost

- (3) *Net interest rate spread represents the difference between the yield on average interest-earning assets and the cost of average interest-bearing liabilities.*
- (4) *Net interest margin represents net interest income divided by average total interest-earning assets.*



**Rate/Volume Analysis**

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

(in thousands)	Nine months ended September 30, 2012 vs. 2011			Three months ended September 30, 2012 vs. 2011		
	Total	Rates	Volumes <sup>1</sup>	Total	Rates	Volumes <sup>1</sup>
Interest earned on:						
Loans and leases:						
Commercial loans and leases	\$ (369 )	\$ (167 )	\$ (202 )	\$ (88 )	\$ (108 )	\$ 20
Commercial real estate	808	(381 )	1,189	256	(549 )	806
Construction and land	304	137	167	57	84	(27 )
Residential real estate	(95 )	(32 )	(63 )	(40 )	(50 )	10
Consumer	11	(5 )	15	3	(6 )	9
Taxable securities	(8 )	(43 )	36	(1 )	(59 )	58
Federal funds sold	29	2	26	9	2	7
Interest-bearing deposits in other banks	-	-	-	-	-	-
Total interest income	679	(489 )	1,168	195	(688 )	883
Interest paid on:						
Savings deposits	(14 )	(15 )	1	(5 )	(22 )	17
Checking plus interest deposits	(5 )	(12 )	8	(4 )	(24 )	20
Money market accounts	(49 )	(75 )	26	(30 )	(142 )	112
Time deposit \$100,000 and over	24	(15 )	39	(6 )	(0 )	(6 )
Other time deposits	114	24	90	35	47	(11 )
Short-term borrowings	(12 )	(9 )	(2 )	(10 )	(57 )	47
Long-term borrowing	(19 )	(30 )	10	(4 )	(9 )	5
Total interest expense	40	(132 )	172	(23 )	(207 )	184
Net interest earned	\$ 639	\$ (357 )	\$ 996	\$ 218	\$ (481 )	\$ 699

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

**Comparison of Results of Operations**

*A comparison between the nine months ended September 30, 2012 and September 30, 2011 is presented below.*

## **General**

Net income available to common shareholders decreased \$42 thousand, or 5.6%, to \$711 thousand for the nine months ended September 30, 2012 compared to \$753 thousand for the nine months ended September 30, 2011. The decrease was primarily due to a \$193 thousand, or 69.4%, increase in dividends paid on preferred stock due to the outstanding amount of preferred stock increasing from \$6.0 million to \$12.6 million at the end of the third quarter of 2011. This increase was a result of our redeeming the preferred stock issued as part of the U.S. Department of Treasury's Troubled Asset Relief Program Capital Purchase Program and issuing new preferred stock to the U.S. Treasury as part of its Small Business Lending Fund (SBLF) program in September 2011. Partially offsetting the increased dividends was a \$639 thousand or 6.9% increase in net interest income, which consisted of an increase of \$679 thousand, or 6.3%, in interest income with an increase of only \$40 thousand, or 2.7%, in interest expense. Non-interest income during the first nine months of 2012 increased \$46 thousand compared to the first nine months of, 2011, primarily as a result of the \$171 thousand in additional revenues from loan related fees and increased mortgage banking revenues partially offset by a \$131 thousand loss on the sale of other real estate owned (for which there was no comparable gain or loss in the first nine months of 2011). Non-interest expenses increased \$486 thousand or 6.6% period over period, mostly from increases in staff with the opening of a new branch, and other required staffing additions to support a growing organization.

## **Interest Income**

Interest income increased \$679 thousand, or 6.3%, to \$11.5 million for the nine months ended September 30, 2012 compared to \$10.8 million for the same period 2011. The increase was primarily due to a \$658 thousand, or 6.1%, increase in interest income on loans. The increase in interest income on loans was due to a 9.2% increase in the average balance of the loan portfolio compared to the nine months ended September 30, 2011, partially offset by a decrease in the average yield on such loans. In addition to loans, other sources of interest income increased by \$21 thousand over the same period in 2011, primarily as a result of a \$24.1 million increase in the average balances of these other forms of interest earning assets. These other interest earning assets, consisting of federal funds sold and investment securities increased 88.6% on average, from their averages during the first nine months of 2011.

## **Interest Expense**

Interest expense remained relatively unchanged, increasing \$40 thousand, or 2.7%, totaling \$1.5 million for both the nine months ended September 30, 2012 and the same period 2011. This small increase was primarily attributable to an increase based upon our growth in average interest-bearing deposits and borrowings, offset by reductions in the average rates paid on these sources of funds. For the first nine months of 2012 versus 2011, average interest bearing funds increased by \$17 million or 8%, while the average rates paid on these funds decreased by 4 basis points from 91 basis points in 2011 to 87 basis points for 2012.

## **Net Interest Income**

Net interest income is the Bank's largest component of revenue. Net interest income increased \$639 thousand, or 6.9%, during the nine months ended September 30, 2012 compared to the nine months ended September 30, 2011. As noted above, the increase in net interest income was due to an increase of \$679 thousand, or 6.3%, in interest income with only a \$40 thousand or 2.7%, increase in interest expense during the nine month period.

## **Provision for Credit Losses**

We establish a provision for credit losses, which is a charge to earnings, in order to maintain the allowance for credit losses at a level we consider adequate to absorb credit losses incurred in the loan portfolio that are both probable and reasonably estimable at the balance sheet date. In determining the level of the allowance for credit losses, management considers past and current loss experience, evaluations of real estate collateral, current economic conditions, volume and type of lending, adverse situations that may affect a borrower's ability to repay a loan and the levels of

nonperforming loans. The amount of the allowance is based on estimates and actual losses may vary from such estimates as more information becomes available or economic conditions change. This evaluation is inherently subjective as it requires estimates that are susceptible to significant revision as circumstances change as more information becomes available. The allowance for credit losses is assessed on a quarterly basis and provisions are made for credit losses as required in order to maintain the allowance.

Based on management's evaluation of the above factors, we had a provision for credit losses of \$650 thousand for the nine months ended September 30, 2012 compared to \$740 thousand for the same period in 2011, a decrease of \$90 thousand, or 12.2%. A large portion of the decrease in the provision for credit losses was attributable to the reduction in non-performing loans. The reduction in loss provisions due to improvements in asset quality, was more than sufficient to cover the provisioning required by the growth in loans. Nonperforming loans totaled \$2.6 million at September 30, 2012, which represented .89% of total loans, while at September 30, 2011, nonperforming loans were \$3.8 million or 1.42 % of total loans.

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

## **Noninterest Income**

Noninterest income was \$549 thousand for the nine months ended September 30, 2012 compared to \$503 thousand for the nine months ended September 30, 2011, representing a \$46 thousand increase. Service charges on deposit accounts, which consist of account activity fees such as overdraft fees and other traditional banking fees, increased slightly by 2.6% for the first nine months of 2012 compared to the same period in 2011. The Bank began selling mortgage loans into the secondary market during 2010. The income derived from this activity increased \$92 thousand for the nine months ended September 30, 2012 compared to the same period in 2011 as the Company hired a dedicated mortgage loan originator to increase the volume of loans closed and sold. Other operating income consists mainly of certain loan fees and non-depository account transaction based fees. Various fees such as wire and ATM increased \$31 thousand due to increased customer activity over the same period. Additionally other operating income for 2012 benefited from a \$49.9 thousand onetime pre-payment penalty collected on a commercial credit relationship. Partially offsetting these increases was a net loss of \$131 thousand on the sale of one property held in OREO which was recorded in the first nine months of 2012, while no such loss was incurred in the first nine months of 2011.

## **Noninterest Expenses**

Noninterest expenses increased by \$486 thousand or 6.6%, and were \$7.8 million for the nine months ended September 30, 2012 compared to \$7.4 million for the nine months ended September 30, 2011. This increase was due primarily to increases in salaries and employee benefits expenses, which is the largest component of noninterest expense, which increased \$539 thousand or 14.8% in the first nine months of 2012 compared to the same period in 2011, due to our continued growth. We also recorded increases in occupancy costs resulting from our branch expansion, and increases in professional fees which increased \$195 thousand primarily from legal and investment banking fees for ongoing strategic growth initiatives; higher data processing costs as we increased our number of customers, and business development expenses related to our continued organic growth initiatives. Partially offsetting these expense increases were reductions in the level of FDIC assessments which decreased \$30 thousand or 11.5% in the 2012 period compared to the 2011 period primarily due to changes in the assessment base and rate calculation as required by the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010; and lower levels of other expenses and OREO valuation costs due to lower operating costs of foreclosed properties and a stabilization of valuations on the properties held as OREO.

*A comparison between the three months ended September 30, 2012 and September 30, 2011 is presented below.*

## **General**

Net income available to common shareholders increased by \$8 thousand, or 3.6%, to \$230 thousand for the three months ended September 30, 2012 compared to \$222 thousand for the three months ended September 30, 2011. The increase was primarily due to a \$50 thousand increase in net income resulting from higher levels of net interest income and non-interest income, and a reduction of the provision for credit losses for the three month period, partially offset by a higher level of noninterest expenses. Net interest income grew 6.9% to \$3.4 million and noninterest income increased 55.4% to \$216 thousand, while the provision expense decreased by 45% to \$308 thousand for the third quarter. Noninterest expenses increased 20.2% to \$2.7 million during the three month period compared to the same period in 2011. The resulting increase in net income of \$50 thousand was partially offset by an increase of \$42 thousand, or 36.5%, in dividends paid on preferred stock due to an increase in the average balance of the preferred stock.

### **Interest Income**

Interest income increased \$196 thousand, or 5.3%, to \$3.9 million for the three months ended September 30, 2012 compared to \$3.7 million for the same period 2011. The increase was primarily due to a \$188 thousand, or 5.1%, increase in interest income on loans. The increase in interest income on loans was due to a 9.8% increase in the average balance of the loan portfolio compared to the three months ended September 30, 2011, partially offset by a decrease in the average yield. In addition, other interest income which consists of federal funds sold, increased by \$9 thousand over the same period in 2011, primarily as a result of a \$14.5 million increase in the average balance of federal funds sold.

### **Interest Expense**

Interest expense decreased \$23 thousand, or 4.5%, to \$486 thousand for the three months ended September 30, 2012, compared to \$509 thousand for the same period in 2011. This decrease was primarily attributable to an 8 basis point overall decrease in the average rate paid on deposits while growth in average interest-bearing deposits increased 8.0%. For the third quarter of 2012 versus 2011, given the growth in noninterest bearing deposit balances, and with a reduction in interest rates paid on interest-bearing demand, money market and saving accounts, we were able to decrease deposit related interest expense by \$9 thousand during the period despite the \$15.3 million growth in the levels of interest-bearing deposits on average.

### **Net Interest Income**

Net interest income increased \$219 thousand, or 6.9%, during the three months ended September 30, 2012 compared to the three months ended September 30, 2011. As noted above, the increase in net interest income was due to an increase of \$196 thousand, or 5.3%, in interest income with a decrease of \$23 thousand or 4.5%, in interest expense during the three month period.



### **Provision for Credit Losses**

Based on management's evaluation, we had a provision for credit losses of \$308 thousand for the three months ended September 30, 2012 compared to \$558 thousand for the same period in 2011, a decrease of \$250 thousand. The provision for 2012 reflects the additional general provisions that are required given the continued growth in the size of our loan portfolio, and smaller provisions due to a lower number and amount of troubled loans that are individually evaluated for impairment.

### **Noninterest Income**

Noninterest income was \$216 thousand for the three months ended September 30, 2012 compared to \$139 thousand for the three months ended September 30, 2011, a \$77 thousand or 55.4% increase. Service charges on deposit accounts increased moderately by \$12 thousand or 16% in the 2012 period compared to the third quarter of 2011, while other operating income increased \$38 thousand or 64% due to higher transaction fees and an increase in rent collected on OREO properties. In addition, our mortgage banking revenues increased from \$4 thousand for the third quarter of 2011, to \$31 thousand for the same three months in 2012, an increase of \$27 thousand or over 600%, due to a higher level of origination volume.

### **Noninterest Expenses**

Noninterest expenses increased \$447 thousand or 20.2% to \$2.7 million for the three months ended September 30, 2012 from \$2.2 million for the three months ended September 30, 2011. Salaries and employee benefits increased \$235 thousand or 18.7% period over period primarily as a result of an increase in staffing levels from our continued branch expansion as well as increasing the infrastructure to support a larger organization. The \$40 thousand or 11.8% increase in occupancy and equipment expense is a result of opening a new branch location in May 2012. Data processing fees increased \$41 thousand or 97.6% as a result of customer growth while professional fee increased \$55 thousand or 69.6% primary due to various legal and investment banking costs associated with our growth initiatives. FDIC expenses increased by \$41 thousand given our growth in assets, while other operating expenses increased slightly primarily as a result of additional operating expenses resulting from OREO properties.

### **Nonperforming and Problem Assets**

Management performs reviews of all delinquent loans and our loan officers contact customers to attempt to resolve potential credit issues in a timely manner. When in the best interests of the Bank and the customer, we will do a



troubled debt restructure with respect to a particular loan. When not possible, we are aggressively moving loans through the legal and foreclosure process within applicable legal constraints.

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

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

(in thousands)	September 30, 2012	December 31, 2011
Non-accrual loans:		
Real estate loans:		
Commercial	\$ 390	\$ 1,988
Residential - first lien	233	368
Residential - junior lien	-	44
Construction & land	432	-
Commercial	1,542	3,229
Consumer	-	9
Total non-accrual loans	2,597	5,638
Trouble debt restructure loans:		
Real estate loans:		
Commercial	-	-
Residential - first lien	-	240
Construction & land	-	-
Commercial	-	-
Total trouble debt restructure loans	-	240
Total non-performing loans	2,597	5,878
Other real estate owned:		
Land	595	595
Commercial	2,130	1,084
Residential	178	206
Total other real estate owned	2,903	1,885
Total non-performing assets	\$ 5,500	\$ 7,763
Ratios:		
Non-performing loans to total gross loans	0.87	2.12
Non-performing assets to total assets	1.49	2.40

Included in total non-accrual loans above are two trouble debt restructured loans totaling \$250 thousand that were not performing in accordance with the modified terms, and the accrual of interest has ceased. There was one residential first lien loan totaling \$208 thousand that was 90 days or more past due and still accruing interest at September 30, 2012.

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

Nonperforming assets amounted to \$5.5 million or 1.51% of total assets, at September 30, 2012 compared to \$7.8 million or 2.40% of total assets at December 31, 2011. Total nonperforming assets decreased by \$2.2 million during 2012 due primarily as a result of a reduction in non-accrual loans of \$3.0 or 53.9%. OREO fluctuations are due to an additional commercial property of \$1.6 million off set by the sales of one commercial and one residential property.

At September 30, 2012, our nonperforming loans of \$2.6 million consisted mainly of one non-owner occupied commercial real estate loan, one commercial land credit, several commercial relationships partially guaranteed by the Small Business Administration (“SBA”) and one residential mortgage. The composition of our nonperforming loans is further described below:

One owner occupied commercial real estate loan totaling \$387 thousand to a local borrower who also owns a property housing one of his business ventures in Sussex County Delaware.

One commercial land loan for \$432 thousand in Prince Georges County, Maryland which in addition to the collateral has personal guarantees associated with the loan.

One commercial loan relationship totaling \$938 thousand for a medical care facility

One commercial relationship totaling \$348 thousand, for which the full amount is guaranteed by the SBA, and claims have been submitted

One residential first lien mortgage for approximately \$233 thousand.

Nine small commercial loans totaling \$259 thousand.

#### **Allowance for Credit Losses**

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

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

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

The allowance for credit losses is maintained at a level to provide for losses that are probable and can be reasonably estimated. Management’s periodic evaluation of the adequacy of the allowance is based on Howard Bank’s past credit

loss experience, known and inherent losses in the portfolio, adverse situations that may affect the borrower's ability to repay, the estimated value of any underlying collateral, composition of the loan portfolio, current economic conditions and other relevant factors. This evaluation is inherently subjective as it requires material estimates that may be susceptible to significant change, including the amounts and timing of future cash flows expected to be received on impaired loans.

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

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

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

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

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

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

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

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

As of September 30, 2012 and December 31, 2011, nonperforming loans amounted to \$2.6 million and \$5.9 million, respectively. The amount of nonperforming loans requiring specific reserves totaled \$1.2 million and \$2.3 million, respectively. The amount of nonperforming loans with no specific valuation allowance totaled \$1.4 million and \$3.6 million, respectively.

Nonperforming loans are evaluated and valued at the time the loan is identified as impaired on a case by case basis, at the lower of cost or market value. Market value is measured based on the value of the collateral securing the loan. The value of real estate collateral is determined based on an appraisal by qualified licensed appraisers hired by us. Appraised values may be discounted based on management's historical experience, changes in market conditions from the time of valuation, and/or management's expertise and knowledge of the client and client's business. The difference between the appraised value and the principal balance of the loan will determine the specific allowance valuation required for the loan, if any. Nonperforming loans are reviewed and evaluated on at least a quarterly basis for additional impairment and adjusted accordingly.

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

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The following table represents the activity in the allowance for credit losses for the nine months ended September 30, 2012 and September 30, 2011:

(in thousands)	Unaudited Nine months ended September 30,	
	2012	2011
Balance at beginning of year	\$ 3,433	\$ 3,523
Provision for credit losses	650	740
Loan and lease charge-offs	(1,480 )	(553 )
Loan and lease recoveries	130	306
Balance at period end	\$ 2,733	\$ 4,016

Although total charge-offs increase for the first nine months of 2012 compared to the same period in 2011, of the \$1.5 million in charge-offs for 2012, nearly \$1.2 million of the charge-offs had been independently evaluated for loss as of the end of 2011, and specific reserves had been established on these loans. Thus, because the potential loss had already been identified, and specific reserves established, there was no need to replenish these reserves during 2012.

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

(in thousands)	Nine months ended September 30,		Three months ended September 30,	
	2012	2011	2012	2011
Balance at beginning of period	\$ 3,433	\$ 3,523	\$ 3,076	\$ 3,868
Charge-offs:				
Real estate				
Construction and land loans	-	-	-	-
Residential first lien loans	(23 )	-	-	-
Residential junior lien loans	(44 )	-	-	-
Commercial owner occupied laons	-	-	-	-
Commercial non-owner occupied loans	(268 )	-	(268 )	-
Commercial loans and leases	(1,130 )	(532 )	(463 )	(394 )
Consumer loans	(15 )	(21 )	-	(16 )
	(1,480 )	(553 )	(731 )	(410 )
Recoveries:				
Real estate				
Construction and land loans	-	-	-	-
Residential first lien loans	-	-	-	-
Residential junior lien loans	-	-	-	-
Commercial owner occupied laons	-	-	-	-
Commercial non-owner occupied loans	63	-	63	-
Commercial loans and leases	65	305	16	-



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Consumer loans	2 130	1 306	1 80	- -
Net recoveries (charge-offs)	(1,350 )	(247 )	(651 )	(410 )
Provision for credit losses	650	740	308	558
Balance at end of period	\$ 2,733	\$ 4,016	\$ 2,733	\$ 4,016

**Allocation of Allowance for Credit Losses**

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

(dollars in thousands)	September 30, 2012		December 31, 2011	
	Amount	Percent <sup>1</sup>	Amount	Percent <sup>1</sup>
Real estate				
Construction and land loans	\$ 192	<b>12.0</b>	% \$ 174	14.2 %
Residential first lien loans	105	7.7	111	8.0
Residential junior lien loans	22	2.7	64	3.3
Commercial owner occupied loans	651	19.7	611	16.8
Commercial non-owner occupied loans	349	28.8	197	27.8
Commercial loans and leases	1,383	28.6	2,233	29.4
Consumer loans	31	0.5	43	0.5
Total	\$ 2,733	<b>100.0</b>	% \$ 3,433	100.0 %

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

## Liquidity and Capital Resources

Liquidity is the ability to meet current and future financial obligations. Our primary sources of funds consist of deposit inflows, loan repayments, advances from the FHLB, principal repayments and the sale of securities available for sale. While maturities and scheduled amortization of loans and securities are predictable sources of funds, deposit flows and loan prepayments are greatly influenced by general interest rates, economic conditions and competition. Our Asset Liability Committee is responsible for establishing and monitoring our liquidity targets and strategies in order to ensure that sufficient liquidity exists for meeting the borrowing needs and deposit withdrawals of our customers as well as unanticipated contingencies. We believe that we have enough sources of liquidity to satisfy our short- and long-term liquidity needs as of September 30, 2012 and December 31, 2011, and expect to maintain our focus on retaining appropriate liquidity levels now that we have completed our initial public offering.

We regularly monitor and adjust our investments in liquid assets based upon our assessment of:

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

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

Our most liquid assets are cash and cash equivalents. The level of these assets is dependent on our operating, financing, lending and investing activities during any given period. At September 30, 2012 and December 31, 2011,

cash and cash equivalents totaled \$18.3 million and \$18.2 million, respectively.

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

At September 30, 2012 and December 31, 2011, we had \$79.1 million and \$59.5 million, respectively, in loan commitments outstanding, including commitments issued to originate loans of \$31.4 million and \$31.2 million at September 30, 2012 and December 31, 2011, respectively, and \$41.3 million and \$23.4 million in unused lines of credit to borrowers on these same dates, respectively. In addition to commitments to originate loans and unused lines of credit we had \$6.4 million and \$4.9 in letters of credit at September 30, 2012 and December 31, 2011, respectively. Certificates of deposit due within one year of September 30, 2012 totaled \$60.7 million, or 16.5% of total deposits. Should these deposits not remain with us, we may be required to seek other sources of funds, including loan and securities sales, and FHLB advances. Depending on market conditions, we may be required to pay higher rates on our deposits or other borrowings than we currently pay on the certificates of deposit. We believe, however, based on historical experience and current market interest rates that we will retain upon maturity a large portion of our certificates of deposit with maturities of one year or less.

Our primary investing activity is originating loans. During the first nine months of 2012 cash was utilized by net loan growth of \$25.4 million, while for the nine month ended September 30, 2011 cash was used to fund net loan growth totaled \$17.0 million. During these periods, we purchased \$44.0 million and \$39.2 million of securities, respectively.

Financing activities consist primarily of activity in deposit accounts and FHLB advances. We experienced a net increase in deposits of \$24.7 million during the first nine months of 2012. Deposit flows are affected by the overall level of interest rates, the interest rates and products offered by us and our local competitors, and by other factors.

Liquidity management is both a daily and long-term function of business management. If we require funds beyond our ability to generate them internally, we have borrowing agreements in place with the FHLB, which provide an additional source of funds. Total FHLB advances were unchanged at \$16 million at September 30, 2012 and December 31, 2011. At September 30, 2012, we had the ability to borrow up to a total of \$71.2 million based upon our credit availability at the FHLB, subject to collateral requirements.

The Bank is subject to various regulatory capital requirements, including a risk-based capital measure. The risk-based capital guidelines include both a definition of capital and a framework for calculating risk-weighted assets by assigning balance sheet assets and off-balance sheet items to broad risk categories. At September 30, 2012 and December 31, 2011, the Bank exceeded all regulatory capital requirements. The Bank is considered “well capitalized” under regulatory guidelines.

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

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

Outstanding loan commitments and lines of credit at September 30, 2012 and December 31, 2011 are as follows:

(in thousands)	September 30, 2012	December 31, 2011
Unfunded loan commitments	\$ 31,370	\$ 31,203
Unused lines of credit	41,337	23,424
Letters of credit	6,398	4,902

Commitments to extend credit are agreements to lend to a customer as long as there is no violation of any condition established in the contract. We generally require collateral to support financial instruments with credit risk on the same basis as we do for balance sheet instruments. Management generally bases the collateral required on the credit evaluation of the counterparty. Commitments generally have interest rates at current market rates, expiration dates or other termination clauses and may require payment of a fee. Available credit lines represent the unused portion of lines of credit previously extended and available to the customer so long as there is no violation of any contractual condition. These lines generally have variable interest rates. Since we expect many of the commitments to expire without being drawn upon, and since it is unlikely that all customers will draw upon their lines of credit in full at any one time, the total commitment amount or line of credit amount does not necessarily represent future cash

requirements. We evaluate each customer's credit-worthiness on a case-by-case basis. Because we conservatively underwrite these facilities at inception, we have not had to withdraw any commitments. We are not aware of any loss that we would incur by funding our commitments or lines of credit.

The credit risk involved in these financial instruments is essentially the same as that involved in extending loan facilities to customers. No amount has been recognized in the statement of financial condition at September 30, 2012 or December 31, 2011 as a liability for credit loss related to these commitments.

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

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

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

Not applicable

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

As of the end of the period covered by this quarterly report on Form 10-Q Bancorp's Chief Executive Officer and Chief Financial Officer evaluated the effectiveness of Bancorp's disclosure controls and procedures as defined in Rule 13a-15(e) under the Securities Exchange Act of 1934, as amended (the "Exchange Act"). Based upon that evaluation, Bancorp's Chief Executive Officer and Chief Financial Officer concluded that Bancorp's disclosure controls and procedures are effective as of September 30, 2012. Disclosure controls and procedures are controls and other procedures that are designed to ensure that information required to be disclosed by Bancorp in the reports that it files or submits under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms.

In addition, there were no changes in Bancorp's internal control over financial reporting (as defined in Rule 13a-15(f) under the Exchange Act) during the quarter ended September 30, 2012, that have materially affected, or are reasonably likely to materially affect Bancorp's internal control over financial reporting.

#### **PART II - Other Information**

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

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

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

There have been no material changes in the risk factors from those disclosed in our final prospectus dated May 21, 2012, as filed with the SEC on May 23, 2012.

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

## Edgar Filing: Howard Bancorp Inc - Form 10-Q

Our registration statement on Form S-1, File Number 333-178204, with respect to our initial public offering of our common stock, was declared effective by the SEC on May 14, 2012. We sold a total of 827,761 shares of common stock in our initial public offering for aggregate gross proceeds of \$6,042,655, plus an additional 4,193,457 shares in a concurrent private placement which raised additional proceeds of \$4,150,802.

After expenses, we raised net proceeds of approximately \$9.0 million, and Bancorp has not yet used any of the net proceeds of the initial public offering, which have been placed in in deposit accounts at Howard Bank until they can be utilized.

### Item 3. Defaults upon Senior Securities

None

### Item 4. Mine Safety Disclosures

Not applicable

### Item 5. Other Information

None

### Item 6. Exhibits

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

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





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

101 Extensible Business Reporting Language (“XBRL”) – filed herewith

101.INS XBRL Instance File

101.SCH XBRL Schema File

101.CAL XBRL Calculation File

101.DEF XBRL Definition File

101.LAB XBRL Label File

101.PRE XBRL Presentation File

## Signatures

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

HOWARD BANCORP, INC.  
(Registrant)

November XX, 2012 /s/ Mary Ann Scully  
Date MARY ANN SCULLY  
PRESIDENT AND CEO

November XX, 2012 /s/ George C. Coffman  
Date GEORGE C. COFFMAN  
EVP AND CFO