SHORE BANCSHARES INC
Form 10-Q
November 09, 2009

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

FORM 10-Q

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

For the Quarterly Period Ended September 30, 2009

OR

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

For the transition period from ________ to ________

Commission file number 0-22345

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

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

(410) 822-1400
Registrant’s Telephone Number, Including Area Code

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

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

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes £ No £ (Not Applicable)

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

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

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

APPLICABLE ONLY TO CORPORATE ISSUERS

Indicate the number of shares outstanding of each of the issuer’s classes of common stock, as of the latest practicable date: 8,418,963 shares of common stock outstanding as of October 31, 2009.

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PART I – FINANCIAL INFORMATION

Item 1. Financial Statements.

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

	September 30, 2009 (Unaudited)	December 31, 2008
ASSETS		
Cash and due from banks	$ 13,699	$ 16,803
Interest bearing deposits with other banks	1,601	481
Federal funds sold	72,061	10,010
Investment securities:		
Available for sale, at fair value	94,917	79,204
Held to maturity, at amortized cost – fair value of $9,183 (2009) and $10,390 (2008)	9,004	10,252
Loans	918,601	888,528
Less: allowance for credit losses	(10,723)	(9,320)
Loans, net	907,878	879,208
Insurance premiums receivable	1,193	1,348
Premises and equipment, net	14,012	13,855
Accrued interest receivable	4,769	4,606
Goodwill	15,954	15,954
Other intangible assets, net	5,535	5,921
Deferred income taxes	2,903	1,579
Other real estate owned	2,062	148
Interest rate caps	6,034	-
Other assets	6,063	5,272
TOTAL ASSETS	$ 1,157,685	$ 1,044,641
LIABILITIES		
Deposits:		
Noninterest bearing demand	$ 124,440	$ 102,584
Interest bearing demand	113,735	125,370
Money market and savings	243,576	150,958
Certificates of deposit $100,000 or more	275,351	235,235
Other time	235,094	231,224
Total deposits	992,196	845,371
Accrued interest payable	2,218	2,350
Short-term borrowings	17,673	52,969
Long-term debt	1,947	7,947
Other liabilities	15,432	8,619
TOTAL LIABILITIES	1,029,466	917,256
STOCKHOLDERS' EQUITY		
	84	84

Common stock, par value $.01 per share; shares authorized – 35,000,000; shares issued and outstanding – 8,418,963 (2009) and 8,404,684 (2008)				
Warrants		1,543		-
Additional paid in capital		29,844		29,768
Retained earnings		96,283		96,140
Accumulated other comprehensive income		465		1,393
TOTAL STOCKHOLDERS' EQUITY		128,219		127,385
TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY	$	1,157,685	$	1,044,641

See accompanying notes to Consolidated Financial Statements.

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

	For the Three Months Ended September 30, 2009	For the Three Months Ended September 30, 2008	For the Nine Months Ended September 30, 2009	For the Nine Months Ended September 30, 2008
INTEREST INCOME				
Interest and fees on loans	$ 14,001	$ 14,179	$ 41,372	$ 42,700
Interest and dividends on investment securities:				
Taxable	800	924	2,324	2,949
Tax-exempt	77	95	241	327
Interest on federal funds sold	31	79	61	284
Interest on deposits with other banks	4	21	11	88
Total interest income	14,913	15,298	44,009	46,348
INTEREST EXPENSE				
Interest on deposits	4,368	4,955	13,094	15,295
Interest on short-term borrowings	19	344	96	1,026
Interest on long-term debt	98	90	247	456
Total interest expense	4,485	5,389	13,437	16,777
NET INTEREST INCOME	10,428	9,909	30,572	29,571
Provision for credit losses	1,702	875	5,318	1,952
NET INTEREST INCOME AFTER PROVISION FOR CREDIT LOSSES	8,726	9,034	25,254	27,619
NONINTEREST INCOME				
Service charges on deposit accounts	861	923	2,558	2,711
Other service charges and fees	763	668	2,275	2,169
Investment securities gains	-	-	49	-
Other than temporary impairment of securities	-	(371)	-	(371)
Insurance agency commissions income	2,744	2,845	8,972	9,595
Gain on disposals of premises and equipment	-	1,264	-	1,255
Loss on sale of investment in unconsolidated subsidiary	-	(337)	-	(337)
Other noninterest income	351	254	1,562	920
Total noninterest income	4,719	5,246	15,416	15,942
NONINTEREST EXPENSE				
Salaries and wages	4,765	4,662	14,064	13,837
Employee benefits	1,211	1,140	3,791	3,708
Occupancy expense	616	558	1,752	1,594
Furniture and equipment expense	299	310	915	894
Data processing	675	610	1,865	1,728
Directors' fees	109	131	394	426
Amortization of intangible assets	128	128	386	386
Insurance agency commissions expense	428	447	1,515	1,770

FDIC insurance premium expense		458		135		1,621		209
Other noninterest expenses		1,608		1,308		4,570		4,197
Total noninterest expense		10,297		9,429		30,873		28,749
INCOME BEFORE INCOME TAXES		3,148		4,851		9,797		14,812
Income tax expense		1,197		1,780		3,740		5,603
NET INCOME		1,951		3,071		6,057		9,209
Preferred stock dividends and discount accretion		-		-		1,876		-
Net income available to common shareholders	$	1,951	$	3,071	$	4,181	$	9,209
Basic earnings per common share	$	0.23	$	0.37	$	0.50	$	1.10
Diluted earnings per common share	$	0.23	$	0.37	$	0.50	$	1.10
Cash dividends paid per common share	$	0.16	$	0.16	$	0.48	$	0.48

See accompanying notes to Consolidated Financial Statements.

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SHORE BANCSHARES, INC.
CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY (Unaudited)
For the Nine Months Ended September 30, 2009 and 2008
(Dollars in thousands, except per share amounts)

	Preferred Stock	Common Stock	Warrants	Additional Paid in Capital	Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Total Stockholders' Equity
Balances, January 1, 2009	$ -	$ 84	$ -	$ 29,768	$ 96,140	$ 1,393	$ 127,385
Comprehensive income:							
Net income	-	-	-	-	6,057	-	6,057
Unrealized losses on available-for-sale securities, net of taxes	-	-	-	-	-	(276)	(276)
Unrealized losses on cash flow hedging activities, net of taxes	-	-	-	-	-	(652)	(652)
Total comprehensive income							5,129
Warrants issued	-	-	1,543	-	-	-	1,543
Preferred shares issued pursuant to TARP	25,000	-	-	-	-	-	25,000
Discount from issuance of preferred stock	(1,543)	-	-	-	-	-	(1,543)
Discount accretion	68	-	-	-	(68)	-	-
Repurchase of preferred stock	(23,525)	-	-	-	-	-	(23,525)
Common shares issued for employee stock-based awards	-	-	-	2	-	-	2
Stock-based compensation expense	-	-	-	74	-	-	74
Preferred stock dividends	-	-	-	-	(1,808)	-	(1,808)
Cash dividends paid ($0.48 per share)	-	-	-	-	(4,038)	-	(4,038)
	$ -	$ 84	$ 1,543	$ 29,844	$ 96,283	$ 465	$ 128,219

Balances, September 30, 2009							
Balances, January 1, 2008	$ -	$ 84	$ -	$ 29,539	$ 90,365	$ 247	$ 120,235
Adjustment to initially apply EITF Issue 06-4	-	-	-	-	(318)	-	(318)
Comprehensive income:							
Net income	-	-	-	-	9,209	-	9,209
Unrealized gains on available-for-sale securities, net of taxes	-	-	-	-	-	102	102
Total comprehensive income							9,311
Shares issued for employee stock-based awards	-	-	-	136	-	-	136
Stock-based compensation expense	-	-	-	69	-	-	69
Cash dividends paid ($0.48 per share)	-	-	-	-	(4,032)	-	(4,032)
Balances, September 30, 2008	$ -	$ 84	$ -	$ 29,744	$ 95,224	$ 349	$ 125,401

See accompanying notes to Consolidated Financial Statements.

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

	For the Three Months Ended September 30, 2009	For the Three Months Ended September 30, 2008	For the Nine Months Ended September 30, 2009	For the Nine Months Ended September 30, 2008
Net income	$ 1,951	$ 3,071	$ 6,057	$ 9,209
Other comprehensive (loss) income:				
Securities available for sale:				
Unrealized holding gains (losses) on available-for-sale securities	604	926	(410)	175
Tax effect	(241)	(370)	163	(73)
Reclassification of (gains) losses recognized in net income	-	-	(49)	-
Tax effect	-	-	20	-
Net of tax amount	363	556	(276)	102
Cash flow hedging activities:				
Unrealized holding losses on cash flow hedging activities	(1,093)	-	(1,093)	-
Tax effect	441	-	441	-
Net of tax amount	(652)	-	(652)	-
Total other comprehensive (loss) income	(289)	556	(928)	102
Comprehensive income	$ 1,662	$ 3,627	$ 5,129	$ 9,311

See accompanying notes to Consolidated Financial Statements.

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

	For the Nine Months Ended September 30,	
	2009	2008
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net income	$ 6,057	$ 9,209
Adjustments to reconcile net income to net cash provided by operating activities:		
Provision for credit losses	5,318	1,952
Depreciation and amortization	1,370	1,330
Discount accretion on debt securities	(191)	(164)
Stock-based compensation expense	74	69
Gain on sales of securities	(49)	-
Other than temporary impairment of securities	-	371
Gain on disposals of premises and equipment	-	(1,255)
Loss on sale of investment in unconsolidated subsidiary	-	337
Loss on sales of other real estate owned	-	50
Write-downs of other real estate owned	159	-
Net changes in:		
Insurance premiums receivable	155	(81)
Accrued interest receivable	(163)	(15)
Other assets	(2,124)	(1,592)
Accrued interest payable	(132)	(656)
Other liabilities	285	579
Net cash provided by operating activities	10,759	10,134
CASH FLOWS FROM INVESTING ACTIVITIES:		
Proceeds from maturities and principal payments of securities available for sale	36,686	71,189
Proceeds from sales of investment securities available for sale	2,048	-
Purchases of securities available for sale	(54,851)	(56,416)
Proceeds from maturities and principal payments of securities held to maturity	2,815	2,991
Purchases of securities held to maturity	(1,563)	(1,012)
Net increase in loans	(36,059)	(90,109)
Purchases of premises and equipment	(982)	(292)
Proceeds from sales of premises and equipment	-	2,773
Proceeds from sale of investment in unconsolidated subsidiary	-	600
Proceeds from sales of other real estate owned	-	264
Purchases of interest rate caps	(6,475)	-
Net cash used in investing activities	(58,381)	(70,012)
CASH FLOWS FROM FINANCING ACTIVITIES:		
Net increase in demand, money market and savings deposits	102,839	29,990
Net increase in certificates of deposit	43,987	43,332
Net (decrease) increase in short-term borrowings	(35,296)	5,384

Proceeds from issuance of long-term debt		-		3,000
Repayment of long-term debt		(6,000)		(7,000)
Net receipt of counterparty collateral – interest rate caps		6,528		
Proceeds from issuance of preferred stock and warrants		25,000		-
Repurchase of preferred stock		(23,525)		-
Proceeds from issuance of common stock		2		136
Preferred stock dividends paid		(1,808)		-
Common stock dividends paid		(4,038)		(4,032)
Net cash provided by financing activities		107,689		70,810
Net increase in cash and cash equivalents		60,067		10,932
Cash and cash equivalents at beginning of period		27,294		26,880
Cash and cash equivalents at end of period	$	87,361	$	37,812
Supplemental cash flows information:				
Interest paid	$	13,569	$	17,433
Income taxes paid	$	3,678	$	7,437
Transfers from loans to other real estate owned	$	2,072	$	138

See accompanying notes to Consolidated Financial Statements.

Shore Bancshares, Inc.
Notes to Consolidated Financial Statements
For the Three and Nine Months Ended September 30, 2009 and 2008
(Unaudited)

Note 1 - Basis of Presentation

The consolidated financial statements include the accounts of Shore Bancshares, Inc. and its subsidiaries with all significant intercompany transactions eliminated.The consolidated financial statements conform to accounting principles generally accepted in the United States of America ("GAAP") and to prevailing practices within the banking industry. The accompanying interim financial statements are unaudited; however, in the opinion of management all adjustments necessary to present fairly the consolidated financial position at September 30, 2009, the consolidated results of operations for the three and nine months ended September 30, 2009 and 2008, changes in stockholders' equity for the nine months ended September 30, 2009 and 2008, and cash flows for the nine months ended September 30, 2009 and 2008, have been included. All such adjustments are of a normal recurring nature. The amounts as of December 31, 2008 were derived from the 2008 audited financial statements. The results of operations for the three and nine months ended September 30, 2009 are not necessarily indicative of the results to be expected for any other interim period or for the full year. This Quarterly Report on Form 10-Q should be read in conjunction with the Annual Report of Shore Bancshares, Inc. on Form 10-K for the year ended December 31, 2008.

The Financial Accounting Standards Board's (FASB) Accounting Standards Codification (ASC) became effective on July 1, 2009. At that date, the ASC became FASB's officially recognized source of authoritative U.S. generally accepted accounting principles (GAAP) applicable to all public and non-public non-governmental entities, superseding existing FASB, American Institute of Certified Public Accountants (AICPA), Emerging Issues Task Force (EITF) and related literature. Rules and interpretive releases of the SEC under the authority of federal securities laws are also sources of authoritative GAAP for SEC registrants. All other accounting literature is considered non-authoritative. The switch to the ASC affects the way companies refer to U.S. GAAP in financial statements and accounting policies. Citing particular content in the ASC involves specifying the unique numeric path to the content through the Topic, Subtopic, Section and Paragraph structure.

The Company has evaluated events and transactions occurring subsequent to the balance sheet date of September 30, 2009 for items that should potentially be recognized or disclosed in these financial statements as prescribed by recently issued FASB ASC Topic 855, "Subsequent Events". The evaluation was conducted through November 9, 2009, the date these financial statements were issued.

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

Note 2 – Earnings Per Share

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

	For the Three Months Ended September 30,	For the Nine Months Ended September 30,

(In thousands, except per share data)	2009	2008	2009	2008
Net income available to common shareholders	$ 1,951	$ 3,071	$ 4,181	$ 9,209
Weighted average shares outstanding - Basic	8,419	8,405	8,412	8,398
Dilutive effect of stock-based awards	4	6	4	7
Weighted average shares outstanding - Diluted	8,423	8,411	8,416	8,405
Earnings per common share - Basic	$ 0.23	$ 0.37	$ 0.50	$ 1.10
Earnings per common share - Diluted	$ 0.23	$ 0.37	$ 0.50	$ 1.10

That portion of a warrant to purchase 173 thousand weighted average shares of common stock was excluded from the diluted earnings per share calculation for the three months ended September 30, 2009 because its effect would have been antidilutive. That portion of a warrant to purchase 168 thousand weighted average shares was excluded from the diluted earnings per share calculation for the nine months ended September 30, 2009 because its effect would have been antidilutive. There were 3,000 and 16,000 antidilutive weighted average stock-based awards excluded from the diluted earnings per share calculation for the three and nine months ended September 30, 2008, respectively.

Note 3 – Impaired Loans

A loan is considered impaired if it is probable that the Company will not collect all principal and interest payments according to the loan's contracted terms. The impairment of a loan is measured at the present value of expected future cash flows using the loan's effective interest rate, or at the loan's observable market price or the fair value of the collateral if the loan is collateral dependent. Interest income generally is not recognized on specific impaired loans unless the likelihood of further loss is remote. Interest payments received on such loans are applied as a reduction of the loan's principal balance. Interest income on other nonaccrual loans is recognized only to the extent of interest payments received.

Information with respect to impaired loans and the related valuation allowance is shown below:

(Dollars in thousands)	September 30, 2009	December 31, 2008	September 30, 2008
Impaired loans with a valuation allowance	$ 548	$ 2,550	$ 2,290
Impaired loans with no valuation allowance	14,919	5,565	5,206
Total impaired loans	$ 15,467	$ 8,115	$ 7,496
Allowance for credit losses applicable to impaired loans	$ 226	$ 341	$ 318
Allowance for credit losses applicable to other than impaired loans	10,497	8,979	8,300
Total allowance for credit losses	$ 10,723	$ 9,320	$ 8,618
Average recorded investment in impaired loans	$ 11,733	$ 5,477	$ 4,817

Gross interest income of $576 thousand for the first nine months of 2009, $476 thousand for fiscal year 2008 and $314 thousand for the first nine months of 2008 would have been recorded if nonaccrual loans had been current and performing in accordance with their original terms. Interest actually recorded on such loans was $4 thousand for the first nine months of 2009, $193 thousand for fiscal year 2008 and $193 thousand for the first nine months of 2008.

Impaired loans do not include groups of smaller balance homogenous loans such as residential mortgage and consumer installment loans that are evaluated collectively for impairment. Reserves for probable credit losses related to these loans are based upon historical loss ratios and are included in the allowance for credit losses.

Note 4 – Investment Securities

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

(Dollars in thousands)	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
Available-for-sale securities:				
September 30, 2009:				
Obligations of U.S. Treasury	$ 5,996	$ 3	$ -	$ 5,999
Obligations of U.S. Government agencies and corporations	52,913	1,043	68	53,888
Mortgage-backed securities	30,453	898	22	31,329
Federal Home Loan Bank stock	2,822	-	-	2,822
Federal Reserve Bank stock	302	-	-	302
Other equity securities	566	11	-	577
	$ 93,052	$ 1,955	$ 90	$ 94,917
December 31, 2008:				
Obligations of U.S. Treasury	$ 1,000	$ -	$ -	$ 1,000
Obligations of U.S. Government agencies and corporations	49,996	1,451	-	51,447
Mortgage-backed securities	22,028	879	8	22,899
Federal Home Loan Bank stock	3,003	-	-	3,003
Federal Reserve Bank stock	302	-	-	302
Other equity securities	551	2	-	553
	$ 76,880	$ 2,332	$ 8	$ 79,204
Held-to maturity securities:				
September 30, 2009:				
Obligations of states and political subdivisions	$ 9,004	$ 192	$ 13	$ 9,183
December 31, 2008:				
Obligations of states and political subdivisions	$ 10,252	$ 159	$ 21	$ 10,390

Gross unrealized losses and fair value by length of time that the individual available-for-sale securities have been in a continuous unrealized loss position at September 30, 2009, are as follows:

	Less than 12 Months		More than 12 Months		Total	
(Dollars in thousands)	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
Available-for-sale securities:						
U.S. Gov't. agencies and corporations	$ 13,152	$ 68	$ -	$ -	$ 13,152	$ 68
Mortgage-backed securities	2,314	22	-	-	2,314	22
Total	$ 15,466	$ 90	$ -	$ -	$ 15,466	$ 90

The available-for-sale securities have a fair value of approximately $94.9 million. Of these securities, approximately $15.5 million have unrealized losses when compared to their purchase prices. The securities with the unrealized losses in the available-for-sale portfolio all have modest duration risk, low credit risk, and minimal losses (approximately 0.10%) when compared to amortized cost. The unrealized losses that exist are the result of market changes in interest rates since original purchase. Because the Company does not intend to sell these securities and it is not more likely than not that the Company will be required to sell these securities before recovery of their amortized cost bases, which may be at maturity, the Company considers the unrealized losses in the available-for-sale portfolio to be temporary.

Gross unrealized losses and fair value by length of time that the individual held-to-maturity securities have been in a continuous unrealized loss position at September 30, 2009, are as follows:

	Less than 12 Months		More than 12 Months		Total	
(Dollars in thousands)	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
Held-to-maturity securities:						
Obligations of states and political subdivisions	$ 501	$ 6	$ 806	$ 7	$ 1,307	$ 13

The held-to-maturity securities have a fair value of approximately $9.2 million, of which approximately $1.3 million of these securities have unrealized losses when compared to their purchase price. All of the securities with unrealized losses are municipal securities with modest duration risk, low credit risk, and minimal losses (approximately 0.14%) when compared to amortized cost. The unrealized losses that exist are the result of market changes in interest rates since the original purchase. Because the Company does not intend to sell these securities and it is not more likely than not that the Company will be required to sell these securities before recovery of their amortized cost bases, which may be at maturity, the Company considers that the unrealized losses in the held-to-maturity portfolio are temporary.

Note 5 – Commitments

In the normal course of business, to meet the financial needs of its customers, the Company's bank subsidiaries enter into financial instruments with off-balance sheet risk. These financial instruments include commitments to extend credit and standby letters of credit. At September 30, 2009, total commitments to extend credit were approximately $158.4 million. The comparable amount was $211.4 million at December 31, 2008. Outstanding letters of credit were approximately $20.1 million at September 30, 2009 and $12.5 million at December 31, 2008.

Note 6 - Stock-Based Compensation

At September 30, 2009, Shore Bancshares, Inc. had three equity compensation plans: (i) the Shore Bancshares, Inc. 2006 Stock and Incentive Compensation Plan ("2006 Equity Plan"); (ii) the Shore Bancshares, Inc. Employee Stock Purchase Plan ("ESPP"); and (iii) the Shore Bancshares, Inc. 1998 Stock Option Plan (the "1998 Option Plan"). The plans are described in detail in Note 13 to the audited financial statements contained in the Annual Report of Shore Bancshares, Inc. on Form 10-K for the year ended December 31, 2008. Under the terms of the 1998 Option Plan, Shore Bancshares, Inc.'s ability to grant options thereunder terminated on March 3, 2008, but stock options granted under that plan were outstanding at September 30, 2009.

Stock-based awards granted to date are generally time-based, vest on each anniversary of the grant date over a three to five-year period of time and, in the case of stock options, expire 10 years from the grant date. ESPP awards are rights granted to employees to purchase shares of Shore Bancshares, Inc. common stock at 85% of the fair market value on the date of grant. ESPP awards are 100% vested when granted and have 27-month terms.

During the three and nine months ended September 30, 2009, the Company recognized pre-tax stock-based compensation expense of $28 thousand and $74 thousand, respectively, compared to $22 thousand and $69 thousand, respectively, for the same periods last year. Stock-based compensation expense is recognized ratably over the requisite service period for all awards and is based on the grant-date fair value. Unrecognized stock-based compensation expense related to nonvested share-based compensation arrangements was $483 thousand as of September 30, 2009. The weighted-average period over which this unrecognized expense was expected to be recognized was 2.8 years.

The following table summarizes restricted stock award activity for the Company under the 2006 Equity Plan for the nine months ended September 30, 2009:

	Number of Shares	Weighted Average Grant Date Fair Value
Nonvested at January 1, 2009	16,859	$ 22.55
Granted	14,254	18.12
Vested	(3,708)	22.63
Cancelled	-	-
Nonvested at September 30, 2009	27,405	$ 20.23

The Company estimates the fair value of stock options using the Black-Scholes valuation model with weighted average assumptions for dividend yield, expected volatility, risk-free interest rate and expected lives (in years). The expected dividend yield is calculated by dividing the total expected annual dividend payout by the average stock price. The expected volatility is based on historical volatility of the underlying securities. The risk-free interest rate is based on the Federal Reserve Bank's constant maturities daily interest rate in effect at grant date. The expected life of the options represents the period of time that the Company expects the awards to be outstanding based on historical experience with similar awards. Stock-based compensation expense recognized in the consolidated statements of income for the nine months ended September 30, 2009 and 2008 reflected forfeitures as they occurred.

No options were granted during the first nine months of 2009 or 2008.

The following table summarizes stock option activity for the Company under all plans for the nine months ended September 30, 2009:

	Number of Shares	Weighted Average Exercise Price	Aggregate Intrinsic Value
Outstanding at beginning of year	18,550	$ 15.52	
Granted	-	-	
Exercised	(25)	21.33	
Expired/Cancelled	(4,975)	21.33	
Outstanding at end of period	13,550	13.37	$ 45,536
Exercisable at end of period	13,550	$ 13.37	$ 45,536

The following summarizes information about options outstanding at September 30, 2009:

Options Outstanding		Options Outstanding and Exercisable	
Exercise Price	Number	Number	Weighted Average Remaining Contract Life (in years)
$ 14.00	3,255	3,255	0.4
13.17	10,295	10,295	2.6
	13,550	13,550	

The total intrinsic value of stock options exercised during the nine months ended September 30, 2009 was less than $1 thousand. The comparable amount for the nine months ended September 30, 2008 was approximately $80 thousand. Cash received upon exercise of options during the first nine months of 2009 and 2008 was approximately $1 thousand and $136 thousand, respectively.

Note 7 – Segment Reporting

The Company operates in two primary business segments: Community Banking and Insurance Products and Services. Through the Community Banking business, the Company provides services to consumers and small businesses on the Eastern Shore of Maryland and Delaware through its 19-branch network. Community banking activities include small business services, retail brokerage, and consumer banking products and services. Loan products available to consumers include mortgage, home equity, automobile, marine, and installment loans, credit cards and other secured and unsecured personal lines of credit. Small business lending includes commercial mortgages, real estate development loans, equipment and operating loans, as well as secured and unsecured lines of credit, credit cards, accounts receivable financing arrangements, and merchant card services.

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

Selected financial information by business segments for the first nine months of 2009 and 2008 is included in the following table:

(Dollars in thousands)	Community Banking	Insurance Products and Services	Parent Company	Consolidated Total
2009				
Interest income	$ 43,957	$ 52	$ -	$ 44,009
Interest expense	(13,378)	-	(59)	(13,437)
Provision for credit losses	(5,318)	-	-	(5,318)
Noninterest income	5,952	9,464	-	15,416
Noninterest expense	(17,806)	(8,456)	(4,611)	(30,873)
Net intersegment income (expense)	(4,118)	(362)	4,480	-
Income (loss) before taxes	9,289	698	(190)	9,797
Income tax (expense) benefit	(3,546)	(267)	73	(3,740)
Net income	$ 5,743	$ 431	$ (117)	$ 6,057
Total assets	$ 1,133,949	$ 19,805	$ 3,931	$ 1,157,685
2008				
Interest income	$ 46,299	$ 49	$ -	$ 46,348
Interest expense	(16,676)	-	(101)	(16,777)
Provision for credit losses	(1,952)	-	-	(1,952)
Noninterest income	5,865	10,077	-	15,942
Noninterest expense	(15,486)	(9,128)	(4,135)	(28,749)
Net intersegment income (expense)	(3,577)	(312)	3,889	-
Income (loss) before taxes	14,473	686	(347)	14,812
Income tax (expense) benefit	(5,475)	(259)	131	(5,603)
Net income	$ 8,998	$ 427	$ (216)	$ 9,209
Total assets	$ 1,013,939	$ 20,332	$ 2,755	$ 1,037,026

Note 8 – Disclosures about Fair Value of Financial Instruments

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

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

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

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

Financial Liabilities

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

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

The estimated fair values of the Company's financial instruments, excluding goodwill, as of September 30, 2009 and December 31, 2008 are as follows:

	September 30, 2009		December 31, 2008	
(Dollars in thousands)	Carrying Amount	Estimated Fair Value	Carrying Amount	Estimated Fair Value
Financial assets:				
Cash and cash equivalents	$ 87,361	$ 87,361	$ 27,294	$ 27,294
Investment securities	103,921	104,100	89,456	89,594
Loans	918,601	936,054	888,528	914,695
Less: allowance for loan losses	(10,723)	-	(9,320)	_ -
	$ 1,099,160	$ 1,127,515	$ 995,958	$ 1,031,583
Financial liabilities:				
Deposits	$ 992,196	$ 1,001,146	$ 845,371	$ 861,951
Short-term borrowings	17,673	17,673	52,969	52,969
Long-term debt	1,947	2,065	7,947	8,060
	$ 1,011,816	$ 1,020,884	$ 906,287	$ 922,980

	September 30, 2009		December 31, 2008	
(Dollars in thousands)	Carrying Amount	Estimated Fair Value	Carrying Amount	Estimated Fair Value
Unrecognized financial instruments:				
Commitments to extend credit	$ 158,374	$ -	$ 211,423	$ -
Standby letters of credit	20,127	-	12,508	-
	$ 178,501	$ -	$ 223,931	$ -

Note 9 – Fair Value Measurements

ASC 820, "Fair Value Measurements and Disclosures," provides a framework for measuring and disclosing fair value under GAAP. This accounting guidance requires disclosures about the fair values of assets and liabilities recognized in the balance sheet, whether the measurements are made on a recurring basis or on a nonrecurring basis.

ASC 820 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. ASC 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 liabilities and to determine fair value disclosures. Securities available for sale and derivative assets and liabilities are recorded at fair value on a recurring basis. Additionally, from time to time, the Company may be required to record at fair value other assets on a nonrecurring basis, such as loans held for investment (impaired loans) and foreclosed assets (other real estate owned). These nonrecurring fair value adjustments typically involve application of lower of cost or market accounting or write-downs of individual assets.

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

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

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

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

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

Investment Securities Available for Sale
Investment securities available for sale are recorded at fair value on a recurring basis. Fair value measurement is based upon quoted prices, if available. If quoted prices are not available, fair values are measured using independent pricing models or other model-based valuation techniques such as the present value of future cash flows, adjusted for the security's credit rating, prepayment assumptions and other factors such as credit loss assumptions. Level 1 securities include those traded on an active exchange such as the New York Stock Exchange, Treasury securities that are traded by dealers or brokers in active over-the-counter markets and money market funds. Level 2 securities include mortgage-backed securities issued by government sponsored entities, municipal bonds and corporate debt securities. Securities classified as Level 3 include asset-backed securities in less liquid markets.

Loans
The Company does not record loans at fair value on a recurring basis; however, from time to time, a loan is considered impaired and an allowance for loan loss is established. Loans for which it is probable that payment of interest and principle will not be made in accordance with the contractual terms of the loan are considered impaired. The fair values of impaired loans are estimated using one of several methods, including the collateral value, market value of similar debt, enterprise value, liquidation value and discounted cash flows. Those impaired loans not requiring a specific allowance represent loans for which the fair values of expected repayments or collateral exceed the recorded investment in such loans. At September 30, 2009, substantially all of the impaired loans were evaluated based upon the fair value of the collateral. In accordance with ASC 820, impaired loans that have an allowance established based on the fair value of collateral require classification in the fair value hierarchy. When the fair value of the collateral is based on an observable market price or a current appraised value, the Company records the loan as nonrecurring Level 2. When an appraised value is not available or management determines the fair value of the collateral is further impaired below the appraised value and there is no observable market price, the Company records the loan as nonrecurring Level 3.

Foreclosed Assets
Foreclosed assets are adjusted for fair value upon transfer of loans to foreclosed assets. Subsequently, foreclosed assets are carried at the lower of carrying value and fair value. Fair value is based upon independent market prices, appraised value of the collateral or management's estimation of the value of the collateral. When the fair value of the collateral is based on an observable market price or a current appraised value, the Company records the foreclosed asset as nonrecurring Level 2. When an appraised value is not available or management determines the fair value of

the collateral is further impaired below the appraised value and there is no observable market price, the Company records the foreclosed asset as nonrecurring Level 3.

Derivative Assets and Liabilities

Derivative instruments held or issued by the Company for risk management purposes are traded in over-the-counter markets where quoted market prices are not readily available. For those derivatives, the Company measures fair value using models that use primarily market observable inputs, such as yield curves and option volatilities, and include the value associated with counterparty credit risk. The Company classifies derivative instruments held or issued for risk management purposes as recurring Level 2. As of September 30, 2009, the Company's derivative instruments consisted solely of interest rate caps. Derivative assets and liabilities are included in other assets and liabilities, respectively, in the accompanying consolidated balance sheet.

Assets Recorded at Fair Value on a Recurring Basis

The table below presents the recorded amount of assets measured at fair value on a recurring basis at September 30, 2009.

(Dollars in thousands)	Fair Value	Quoted Prices (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Securities available for sale:				
U.S. Treasury	$ 5,999	$ 5,999	$ -	$ -
U.S. Government agencies	53,888	-	53,888	-
Mortgage-backed securities	31,329	-	31,329	-
Federal Home Loan Bank stock	2,822	-	2,822	-
Federal Reserve Bank stock	302	-	302	-
Other equity securities	577	-	577	-
	$ 94,917	$ 5,999	$ 88,918	$ -
Interest rate caps	$ 6,034	$ -	$ 6,034	$ -

Assets Recorded at Fair Value on a Nonrecurring Basis

The table below presents the recorded amount of assets measured at fair value on a nonrecurring basis at September 30, 2009.

(Dollars in thousands)	Fair Value	Quoted Prices (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Impaired loans	$ 15,241	$ -	$ -	$ 15,241
Other real estate owned	2,062	-	-	2,062

Impaired loans had a carrying amount of $15.5 million with a valuation allowance of $226 thousand at September 30, 2009.

Note 10 – Restricted Investment in Bank Stock

Restricted stock, which represents required investments in the common stock of two correspondent banks, is carried at cost and, as of September 30, 2009 and December 31, 2008, consisted of the common stock of the Federal Home Loan Bank ("FHLB") of Atlanta and the FHLB of Pittsburgh.

Management's determination of whether these investments are impaired is based on an assessment of the ultimate recoverability of their costs rather than by recognizing temporary declines in value. The determination of whether a decline affects the ultimate recoverability of the cost of an investment is influenced by criteria such as (1) the significance of the decline in net assets of the issuing bank as compared to the capital stock amount for that bank and the length of time this situation has persisted, (2) commitments by the issuing bank to make payments required by law or regulation and the level of such payments in relation to the operating performance of that bank, and (3) the impact of legislative and regulatory changes on institutions and, accordingly, on the customer base of the issuing bank.

During the third quarter, the FHLB of Atlanta paid its first dividend of 2009. Prior to the dividend paid in the third quarter of 2009, the FHLB of Atlanta last paid a dividend in the third quarter of 2008. Also during the third quarter of 2009, the FHLB of Atlanta announced that it would not repurchase excess activity-based stock outstanding as of the end of the second quarter of 2009. Since December 2008, the FHLB of Pittsburgh voluntarily suspended the payment of dividends and the repurchase of excess capital stock from member banks. The FHLB of Pittsburgh last paid a dividend in the third quarter of 2008.

Management believes that no impairment charge in respect of the restricted stock is necessary as of September 30, 2009.

Note 11 – Derivative Instruments and Hedging Activities

ASC 815, "Derivatives and Hedging", defines derivatives, requires that derivatives be carried at fair value on the balance sheet and provides for hedge accounting when certain conditions are met. Changes in the fair values of derivative instruments designated as "cash flow" hedges, to the extent the hedges are highly effective, are recorded in other comprehensive income, net of taxes. Ineffective portions of cash flow hedges, if any, are recognized in current period earnings. The Company uses derivative instruments to hedge its exposure to changes in interest rates. The Company does not use derivatives for any trading or other speculative purposes.

During the second quarter of 2009, the Company entered into 5-year interest rate swap agreements with notional amounts of $70 million to effectively fix the interest rate on $70 million of the Company's money market deposit accounts at 2.97%. Because the interest rate swaps did not qualify for the hedge accounting, the Company restructured the original transactions and purchased interest rate caps for $6.5 million during the third quarter of 2009. The interest rate caps qualify for hedge accounting. At September 30, 2009, the aggregate fair value of these derivatives was an asset of $6.0 million. For the nine months ended September 30, 2009, other noninterest income included a gain relating to the swap transactions of $420 thousand which was recorded in the second quarter of 2009.

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

Note 12 – Repurchase of Preferred Stock

On April 15, 2009, the Company completed the repurchase of all 25,000 shares of its Fixed Rate Cumulative Perpetual Preferred Stock, Series A, with a liquidation value of $1,000 per share, that were sold to the U.S. Department of Treasury ("Treasury") on January 9, 2009 pursuant to the Troubled Asset Relief Program Capital Purchase Program. The repurchase price was $25 million, plus accrued dividends of $208 thousand. At the time of the repurchase, the preferred stock had a carrying value of $23.5 million. The difference between the repurchase price and carrying value represented an additional accelerated deemed dividend of $1.5 million. As a result, dividends paid on the preferred stock totaled $1.8 million for the nine months ended September 30, 2009. The repurchase was approved by the Treasury following consultation with and approval from the Federal Reserve Bank of Richmond and the Federal Deposit Insurance Corporation.

Note 13 – New Accounting Pronouncements

Pronouncements adopted

As discussed in Note 1 – Basis of Presentation, the FASB established the Accounting Standards Codification as the source of authoritative accounting principles recognized by the FASB to be applied by non-governmental entities in the preparation of financial statements in conformity with generally accepted accounting principles. Rules and interpretive releases of the SEC under authority of federal securities laws are also sources of authoritative guidance for SEC registrants. All guidance contained in the ASC carries an equal level of authority. All non-grandfathered, non-SEC accounting literature not included in the ASC is superseded and deemed non-authoritative.

FASB ASC Topic 260, "Earnings Per Share". New accounting guidance under ASC Topic 260 clarifies that instruments granted in share-based payment transactions can be participating securities prior to the requisite service having been rendered. A basic principle of this guidance is that unvested share-based payment awards that contain nonforfeitable rights to dividends or dividend equivalents (whether paid or unpaid) are participating securities and are to be included in the computation of EPS pursuant to the two-class method. The provisions of this guidance are effective for financial statements issued for fiscal years beginning after December 15, 2008, and interim periods within those years. All prior-period EPS data presented are required to be adjusted retrospectively to conform with the provisions of this guidance. The Company adopted this new accounting guidance effective March 31, 2009, and adoption did not have a material effect on the Company’s consolidated results of operations or earnings per share.

FASB ASC Topic 805, "Business Combinations". New accounting guidance under ASC Topic 805 recognizes and measures the goodwill acquired in a business combination and defines a bargain purchase, and requires the acquirer to recognize that excess as a gain attributable to the acquirer. In contrast, previous accounting guidance required the "negative goodwill" amount to be allocated as a pro rata reduction of the amounts assigned to assets acquired. ASC Topic 805 requires that assets acquired and liabilities assumed in a business combination that arise from contingencies be recognized at fair value if fair value can be reasonably estimated. If fair value of such an asset or liability cannot be reasonably estimated, the asset or liability would generally be recognized in accordance with ASC Topic 450, "Contingencies." Under ASC Topic 805, the requirements of ASC Topic 420, "Exit or Disposal Cost Obligations," would have to be met in order to accrue for a restructuring plan in purchase accounting. This new accounting guidance applies prospectively to business combinations for which the acquisition date is on or after December 15, 2008. The Company adopted this guidance effective January 1, 2009. This new accounting guidance will change the Company's accounting treatment for business combinations on a prospective basis.

FASB ASC Topic 810, "Consolidation". During December 2007, the FASB issued new accounting guidance under ASC Topic 810 to establish accounting and reporting standards for the noncontrolling interest in a subsidiary and for the deconsolidation of a subsidiary. It clarifies that a noncontrolling interest in a subsidiary is an ownership interest in the consolidated entity that should be reported as equity in the consolidated financial statement, but separate from the parent's equity. This guidance is effective for fiscal years, and interim periods within those fiscal years, beginning on or after December 15, 2008. Management adopted this new accounting guidance effective January 1, 2009, and adoption did not have a material impact on the Company's consolidated financial condition or results of operations.

FASB ASC Topic 815, "Derivatives and Hedging". New accounting guidance under ASC Topic 815 is intended to enhance the disclosures required under previous accounting guidance to include how and why an entity uses derivative instruments, how derivative instruments and related hedge items are accounted for and their impact on an entity's financial positions, results of operations and cash flows. This guidance is effective for financial statements issued for fiscal years and interim periods beginning after November 15, 2008. Adoption of this new accounting guidance did not have a material impact on the consolidated financial statements.

FASB ASC Topic 820, "Fair Value Measurements and Disclosures". New accounting guidance under ASC Topic 820 addresses concerns regarding (1) determining whether a market is not active and a transaction is not orderly, (2) recognition and presentation of other-than-temporary impairments and (3) interim disclosures of fair values of financial instruments. The guidance is effective for interim and annual periods ending after June 15, 2009, with early adoption permitted for periods ending after March 15, 2009. The Company adopted the new accounting guidance effective June
30, 2009 and adoption did not have a material effect on the Company's consolidated results of operations.

FASB ASC Topic 855, "Subsequent Events". New accounting guidance under ASC Topic 855 incorporates accounting guidance that originated as U.S. auditing standards into the body of authoritative literature issued by the FASB. This guidance is based on the same principles as those that currently exist in the auditing standards. However, the new guidance does make a few changes such as eliminating Type I and Type II subsequent events and requiring an entity to disclose the date through which it evaluated subsequent events. This guidance is effective for interim or annual periods ending after June 15, 2009. The Company adopted this new accounting guidance effective June 30, 2009 and adoption did not have a material effect on the Company's consolidated financial statements.

Pronouncements issued but not yet effective

FASB ASC Topic 810, "Consolidation." New accounting guidance under ASC Topic 810 amends prior guidance to change how a company determines when an entity that is insufficiently capitalized or is not controlled through voting (or similar rights) should be consolidated. The determination of whether a company is required to consolidate an entity is based on, among other things, an entity's purpose and design and a company's ability to direct the activities of the entity that most significantly impact the entity's economic performance. This guidance requires additional disclosures about the reporting entity's involvement with variable-interest entities and any significant changes in risk exposure due to that involvement as well as its affect on the entity's financial statements. This new accounting guidance will be effective January 1, 2010 and is not expected to have a significant impact on the Company's financial statements.

FASB ASC Topic 860, "Transfers and Servicing." New accounting guidance under ASC Topic 860 amends prior accounting guidance to enhance reporting about transfers of financial assets, including securitizations, and where companies have continuing exposure to the risks related to transferred financial assets. This guidance eliminates the concept of a "qualifying special-purpose entity" and changes the requirements for derecognizing financial assets. This guidance also requires additional disclosures about all continuing involvements with transferred financial assets including information about gains and losses resulting from transfers during the period. This new accounting guidance will be effective January 1, 2010 and is not expected to have a significant impact on the Company's financial statements.

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

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

Forward-Looking Information

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

Introduction

The following discussion and analysis is intended as a review of significant factors affecting the financial condition and results of operations of Shore Bancshares, Inc. and its consolidated subsidiaries for the periods indicated. This discussion and analysis should be read in conjunction with the unaudited consolidated financial statements and related notes presented in this report, as well as the audited consolidated financial statements and related notes included in the Annual Report of Shore Bancshares, Inc. on Form 10-K for the year ended December 31, 2008.

Shore Bancshares, Inc. is the largest independent financial holding company located on the Eastern Shore of Maryland. It is the parent company of The Talbot Bank of Easton, Maryland located in Easton, Maryland ("Talbot Bank"), The Centreville National Bank of Maryland located in Centreville, Maryland ("Centreville National Bank") and The Felton Bank, located in Felton, Delaware ("Felton Bank") (collectively, the "Banks"). The Banks operate 19 full service branches in Kent County, Queen Anne's County, Talbot County, Caroline County and Dorchester County in Maryland and Kent County, Delaware. The Company engages in the insurance business through three insurance producer firms, The Avon-Dixon Agency, LLC, Elliott Wilson Insurance, LLC and Jack Martin Associates, Inc.; a wholesale insurance company, TSGIA, Inc.; and two insurance premium finance companies, Mubell Finance, LLC and ESFS, Inc. (all of the foregoing are collectively referred to as the "Insurance Subsidiary") and the mortgage broker business through Wye Mortgage Group, LLC, all of which are wholly-owned subsidiaries of Shore Bancshares, Inc.

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

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

Critical Accounting Policies

Our financial statements are prepared in accordance with accounting principles generally accepted in the United States of America ("GAAP"). The financial information contained within the financial statements is, to a significant extent, financial information contained that is based on measures of the financial effects of transactions and events that have already occurred. A variety of factors could affect the ultimate value that is obtained either when earning income, recognizing an expense, recovering an asset or relieving a liability.

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

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

Three basic components comprise our allowance for credit losses: (i) a specific allowance; (ii) a formula allowance; and (iii) a nonspecific allowance. Each component is determined based on estimates that can and do change when the actual events occur. The specific allowance is used to individually allocate an allowance to loans identified as impaired. An impaired loan may show deficiencies in the borrower's overall financial condition, payment history, support available from financial guarantors and/or the fair market value of collateral. When a loan is identified as impaired, a specific allowance is established based on our assessment of the loss that may be associated with the individual loan. The formula allowance is used to estimate the loss on internally risk rated loans, exclusive of those identified as impaired. Loans identified as special mention, substandard, doubtful and loss, as well as impaired, are segregated from performing loans. Remaining loans are then grouped by type (commercial, commercial real estate and construction, residential real estate or consumer). Each loan type is assigned an allowance factor based on management's estimate of the risk, complexity and size of individual loans within a particular category. Classified loans are assigned higher allowance factors than non-rated loans due to management's concerns regarding collectibility or management's knowledge of particular elements regarding the borrower. Allowance factors grow with the worsening of the internal risk rating. The nonspecific formula is used to estimate the loss of non-classified loans stemming from more global factors such as delinquencies, loss history, trends in volume and terms of loans, effects of changes in lending policy, the experience and depth of management, national and local economic trends, concentrations of credit, the quality of the loan review system and the effect of external factors such as competition and regulatory requirements. The nonspecific allowance captures losses that have impacted the portfolio but have yet to be recognized in either the formula or specific allowance.

OVERVIEW

Net income for the third quarter of 2009 was $1.951 million, or diluted earnings per common share of $0.23, compared to $3.1 million, or diluted earnings per common share of $0.37, for the third quarter of 2008. For the second quarter of 2009, net income was $354 thousand or $0.04 diluted earnings per common share. Annualized return on average assets was 0.66% for the three months ended September 30, 2009, compared to 1.19% for the same period in 2008. Annualized return on average stockholders' equity was 6.03% for the third quarter of 2009, compared to 9.81% for the third quarter of 2008. For the second quarter of 2009, annualized return on average assets was 0.13% and return on average equity was 1.07%.

Net income for the first nine months of 2009 was $4.2 million, or diluted earnings per common share of $0.50, compared to $9.2 million, or diluted earnings per common share of $1.10, for the first nine months of 2008. Annualized return on average assets was 0.50% for the nine months ended September 30, 2009, compared to 1.23% for the same period in 2008. Annualized return on average stockholders' equity was 4.08% for the first nine months of 2009, compared to 9.95% for the first nine months of 2008.

During the first nine months of 2009, net income available to common stockholders was negatively impacted by $1.9 million in dividends and discount accretion associated with the January 9, 2009 sale and April 15, 2009 repurchase of preferred stock under the U.S. Department of the Treasury’s Troubled Asset Relief Program Capital Purchase Program. These dividends and discount accretion had no impact on net income available to common stockholders for the third quarter of 2009.

RESULTS OF OPERATIONS

Net Interest Income

Net interest income for the three months ended September 30, 2009 was $10.4 million, an increase of 5.2% when compared to the same period last year. An increase in average earning assets and lower rates paid on interest bearing liabilities were sufficient to offset the decline in yields on earning assets. The net interest margin was 3.79% for the third quarter of 2009, a decrease of 31 basis points when compared to the third quarter of 2008. The 400 basis-point reduction in interest rates by the Federal Reserve during 2008 had a significant impact on the overall yield on earning assets. Net interest income increased 3.4% from the second quarter of 2009, also due to a higher volume of average earning assets and lower rates paid partially offset by lower yields earned. The net interest margin decreased six basis points from 3.85% for the second quarter of 2009.

Interest income was $14.9 million for the third quarter of 2009, a decrease of 2.5% from the third quarter of 2008. Average earning assets increased 13.3% during the third quarter of 2009 when compared to the same period in 2008, while yields earned decreased 89 basis points to 5.41%. Average loans increased 7.7% while the yield earned on loans decreased 57 basis points. Loans comprised 83.6% of total average earning assets for the third quarter of 2009, a decrease from the 87.9% for the third quarter of 2008. The mix of earning assets shifted from loans and securities to Federal funds sold which comprised 7.4% of total earning assets compared to 1.8% for the third quarter of 2008. Interest income increased 1.9% when compared to the second quarter of 2009. Average earning assets increased 3.7% during the third quarter of 2009 when compared to the second quarter of 2009, while yields earned decreased 15 basis points.

Interest expense decreased 16.8% for the three months ended September 30, 2009 when compared to the same period last year. Average interest bearing liabilities increased 15.8%, while rates paid decreased 78 basis points to 1.97%. During the second quarter of 2009, the Company began to participate in the Promontory Insured Network Deposits Program (“IND”). The $165.0 million increase in average interest bearing deposits for the third quarter of 2009 over the same period of 2008 included approximately $88.9 million from the IND program. The Company incurs the largest amount of interest expense from time deposits. For the three months ended September 30, 2009, the average balance of certificates of deposit $100,000 or more increased 39.5% when compared to the same period last year, while the average rate paid on these certificates of deposit decreased 113 basis points to 2.82%. Comparing the third quarter of 2009 to the third quarter of 2008, average other time deposits increased 5.2% while the rate paid on average other time deposits decreased 73 basis points. Comparing the third quarter of 2009 to the second quarter of 2009, interest expense decreased 1.3% and average interest bearing liabilities increased 4.3%, while rates paid decreased 13 basis points. Average interest bearing deposits for the third quarter of 2009 included approximately $88.9 million from the IND program, compared to approximately $60.6 million for the second quarter of 2009.

Net interest income for the nine months ended September 30, 2009 was $30.6 million, an increase of 3.4% when compared to the same period last year. An increase in the volume of average earning assets and a reduction in the cost of funds were sufficient to offset the decline in yields on earning assets. The net interest margin was 3.90% for the first nine months of 2009, a decrease of 31 basis points when compared to the first nine months of 2008.

Interest income was $44.0 million for the first nine months of 2009, a decrease of 5.0% from the first nine months of 2008. Average earning assets increased 11.7% during the nine months ended September 30, 2009 when compared to the same period in 2008, while yields earned decreased 99 basis points to 5.60%. Comparing the nine months ended September 30, 2009 to the same period of last year, average loans increased 10.4% while the yield earned on loans decreased 85 basis points. Loans comprised 86.2% and 87.2% of total average earning assets for the first nine months of 2009 and 2008, respectively.

Interest expense decreased 19.9% for the nine months ended September 30, 2009 when compared to the same period last year. Average interest bearing liabilities increased 12.3%, while rates paid decreased 84 basis points to 2.10%. For the nine months ended September 30, 2009, the average balance of certificates of deposit $100,000 or more increased 35.4% when compared to the same period last year, while the average rate paid on these certificates of deposit decreased 113 basis points to 3.13%. Average other time deposits increased 6.8%, while the rate paid on average other time deposits decreased 79 basis points when compared to the first nine months of 2008.

Analysis of Interest Rates and Interest Differentials

The following table presents the distribution of the average consolidated balance sheets, interest income/expense, and annualized yields earned and rates paid for the three months ended September 30, 2009 and 2008.

(Dollars in thousands)	For the Three Months Ended September 30, 2009 Average Balance	Income(1)/ Expense	Yield/ Rate	For the Three Months Ended September 30, 2008 Average Balance	Income(1)/ Expense	Yield/ Rate
Earning assets						
Loans (2), (3)	$ 920,241	$ 14,042	6.05%	$ 854,371	$ 14,225	6.62%
Investment securities						
Taxable	89,101	800	3.56	84,713	924	4.34
Tax-exempt	8,125	118	5.76	10,320	145	5.63
Federal funds sold	81,466	31	0.16	17,921	79	1.74
Interest bearing deposits	1,605	4	0.77	4,218	21	2.01
Total earning assets	1,100,538	14,995	5.41%	971,543	15,394	6.30%
Cash and due from banks	20,042			14,306		
Other assets	57,049			50,358		
Allowance for credit losses	(11,042)			(8,468)		
Total assets	$ 1,166,587			$ 1,027,739		
Interest bearing liabilities						
Demand deposits	$ 125,233	82	0.26%	$ 112,000	97	0.34%
Money market and savings deposits	245,801	412	0.67	183,408	673	1.46
Certificates of deposit $100,000 or more	274,580	1,954	2.82	196,810	1,953	3.95
Other time deposits	237,757	1,920	3.20	226,110	2,232	3.93
Interest bearing deposits	883,371	4,368	1.96	718,328	4,955	2.74
Short-term borrowings	18,373	19	0.42	53,450	344	2.56
Long-term debt	1,947	98	19.90	8,485	90	4.21
Total interest bearing liabilities	903,691	4,485	1.97%	780,263	5,389	2.75%
Noninterest bearing deposits	117,933			111,915		
Other liabilities	16,554			10,978		
Stockholders' equity	128,409			124,583		
Total liabilities and stockholders' equity	$ 1,166,587			$ 1,027,739		
Net interest spread		$ 10,510	3.44%		$ 10,005	3.55%
Net interest margin			3.79%			4.10%
Tax-equivalent adjustment						
Investment securities		$ 41			$ 50	
Loans		41			46	
		$ 82			$ 96	

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The following table presents the distribution of the average consolidated balance sheets, interest income/expense, and annualized yields earned and rates paid for the nine months ended September 30, 2009 and 2008.

	For the Nine Months Ended September 30, 2009			For the Nine Months Ended September 30, 2008		
(Dollars in thousands)	Average Balance	Income(1)/ Expense	Yield/ Rate	Average Balance	Income(1)/ Expense	Yield/ Rate
Earning assets						
Loans (2), (3)	$ 910,842	$ 41,497	6.09%	$ 824,775	$ 42,829	6.94%
Investment securities						
Taxable	79,797	2,324	3.89	86,633	2,949	4.55
Tax-exempt	8,443	371	5.87	11,395	502	5.89
Federal funds sold	53,227	61	0.15	17,893	284	2.12
Interest bearing deposits	4,053	11	0.35	4,746	88	2.49
Total earning assets	1,056,362	44,264	5.60%	945,442	46,652	6.59%
Cash and due from banks	16,960			14,408		
Other assets	52,700			50,690		
Allowance for credit losses	(10,523)			(8,097)		
Total assets	$ 1,115,499			$ 1,002,443		
Interest bearing liabilities						
Demand deposits	$ 123,821	230	0.25%	$ 112,309	363	0.43%
Money market and savings deposits	207,588	937	0.60	180,087	2,032	1.51
Certificates of deposit $100,000 or more	252,978	5,920	3.13	186,879	5,963	4.26
Other time deposits	236,643	6,007	3.39	221,564	6,937	4.18
Interest bearing deposits	821,030	13,094	2.13	700,839	15,295	2.92
Short-term borrowings	27,718	96	0.46	47,409	1,026	2.89
Long-term debt	5,925	247	5.57	12,821	456	4.75
Total interest bearing liabilities	854,673	13,437	2.10%	761,069	16,777	2.94%
Noninterest bearing deposits	110,663			106,328		
Other liabilities	13,074			11,419		
Stockholders' equity	137,089			123,627		
Total liabilities and stockholders' equity	$ 1,115,499			$ 1,002,443		
Net interest spread		$ 30,827	3.50%		$ 29,875	3.65%
Net interest margin			3.90%			4.22%
Tax-equivalent adjustment						
Investment securities		$ 130			$ 175	
Loans		125			129	
		$ 255			$ 304	

(1) All amounts are reported on a tax equivalent basis computed using the statutory federal income tax rate of 35% exclusive of the alternative minimum tax rate and nondeductible interest expense.
(2) Average loan balances include nonaccrual loans.
(3)

Interest income on loans includes amortized loan fees, net of costs, for each loan category and yield calculations are stated to include all.

Noninterest Income

Noninterest income for the third quarter of 2009 decreased $527 thousand, or 10.0%, when compared to the third quarter of 2008. The decrease from the third quarter of 2008 was primarily due to a $1.3 million gain on the sale of a bank branch in August 2008. The gain on the branch sale was partially offset by a $371 thousand other than temporary impairment of Freddie Mac Preferred Stock and a $337 thousand loss on the sale of the Company's investment in Delmarva Bank Data Processing Center, Inc., an unconsolidated subsidiary. A mark to market gain on interest rate swaps of $420 thousand during the second quarter of 2009 and a decrease in insurance agency commissions of $149 thousand accounted for most of the decrease from the second quarter of 2009.

Noninterest income for the first nine months of 2009 decreased $526 thousand, or 3.3%, when compared to the same period in 2008. The mark to market gain on interest rate swaps of $420 thousand during the second quarter of 2009, offset by a decrease in insurance agency commissions of $623 thousand, accounted for part of the decrease compared to the first nine months of 2008. In addition, noninterest income for the first nine months in 2008 included the previously mentioned $1.3 million gain on the branch sale and the $708 thousand combined loss relating to the other than temporary impairment and the sale of the investment in the unconsolidated subsidiary.

Noninterest Expense
Noninterest expense for the third quarter of 2009 increased $868 thousand, or 9.2%, when compared to the third quarter of 2008. The increase was primarily attributable to higher FDIC insurance premiums of $323 thousand and write-downs of other real estate owned of $159 thousand. Noninterest expense decreased $396 thousand, or 3.7%, from the second quarter of 2009 primarily due to lower FDIC insurance premiums of $462 thousand. The second quarter 2009 FDIC insurance premium included a special one-time assessment of $513 thousand.

Noninterest expense for the first nine months of 2009 increased $2.1 million, or 7.4%, when compared to the first nine months of 2008. The increase was primarily attributable to higher FDIC insurance premiums of $1.4 million. The increase in FDIC insurance premiums was attributable to higher overall rates, a one-time special assessment of $513 thousand and growth in the Company's total deposits.

Income Taxes
The Company's effective tax rate was 38.0% for the three months ended September 30, 2009, compared to 36.7% for the same period last year. For the nine months ended September 30, 2009 and 2008, the effective tax rates were 38.2% and 37.8%, respectively. Management is not aware of any development with respect to tax law or our tax structure that is likely to have a material impact on our future effective tax rate.

ANALYSIS OF FINANCIAL CONDITION

Loans
Loans, net of unearned income, totaled $918.6 million at September 30, 2009, an increase of $30.1 million, or 3.4%, since December 31, 2008. Average loans, net of unearned income, were $920.2 million for the three months ended September 30, 2009, an increase of $65.9 million, or 7.7%, when compared to the same period last year. Average loans, net of unearned income, were $910.8 million for the nine months ended September 30, 2009, an increase of $86.1 million, or 10.4%, when compared to the same period in 2008.

Allowance for Credit Losses
We have established an allowance for credit losses, which is increased by provisions charged against earnings and recoveries of previously charged-off debts. The allowance is decreased by current period charge-offs of uncollectible debts. Management evaluates the adequacy of the allowance for credit losses on a quarterly basis and adjusts the provision for credit losses based upon this analysis. The evaluation of the adequacy of the allowance for credit losses is based on a risk rating system of individual loans, as well as on a collective evaluation of smaller balance homogenous loans based on factors such as past credit loss experience, local economic trends, nonperforming and problem loans, and other factors which may impact collectibility. A loan is placed on nonaccrual when it is specifically determined to be impaired and principal and interest is delinquent for 90 days or more. Please refer to the discussion above under the caption "Critical Accounting Policies" for an overview of the underlying methodology management employs on a quarterly basis to maintain the allowance.

The provision for credit losses for the three months ended September 30, 2009 and 2008 was $1.7 million and $875 thousand, respectively. The provision for credit losses for the second quarter of 2009 was $1.7 million. The continued increased level of provision expense was the result of sustained growth in the loan portfolio, the overall increase in nonperforming assets and loan charge-offs, and management's assessment of general economic conditions. The provision for credit losses for the nine months ended September 30, 2009 and 2008 was $5.3 million and $2.0 million, respectively. We continue to emphasize credit quality and believe that our underwriting guidelines are strong. However, the continuation or worsening of the current economic recession will likely cause us to experience higher levels of provision expense, nonperforming assets and charge-offs. As problem loans are identified, management takes prompt action to quantify and minimize losses and also works with the borrowers in an effort to reach mutually acceptable resolutions.

Net charge-offs were $1.8 million for the three months ended September 30, 2009, compared to $539 thousand for the same period last year and $1.6 million for the second quarter of 2009. The allowance for credit losses as a percentage of average loans was 1.17% for the third quarter of 2009, 1.01% for the third quarter of 2008 and 1.18% for the second quarter of 2009. Net charge-offs were $3.9 million for the first nine months of 2009, compared to $885 thousand for the same period in 2008. The allowance for credit losses as a percentage of average loans increased to 1.18% for the first nine months of 2009 from 1.04% for the same period last year. Nonperforming assets were $17.5 million at September 30, 2009, compared to $8.3 million at December 31, 2008, with nonaccrual loans increasing $7.4 million and other real estate owned increasing $1.9 million. The increase in nonaccrual loans was primarily in residential real estate. Loans past due 90 days and still accruing at September 30, 2009 increased to $9.1 million from $1.4 million at December 31, 2008. The increase was primarily related to a $5 million secured participation loan purchased from a regional bank. The customer continues to make interest payments, but the loan has matured and the lead bank is negotiating a renewal with the customer. Based on management's quarterly evaluation of the adequacy of the allowance for credit losses, it believes that the allowance for credit losses and the related provision were adequate at September 30, 2009 to provide for probable losses inherent in our loan portfolio.

The following table presents a summary of the activity in the allowance for credit losses:

(Dollars in thousands)	For the Three Months Ended September 30, 2009	For the Three Months Ended September 30, 2008	For the Nine Months Ended September 30, 2009	For the Nine Months Ended September 30, 2008
Allowance balance – beginning of period	$ 10,784	$ 8,282	$ 9,320	$ 7,551
Charge-offs:				
Real estate – construction	(148)	(381)	(363)	(381)
Real estate – residential	(811)	(74)	(1,762)	(145)
Real estate – commercial	(522)	-	(695)	-
Commercial	(250)			