SHORE BANCSHARES INC
Form 10-Q
November 09, 2012

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

_____

FORM 10-Q

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**

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) 763-7800

Registrant's Telephone Number, Including Area Code

N/A

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

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

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

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

Large accelerated filer £	Accelerated filer R
Non-accelerated filer £ (Do not check if a smaller reporting company)	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: 8,457,359 shares of common stock outstanding as of October 31, 2012.

INDEX

PART I – FINANCIAL INFORMATION

Item 1. Financial Statements.

SHORE BANCSHARES, INC.

CONSOLIDATED BALANCE SHEETS

(Dollars in thousands, except per share amounts)

	September 30, 2012	December 31, 2011
ASSETS	(Unaudited)	
Cash and due from banks	$22,005	$22,986
Interest-bearing deposits with other banks	138,422	99,776
Federal funds sold	23,021	4,980
Investment securities:		
Available for sale, at fair value	126,372	129,780
Held to maturity, at amortized cost – fair value of $4,326 (2012) and $6,732 (2011)	4,075	6,480
Loans	808,030	841,050
Less: allowance for credit losses	(12,955)	(14,288)
Loans, net	795,075	826,762
Premises and equipment, net	15,537	14,662
Goodwill	12,454	12,454
Other intangible assets, net	3,890	4,208
Other real estate and other assets owned, net	8,418	9,385
Other assets	29,364	26,720
TOTAL ASSETS	$1,178,633	$1,158,193
LIABILITIES		
Deposits:		
Noninterest-bearing	$156,579	$133,801
Interest-bearing	881,935	876,118
Total deposits	1,038,514	1,009,919
Short-term borrowings	13,079	17,817
Other liabilities	8,422	8,753
Long-term debt	455	455
TOTAL LIABILITIES	1,060,470	1,036,944
STOCKHOLDERS' EQUITY		
Common stock, par value $.01 per share; shares authorized – 35,000,000; shares issued and outstanding – 8,457,359 (2012 and 2011)	85	85

Additional paid in capital	32,120	32,052
Retained earnings	86,152	90,801
Accumulated other comprehensive loss	(194)	(1,689)
TOTAL STOCKHOLDERS' EQUITY	118,163	121,249
TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY	$1,178,633	$1,158,193

See accompanying notes to Consolidated Financial Statements.

SHORE BANCSHARES, INC.

CONSOLIDATED STATEMENTS OF OPERATIONS (Unaudited)

(Dollars in thousands, except per share amounts)

	For the Three Months Ended September 30,		For the Nine Months Ended September 30,	
	2012	2011	2012	2011
INTEREST INCOME				
Interest and fees on loans	$10,604	$12,003	$32,505	$35,900
Interest and dividends on investment securities:				
Taxable	685	795	2,149	2,234
Tax-exempt	22	38	92	116
Interest on federal funds sold	3	3	7	24
Interest on deposits with other banks	79	29	188	47
Total interest income	11,393	12,868	34,941	38,321
INTEREST EXPENSE				
Interest on deposits	2,647	2,720	7,931	8,322
Interest on short-term borrowings	10	15	36	41
Interest on long-term debt	6	10	16	31
Total interest expense	2,663	2,745	7,983	8,394
NET INTEREST INCOME	8,730	10,123	26,958	29,927
Provision for credit losses	6,200	3,650	18,095	15,435
NET INTEREST INCOME AFTER PROVISION FOR CREDIT LOSSES	2,530	6,473	8,863	14,492
NONINTEREST INCOME				
Service charges on deposit accounts	628	697	1,898	2,145
Trust and investment fee income	410	389	1,279	1,183
Gains on sales of investment securities	278	354	278	435
Insurance agency commissions	2,427	2,312	7,522	7,297
Other noninterest income	258	771	2,175	2,239
Total noninterest income	4,001	4,523	13,152	13,299
NONINTEREST EXPENSE				
Salaries and wages	4,386	4,097	13,178	12,447
Employee benefits	945	878	3,071	2,917
Occupancy expense	625	585	1,950	1,749
Furniture and equipment expense	265	262	728	825
Data processing	703	661	2,063	2,192
Directors’ fees	131	198	367	417

Goodwill and other intangible assets impairment	-	1,344	-	1,344
Amortization of other intangible assets	96	129	318	386
Insurance agency commissions expense	275	250	1,004	982
FDIC insurance premium expense	376	180	993	1,044
Write-downs of other real estate owned	224	395	1,077	563
Other noninterest expenses	1,683	1,698	5,121	4,896
Total noninterest expense	9,709	10,677	29,870	29,762
(LOSS) INCOME BEFORE INCOME TAXES	(3,178)	319	(7,855)	(1,971)
Income tax (benefit) expense	(1,357)	225	(3,291)	(749)
NET (LOSS) INCOME	$(1,821)	$94	$(4,564)	$(1,222)
Basic net (loss) income per common share	$(0.22)	$0.01	$(0.54)	$(0.14)
Diluted net (loss) income per common share	$(0.22)	$0.01	$(0.54)	$(0.14)
Dividends paid per common share	$-	$0.01	$0.01	$0.08

See accompanying notes to Consolidated Financial Statements.

SHORE BANCSHARES, INC.

CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (LOSS) (Unaudited)

(Dollars in thousands)

	For the Three Months Ended September 30,		For the Nine Months Ended September 30,	
	2012	2011	2012	2011
Net (loss) income	$ (1,821)	$ 94	$ (4,564)	$ (1,222)
Other comprehensive income (loss)				
Securities available for sale:				
Unrealized holding gains on available-for-sale securities	609	723	1,524	1,555
Tax effect	(245)	(292)	(614)	(632)
Reclassification of gains recognized in net income	(278)	(354)	(278)	(435)
Tax effect	112	143	112	176
Net of tax amount	198	220	744	664
Cash flow hedging activities:				
Unrealized holding gains (losses) on cash flow hedging activities	479	(484)	1,259	(821)
Tax effect	(193)	196	(508)	331
Net of tax amount	286	(288)	751	(490)
Total other comprehensive income (loss)	484	(68)	1,495	174
Comprehensive (loss) income	$ (1,337)	$ 26	$ (3,069)	$ (1,048)

See accompanying notes to Consolidated Financial Statements.

SHORE BANCSHARES, INC.

CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY (Unaudited)

For the Nine Months Ended September 30, 2012 and 2011

(Dollars in thousands, except per share amounts)

	Common Stock	Warrant	Additional Paid in Capital	Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Total Stockholders' Equity
Balances, January 1, 2012	$ 85	$ -	$ 32,052	$ 90,801	$ (1,689)	$ 121,249
Comprehensive loss:						
Net loss	-	-	-	(4,564)	-	(4,564)
Unrealized gains on available-for-sale securities, net of taxes	-	-	-	-	744	744
Unrealized gains on cash flow hedging activities, net of taxes	-	-	-	-	751	751
Total comprehensive loss						(3,069)
Stock-based compensation	-	-	68	-	-	68
Cash dividends paid ($0.01 per share)	-	-	-	(85)	-	(85)
Balances, September 30, 2012	$ 85	$ -	$ 32,120	$ 86,152	$ (194)	$ 118,163
Balances, January 1, 2011	$ 84	$ 1,543	$ 30,242	$ 92,458	$ (1,814)	$ 122,513
Comprehensive loss:						
Net loss	-	-	-	(1,222)	-	(1,222)
Unrealized gains on available-for-sale securities, net of taxes	-	-	-	-	664	664
Unrealized losses on cash flow hedging activities, net of taxes	-	-	-	-	(490)	(490)
Total comprehensive loss						(1,048)
Shares issued for employee stock-based awards	1	-	(1)	-	-	-
Stock-based compensation	-	-	197	-	-	197
Cash dividends paid ($0.08 per share)	-	-	-	(676)	-	(676)

Balances, September 30, 2011	$ 85	$ 1,543	$ 30,438	$ 90,560	$ (1,640)	$ 120,986

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,	
	2012	2011
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net loss	$(4,564)	$(1,222)
Adjustments to reconcile net loss to net cash provided by operating activities:		
Provision for credit losses	18,095	15,435
Goodwill and other intangible assets impairment	-	1,344
Depreciation and amortization	2,011	1,802
Discount accretion on debt securities	(56)	(94)
Stock-based compensation expense	174	241
Excess tax expense from stock-based arrangements	(106)	(44)
Deferred income tax benefit	(63)	(880)
Gains on sales of investment securities	(278)	(435)
(Gains) losses on disposals of premises and equipment	(214)	4
Losses on sales and write-downs of other real estate owned	1,549	651
Net changes in:		
Accrued interest receivable	473	1,039
Other assets	(3,085)	1,031
Accrued interest payable	(66)	(172)
Other liabilities	(265)	(2,730)
Net cash provided by operating activities	13,605	15,970
CASH FLOWS FROM INVESTING ACTIVITIES:		
Proceeds from maturities and principal payments of investment securities available for sale	34,795	42,746
Proceeds from sales of investment securities available for sale	6,275	17,446
Purchases of investment securities available for sale	(36,717)	(65,927)
Proceeds from maturities and principal payments of investment securities held to maturity	2,395	186
Net change in loans	8,877	7,025
Purchases of premises and equipment	(1,842)	(525)
Proceeds from sales of premises and equipment	307	4
Proceeds from sales of other real estate owned	4,133	2,879
Investment in unconsolidated subsidiary	-	**(12)**
Net cash provided by investing activities	18,223	3,822
CASH FLOWS FROM FINANCING ACTIVITIES:		
Net change in noninterest-bearing deposits	22,778	11,634
Net change in interest-bearing deposits	5,817	20,769
Net change in short-term borrowings	(4,738)	(749)

Excess tax expense from stock-based arrangements	106	44
Common stock dividends paid	(85)	(676)
Net cash provided by financing activities	23,878	31,022
Net increase in cash and cash equivalents	55,706	50,814
Cash and cash equivalents at beginning of period	127,742	77,964
Cash and cash equivalents at end of period	$183,448	$128,778
Supplemental cash flows information:		
Interest paid	$8,050	$8,567
Income taxes paid	$122	$1,986
Transfers from loans to other real estate owned	$4,715	$9,693

See accompanying notes to Consolidated Financial Statements.

Shore Bancshares, Inc.

Notes to Consolidated Financial Statements

For the Three and Nine Months Ended September 30, 2012 and 2011

(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, 2012, the consolidated results of operations and comprehensive income (loss) for the three and nine months ended September 30, 2012 and 2011, and changes in stockholders' equity and cash flows for the nine months ended September 30, 2012 and 2011, have been included. All such adjustments are of a normal recurring nature. The amounts as of December 31, 2011 were derived from the 2011 audited financial statements. The results of operations for the three and nine months ended September 30, 2012 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, 2011. For purposes of comparability, certain reclassifications have been made to amounts previously reported to conform with the current period presentation.

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

Recent Accounting Standards

Accounting Standards Update ("ASU") 2011-03, "*Transfers and Servicing (Topic 860) - Reconsideration of Effective Control for Repurchase Agreements.*" ASU 2011-03 affects all entities that enter into agreements to transfer financial assets that both entitle and obligate the transferor to repurchase or redeem the financial assets before their maturity. The amendments in ASU 2011-03 remove from the assessment of effective control the criterion relating to the transferor's ability to repurchase or redeem financial assets on substantially the agreed terms, even in the event of default by the transferee. ASU 2011-03 also eliminates the requirement to demonstrate that the transferor possesses adequate collateral to fund substantially all the cost of purchasing replacement financial assets. ASU 2011-03 became effective for the Company on January 1, 2012 and did not have a significant impact on the Company's financial statements.

ASU 2011-04, "Fair Value Measurement (Topic 820) - Amendments to Achieve Common Fair Value Measurements and Disclosure Requirements in U.S. GAAP and IFRSs." ASU 2011-04 amends Topic 820, "Fair Value Measurements and Disclosures," to converge the fair value measurement guidance in U.S. Generally Accepted Accounting Principles and International Financial Reporting Standards. ASU 2011-04 clarifies the application of existing fair value measurement requirements, changes certain principles in Topic 820 and requires additional fair value disclosures. ASU 2011-04 became effective for the Company on January 1, 2012 and, aside from new disclosures included in Note 8 – Fair Value Measurements, did not have a significant impact on the Company’s financial statements.

ASU 2011-08, "Intangibles - Goodwill and Other (Topic 350) - Testing Goodwill for Impairment." ASU 2011-08 amends Topic 350, "Intangibles – Goodwill and Other," to give entities the option to first assess qualitative factors to determine whether the existence of events or circumstances leads to a determination that it is more likely than not that the fair value of a reporting unit is less than its carrying amount. If, after assessing the totality of events or circumstances, an entity determines it is not more likely than not that the fair value of a reporting unit is less than its carrying amount, then performing the two-step impairment test is unnecessary. However, if an entity concludes otherwise, then it is required to perform the first step of the two-step impairment test by calculating the fair value of the reporting unit and comparing the fair value with the carrying amount of the reporting unit. ASU 2011-08 became effective for the Company on January 1, 2012 and did not have a significant impact on the Company's financial statements.

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

Note 2 – Earnings/(Loss) Per Share

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

	For the Three Months Ended September 30,		For the Nine Months Ended September 30,	
(In thousands, except per share data)	2012	2011	2012	2011
Net (loss) income	$(1,821)	$94	$(4,564)	$(1,222)
Weighted average shares outstanding - Basic	8,457	8,457	8,457	8,449
Dilutive effect of common stock equivalents	-	-	-	-
Weighted average shares outstanding - Diluted	8,457	8,457	8,457	8,449
(Loss) earnings per common share - Basic	$(0.22)	$0.01	$(0.54)	$(0.14)
(Loss) earnings per common share - Diluted	$(0.22)	$0.01	$(0.54)	$(0.14)

The calculations of diluted earnings/(loss) per share for the three and nine months ended September 30, 2012 excluded 54 thousand and 43 thousand weighted average common stock equivalents, respectively, because the effect of including them would have been antidilutive. The calculations of diluted earnings/(loss) per share for the three and nine months ended September 30, 2011 each excluded 180 thousand weighted average common stock equivalents because the effect of including them would have been antidilutive.

Note 3 – Investment Securities

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

(Dollars in thousands)	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
Available-for-sale securities:				
September 30, 2012:				
Obligations of U.S. Government agencies and corporations	$ 34,812	$ 925	$ 2	$ 35,735
Mortgage-backed securities	87,427	2,588	2	90,013
Equity securities	589	35	-	624
Total	$ 122,828	$ 3,548	$ 4	$ 126,372
December 31, 2011:				
Obligations of U.S. Government agencies and corporations	$ 41,360	$ 803	$ 15	$ 42,148
Mortgage-backed securities	85,545	1,587	99	87,033
Equity securities	577	22	-	599
Total	$ 127,482	$ 2,412	$ 114	$ 129,780
Held-to-maturity securities:				
September 30, 2012:				
Obligations of states and political subdivisions	$ 4,075	$ 251	$ -	$ 4,326
December 31, 2011:				
Obligations of states and political subdivisions	$ 6,480	$ 252	$ -	$ 6,732

The following table provides information about gross unrealized losses and fair value by length of time that the individual available-for-sale securities have been in a continuous unrealized loss position at September 30, 2012.

	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	$ 2,998	$ 2	$ -	$ -	$ 2,998	$ 2
Mortgage-backed securities	1,571	2	-	-	1,571	2
Total	$ 4,569	$ 4	$ -	$ -	$ 4,569	$ 4

Total available-for-sale securities have a fair value of approximately $126.4 million. Of these securities, approximately $4.6 million have unrealized losses when compared to their amortized cost. All of the securities with the unrealized losses in the available-for-sale portfolio have modest duration risk, low credit risk, and minimal losses when compared to total amortized cost. The unrealized losses on debt securities that exist are the result of market changes in interest rates since original purchase. Because the Company does not intend to sell these debt securities and it is not more likely than not that the Company will be required to sell these securities before recovery of their amortized cost bases, which may be at maturity, the Company considers the unrealized losses in the available-for-sale portfolio to be temporary. There were no unrealized losses in the held-to-maturity securities portfolio at September 30, 2012.

The following table provides information on the amortized cost and estimated fair values of investment securities by maturity date at September 30, 2012.

	Available for sale		Held to maturity	
(Dollars in thousands)	Amortized Cost	Estimated Fair Value	Amortized Cost	Estimated Fair Value
Due in one year or less	$5,015	$5,031	$1,415	$ 1,422
Due after one year through five years	18,240	18,305	1,148	1,206
Due after five years through ten years	4,409	4,579	1,008	1,141
Due after ten years	94,575	97,833	504	557
	122,239	125,748	4,075	4,326
Equity securities	589	624	-	-
Total	$122,828	$126,372	$4,075	$ 4,326

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

Note 4 – Loans and allowance for credit losses

The Company makes residential mortgage, commercial and consumer loans to customers primarily in Talbot County, Queen Anne's County, Kent County, Caroline County and Dorchester County in Maryland and in Kent County, Delaware. The following table provides information about the principal classes of the loan portfolio at September 30, 2012 and December 31, 2011.

(Dollars in thousands)	September 30, 2012	December 31, 2011
Construction	$108,721	$119,883
Residential real estate	302,449	321,604
Commercial real estate	321,817	315,439
Commercial	61,531	69,485
Consumer	13,512	14,639
Total loans	808,030	841,050
Allowance for credit losses	(12,955)	(14,288)
Total loans, net	$795,075	$826,762

Loans are stated at their principal amount outstanding net of any deferred fees and costs. Interest income on loans is accrued at the contractual rate based on the principal amount outstanding. Fees charged and costs capitalized for originating loans are being amortized substantially on the interest method over the term of the loan. A loan is placed

on nonaccrual when it is specifically determined to be impaired or when principal or interest is delinquent for 90 days or more, unless the loan is well secured and in the process of collection. Any unpaid interest previously accrued on those loans is reversed from income. Interest payments received on nonaccrual loans are applied as a reduction of the loan principal balance unless collectability of the principal amount is reasonably assured, in which case interest is recognized on a cash basis. Loans are returned to accrual status when all principal and interest amounts contractually due are brought current and future payments are reasonably assured.

A loan is considered impaired if it is probable that the Company will not collect all principal and interest payments according to the loan's contractual terms. An impaired loan may show deficiencies in the borrower's overall financial condition, payment history, support available from financial guarantors and/or the fair market value of collateral. The impairment of a loan is measured at the present value of expected future cash flows using the loan's effective interest rate, or at the loan's observable market price or the fair value of the collateral if the loan is collateral dependent. Generally, the Company measures impairment on such loans by reference to the fair value of the collateral. Income on impaired loans is recognized on a cash basis, and payments are first applied against the principal balance outstanding (i.e., placing impaired loans on nonaccrual status). Generally, interest income is not recognized on specific impaired loans unless the likelihood of further loss is remote. The allowance for credit losses includes specific reserves related to impaired loans. Impaired loans do not include groups of smaller balance homogenous loans such as residential mortgage and consumer installment loans that are evaluated collectively for impairment. Reserves for probable credit losses related to these loans are based on historical loss ratios and are included in the formula portion of the allowance for credit losses.

Loans are evaluated on a case-by-case basis for impairment. Once the amount of impairment has been determined, the uncollectible portion is charged off. As seen in the table below, the difference between the unpaid principal balance and the recorded investment is the amount of partial charge-offs that have been taken. In some cases, a specific allocation within the allowance for credit losses is made until such time that a charge-off is made.

A loan is considered a troubled debt restructuring if a borrower is experiencing financial difficulties and a creditor has granted a concession. Concessions may include interest rate reductions or below market interest rates, principal forgiveness, restructuring amortization schedules and other actions intended to minimize potential losses.

The following tables provide information on impaired loans and any related allowance by loan class as of September 30, 2012 and December 31, 2011.

(Dollars in thousands)	Unpaid principal balance	Recorded investment with no allowance	Recorded investment with an allowance	Related allowance	Year-to-date average recorded investment	Quarter-to-date average recorded investment
September 30, 2012						
Impaired nonaccrual loans:						
Construction	$15,509	$ 11,456	$ 19	$ 19	$ 13,717	$ 12,770
Residential real estate	20,424	14,440	-	-	18,920	17,092
Commercial real estate	16,149	11,916	-	-	12,567	11,446
Commercial	2,124	1,557	-	-	1,760	1,572
Consumer	58	54	-	-	50	55
Total	54,264	39,423	19	19	47,014	42,935
Impaired accruing restructured loans:						
Construction	28,479	28,479	-	-	17,304	22,779
Residential real estate	5,231	5,231	-	-	4,258	5,120
Commercial real estate	16,986	16,986	-	-	14,173	16,032
Commercial	89	89	-	-	74	79
Consumer	-	-	-	-	-	-
Total	50,785	50,785	-	-	35,809	44,010
Total impaired loans:						
Construction	43,988	39,935	19	19	31,021	35,549
Residential real estate	25,655	19,671	-	-	23,178	22,212
Commercial real estate	33,135	28,902	-	-	26,740	27,478
Commercial	2,213	1,646	-	-	1,834	1,651
Consumer	58	54	-	-	50	55
Total	$105,049	$ 90,208	$ 19	$ 19	$ 82,823	$ 86,945

11

(Dollars in thousands)	Unpaid principal balance	Recorded investment with no allowance	Recorded investment with an allowance	Related allowance	Year-to-date average recorded investment	Quarter-to-date average recorded investment
December 31, 2011						
Impaired nonaccrual loans:						
Construction	$ 22,883	$ 14,005	$ 1,550	$ 170	$ 16,555	$ 16,367
Residential real estate	22,431	16,925	3,181	1,296	15,430	18,118
Commercial real estate	17,372	14,012	-	-	14,624	13,545
Commercial	2,119	1,669	-	-	2,539	1,680
Consumer	30	28	-	-	32	34
Total	64,835	46,639	4,731	1,466	49,180	49,744
Impaired accruing restructured loans:						
Construction	11,781	11,781	-	-	10,663	10,930
Residential real estate	3,792	3,792	-	-	6,093	3,156
Commercial real estate	9,566	9,566	-	-	7,960	9,949
Commercial	69	69	-	-	111	35
Consumer	-	-	-	-	-	-
Total	25,208	25,208	-	-	24,827	24,070
Total impaired loans:						
Construction	34,664	25,786	1,550	170	27,218	27,297
Residential real estate	26,223	20,717	3,181	1,296	21,523	21,274
Commercial real estate	26,938	23,578	-	-	22,584	23,494
Commercial	2,188	1,738	-	-	2,650	1,715
Consumer	30	28	-	-	32	34
Total	$ 90,043	$ 71,847	$ 4,731	$ 1,466	$ 74,007	$ 73,814

The following tables provide information on troubled debt restructurings by loan class as of September 30, 2012 and December 31, 2011. The amounts include nonaccrual troubled debt restructurings.

(Dollars in thousands)	Number of contracts	Premodification outstanding recorded investment	Postmodification outstanding recorded investment
Troubled debt restructurings:			
September 30, 2012			
Construction	19	$ 33,277	$ 29,518
Residential real estate	28	14,145	7,614
Commercial real estate	22	24,065	20,418
Commercial	3	149	126
Consumer	1	30	27
Total	73	$ 71,666	$ 57,703
December 31, 2011			
Construction	9	$ 12,981	$ 12,539
Residential real estate	20	11,471	10,359
Commercial real estate	20	15,874	14,175
Commercial	1	69	69
Consumer	-	-	-
Total	50	$ 40,395	$ 37,142

(Dollars in thousands)	Number of contracts	Recorded investment
Troubled debt restructurings that subsequently defaulted (1):		
September 30, 2012		
Construction	7	$ 2,129
Residential real estate	13	2,902
Commercial real estate	6	3,433
Commercial	1	36
Consumer	1	27
Total	28	$ 8,527
December 31, 2011		
Construction	3	$ 758
Residential real estate	10	7,353
Commercial real estate	5	6,751
Commercial	-	-
Consumer	-	-
Total	18	$ 14,862

(1) Generally, a loan is considered in default when principal or interest is past due 30 days or more.

Management uses risk ratings as part of its monitoring of the credit quality in the Company's loan portfolio. Loans that are identified as special mention, substandard and doubtful are adversely rated and are assigned higher risk ratings than favorably rated loans.

The following tables provide information on loan risk ratings as of September 30, 2012 and December 31, 2011.

(Dollars in thousands)	Pass/Performing	Special mention	Substandard	Doubtful	Nonaccrual	Total
September 30, 2012						
Construction	$ 43,334	$ 31,359	$ 22,553	$ -	$ 11,475	$ 108,721
Residential real estate	246,805	24,191	16,580	433	14,440	302,449
Commercial real estate	254,339	30,873	24,689	-	11,916	321,817
Commercial	54,488	3,870	1,556	60	1,557	61,531
Consumer	13,252	120	86	-	54	13,512
Total	$ 612,218	$ 90,413	$ 65,464	$ 493	$ 39,442	$ 808,030

(Dollars in thousands)	Pass/Performing	Special mention	Substandard	Doubtful	Nonaccrual	Total
December 31, 2011						
Construction	$ 50,403	$ 30,373	$ 23,552	$ -	$ 15,555	$ 119,883
Residential real estate	261,910	13,467	25,676	445	20,106	321,604
Commercial real estate	257,247	16,001	28,179	-	14,012	315,439
Commercial	59,178	3,813	4,748	77	1,669	69,485
Consumer	14,520	32	59	-	28	14,639
Total	$ 643,258	$ 63,686	$ 82,214	$ 522	$ 51,370	$ 841,050

The following tables provide information on the aging of the loan portfolio as of September 30, 2012 and December 31, 2011.

(Dollars in thousands)	Accruing Current	30-59 days past due	60-89 days past due	90 days or more past due	Total past due	Nonaccrual	Total
September 30, 2012							
Construction	$96,156	$1,090	$-	$-	$1,090	$ 11,475	$108,721
Residential real estate	281,610	4,274	1,113	1,012	6,399	14,440	302,449
Commercial real estate	303,008	971	2,371	3,551	6,893	11,916	321,817
Commercial	59,756	69	82	67	218	1,557	61,531
Consumer	13,228	174	11	45	230	54	13,512
Total	$753,758	$6,578	$3,577	$4,675	$14,830	$ 39,442	$808,030
Percent of total loans	93.3 %	0.8 %	0.4 %	0.6 %	1.8 %	4.9 %	

(Dollars in thousands)	Accruing Current	30-59 days past due	60-89 days past due	90 days or more past due	Total past due	Nonaccrual	Total
December 31, 2011							
Construction	$102,441	$1,246	$316	$325	$1,887	$ 15,555	$119,883
Residential real estate	289,459	4,417	5,291	2,331	12,039	20,106	321,604
Commercial real estate	289,760	10,073	1,594	-	11,667	14,012	315,439
Commercial	64,581	1,350	1,819	66	3,235	1,669	69,485
Consumer	14,492	112	6	1	119	28	14,639
Total	$760,733	$17,198	$9,026	$2,723	$28,947	$ 51,370	$841,050
Percent of total loans	90.5 %	2.0 %	1.1 %	0.3 %	3.4 %	6.1 %	

The Company has established an allowance for credit losses, which is increased by provisions charged against earnings and recoveries of previously charged-off debts and is decreased by current period charge-offs of uncollectible debts. Management evaluates the adequacy of the allowance for credit losses on a quarterly basis and adjusts the provision for credit losses based on this analysis. Allocation of a portion of the allowance to one loan class does not preclude its availability to absorb losses in other loan classes.

The following tables provide a summary of the activity in the allowance for credit losses allocated by loan class for the three months ended September 30, 2012 and 2011.

(Dollars in thousands)	Construction	Residential real estate	Commercial real estate	Commercial	Consumer	Unallocated	Total
For the three months ended September 30, 2012							
Allowance for credit losses:							
Beginning balance	$ 2,845	$ 4,237	$ 3,952	$ 1,063	$ 485	$ 408	$ 12,990
Charge-offs	(3,222)	(2,323)	(742)	(73)	(31)	-	(6,391)
Recoveries	5	5	116	22	8	-	156
Net charge-offs	(3,217)	(2,318)	(626)	(51)	(23)	-	(6,235)
Provision	3,699	2,268	275	524	(158)	(408)	6,200
Ending balance	$ 3,327	$ 4,187	$ 3,601	$ 1,536	$ 304	$ -	$ 12,955

(Dollars in thousands)	Construction	Residential real estate	Commercial real estate	Commercial	Consumer	Unallocated	Total
For the three months ended September 30, 2011							
Allowance for credit losses:							
Beginning balance	$ 3,533	$ 4,184	$ 5,251	$ 2,710	$ 605	$ 75	$ 16,358
Charge-offs	(1,005)	(2,859)	(1,385)	(1,519)	(33)	-	(6,801)
Recoveries	-	38	229	47	19	-	333
Net charge-offs	(1,005)	(2,821)	(1,156)	(1,472)	(14)	-	(6,468)

Provision	870	2,679	(404)	315	19	171	3,650
Ending balance	$ 3,398	$ 4,042	$ 3,691	$ 1,553	$ 610	$ 246	$ 13,540

16

The following tables provide a summary of the activity in the allowance for credit losses allocated by loan class for the nine months ended September 30, 2012 and 2011.

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

(Dollars in thousands)	Construction	Residential real estate	Commercial real estate	Commercial	Consumer	Unallocated	Total
For the nine months ended September 30, 2011							
Allowance for credit losses:							
Beginning balance	$ 3,327	$ 4,833	$ 3,665	$ 1,422	$ 637	$ 343	$ 14,227
Charge-offs	(2,419)	(7,340)	(3,878)	(3,290)	(148)	-	(17,075)
Recoveries	49	106	234	504	60	-	953
Net charge-offs	(2,370)	(7,234)	(3,644)	(2,786)	(88)	-	(16,122)
Provision	2,441	6,443	3,670	2,917	61	(97)	15,435
Ending balance	$ 3,398	$ 4,042	$ 3,691	$ 1,553	$ 610	$ 246	$ 13,540

The following tables include impairment information relating to loans and the allowance for credit losses as of September 30, 2012 and 2011.

(Dollars in thousands)	Construction	Residential real estate	Commercial real estate	Commercial	Consumer	Unallocated	Total
September 30, 2012							
Loans individually evaluated for impairment	$ 39,954	$ 19,671	$ 28,902	$ 1,646	$ 54	$ -	$ 90,227
Loans collectively evaluated for impairment	68,767	282,778	292,915	59,885	13,458	-	717,803
Total loans	$ 108,721	$ 302,449	$ 321,817	$ 61,531	$ 13,512	$ -	$ 808,030
Allowance for credit losses allocated to:							
Loans individually evaluated for impairment	$ 19	$ -	$ -	$ -	$ -	$ -	$ 19
Loans collectively evaluated for impairment	3,308	4,187	3,601	1,536	304	-	12,936
Total allowance for credit losses	$ 3,327	$ 4,187	$ 3,601	$ 1,536	$ 304	$ -	$ 12,955

(Dollars in thousands)	Construction	Residential real estate	Commercial real estate	Commercial	Consumer	Unallocated	Total
September 30, 2011							
Loans individually evaluated for impairment	$ 27,426	$ 19,944	$ 23,410	$ 1,690	$ 40	$ -	$ 72,510
Loans collectively evaluated for impairment	99,593	307,811	298,134	69,792	14,726	-	790,056
Total loans	$ 127,019	$ 327,755	$ 321,544	$ 71,482	$ 14,766	$ -	$ 862,566
Allowance for credit losses allocated to:							
Loans individually evaluated for impairment	$ -	$ 90	$ -	$ -	$ -	$ -	$ 90
Loans collectively evaluated for impairment	3,398	3,952	3,691	1,553	610	246	13,450
Total allowance for credit losses	$ 3,398	$ 4,042	$ 3,691	$ 1,553	$ 610	$ 246	$ 13,540

Note 5 – Other Assets

The Company had the following other assets at September 30, 2012 and December 31, 2011.

(Dollars in thousands)	September 30, 2012	December 31, 2011
Nonmarketable investment securities	$ 2,808	$ 2,866
Insurance premiums receivable	443	876
Accrued interest receivable	3,460	3,933
Income taxes receivable	3,780	719
Deferred income taxes	8,087	9,036
Interest rate caps (1)	24	250
Prepaid expenses	2,945	3,641
Other assets	7,817	5,399
Total	$ 29,364	$ 26,720

(1) See Note 9 for further discussion.

Note 6 – Other Liabilities

The Company had the following other liabilities at September 30, 2012 and December 31, 2011.

(Dollars in thousands)	September 30, 2012	December 31, 2011
Accrued interest payable	$ 503	$ 569
Other liabilities	7,919	8,184
Total	$ 8,422	$ 8,753

Note 7 - Stock-Based Compensation

As of September 30, 2012, the Company maintained the Shore Bancshares, Inc. 2006 Stock and Incentive Compensation Plan ("2006 Equity Plan") under which it may issue shares of common stock or grant other equity-based awards. The Company's ability to grant options under the Shore Bancshares, Inc. 1998 Stock Option Plan (the "1998 Option Plan") expired on March 3, 2008 and all of the remaining 7,125 outstanding options expired on May 9, 2012.

Stock-based awards granted to date generally are time-based, vest in equal installments on each anniversary of the grant date over a three- to five-year period of time, and, in the case of stock options, expire 10 years from the grant date. Stock-based compensation expense is recognized ratably over the requisite service period for all awards, is based on the grant-date fair value and reflects forfeitures as they occur.

During the first quarter of 2012, the Company granted options to purchase 54,216 shares of the Company's common stock pursuant to the 2006 Equity Plan. The options have an exercise price of $6.64 and vest 50% after two years from date of grant and 50% after three years from date of grant.

The following tables provide information on stock-based compensation expense for the three and nine months ended September 30, 2012 and 2011.

	For the Three Months Ended September 30,		For the Nine Months Ended September 30,	
(Dollars in thousands)	2012	2011	2012	2011
Stock-based compensation expense	$33	$104	$174	$241

	September 30,	
(Dollars in thousands)	2012	2011
Unrecognized stock-based compensation expense	$178	$264
Weighted average period unrecognized expense is expected to be recognized	2.2 years	0.8 years

The following table summarizes restricted stock award activity for the Company under the 2006 Equity Plan for the nine months ended September 30, 2012.

	Number of Shares	Weighted Average Grant Date Fair Value
Nonvested at beginning of period	45,779	$ 13.20
Granted	-	-
Vested	(39,231)	12.92
Cancelled	-	-
Nonvested at end of period	6,548	$ 14.89

The following table summarizes stock option activity for the Company under the 2006 Equity Plan for the nine months ended September 30, 2012.

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

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

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

There was no aggregate intrinsic value of the options outstanding under the 2006 Equity Plan based on the $6.02 market value per share of Shore Bancshares, Inc.'s common stock at September 30, 2012. Since there were no options exercised during the first nine months of 2012 or 2011, there was no intrinsic value associated with stock options exercised and no cash received on exercise of options. At September 30, 2012, the weighted average remaining contract life of options outstanding was 9.5 years.

Note 8 – Fair Value Measurements

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

The Company 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 impaired loans and other real estate and other assets owned (foreclosed assets). These nonrecurring fair value adjustments typically involve application of lower of cost or market accounting or write-downs of individual assets.

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

values. These hierarchy levels are:

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

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

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

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

Investment Securities Available for Sale

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

Derivative Assets

Derivative instruments held by the Company for risk management purposes are traded in over-the-counter markets where quoted market prices are not readily available. For those derivatives, the Company measures fair value using third-party models that use primarily market observable inputs, such as yield curves and option volatilities, and include the value associated with counterparty credit risk. The Company classifies its derivative instruments held for risk management purposes as Level 2 in the fair value hierarchy. As of September 30, 2012 and December 31, 2011, the Company's derivative instruments consisted solely of interest rate caps. These derivative assets are included in other assets in the accompanying consolidated balance sheets.

The tables below present the recorded amount of assets measured at fair value on a recurring basis at September 30, 2012 and December 31, 2011. No assets were transferred from one hierarchy level to another during the first nine months of 2012 or 2011.

(Dollars in thousands)	Fair Value	Quoted Prices (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
September 30, 2012				
Securities available for sale:				
U.S. Government agencies	$35,735	$ -	$35,735	$ -
Mortgage-backed securities	90,013	-	90,013	-
Other equity securities	624	-	624	-
Total	$126,372	$ -	$126,372	$ -
Interest rate caps	$24	$ -	$24	$ -

(Dollars in thousands)	Fair Value	Quoted Prices (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
December 31, 2011				
Securities available for sale:				
U.S. Government agencies	$42,148	$ -	$42,148	$ -
Mortgage-backed securities	87,033	-	87,033	-
Other equity securities	599	-	599	-
Total	$129,780	$ -	$129,780	$ -
Interest rate caps	$250	$ -	$250	$ -

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

Loans

The Company does not record loans at fair value on a recurring basis; however, from time to time, a loan is considered impaired and a valuation allowance may be established if there are losses associated with the loan. Loans are considered impaired if it is probable that payment of interest and principal will not be made in accordance with contractual terms. The fair value of impaired loans can be estimated using one of several methods, including the collateral value, market value of similar debt, liquidation value and discounted cash flows. At September 30, 2012 and December 31, 2011, substantially all impaired loans were evaluated based on the fair value of the collateral and were classified as Level 3 in the fair value hierarchy.

Other Real Estate and Other Assets Owned (Foreclosed Assets)

Foreclosed assets are adjusted for fair value upon transfer of loans to foreclosed assets. Subsequently, foreclosed assets are carried at the lower of carrying value and fair value. Fair value is based on independent market prices, appraised value of the collateral or management's estimation of the value of the collateral. At September 30, 2012 and December 31, 2011, foreclosed assets were classified as Level 3 in the fair value hierarchy.

The tables below summarize the changes in the recorded amount of assets measured at fair value on a nonrecurring basis for the nine months ended September 30, 2012 and September 30, 2011. All assets measured at fair value on a nonrecurring basis were classified as Level 3 in the fair value hierarchy for the periods presented.

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

(Dollars in thousands)	Construction	Residential real estate	Commercial real estate	Commercial	Consumer	Total
For the nine months ended September 30, 2011						
Impaired loans:						
Beginning balance	$ 28,175	$ 15,327	$ 13,280	$ 4,374	$ 30	$61,186
Charge-offs	(2,503)	(6,734)	(3,623)	(2,600)	-	(15,460)
Payments	(916)	(6,569)	(2,012)	(529)	(1)	(10,027)
Transfers to other real estate owned	(2,018)	(1,272)	(4,686)	(388)	-	(8,364)
Returned to performing status	-	(1,907)	-	-	-	(1,907)
Changed to nonaccrual status	(419)	(2,891)	(930)	-	-	(4,240)
Additions	5,107	23,990	21,381	833	11	51,322

Changes in allowance	-	(90)	-	-	-	(90)
Ending balance	$ 27,426	$ 19,854	$ 23,410	$ 1,690	$ 40	$72,420

(Dollars in thousands)	For the Nine Months Ended September 30, 2012	2011
Other real estate owned:		
Beginning balance	$9,385	$3,702
Sales	(4,605)	(2,967)
Write-downs	(1,077)	(563)
Additions	4,715	9,693
Ending balance	$8,418	$9,865

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

Cash and Cash Equivalents

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

Investment Securities Held to Maturity

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

Loans

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

Financial Liabilities

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

Commitments to Extend Credit and Standby Letters of Credit

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

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

	September 30, 2012		December 31, 2011	
(Dollars in thousands)	Carrying Amount	Estimated Fair Value	Carrying Amount	Estimated Fair Value
Financial assets				
Level 2 inputs				
Cash and cash equivalents	$183,448	$183,448	$127,742	$127,742
Investment securities held to maturity	4,075	4,326	6,480	6,732
Level 3 inputs				
Loans, net	795,075	821,480	826,762	856,917
Financial liabilities				
Level 2 inputs				
Deposits	$1,038,514	$1,042,244	$1,009,919	$1,013,964
Short-term borrowings	13,079	13,079	17,817	17,817
Long-term debt	455	455	455	470

Note 9 – Derivative Instruments and Hedging Activities

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

During the second quarter of 2009, as part of its overall interest rate risk management strategy, the Company purchased interest rate caps for $7.1 million to effectively fix the interest rate at 2.97% for five years on $70 million of the Company's money market deposit accounts. The interest rate caps qualified for hedge accounting. The aggregate fair value of these derivatives was an asset of $24 thousand at September 30, 2012 and $250 thousand at December 31, 2011. The change in fair value included a $1.3 million adjustment to record unrealized holding gains on the interest rate caps and a $1.5 million charge to interest expense associated with the hedged money market deposit accounts. For the first nine months of 2011, the change in fair value included an $821 thousand adjustment to record unrealized holding losses and a $907 thousand charge to interest expense. The Company expects that the charge to interest expense associated with the hedged deposits over the next 12 months will be approximately $2.4 million.

By entering into derivative instrument contracts, the Company exposes itself, from time to time, to counterparty credit risk. Counterparty credit risk is the risk that the counterparty will fail to perform under the terms of the derivative contract. When the fair value of a derivative contract is in an asset position, the counterparty has a liability to the Company, which creates credit risk for the Company. The Company attempts to minimize this risk by selecting counterparties with investment grade credit ratings, limiting its exposure to any single counterparty and regularly monitoring its market position with each counterparty. Collateral required by the counterparties, recorded in other liabilities, was $428 thousand at both September 30, 2012 and December 31, 2011.

Note 10 – Financial Instruments with Off-Balance Sheet Risk

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

The following table provides information on commitments outstanding at September 30, 2012 and December 31, 2011.

(Dollars in thousands)	September 30, 2012	December 31, 2011
Commitments to extend credit	$ 136,050	$ 136,222
Letters of credit	12,254	11,311

Total	$ 148,304	$ 147,533

Note 11 – Segment Reporting

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

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

During the third quarter of 2012, goodwill and other intangible assets were subjected to an annual assessment for impairment. As a result of the assessment, the Company determined that there was no impairment. During the third quarter of 2011, when goodwill and other intangible assets were assessed for impairment, it was determined that goodwill and other intangible assets were impaired in our Insurance Products and Services segment, primarily relating to the Company's retail insurance business. The Company recorded goodwill impairment charges of $1.2 million and other intangible assets impairment charges of $120 thousand reflected in the table below in noninterest expense.

The following table includes selected financial information by business segments for the first nine months of 2012 and 2011.

(Dollars in thousands)	Community Banking	Insurance Products and Services	Parent Company	Consolidated Total
2012				
Interest income	$ 34,882	$ 59	$ -	$ 34,941
Interest expense	(7,967)	-	(16)	(7,983)
Provision for credit losses	(18,095)	-	-	(18,095)
Noninterest income	5,089	7,974	89	13,152
Noninterest expense	(17,969)	(7,407)	(4,494)	(29,870)
Net intersegment (expense) income	(3,903)	(392)	4,295	-
(Loss) income before taxes	(7,963)	234	(126)	(7,855)
Income tax benefit (expense)	3,336	(98)	53	3,291
Net (loss) income	$ (4,627)	$ 136	$ (73)	$ (4,564)
Total assets	$ 1,159,766	$ 16,920	$ 1,947	$ 1,178,633
2011				
Interest income	$ 38,220	$ 101	$ -	$ 38,321
Interest expense	(8,363)	-	(31)	(8,394)
Provision for credit losses	(15,435)	-	-	(15,435)
Noninterest income	5,489	7,711	99	13,299
Noninterest expense	(17,123)	(8,395)	(4,244)	(29,762)
Net intersegment (expense) income	(4,267)	(391)	4,658	-
(Loss) income before taxes	(1,479)	(974)	482	(1,971)
Income tax benefit (expense)	562	370	(183)	749
Net (loss) income	$ (917)	$ (604)	$ 299	$ (1,222)
Total assets	$ 1,138,228	$ 17,189	$ 2,119	$ 1,157,536

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

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

Forward-Looking Information

Portions of this Quarterly Report on Form 10-Q contain forward-looking statements within the meaning of The Private Securities Litigation Reform Act of 1995. Statements that are not historical in nature, including statements that include the words "anticipate", "estimate", "should", "expect", "believe", "intend", and similar expressions, are expressions ab 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 Company's financial condition and results of operations for the periods indicated. This discussion and analysis should be read in conjunction with the unaudited consolidated financial statements and related notes presented elsewhere in this report, as well as the audited consolidated financial statements and related notes included in the Annual Report of Shore Bancshares, Inc. on Form 10-K for the year ended December 31, 2011.

Shore Bancshares, Inc. is the largest independent financial holding company located on the Eastern Shore of Maryland. It is the parent company of The Talbot Bank of Easton, Maryland located in Easton, Maryland ("Talbot Bank") and CNB located in Centreville, Maryland (together with Talbot Bank, the "Banks"). Until January 1, 2011, the Company also served as the parent company to The Felton Bank located in Felton, Delaware. On January 1, 2011, The Felton Bank merged into CNB, with CNB as the surviving bank. The Banks operate 18 full service branches in Kent County, Queen Anne's County, Talbot County, Caroline County and Dorchester County in Maryland and Kent County, Delaware. The Company engages in the insurance business through three insurance producer firms, The Avon-Dixon Agency, LLC, Elliott Wilson Insurance, LLC and Jack Martin Associates, Inc.; a wholesale insurance company, TSGIA, Inc.; and two insurance premium finance companies, Mubell Finance, LLC and ESFS, Inc. (all of the foregoing are collectively referred to as the "Insurance Subsidiary"). Each of these entities is a wholly-owned subsidiary of Shore Bancshares, Inc. The Company engages in the mortgage brokerage business under the name "Wye Mortgage Group" through a minority series investment in an unrelated Delaware limited liability company.

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

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

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.

Allowance for Credit Losses

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

Three basic components comprise our allowance for credit losses: (i) a specific allowance; (ii) a formula allowance; and (iii) a nonspecific allowance. Each component is determined based on estimates that can and do change when the actual events occur. The specific allowance is established against impaired loans (i.e., nonaccrual loans and troubled debt restructurings) based on our assessment of the losses that may be associated with the individual loans. The specific allowance remains until charge-offs are made. An impaired loan may show deficiencies in the borrower's overall financial condition, payment history, support available from financial guarantors and/or the fair market value of collateral. The formula allowance is used to estimate the loss on internally risk-rated loans, exclusive of those identified as impaired. Loans are grouped by type (construction, residential real estate, commercial real estate, commercial or consumer). Each loan type is assigned an allowance factor based on management's estimate of the risk, complexity and size of individual loans within a particular category. Loans identified as special mention, substandard, and doubtful are adversely rated. These loans are assigned higher allowance factors than favorably rated loans due to management's concerns regarding collectability or management's knowledge of particular elements regarding the borrower. As seen in Note 4, "Loans and Allowance for Credit Losses", in the Notes to Consolidated Financial Statements, special mention loans increased $26.7 million from the end of 2011 to the end of the third quarter of 2012. Approximately $6.6 million of these loans are expected to be upgraded by the end of 2012. The nonspecific allowance captures losses that have impacted the portfolio but have yet to be recognized in either the specific or formula allowance.

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

Goodwill and Other Intangible Assets

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

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

During the third quarter of 2012, goodwill and other intangible assets were subjected to the annual assessment for impairment. As a result of the assessment, it was determined that there was no impairment at the Company's subsidiaries that have these intangible assets on their balance sheets. During the third quarter of 2011, when goodwill and other intangible assets were assessed for impairment, it was determined that goodwill and other intangible assets were impaired in our Insurance Products and Services segment, primarily relating to the Company's retail insurance business. The Company recorded goodwill impairment charges of $1.2 million and other intangible assets impairment charges of $120 thousand reflected in noninterest expense.

Fair Value

The Company measures certain financial assets and liabilities at fair value. Investment securities and interest rate caps are significant financial assets measured at fair value on a recurring basis. Impaired loans and other real estate owned are significant financial assets measured at fair value on a nonrecurring basis. See Note 8, “Fair Value Measurements”, in the Notes to Consolidated Financial Statements for a further discussion of fair value.

OVERVIEW

The Company reported a net loss of $1.8 million for the third quarter of 2012, or diluted loss per common share of $(0.22), compared to net income of $94 thousand, or diluted income per common share of $0.01, for the third quarter of 2011. For the second quarter of 2012, the Company reported net income of $293 thousand, or diluted income per common share of $0.03. When comparing the third quarter of 2012 to the third quarter of 2011, the main reasons for the difference in results were an increase in the provision for credit losses of $2.6 million and a decline in net interest income of $1.4 million. When comparing the third quarter of 2012 to the second quarter of 2012, the primary reason for the difference in results was an increase in the provision for credit losses of $2.7 million. Annualized return on average assets was (0.61)% for the three months ended September 30, 2012, compared to 0.03% for the same period in 2011. Annualized return on average stockholders’ equity was (6.07)% for the third quarter of 2012, compared to 0.31% for the third quarter of 2011. For the second quarter of 2012, annualized return on average assets was 0.10% and return on average equity was 0.99%.

For the first nine months of 2012, the Company reported a net loss of $4.6 million, or diluted loss per common share of $(0.54), compared to a net loss of $1.2 million, or diluted loss per common share of $(0.14), for the first nine months of 2011. When comparing the first nine months of 2012 to the first nine months of 2011, the principal factors driving the difference were an increase in the provision for credit losses of $2.7 million and a decline in net interest income of $3.0 million. Annualized return on average assets was (0.52)% for the nine months ended September 30, 2012, compared to (0.14)% for the same period in 2011. Annualized return on average stockholders’ equity was (5.08)% for the first nine months of 2012, compared to (1.34)% for the first nine months of 2011.

RESULTS OF OPERATIONS

Net Interest Income

Tax-equivalent net interest income is net interest income adjusted for the tax-favored status of income from certain loans and investments. As shown in the table below, tax-equivalent net interest income for the third quarter of 2012 was $8.8 million, compared to $10.2 million for the third quarter of 2011. The decrease was primarily due to lower yields earned on average earning assets and a decline in higher-yielding average loan balances. Net interest margin is tax-equivalent net interest income (annualized) divided by average earning assets. Our net interest margin was 3.15%

for the third quarter of 2012 and 3.77% for the third quarter of 2011. Loan charge-offs continued to negatively impact our net interest income and net interest margin. For the second quarter of 2012, tax-equivalent net interest income was $9.1 million and the net interest margin was 3.36%.

On a tax-equivalent basis, interest income was $11.4 million for the third quarter of 2012, declining from the $12.9 million recorded for the third quarter of 2011. The decrease in interest income was due to a 69 basis point decline in yields earned on average earning assets (*i.e.*, loans, investment securities, federal funds sold and interest-bearing deposits with other banks) that was partially offset by a 3.6% increase in average balances of earning assets. Changes in the balances and rates related to loans had the largest impact on interest income. For the third quarter of 2012, average loans decreased 7.0% and the yield earned on loans decreased from 5.49% to 5.23% when compared to the third quarter of 2011, which reduced interest income by $1.4 million. Loans comprised 72.9% of total average earning assets for the third quarter of 2012, compared to 81.2% for the third quarter of 2011. Taxable investment securities grew $25.8 million, or 23.5%, when comparing the third quarter of 2012 with the third quarter of 2011, although yields declined from 2.88% to 2.01%, which reduced interest income $110 thousand. The yields on taxable investment securities decreased because the reinvestment rates on investment securities purchased during 2012 were lower than the yields on the investment securities that matured during the period. Partially offsetting the decrease in interest income from loans and taxable investment securities was a $79.6 million increase in the average balance of interest-bearing deposits and a 5 basis point increase in rates earned on these assets, which increased interest income $50 thousand. The increase in the average balance of interest-bearing deposits reflected higher levels of excess cash to be invested. Tax-equivalent interest income decreased 2.6% when compared to the second quarter of 2012. Average earning assets increased 2.0% during the third quarter of 2012 when compared to the second quarter of 2012, while yields earned declined 25 basis points.

Interest expense decreased $82 thousand, or 3.0%, when comparing the third quarter of 2012 to the third quarter of 2011. The decrease in interest expense was due to a 7 basis point decline in rates paid on interest-bearing liabilities (*i.e.*, deposits and borrowings) that was partially offset by a 3.4% increase in average balances of interest-bearing liabilities. Changes in the balances and rates related to time deposits (*i.e.*, certificates of deposit $100,000 or more and other time deposits) had the largest impact on interest expense. For the three months ended September 30, 2012, the average balances of certificates of deposit $100,000 or more and other time deposits each increased over 1.0% when compared to the same period last year, while the average rates paid on these time deposits decreased 17 and 25 basis points, respectively, which reduced interest expense by $211 thousand. The decline in rates on time deposits reflected current market conditions. Partially offsetting the decrease in interest expense from time deposits was a 4.5% increase in the average balance of money market and savings deposits and a 16 basis point increase in rates paid on these deposits, which increased interest expense $142 thousand. Interest on money market and savings deposits included an adjustment to expense related to interest rate caps and the hedged deposits associated with them. This adjustment increased interest expense by $524 thousand for the third quarter of 2012 and $348 thousand for the third quarter of 2011. See Note 9, “Derivative Instruments and Hedging Activities”, in the Notes to Consolidated Financial Statements for additional information. When comparing the third quarter of 2012 to the second quarter of 2012, interest expense stayed relatively unchanged with average balances of total interest-bearing liabilities increasing 1.9% and the interest rate paid on interest-bearing liabilities declining 3 basis points.

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, 2012 and 2011.

	For the Three Months Ended September 30, 2012			For the Three Months Ended September 30, 2011		
(Dollars in thousands)	Average Balance	Income(1)/ Expense	Yield/ Rate	Average Balance	Income(1)/ Expense	Yield/ Rate
Earning assets						
Loans (2), (3)	$808,244	$ 10,631	5.23 %	$869,221	$ 12,033	5.49 %
Investment securities						
Taxable	135,257	685	2.01	109,498	795	2.88
Tax-exempt	2,614	34	5.07	4,440	57	5.12
Federal funds sold	11,971	3	0.11	15,905	3	0.07
Interest-bearing deposits	150,170	79	0.21	70,572	29	0.16
Total earning assets	1,108,256	11,432	4.10 %	1,069,636	12,917	4.79 %
Cash and due from banks	20,158			20,414		
Other assets	69,921			69,394		
Allowance for credit losses	(14,189)			(16,856)		
Total assets	$1,184,146			$1,142,588		
Interest-bearing liabilities						
Demand deposits	$167,423	74	0.18 %	$154,685	78	0.20 %
Money market and savings deposits (4)	279,003	832	1.19	266,871	690	1.03
Certificates of deposit $100,000 or more	238,624	875	1.46	235,362	965	1.63
Other time deposits	207,547	866	1.66	204,836	987	1.91
Interest-bearing deposits	892,597	2,647	1.18	861,754	2,720	1.25
Short-term borrowings	14,909	10	0.27	15,640	15	0.37
Long-term debt	455	6	4.58	932	10	4.46
Total interest-bearing liabilities	907,961	2,663	1.17 %	878,326	2,745	1.24 %
Noninterest-bearing deposits	148,096			133,214		
Other liabilities	8,768			9,721		
Stockholders' equity	119,321			121,327		
Total liabilities and stockholders' equity	$1,184,146			$1,142,588		
Net interest spread		$ 8,769	2.93 %		$ 10,172	3.55 %
Net interest margin			3.15 %			3.77 %
Tax-equivalent adjustment						
Loans		$ 27			$ 30	
Investment securities		12			19	
Total		$ 39			$ 49	

(1) All amounts are reported on a tax-equivalent basis computed using the statutory federal income tax rate of 34.0% for 2012 and 2011 exclusive of the alternative minimum tax rate and nondeductible interest expense.

(2) Average loan balances include nonaccrual loans.

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

(4) Interest on money market and savings deposits includes an adjustment to expense related to interest rate caps and the hedged deposits associated with them. This adjustment increased interest expense by $524 thousand for the third quarter of 2012 and $348 thousand for the third quarter of 2011.

Tax-equivalent net interest income for the nine months ended September 30, 2012 was $27.1 million, as seen in the table below. This was a decrease of 10.0% when compared to the same period last year. As with the quarterly results, the decrease was mainly due to lower yields earned on average earning assets and a decline in higher-yielding average loan balances. The net interest margin was 3.31% for the first nine months of 2012 and 3.79% for the first nine months of 2011.

On a tax-equivalent basis, interest income was $35.1 million for the first nine months of 2012, a decrease of 8.9% when compared to the first nine months of 2011. The decrease in interest income was due to a decline of 56 basis points in yields earned on average earning assets that was partially offset by an increase of 3.0% in average balances of earning assets. When comparing the nine-month period ended September 30, 2012 to the same period of last year, the 6.9% decrease in average loans and the 16 basis point decrease in yields earned on average loans was the primary reason for the decline in interest income. Loans comprised 74.8% and 82.8% of total average earning assets for the first nine months of 2012 and 2011, respectively.

Interest expense was $8.0 million for the nine months ended September 30, 2012, a decrease of 4.9% when compared to the same period last year. The decrease in interest expense was due to a decline of 10 basis points in rates paid on average interest-bearing liabilities that was partially offset by an increase of 2.8% in average balances of interest-bearing liabilities. For the nine months ended September 30, 2012, the 1.6% decrease in average time deposits and the 23 basis point decrease in rates paid on average time deposits were the primary reasons for the decline in interest expense when compared to the same period last year. Partially offsetting the decrease in interest expense from time deposits was higher interest expense relating to a 5.7% increase in the average balance of money market and savings deposits and a 19 basis point increase in rates paid on these deposits

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, 2012 and 2011.

	For the Nine Months Ended September 30, 2012			For the Nine Months Ended September 30, 2011		
(Dollars in thousands)	Average Balance	Income(1)/ Expense	Yield/ Rate	Average Balance	Income(1)/ Expense	Yield/ Rate
Earning assets						
Loans (2), (3)	$819,088	$ 32,588	5.31 %	$879,509	$ 36,008	5.47 %
Investment securities						
Taxable	131,863	2,149	2.18	105,939	2,234	2.82
Tax-exempt	3,548	140	5.27	4,543	175	5.16
Federal funds sold	10,992	7	0.09	28,896	24	0.11
Interest-bearing deposits	128,756	188	0.19	43,959	47	0.14
Total earning assets	1,094,247	35,072	4.28 %	1,062,846	38,488	4.84 %
Cash and due from banks	19,920			19,356		
Other assets	69,514			67,588		
Allowance for credit losses	(14,523)			(16,826)		
Total assets	$1,169,158			$1,132,964		
Interest-bearing liabilities						
Demand deposits	$157,835	216	0.18 %	$141,447	227	0.21 %
Money market and savings deposits (4)	278,297	2,423	1.16	263,216	1,918	0.97
Certificates of deposit $100,000 or more	240,595	2,626	1.46	246,362	3,073	1.67
Other time deposits	204,789	2,666	1.74	206,470	3,104	2.01
Interest-bearing deposits	881,516	7,931	1.20	857,495	8,322	1.30
Short-term borrowings	15,448	36	0.31	14,947	41	0.36
Long-term debt	455	16	4.61	932	31	4.51
Total interest-bearing liabilities	897,419	7,983	1.19 %	873,374	8,394	1.29 %
Noninterest-bearing deposits	142,874			127,238		
Other liabilities	8,949			10,696		
Stockholders' equity	119,916			121,656		
Total liabilities and stockholders' equity	$1,169,158			$1,132,964		
Net interest spread		$ 27,089	3.09 %		$ 30,094	3.55 %

Net interest margin	3.31 %	3.79 %
Tax-equivalent adjustment		
Loans	$ 83	$ 108
Investment securities	48	59
Total	$ 131	$ 167

(1) All amounts are reported on a tax-equivalent basis computed using the statutory federal income tax rate of 34.0% for 2012 and 2011 exclusive of the alternative minimum tax rate and nondeductible interest expense.

(2) Average loan balances include nonaccrual loans.

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

(4) Interest on money market and savings deposits includes an adjustment to expense related to interest rate caps and the hedged deposits associated with them. This adjustment increased interest expense by $1.5 million for the first nine months of 2012 and $907 thousand for the first nine months of 2011.

Noninterest Income

Noninterest income for the third quarter of 2012 decreased $522 thousand, or 11.5%, when compared to the third quarter of 2011. The lower amount was primarily the result of a decline in other noninterest income ($513 thousand) which included $581 thousand in losses on the sales of other real estate owned, mainly relating to two properties. The decrease in other noninterest income was partially offset by higher insurance agency commissions ($115 thousand). Total noninterest income for the third quarter of 2012 decreased $576 thousand, or 12.6%, when compared to the second quarter of 2012. The lower amount when compared to the second quarter of 2012 was primarily the result of a decrease in other noninterest income ($845 thousand), mainly from the $581 thousand in losses on the sales of other real estate owned. The decrease in other noninterest income was partially offset by an increase in gains on sales of investment securities ($278 thousand). Included in other noninterest income for the second quarter of 2012 was a $217 thousand gain on the sale of a bank branch building.

Total noninterest income for the nine months ended September 30, 2012 decreased $147 thousand, or 1.1%, when compared to the same period in 2011, primarily due to a decline in service charges on deposit accounts ($247 thousand) and gains on sales of investment securities ($157 thousand). Service charges on deposit accounts declined mainly due to a reduction in customer use of overdraft protection programs. The decrease in noninterest income was partially offset by higher insurance agency commissions ($225 thousand).

Noninterest Expense

Noninterest expense for the third quarter of 2012 decreased $968 thousand, or 9.1%, when compared to the third quarter of 2011, mostly due to a decline in goodwill impairment ($1.3 million) and write-downs of other real estate owned ($171 thousand). Goodwill and other intangible assets were subjected to the annual assessment for impairment during the third quarter of 2012. As a result of the assessment, it was determined that there was no impairment at the Company’s subsidiaries that have these intangible assets on their balance sheets. Partially offsetting the decrease in total noninterest expense were increases in salaries and wages ($289 thousand) and FDIC insurance premium expense ($196 thousand). Total noninterest expense for the third quarter of 2012 remained relatively flat when compared to the second quarter of 2012, increasing $46 thousand, or less than 1%.

Total noninterest expense for the nine months ended September 30, 2012 remained relatively unchanged when compared to the same period in 2011, increasing $108 thousand, or 0.4%. The increase was primarily due to higher salaries and wages ($731 thousand), write-downs of other real estate owned ($514 thousand) and other noninterest expenses ($225 thousand). These expenses were partially offset by the $1.3 million decline in goodwill impairment. Salaries and wages included amounts relating to the hiring of a new executive vice president at Talbot Bank during the second quarter of last year as part of that bank’s succession plan, and a new lender at CNB for the Delaware region during the third quarter of last year. Other noninterest expenses included higher amounts relating to collection expense for loans ($217 thousand). Along with higher amounts for the provision for loan losses mentioned previously, the higher write-downs of other real estate owned and collection expense for loans reflects the very large cost involved in removing problem loans from the balance sheet.

Income Taxes

The Company reported an income tax benefit of $1.4 million for the third quarter of 2012 and income tax expense of $225 thousand for the third quarter of 2011. The effective tax rate was a 42.7% benefit for the third quarter of 2012 and a 70.5% expense for the third quarter of 2011. The Company reported income tax benefits of $3.3 million and $749 thousand for the first nine months of 2012 and 2011, respectively. The effective tax rate for the first nine months of 2012 was a 41.9% benefit, compared to a 38.0% benefit for the same period of 2011. The effective tax rates for 2011 reflected that $274 thousand of goodwill impairment was not tax deductible.

ANALYSIS OF FINANCIAL CONDITION

Loans

Loans totaled $808.0 million at September 30, 2012, a $33.0 million, or 3.9%, decrease from the $841.1 million at December 31, 2011. Loans included deferred costs net of deferred fees of $258 thousand at September 30, 2012 and $188 thousand at December 31, 2011. Residential real estate loans declined the most ($19.1 million) followed by construction ($11.2 million), commercial ($8.0 million) and consumer ($1.1 million). There was growth in commercial real estate loans which increased $6.4 million since the end of 2011. Fewer high-quality loan opportunities and our level of loan charge-offs continue to deter overall loan growth. See Note 4, “Loans and Allowance for Credit Losses”, in the Notes to Consolidated Financial Statements and below under the caption “Allowance for Credit Losses” for additional information.

Our loan portfolio has a commercial real estate loan concentration, which is defined as a combination of construction and commercial real estate loans. Construction loans were $108.7 million, or 13.5% of total loans, at September 30, 2012, compared to $119.9 million, or 14.3% of total loans, at December 31, 2011. Commercial real estate loans were approximately $321.8 million, or 39.8% of total loans, at September 30, 2012, compared to $315.4 million, or 37.5% of total loans, at December 31, 2011. We do not engage in foreign or subprime lending activities.

Because most of our loans are secured by real estate, the lack of a meaningful upturn in real estate related activities in our local real estate market and construction industry and slow improvement in general economic conditions have had a material adverse effect on the performance of our loan portfolio and the value of the collateral securing that portfolio. Factors impeding our loan performance and overall financial performance include our levels of loan charge-offs and provisions for credit losses.

Allowance for Credit Losses

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

The provision for credit losses was $6.2 million for the third quarter of 2012, $3.7 million for the third quarter of 2011 and $3.5 million for the second quarter of 2012. The higher level of provision for credit losses was primarily in response to loan charge-offs. The provision for credit losses for the first nine months of 2012 and 2011 was $18.1 million and $15.4 million, respectively. Because most of our loans are secured by real estate, the ratio of historically low property values to loan values and fewer real estate sales are negatively impacting credit quality. Nevertheless, we continue to emphasize credit quality and believe that our underwriting guidelines are strong. When problem loans are identified, management takes prompt action to quantify and minimize losses in its focused efforts to dispose of existing problem loans. Management also works with borrowers in an effort to reach mutually acceptable resolutions.

Net charge-offs for the third quarter of 2012 and for the third quarter of 2011 were $6.2 million and $6.5 million, respectively. Net charge-offs for the second quarter of 2012 were $4.1 million. During the third quarter of 2012, most of the loan charge-offs were in the construction and residential real estate loan classes, as seen in the table below, with $4.2 million of these charge-offs from two loan relationships. During the third quarter of 2011, we recorded large loan charge-offs in all loan classes except the consumer class. The allowance for credit losses as a percentage of average loans was 1.60% for the third quarter of 2012, compared to 1.56% for the third quarter of 2011. Net charge-offs were $19.4 million and $16.1 million for the first nine months of 2012 and 2011, respectively. The allowance for credit losses as a percentage of average loans was 1.58% for the first nine months of 2012, compared to 1.54% for the same period in 2011. Management believes that the provision for credit losses and the resulting allowance were adequate to provide for probable losses inherent in our loan portfolio at September 30, 2012.

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, 2012	2011	For the Nine Months Ended September 30, 2012	2011
Allowance balance – beginning of period	$ 12,990	$ 16,358	$ 14,288	$ 14,227
Charge-offs:				
Construction	(3,222)	(1,005)	(5,008)	(2,419)
Residential real estate	(2,323)	(2,859)	(7,996)	(7,340)
Commercial real estate	(742)	(1,385)	(2,177)	(3,878)
Commercial	(73)	(1,519)	(4,513)	(3,290)
Consumer	(31)	(33)	(208)	(148)
Totals	(6,391)	(6,801)	(19,902)	(17,075)
Recoveries:				
Construction	5	-	5	49
Residential real estate	5	38	99	106
Commercial real estate	116	229	123	234
Commercial	22	47	230	504
Consumer	8	19	17	60
Totals	156	333	474	953
Net charge-offs	(6,235)	(6,468)	(19,428)	(16,122)
Provision for credit losses	6,200	3,650	18,095	15,435
Allowance balance – end of period	$ 12,955	$ 13,540	$ 12,955	$ 13,540
Average loans outstanding during the period	$ 808,244	$ 869,221	$ 819,088	$ 879,509
Net charge-offs (annualized) as a percentage of average loans outstanding during the period	3.07 %	2.95 %	3.17 %	2.45 %
Allowance for credit losses at period end as a percentage of average loans	1.60 %	1.56 %	1.58 %	1.54 %

Nonperforming Assets

Nonperforming assets were $103.3 million at September 30, 2012, compared to $88.7 million at December 31, 2011, as shown in the following table. The change in nonperforming assets included a $15.6 million increase in nonperforming loans and a $1.0 million decrease in other real estate owned. The increase in nonperforming loans included a $25.6 million increase in accruing troubled debt restructurings net of an $11.9 million decline in nonaccrual loans. The change in the components of nonperforming assets reflected our continued effort to either develop concessionary workouts relating to problem loans or remove problem loans from our portfolio. See Note 8, “Fair Value Measurements”, in the Notes to Consolidated Financial Statements for additional details on the changes in the balances of nonperforming assets. The ratio of total nonperforming assets to total loans and other real estate owned was 12.65% at September 30, 2012, compared to 10.43% at December 31, 2011. Gross interest income of $731 thousand and $530 thousand for the third quarter of 2012 and 2011, respectively, would have been recorded if nonaccrual loans had been current and performing in accordance with their original terms. The comparable amounts for the first nine months of 2012, for fiscal year 2011 and for the first nine months of 2011 were $2.2 million, $2.6 million and $1.9 million, respectively. No interest was recorded on these loans during the first nine months of 2012 or 2011.

The following table summarizes our nonperforming assets.

(Dollars in thousands)	September 30, 2012	December 31, 2011
Nonperforming assets		
Nonaccrual loans		
Construction	$ 11,475	$ 15,555
Residential real estate	14,440	20,106
Commercial real estate	11,916	14,012
Commercial	1,557	1,669
Consumer	54	28
Total nonaccrual loans	39,442	51,370
Loans 90 days or more past due and still accruing		
Construction	-	325
Residential real estate	1,012	2,331
Commercial real estate	3,551	-
Commercial	67	66
Consumer	45	1
Total loans 90 days or more past due and still accruing	4,675	2,723
Accruing troubled debt restructurings		
Construction	28,479	11,781
Residential real estate	5,231	3,792
Commercial real estate	16,986	9,566
Commercial	89	69
Consumer	-	-
Total accruing troubled debt restructurings	50,785	25,208

Total nonperforming loans	94,902		79,301	
Other real estate owned	8,418		9,385	
Total nonperforming assets	$ 103,320		$ 88,686	
Nonaccrual loans to total loans	4.88	%	6.11	%
Nonaccrual loans to total assets	3.35	%	4.44	%
Nonperforming assets to total loans and other real estate owned	12.65	%	10.43	%
Nonperforming assets to total assets	8.77	%	7.66	%

Investment Securities

The investment portfolio is comprised of securities that are either available for sale or held to maturity. Investment securities available for sale are stated at estimated fair value based on quoted market prices. They represent securities which may be sold as part of the asset/liability management strategy or which may be sold in response to changing interest rates. Net unrealized holding gains and losses on these securities are reported net of related income taxes as accumulated other comprehensive income, a separate component of stockholders' equity. Investment securities in the held to maturity category are stated at cost adjusted for amortization of premiums and accretion of discounts. We have the intent and current ability to hold such securities until maturity. At September 30, 2012, 97% of the portfolio was classified as available for sale and 3% as held to maturity, similar to the 95% and 5%, respectively, at December 31, 2011. With the exception of municipal securities, our general practice is to classify all newly-purchased securities as available for sale. See Note 3, "Investment Securities", in the Notes to Consolidated Financial Statements for additional details on the composition of our investment portfolio.

Investment securities totaled $130.4 million at September 30, 2012, a $5.8 million, or 4.3%, decrease since December 31, 2011. Included in the decrease were sales of $6.0 million in mortgage-backed securities which generated a gain of $278 thousand during the third quarter of 2012. At the end of September 2012, 27.4% of the securities in the portfolio were U.S. Government agencies and 69.0% were mortgage-backed securities, compared to 30.9% and 63.9% , respectively, at year-end 2011, reflecting a shift in the composition of the portfolio to higher-yielding mortgage-backed securities. Our investments in mortgage-backed securities are issued or guaranteed by U.S. Government agencies or government-sponsored agencies.

Although period-end investment securities were lower, the average balance of investment securities increased to $137.9 million for the third quarter of 2012, compared to $113.9 million for the same period in 2011. For the first nine months of 2012, the average balance of investment securities increased to $135.4 million, compared to $110.5 million for the same period in 2011. The increase in the 2012 investment securities average balances when compared to the 2011 balances reflected the investment of excess cash from deposits. Investment securities comprised 12.4% of total average earning assets for the third quarter of 2012, higher than the 10.7% for the third quarter of 2011. Similarly, for the first nine months of 2012 and 2011, investment securities were 12.4% and 10.4% of total earning assets, respectively. The tax-equivalent yields on investment securities were 2.07% and 2.97% for the third quarter of 2012 and 2011, respectively, while the yields were 2.26% and 2.92% for the first nine months of 2012 and 2011, respectively. Yields on investment securities declined because the reinvestment rates on investment securities purchased during 2012 were lower than the yields on the investment securities that matured during the period.

Deposits

Total deposits at September 30, 2012 were $1.039 billion, a $28.6 million, or 2.8%, increase when compared to the $1.010 billion at December 31, 2011. Increases in interest-bearing demand ($5.3 million or 3.3%), money market and savings ($4.3 million or 1.6%) and other time deposits ($5.3 million or 2.7%) contributed to the overall increase in interest-bearing deposits. Partially offsetting this increase was a $9.1 million, or 3.7%, decrease in certificates of deposit $100,000 or more primarily due to a decline in deposits of a large municipal customer. Noninterest-bearing deposits increased $22.8 million, or 17.0%, which reflected continuing growth from our customer base.

Short-Term Borrowings

Short-term borrowings at September 30, 2012 and December 31, 2011 were $13.1 million and $17.8 million, respectively. Short-term borrowings generally consist of securities sold under agreements to repurchase which are issued in conjunction with cash management services for commercial depositors, overnight borrowings from correspondent banks and short-term advances from the Federal Home Loan Bank (the “FHLB”). Short-term advances are defined as those with original maturities of one year or less. At September 30, 2012 and December 31, 2011, short-term borrowings included only repurchase agreements.

Long-Term Debt

At September 30, 2012 and December 31, 2011, the Company had $455 thousand in long-term debt. This debt was acquisition-related, incurred as part of the purchase price of TSGIA, Inc. and is payable to the seller thereof, who remains the President of that subsidiary. The interest rate on the debt is 4.08% and principal and interest are payable in annual installments for five years, with the final payment made on October 1, 2012.

Liquidity and Capital Resources

We derive liquidity through increased customer deposits, maturities in the investment portfolio, loan repayments and income from earning assets. During the second quarter of 2009, we began participating in the Promontory Insured Network Deposits Program which resulted in increased deposits and liquidity. The program has a five-year term and has a guaranteed minimum funding level of $70 million.

To the extent that deposits are not adequate to fund customer loan demand, liquidity needs can be met in the short-term funds markets through arrangements with correspondent banks. The Banks had $15.5 million in unsecured federal funds lines of credit and a reverse repurchase agreement available on a short-term basis from correspondent banks at September 30, 2012 and December 31, 2011. The Banks are also members of the FHLB, which provides another source of liquidity. Through the FHLB, the Banks had credit availability of approximately $68.6 million and $31.6 million at September 30, 2012 and December 31, 2011, respectively. The Banks have pledged, under a blanket lien, all qualifying residential loans under borrowing agreements with the FHLB. Management is not aware of any demands, commitments, events or uncertainties that are likely to materially affect our future ability to maintain liquidity at satisfactory levels.

Total stockholders' equity was $118.2 million at September 30, 2012, compared to $121.2 million at December 31, 2011. The net loss and dividends paid contributed to the decrease in stockholders' equity since the end of 2011. The decrease was partially offset by unrealized gains on available-for-sale securities ($744 thousand) and cash flow hedging activities ($751 thousand) relating to the interest rate caps. To sustain capital and enhance capital ratios, the board of directors of Shore Bancshares, Inc. decreased the quarterly cash dividend on the common stock from $.06 per share to $0.01 per share beginning with the dividend that was paid on May 31, 2011. On May 3, 2012, the board of directors voted to suspend quarterly cash dividends until further notice. If the dividend suspension is continued, the Company will retain approximately $254 thousand in common equity for 2012. We remain well-capitalized which should enable us to fund the costs to resolve our problem loans.

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

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

The table below presents a comparison of the Company's capital ratios to the minimum regulatory requirements as of September 30, 2012 and December 31, 2011.

	September 30, 2012	December 31, 2011	Minimum Regulatory Requirements
Tier 1 risk-based capital ratio	12.36 %	12.55 %	4.00 %
Total risk-based capital ratio	13.61 %	13.80	8.00 %

Leverage ratio	8.74	%	9.29	4.00	%

The Basel Committee on Banking Supervision ("Basel") is a committee of central banks and bank regulators from major industrialized countries that develops broad policy guidelines for use by each country's regulators with the purpose of ensuring that financial institutions have adequate capital given the risk levels of assets and off-balance sheet financial instruments.

In December 2010, Basel released a framework for strengthening international capital and liquidity regulations, referred to as Basel III. Basel III includes defined minimum capital ratios, which must be met when implementation occurs on January 1, 2013. An additional "capital conservation buffer" will be phased-in beginning January 1, 2016 and, when fully phased-in three years later, the minimum ratios will be 2.5% higher. Fully phased-in capital standards under Basel III will require banks to maintain more capital than the minimum levels required under current regulatory capital standards. As Basel III is only a framework, the specific changes in capital requirements are to be determined by each country's banking regulators.

In June 2012, U.S. Federal banking regulators adopted two notices of proposed rulemaking ("NPRs") that would implement in the United States the Basel III regulatory capital reforms and changes required by the Dodd-Frank Wall Street Reform and Consumer Protection Act. A third adopted NPR related to banks that are internationally active or that are subject to market risk rules is not applicable to the Company. Comments on the NPRs were accepted through September 7, 2012.

The first NPR, “Regulatory Capital Rules: Regulatory Capital, Implementation of Basel III, Minimum Regulatory Capital Ratios, Capital Adequacy, and Transition Provisions”, would apply to all depository institutions, bank holding companies with total consolidated assets of $500 million or more, and savings and loan holding companies (collectively, “banking organizations”). Consistent with the international Basel framework, this NPR would:

- Increase the quantity and quality of capital required by proposing a new minimum Common Equity Tier 1 capital ratio of 4.50% of risk-weighted assets and raising the minimum Tier 1 capital ratio from 4.00% to 6.00% of risk-weighted assets;

- Retain the current minimum Total capital ratio of 8.00% of risk-weighted assets and the minimum Tier 1 leverage capital ratio at 4.00% of average assets;

- Introduce a “capital conservation buffer” of 2.50% above the minimum risk-based capital requirements, which must be maintained to avoid restrictions on capital distributions and certain discretionary bonus payments; and

- Revise the definition of capital to improve the ability of regulatory capital instruments to absorb losses.

The new minimum regulatory capital requirements would be phased in from January 1, 2013 through January 1, 2016. The capital conservation buffer would be phased in from January 1, 2016 through January 1, 2019.

The second NPR, “Regulatory Capital Rules: Standardized Approach for Risk-weighted Assets; Market Discipline and Disclosure Requirement”, also would apply to all banking organizations. This NPR would revise and harmonize the rules for calculating risk-weighted assets to enhance risk sensitivity and address weaknesses that have been identified over the past several years. Banks and regulators use risk weighting to assign different levels of risk to different classes of assets and off balance sheet exposures - riskier items require higher capital cushions and less risky items require smaller capital cushions.

Management is currently reviewing the NPRs to determine the impact that they could have on the Company.

Item 3. Quantitative and Qualitative Disclosures about Market Risk.

Our primary market risk is to interest rate fluctuation and management has procedures in place to evaluate and mitigate this risk. This risk and these procedures are discussed in Item 7 of Part II of the Annual Report of Shore Bancshares, Inc. on Form 10-K for the year ended December 31, 2011 under the caption “Market Risk Management”. Management believes that there have been no material changes in our market risks, the procedures used to evaluate and mitigate these risks, or our actual and simulated sensitivity positions since December 31, 2011.

Item 4. Controls and Procedures.

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

An evaluation of the effectiveness of these disclosure controls as of September 30, 2012 was carried out under the supervision and with the participation of management, including the CEO and the PAO. Based on that evaluation, the Company's management, including the CEO and the PAO, has concluded that our disclosure controls and procedures are, in fact, effective at the reasonable assurance level.

There was no change in our internal control over financial reporting during the third quarter of 2012 that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

PART II – OTHER INFORMATION

Item 1A. Risk Factors.

The risks and uncertainties to which our financial condition and operations are subject are discussed in detail in Item 1A of Part I of the Annual Report of Shore Bancshares, Inc. on Form 10-K for the year ended December 31, 2011. Management does not believe that any material changes in our risk factors have occurred since they were last disclosed.

Item 6. Exhibits.

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

SIGNATURES

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

SHORE BANCSHARES, INC.

Date: November 8, 2012 By:/s/ W. Moorhead Vermilye

W. Moorhead Vermilye
Chief Executive Officer
(Principal Executive Officer)

Date: November 8, 2012 By: /s/ Susan E. Leaverton
Susan E. Leaverton, CPA
Treasurer/Principal Accounting Officer

EXHIBIT INDEX

Exhibit Number	Description
31.1	Certifications of the Principal Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act (filed herewith).
31.2	Certifications of the Principal Accounting Officer pursuant to Section 302 of the Sarbanes-Oxley Act (filed herewith).
32	Certification pursuant to Section 906 of the Sarbanes-Oxley Act (furnished herewith).
101	Interactive Data File