

FIRST MARINER BANCORP  
Form 10-Q  
November 09, 2006

**UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION**

WASHINGTON, D.C. 20549

**FORM 10-Q**

(Mark One)

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

For the quarterly period ended September 30, 2006.

**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: 0-21815

**FIRST MARINER BANCORP**

(Exact name of registrant as specified in its charter)

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**Maryland**

(State of Incorporation)

**52-1834860**

(I.R.S. Employer  
Identification Number)

**1501 South Clinton Street,  
Baltimore, MD**

(Address of principal executive offices)

**21224**

(Zip Code)

**410-342-2600**

(Telephone Number)

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 during the preceding 12 months (or for such shorter period that the registrant was required to file such report, and (2) has been subject to such filing requirements for the past 90 days.

Yes  No

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

Large accelerated filer  Accelerated filer  Non-accelerated filer

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

The number of shares of common stock outstanding as of November 3, 2006 is 6,442,386 shares.

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**PART I FINANCIAL INFORMATION****Item 1 Financial Statements**

**First Mariner Bancorp and Subsidiaries**  
**Consolidated Statements of Financial Condition**  
*(dollars in thousands, except per share data)*

|  | September 30,<br>2006<br>(unaudited) | December 31,<br>2005 |
|--|--------------------------------------|----------------------|
| <b>ASSETS</b>  |                                      |                      |
| Cash and due from banks  | \$ 33,659                            | \$ 40,157            |
| Federal funds sold and interest-bearing deposits   | 15,139                               | 5,678                |
| Securities available for sale, at fair value   | 262,996                              | 276,939              |
| Loans held for sale  | 106,369                              | 92,351               |
| Loans receivable   | 859,538                              | 851,586              |
| Allowance for loan losses  | (11,997)                             | (11,743)             |
| Loans, net   | 847,541                              | 839,843              |
| Other real estate owned  | 1,134                                | 931                  |
| Restricted stock investments   | 10,949                               | 13,647               |
| Premises and equipment, net  | 46,712                               | 40,402               |
| Accrued interest receivable  | 10,316                               | 8,037                |
| Deferred income taxes  | 6,058                                | 5,940                |
| Bank-owned life insurance  | 33,107                               | 27,375               |
| Prepaid expenses and other assets  | 12,656                               | 11,178               |
| <b>Total assets</b>  | <b>\$ 1,386,636</b>                  | <b>\$ 1,362,478</b>  |
| <b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>  |                                      |                      |
| <b>Liabilities:</b>  |                                      |                      |
| <b>Deposits:</b>   |                                      |                      |
| Noninterest-bearing  | \$ 192,078                           | \$ 182,049           |
| Interest-bearing   | 724,938                              | 693,961              |
| Total deposits   | 917,016                              | 876,010              |
| Short-term borrowings  | 178,814                              | 199,376              |
| Long-term borrowings   | 128,094                              | 131,000              |
| Junior subordinated deferrable interest debentures   | 73,724                               | 73,724               |
| Accrued expenses and other liabilities   | 8,827                                | 9,993                |
| <b>Total liabilities</b>   | <b>1,306,475</b>                     | <b>1,290,103</b>     |
| <b>Stockholders' equity:</b>   |                                      |                      |
| Common stock, \$.05 par value; 20,000,000 shares authorized; 6,427,852 and 6,262,442 shares issued and outstanding, respectively | 321                                  | 313                  |
| Additional paid-in capital   | 56,930                               | 55,193               |
| Retained earnings  | 26,089                               | 20,185               |
| Accumulated other comprehensive loss   | (3,179)                              | (3,316)              |
| <b>Total stockholders' equity</b>  | <b>80,161</b>                        | <b>72,375</b>        |
| <b>Total liabilities and stockholders' equity</b>  | <b>\$ 1,386,636</b>                  | <b>\$ 1,362,478</b>  |

*See accompanying notes to the consolidated financial statements*



**First Mariner Bancorp and Subsidiaries**  
**Consolidated Statements of Operations**  
*(dollars in thousands except per share data)*

|  | Three Months Ended                   |           | Nine Months Ended                    |           |
|--|--------------------------------------|-----------|--------------------------------------|-----------|
|  | September 30,<br>2006<br>(unaudited) | 2005      | September 30,<br>2006<br>(unaudited) | 2005      |
| <b>Interest income:</b>                                |                                      |           |                                      |           |
| Loans  | \$ 21,238                            | \$ 18,422 | \$ 60,934                            | \$ 49,608 |
| Investments and other earning assets                   | 3,540                                | 3,387     | 10,347                               | 10,393    |
| Total interest income                                  | 24,778                               | 21,809    | 71,281                               | 60,001    |
| Interest expense:                                      |                                      |           |                                      |           |
| Deposits   | 6,396                                | 4,384     | 17,028                               | 11,896    |
| Short-term borrowings                                  | 2,530                                | 2,148     | 7,224                                | 4,495     |
| Long-term borrowings                                   | 3,448                                | 2,862     | 9,741                                | 8,011     |
| Total interest expense                                 | 12,374                               | 9,394     | 33,993                               | 24,402    |
| Net interest income                                    | 12,404                               | 12,415    | 37,288                               | 35,599    |
| Provision for loan losses                              | 261                                  | 1,116     | 1,306                                | 2,511     |
| Net interest income after provision for loan losses    | 12,143                               | 11,299    | 35,982                               | 33,088    |
| Noninterest income:                                    |                                      |           |                                      |           |
| Gain on sale of mortgage loans                         | 1,798                                | 1,859     | 5,504                                | 3,598     |
| Other mortgage-banking revenue                         | 641                                  | 712       | 2,275                                | 1,716     |
| ATM fees   | 786                                  | 802       | 2,395                                | 2,321     |
| Service fees on deposits                               | 1,754                                | 1,866     | 5,202                                | 5,338     |
| Gain on investment securities, net                     | 26                                   |           | 26                                   |           |
| Commissions on sales of nondeposit investment products | 197                                  | 109       | 413                                  | 401       |
| Income from bank-owned life insurance                  | 225                                  | 261       | 733                                  | 770       |
| Commissions on sales of other insurance products       | 628                                  | 620       | 1,946                                | 1,574     |
| Other  | 448                                  | 478       | 1,392                                | 1,122     |
| Total noninterest income                               | 6,503                                | 6,707     | 19,886                               | 16,840    |
| Noninterest expense:                                   |                                      |           |                                      |           |
| Salaries and employee benefits                         | 8,185                                | 8,054     | 25,623                               | 23,017    |
| Occupancy  | 2,126                                | 1,701     | 5,761                                | 4,758     |
| Furniture, fixtures and equipment                      | 789                                  | 779       | 2,339                                | 2,296     |
| Professional services                                  | 207                                  | 219       | 666                                  | 862       |
| Advertising  | 218                                  | 300       | 1,081                                | 1,090     |
| Data processing  | 430                                  | 490       | 1,347                                | 1,529     |
| ATM servicing expenses                                 | 237                                  | 311       | 762                                  | 869       |
| Service and maintenance                                | 544                                  | 501       | 1,610                                | 1,340     |
| Other  | 3,325                                | 2,510     | 8,674                                | 6,710     |
| Total noninterest expense                              | 16,061                               | 14,865    | 47,863                               | 42,471    |
| Net income before income taxes                         | 2,585                                | 3,141     | 8,005                                | 7,457     |
| Income tax expense                                     | 542                                  | 928       | 2,101                                | 2,142     |
| Net income   | \$ 2,043                             | \$ 2,213  | \$ 5,904                             | \$ 5,315  |
| Net income per common share:                           |                                      |           |                                      |           |
| Basic  | \$ 0.32                              | \$ 0.35   | \$ 0.94                              | \$ 0.88   |
| Diluted  | \$ 0.31                              | \$ 0.34   | \$ 0.89                              | \$ 0.82   |

See accompanying notes to the consolidated financial statements.

**First Mariner Bancorp and Subsidiaries**  
**Consolidated Statements of Cash Flows**  
*(dollars in thousands)*

|   | <b>Nine Months Ended September 30,</b> |             |
|---|--|-------------|
|   | <b>2006</b>                            | <b>2005</b> |
|   | <b>(unaudited)</b>                     |             |
| <b>Cash flows from operating activities:</b>                                      |  |             |
| Net income  | \$ 5,904                               | \$ 5,315    |
| <b>Adjustments to reconcile net income to net cash from operating activities:</b> |  |             |
| Stock-based compensation  | 51                                     |             |
| Depreciation and amortization   | 3,464                                  | 2,897       |
| Amortization of unearned loan fees and costs, net                                 | (881)                                  | (790)       |
| Amortization of premiums and discounts on loans, net                              | (547)                                  | (556)       |
| Amortization of premiums and discounts on mortgage-backed securities, net         | 170                                    | 206         |
| Gain on sale of securities available for sale                                     | (26)                                   |             |
| Gain on sale of mortgage loans  | (5,504)                                | (3,598)     |
| Increase in accrued interest receivable   | (2,279)                                | (817)       |
| Provision for loan losses   | 1,306                                  | 2,511       |
| Valuation allowance on other real estate owned                                    | 195                                    |             |
| Gain on sale of other real estate owned   | (14)                                   |             |
| Valuation allowance for loans held for sale                                       | 450                                    |             |
| Loss on disposal of premises and equipment  | 2                                      | 3           |
| Increase in cash surrender value of bank-owned life insurance                     | (733)                                  | (770)       |
| Originations of mortgage loans held for sale                                      | (892,186)                              | (880,128)   |
| Proceeds from mortgage loans held for sale  | 883,672                                | 853,681     |
| Net (decrease) increase in accrued expenses and other liabilities                 | (1,831)                                | 708         |
| Net (increase) decrease in prepaids and other assets                              | (1,477)                                | 48          |
| Net cash used in operating activities   | (10,264)                               | (21,290)    |
| <b>Cash flows from investing activities:</b>                                      |  |             |
| Loan disbursements, net of principal repayments                                   | (8,841)                                | (88,576)    |
| Purchases of premises and equipment   | (9,806)                                | (24,949)    |
| Proceeds from disposals of premises and equipment                                 | 30                                     |             |
| Redemptions (purchases) of restricted stock investments                           | 2,698                                  | (3,507)     |
| Purchase of bank-owned life insurance   | (5,000)                                |             |
| <b>Activity in securities available for sale:</b>                                 |  |             |
| Sales of securities available for sale  | 116                                    |             |
| Maturities/calls/repayments of securities available for sale                      | 20,190                                 | 41,683      |
| Purchase of securities available for sale   | (6,284)                                | (10,367)    |
| Proceeds from sales of other real estate owned                                    | 881                                    |             |
| Net cash used in investing activities   | (6,016)                                | (85,716)    |
| <b>Cash flows from financing activities:</b>                                      |  |             |
| Net increase in deposits  | 41,006                                 | 45,157      |
| Net (decrease) increase in other borrowed funds                                   | (23,467)                               | 93,012      |
| Repayment of repurchase agreements  |  | (10,000)    |
| Excess tax benefit on share-based compensation                                    | 10                                     |             |
| Proceeds from stock issuance  | 1,694                                  | 4,835       |
| Repurchase of common stock, net of costs  |  | (1,578)     |
| Net cash provided by financing activities   | 19,243                                 | 131,426     |
| Increase in cash and cash equivalents   | 2,963                                  | 24,420      |
| Cash and cash equivalents at beginning of period                                  | 45,835                                 | 35,447      |
| Cash and cash equivalents at end of period  | \$ 48,798                              | \$ 59,867   |
| <b>Supplemental information:</b>  |  |             |
| Interest paid on deposits and borrowed funds                                      | \$ 33,369                              | \$ 23,649   |
| Income taxes paid   | \$ 2,924                               | \$ 2,115    |
| Real estate acquired in satisfaction of loans                                     | \$ 1,265                               | \$ 866      |

*See accompanying notes to the consolidated financial statements.*

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**First Mariner Bancorp and Subsidiaries**  
**Notes to Consolidated Financial Statements**  
*(Information as of and for the three and nine months*  
*ended September 30, 2006 and 2005 is unaudited)*

NOTE 1 SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

*Basis Of Presentation*

The accompanying consolidated financial statements for First Mariner Bancorp (the Company) have been prepared in accordance with the instructions for Form 10-Q and, therefore, do not include all information and notes necessary for a full presentation of financial condition, results of operations and cash flows in conformity with accounting principles generally accepted in the United States of America. The consolidated financial statements should be read in conjunction with the audited financial statements included in our 2005 Annual Report on Form 10-K.

The consolidated financial statements include the accounts of the Company's subsidiaries, First Mariner Bank (the Bank), Finance Maryland LLC (Finance Maryland), and FM Appraisals, LLC (FM Appraisals). All significant intercompany balances and transactions have been eliminated.

The consolidated financial statements as of September 30, 2006 and for the three and nine months ended September 30, 2006 and 2005 are unaudited but include all adjustments, consisting only of normal recurring adjustments, which we consider necessary for a fair presentation of financial position and results of operations for those periods. The results of operations for the three and nine months ended September 30, 2006 are not necessarily indicative of the results that will be achieved for the entire year.

The preparation of the financial statements in conformity with U.S. generally accepted accounting principles requires management to make estimates and judgments that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities as of the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates. Material estimates that are particularly susceptible to significant change in the near-term relate to the determination of the allowance for credit losses (the allowance), other than temporary impairment of investment securities, accounting for gain on sale of mortgage loans, determination of changes in fair value for the derivative loan commitments, use of derivatives to manage interest rate risk, and deferred tax assets.

Certain reclassifications have been made to amounts previously reported to conform to the classifications made in 2006.

*Derivative Loan Commitments Hedging Activities*

In connection with our mortgage-banking activities, we enter into commitments to fund residential mortgage loans at specified times in the future. We enter into these commitments through retail and broker channels and also purchase loan commitments from correspondent lenders. A mortgage loan commitment binds the Company to lend funds to a potential borrower at a specified interest rate and within a specified period of time, generally up to 90 days after inception of the rate lock commitment. Such a commitment is referred to as a derivative loan commitment if the loan that will result from exercise of the commitment will be held for sale upon funding under Statement of Financial Accounting Standards No. 133 (SFAS 133), Accounting for Derivative Instruments and Hedging Activities, as amended by Statement of Financial Accounting Standards No. 149 (SFAS 149), Amendment of Statement 133 on Derivative Instruments and Hedging Activities. As such, loan commitments that are derivatives must be recognized at fair value on the consolidated balance sheets with changes in their fair values recorded as part of income from mortgage-banking operations. Fair value of derivative loan commitments is considered the value that would be generated when the loan arising from exercise of the loan commitment is sold in the secondary mortgage market. For accounting purposes, we value this commitment to zero at inception, consistent with the concepts embodied in EITF 02-3, Issues Involved in Accounting for Derivative Contracts Held for Trading Purposes and Contracts Involved in Energy Trading and Risk Management Activities. Subsequent to inception, we estimate the fair value of the commitment, taking into consideration the probability of funding of the loan, and compare it to the fair value calculated at inception to measure the change in value, which is recorded through current period earnings with a corresponding asset for an increase in value or a liability for a decrease in value.

Historically, we have protected the price risk of our rate lock commitments exclusively through the use of best efforts forward delivery commitments, where we commit to sell a loan to a buyer that has agreed to buy the loan at the interest rate committed to the customer. With best efforts forward delivery commitments, we are not exposed to losses nor will we realize gains related to our rate lock commitments due to changes in interest rates. We assume any change in the fair value of the best efforts forward delivery commitments would be equal to any change

in the fair value of the corresponding rate lock commitment with the customer.

Beginning in January 2006, we expanded our secondary marketing and hedging operations, and began to hedge a portion of our rate lock commitments through the use of forward sales of mortgage-backed securities and Eurodollars. The use of forward sales

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of mortgage-backed securities and Eurodollars allows us to aggregate pools of mortgage loans to be sold on a bulk basis, and we expect the overall impact of selling loans in bulk (net of related hedging costs) will produce higher net profits compared to selling loans individually via best efforts forward delivery commitments.

The process of selling loans on a bulk basis and use of forward sales of mortgage-backed securities and Eurodollars to hedge interest rate risk associated with customer interest rate lock commitments involves greater risk than selling loans on an individual basis through best efforts forward delivery commitments. Hedging interest rate risk in bulk sales requires management to estimate the expected fallout (rate lock commitments with customers that do not complete the loan process). Additionally, the fair value of the hedge may not correlate precisely with the change in fair value of the rate lock commitments with the customer due to changes in market conditions, such as demand for loan products, or prices paid for differing types of loan products. Variances from management's estimates for customer fallout or market changes making the forward sale of mortgage-backed securities and/or Eurodollars non-effective may result in higher volatility in our profits from selling mortgage loans originated for sale. We have engaged an experienced third party to assist us in managing our activities in hedging and marketing our bulk sales delivery strategy.

Our sales agreements with investors who buy our loans generally contain covenants which may require us to repurchase loans under certain provisions, including delinquencies, or return premiums paid by those investors should the loan be paid off early. These covenants are usual and customary within the mortgage-banking industry and generally apply for the first 90 days after the loan has been purchased by the investor. We maintain a reserve (included in other liabilities) for potential losses relating to these sales covenants, including estimates for the devaluation of loans as a result of their delinquency status.

### Counterparty Credit Risk

We have exposure to credit loss in the event of contractual non-performance by our trading counterparties and counterparties to our various over-the-counter derivative financial instruments. We manage this credit risk by selecting only well-established, financially strong counterparties, spreading the credit risk among many such counterparties, and by placing contractual limits on the amount of unsecured credit extended to any single counterparty.

### NOTE 2 COMPREHENSIVE INCOME

The following table shows the Company's comprehensive income for the three months ended September 30, 2006 and 2005:

| (dollars in thousands)  | Three Months Ended<br>September 30, |          | Nine Months Ended<br>September 30, |          |
|---|-------------------------------------|----------|------------------------------------|----------|
|   | 2006                                | 2005     | 2006                               | 2005     |
| Net income  | \$ 2,043                            | \$ 2,213 | \$ 5,904                           | \$ 5,315 |
| Other comprehensive income items:   |                                     |          |                                    |          |
| Unrealized holding gains (losses) arising during the period (net of tax expense (benefit) of \$1,268, \$(1,269), \$96, and \$(1,711), respectively) | 2,015                               | (2,018 ) | 153                                | (2,719 ) |
| Less: reclassification adjustment for gains (net of taxes of \$10, \$0, \$10, and \$0, respectively) included in net income                         | (16 )                               |          | (16 )                              |          |
| Total other comprehensive income (loss)   | 1,999                               | (2,018 ) | 137                                | (2,719 ) |
| Total comprehensive income  | \$ 4,042                            | \$ 195   | \$ 6,041                           | \$ 2,596 |

### NOTE 3 PER SHARE DATA

Basic earnings per share is computed by dividing income available to common stockholders by the weighted-average number of common shares outstanding. Diluted earnings per share is computed after adjusting the denominator of the basic earnings per share computation for the effects of all dilutive potential common shares outstanding during the period. The dilutive effects of options, warrants and their equivalents are computed using the treasury stock method. For the three month period ended September 30, 2006 and 2005, there were 8,600 and 257,850 shares, respectively, which were antidilutive and excluded from the computation and for the nine month period ended September 30, 2006 and 2005, there were 5,765 and 193,200 shares, respectively, which were antidilutive and excluded from the computation.

Information relating to the calculation of earnings per common share is summarized as follows:

| (dollars in thousands, except for per share data)       | Three Months Ended |           | Nine Months Ended |           |
|---|--------------------|-----------|-------------------|-----------|
|   | September 30,      |           | September 30,     |           |
|   | 2006               | 2005      | 2006              | 2005      |
| Net income - basic and diluted                          | \$ 2,043           | \$ 2,213  | \$ 5,904          | \$ 5,315  |
| Weighted-average share outstanding - basic              | 6,292,737          | 6,234,250 | 6,278,079         | 6,054,835 |
| Dilutive securities - options and warrants              | 347,237            | 313,876   | 344,006           | 412,013   |
| Adjusted weighted-average shares outstanding - dilutive | 6,639,974          | 6,548,126 | 6,622,085         | 6,466,848 |
| Earnings per share - basic                              | \$ 0.32            | \$ 0.35   | \$ 0.94           | \$ 0.88   |
| Earnings per share - diluted                            | \$ 0.31            | \$ 0.34   | \$ 0.89           | \$ 0.82   |

#### NOTE 4 - STOCK BASED COMPENSATION

We have stock option award arrangements, which provide for the granting of options to acquire common stock to our directors and key employees. Option prices are equal to or greater than the estimated fair market value of the common stock at the date of the grant. On December 19, 2005, the Compensation Committee of the Board of Directors of the Company approved an immediate acceleration of the vesting for all unvested stock options previously awarded. On that date, all outstanding options became fully vested. Prior to that date, options granted had a three-year vesting schedule with the first year vested upon issuance. As of September 30, 2006, all outstanding options are fully vested. All of our options expire ten years after the date of grant. There have been no modifications to the existing plan.

In addition to our stock option plan, we currently offer an employee stock purchase plan whereby our employees can purchase our stock through payroll deductions. We generally provide a discount of up to 10% of the purchase price. As of September 30, 2006, we have set aside 249,243 shares out of our total authorized but unissued shares for these two plans.

In January 2006, we adopted Financial Accounting Standards Board ( FASB ) Statement of Financial Accounting Standards ( SFAS ) No. 123R, Share-Based Payment (Revised 2004) for our shareholder-approved Long-Term Incentive Plan, which permits the grant of share options and shares to our directors and key employees. We made the transition to fair value-based compensation using the modified version of the prospective application, which means the fair value-based method prescribed under SFAS 123R applies to new awards, modification of previous awards, repurchases and cancellations after January 1, 2006 and to any awards that retain service requirements after January 1, 2006. The determination of compensation cost for awards granted prior to January 1, 2006 is based on the same methods and on the same fair values previously determined for the pro forma disclosures previously required. We recognized compensation cost of \$0 and \$50,579 for the three and nine months ended September 30, 2006, respectively. We had no options as of January 1, 2006 for which requisite service remains as we accelerated the vesting of all options in 2005.

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Information with respect to stock options is as follows for the nine months ended September 30, 2006:

|                                    | Number of Shares | Weighted-Average Exercise Price | Weighted-Average Remaining Contractual Term (in years) | Aggregate Intrinsic Value (in thousands) |
|------------------------------------|------------------|---------------------------------|--|--|
| Outstanding at beginning of period | 981,934          | \$ 12.16                        |  |  |
| Granted                            | 9,600            | 18.62                           |  |  |
| Exercised                          | (148,930 )       | 9.47                            |  |  |
| Forfeited/Cancelled                | (10,233 )        | 15.54                           |  |  |
| Outstanding at end of period       | 832,371          | \$ 12.67                        | 6.2  | \$ 5,641,650                             |
| Exercisable at end of period       | 832,371          | \$ 12.67                        | 6.2  | \$ 5,641,650                             |

The weighted average fair values of our option grants for the nine months ended September 30, 2006 and 2005 were \$5.71 and \$6.17, respectively, on the dates of grants. The fair values of our options granted were calculated using the Black-Scholes-Merton option-pricing model with the following weighted average assumptions for the nine months ended September 30, 2006 and 2005:

|                         | 2006    | 2005    |
|-------------------------|---------|---------|
| Dividend yield          | 0.00%   | 0.00%   |
| Expected volatility     | 15.61%  | 17.70%  |
| Risk-free interest rate | 5.12%   | 4.20%   |
| Expected lives          | 8 years | 8 years |

For 2005, prior to adoption of SFAS 123R, the option price was equal to the market price of the common stock at the date of grant for all of our options and, accordingly, we did not record compensation expense related to options granted. If we had applied the fair value-based method to recognize compensation cost for the options granted, our net income and net income per share would have been changed to the following pro forma amounts for the three and nine months ended September 30, 2005:

| (dollars in thousands, except per share data)   | Three Months Ended September 30, 2005 | Nine Months Ended September 30, 2005 |
|---|---------------------------------------|--------------------------------------|
| Net income, as reported   | \$ 2,213                              | \$ 5,315                             |
| Deduct: Total stock-based employee compensation expense determined using the fair value based method for all awards, net of related tax effects | (113 )                                | (711 )                               |
| Pro forma net income  | \$ 2,100                              | \$ 4,604                             |
| Earnings per share:   |                                       |                                      |
| Basic - as reported   | \$ 0.35                               | \$ 0.88                              |
| Basic - pro forma   | \$ 0.34                               | \$ 0.76                              |
| Diluted - as reported   | \$ 0.34                               | \$ 0.82                              |
| Diluted - pro forma   | \$ 0.32                               | \$ 0.71                              |

The total intrinsic value of options exercised and the related tax benefit during the nine months ended September 30, 2006 amounted to \$1.420 million and \$549,000, respectively, and proceeds from exercises of stock options amounted to \$1.410 million for the nine months ended September 30, 2006.

While our employee stock purchase plan provides for a 10% discount from market value at issuance, we do not recognize compensation expense on the discount as: substantially all employees that meet limited employment qualifications may participate in the plan on an equitable basis; the plan incorporates no option features, the purchase price is based solely on the market price of the shares at the date of purchase, and employees are permitted to cancel participation before the purchase date and obtain a refund of amounts previously paid and; the discount from the market price does not exceed the per-share amount of share issuance costs that would have been incurred to raise a significant amount of capital by a public offering.



## NOTE 5 COMMITMENTS AND CONTINGENT LIABILITIES

We are party to financial instruments with off-balance-sheet risk in the normal course of business in order to meet the financing needs of customers. These financial instruments include commitments to extend credit, available lines of credit and standby letters of credit. Our exposure to credit risk is represented by the contractual amounts of those financial instruments. We apply the same credit policies in making commitments and conditional obligations as we do for on-balance-sheet instruments. A summary of the financial instruments at September 30, 2006 whose contract amounts represent potential credit risk is as follows:

| (dollars in thousands)   | September 30,<br>2006 | December 31,<br>2005 |
|--|-----------------------|----------------------|
| Commitments to extend credit (includes unused lines of credit) | \$ 301,624            | \$ 374,944           |
| Standby letters of credit                                      | 4,591                 | 4,825                |

During the third quarter of 2006, we moved our headquarters and certain operations departments into a new building adjacent to the former headquarters building in Canton. Annual rent expense for the new location is \$2.148 million for space on three floors of the building. The lease runs through July of 2016.

## NOTE 6 SEGMENT INFORMATION

We are in the business of providing financial services, and we operate in three business segments commercial and consumer banking, consumer finance and mortgage-banking. Commercial and consumer banking is conducted through First Mariner Bank (the Bank) and involves delivering a broad range of financial services, including lending and deposit taking, to individuals and commercial enterprises. This segment also includes our treasury and administrative functions. Mortgage-banking is conducted through First Mariner Mortgage, a division of the Bank, and involves originating first- and second-lien residential mortgages for sale in the secondary market and to the Bank. Consumer finance is conducted through Finance Maryland, and involves originating small direct consumer loans and the purchase of retail installment sales contracts. The results of our subsidiary, FM Appraisals, are included in the mortgage-banking segment.

The following table presents certain information regarding our business segments:

**For the nine month period ended September 30, 2006:**

| (dollars in thousands)                                 | Commercial and<br>Consumer Banking | Consumer<br>Finance | Mortgage-<br>Banking | Total        |
|--|------------------------------------|---------------------|----------------------|--------------|
| Interest income  | \$ 55,081                          | \$ 10,273           | \$ 5,927             | \$ 71,281    |
| Interest expense                                       | 27,630                             | 2,356               | 4,007                | 33,993       |
| Net interest income                                    | 27,451                             | 7,917               | 1,920                | 37,288       |
| Provision for loan losses                              | (150)                              | 1,456               |                      | 1,306        |
| Net interest income after provision for<br>loan losses | 27,601                             | 6,461               | 1,920                | 35,982       |
| Noninterest income                                     | 10,354                             | 2,315               | 7,217                | 19,886       |
| Noninterest expense                                    | 32,032                             | 6,976               | 8,855                | 47,863       |
| Net intersegment income                                | (41)                               |                     | 41                   |              |
| Net income before income taxes                         | \$ 5,882                           | \$ 1,800            | \$ 323               | \$ 8,005     |
| Total assets   | \$ 1,219,003                       | \$ 61,264           | \$ 106,369           | \$ 1,386,636 |

**For the nine month period ended September 30, 2005:**

| (dollars in thousands)    | Commercial and<br>Consumer Banking | Consumer<br>Finance | Mortgage-<br>Banking | Total     |
|---------------------------|------------------------------------|---------------------|----------------------|-----------|
| Interest income           | \$ 47,972                          | \$ 7,599            | \$ 4,430             | \$ 60,001 |
| Interest expense          | 20,491                             | 1,375               | 2,536                | 24,402    |
| Net interest income       | 27,481                             | 6,224               | 1,894                | 35,599    |
| Provision for loan losses | 1,325                              | 1,186               |                      | 2,511     |
|                           | 26,156                             | 5,038               | 1,894                | 33,088    |

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|   |              |           |            |              |
|---|--------------|-----------|------------|--------------|
| Net interest income after provision for loan losses |              |           |            |              |
| Noninterest income                                  | 10,054       | 1,720     | 5,066      | 16,840       |
| Noninterest expense                                 | 30,079       | 5,715     | 6,677      | 42,471       |
| Net intersegment income                             | (754         | )         | 754        |              |
| Net income before income taxes                      | \$ 5,377     | \$ 1,043  | \$ 1,037   | \$ 7,457     |
| Total assets  | \$ 1,230,615 | \$ 44,655 | \$ 110,000 | \$ 1,385,270 |

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## NOTE 7 FINANCIAL INSTRUMENTS

We utilize various derivative instruments to economically hedge the price risk associated with our outstanding derivative loan commitments, and loans which have settled with the borrower which have not been contracted for sale to investors. Management expects these derivatives will experience changes in fair value opposite to changes in fair value of the derivative loan commitments and warehouse loans, thereby reducing earnings volatility related to the recognition in earnings of changes in the values of the commitments. The instruments used to economically hedge the fair value of the derivative loan commitments include forward loan sales of mortgage-backed securities or Eurodollars under mandatory contracts and forward sales commitments under best efforts contracts. A forward loan sales commitment protects us from losses on sales of the loans arising from exercise of the loan commitments by securing the ultimate sales price and delivery date of the loans. A forward contract to sell mortgage-backed securities or Eurodollars hedges and protects price, volume and other interest rate lock commitment risks. We take into account various factors and strategies in determining the portion of the mortgage pipeline (derivative loan commitments) we want to hedge economically. Estimates of fair value take into consideration the probability of funding the loan.

The notional amounts of forward sales commitments and forward sales of mortgage-backed securities and Eurodollars may differ from the notional amount of interest rate lock commitments and our loans held for sale (warehouse) due to a number of factors. We attempt to approximate the weighted average duration of forward sales of mortgage-backed securities and Eurodollars to the weighted average duration of the loan products in our pipeline or warehouse awaiting sale. Use of shorter duration hedges (such as Eurodollars) will likely result in the notional amounts of the hedge exceeding the notional amounts of our pipeline and warehouse. Use of longer duration hedges will likely result in the notional amounts of the hedge being less than the notional amount of the pipeline and warehouse.

Information pertaining to the notional amounts of our derivative financial instruments is as follows as of September 30, 2006:

| (dollars in thousands)   | Notional<br>Amount | Estimated<br>Fair Value |
|--|--------------------|-------------------------|
| Interest rate lock commitments                                       | \$ 59,967          | \$ 60,067               |
| Open hedge positions:  |                    |                         |
| Forward sales commitments on loan pipeline and funded loans          | \$ 106,489         | \$ 106,388              |
| Forward contracts to sell mortgage-backed securities and Eurodollars | \$ 91,750          | \$ 91,592               |

## NOTE 8 RECENT ACCOUNTING PRONOUNCEMENTS

In May 2005, the Financial Accounting Standards Board (the FASB) issued Statement of Financial Accounting Standard (SFAS) No. 154, Accounting Changes and Error Corrections—a replacement of APB Opinion No. 20 and FASB Statement No. 3. This statement requires retrospective application to prior periods financial statements of changes in accounting principle, unless it is impracticable to determine either the period-specific effects or the cumulative effect of the change. In the case of impracticability in retrospective application, the statement gives guidance as to the appropriate treatment of the change or correction. The statement is effective for accounting changes made in fiscal years beginning after December 15, 2005. The adoption of this standard did not have a material impact on our financial condition, results of operations or liquidity.

In February 2006, the FASB issued SFAS No. 155, Accounting for Certain Hybrid Financial Instruments—an amendment of FASB Statements No. 133 and 140. This statement amends Statements No. 133 and 140 by: permitting fair value remeasurement for any hybrid financial instrument that contains an embedded derivative that otherwise would require bifurcation; clarifying which interest-only strips and principal-only strips are not subject to the requirements of Statement No. 133; establishing a requirement to evaluate interests in securitized financial assets to identify interests that are freestanding derivatives or that are hybrid financial instruments that contain an embedded derivative requiring bifurcation; clarifying that concentrations of credit risk in the form of subordination are not embedded derivatives and; amending Statement No. 140 to eliminate the prohibition on a qualifying special-purpose entity from holding a derivative financial instrument that pertains to a beneficial interest other than another derivative financial instrument. The statement is effective for fiscal years beginning after September 15, 2006. The adoption of this standard is not anticipated to have a material impact on our financial condition, results of operations or liquidity.

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In March 2006, the FASB issued SFAS No. 156, Accounting for Servicing of Financial Assets an amendment of FASB Statement No. 140. This statement amends Statement No. 140 with respect to the accounting for separately recognized servicing assets and servicing liabilities. It requires an entity to recognize a servicing asset or servicing liability each time an obligation is undertaken to service a financial asset by entering into a servicing contract in certain situations and requires all separately recognized

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servicing assets and liabilities to be initially measured at fair value, if practicable. The statement permits the choice between the amortization method and the fair value measurement method for the subsequent measurement of the servicing assets or liabilities and allows for a one-time reclassification of available-for-sale securities to trading securities at initial adoption. The statement also requires separate presentation of servicing assets and servicing liabilities subsequently measured at fair value in the statement of financial position and additional disclosures for all separately recognized servicing assets and servicing liabilities. The statement is effective for fiscal years beginning after September 15, 2006. The adoption of this standard is not anticipated to have a material impact on our financial condition, results of operations or liquidity.

In July 2006, the FASB issued FASB Interpretation No. 48, Accounting for Uncertainty in Income Taxes an interpretation of FASB Statement No. 109. The interpretation clarifies the accounting for uncertainty in income taxes recognized in a company's financial statements in accordance with FASB Statement No. 109, Accounting for Income Taxes. The interpretation prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. It also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosures, and transition. The interpretation is effective for fiscal years beginning after December 15, 2006. The adoption of this interpretation is not anticipated to have a material impact on our financial condition, results of operations or liquidity.

In September 2006, the FASB issued Statement No. 157, Fair Value Measurements. This statement defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles, and expands disclosures about fair value measurements. The statement is effective for financial statements issued for fiscal years beginning after November 15, 2007. The adoption of this interpretation is not anticipated to have a material impact on our financial condition, results of operations or liquidity.

#### NOTE 9 SUBSEQUENT EVENT

On October 26, 2006, we repurchased \$6.884 million in delinquent loans from an investor in accordance with a covenant in our sales agreement. Although the loans were not in our portfolio as of September 30, 2006, we had provided for a fair market value adjustment for them, amounting to \$193,000, in our operating results. All of the loans are 90 days past due. Of the \$6.884 million, \$385,000 have been placed on nonaccrual.

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

The following discussion should be read and reviewed in conjunction with Management's Discussion and Analysis of Financial Condition and Results of Operations set forth in our Annual Report on Form 10-K for the year ended December 31, 2005.

#### Forward-Looking Statements

This quarterly report on Form 10-Q may contain forward-looking language within the meaning of The Private Securities Litigation Reform Act of 1995. Statements may include expressions about our confidence, policies, and strategies, provisions and allowance for loan losses, adequacy of capital levels, and liquidity. All statements included or incorporated by reference in this Quarterly Report on Form 10-Q, other than statements that are purely historical, are forward-looking statements. Statements that include the use of terminology such as anticipates, expects, intends, plans, believes, estimates and similar expressions also identify forward-looking statements. The forward-looking statements are based on our current intent, belief and expectations. Forward-looking statements in this Quarterly Report on Form 10-Q include, but are not limited to, statements of our plans, strategies, objectives, intentions, including, among other statements, statements involving our projected loan and deposit growth, loan collateral values, collectibility of loans, anticipated changes in other operating income, payroll and branching expenses, branch, office and product expansion of the Company and its subsidiaries, and liquidity and capital levels. Such forward-looking statements involve certain risks and uncertainties, including general economic conditions, competition in the geographic and business areas in which we operate, inflation, fluctuations in interest rates, legislation and government regulation. These statements are not guarantees of future performance and are subject to certain risks and uncertainties that are difficult to predict. For a more complete discussion of risks and uncertainties that could cause actual results to differ materially from those contained in the forward-looking statements, see Risk Factors filed as Item 1A of Part I in our Form 10-K for the year ended December 31, 2005 and Risk Factors found in Item 1a of Part II of this 10-Q. Except as required by applicable laws, we do not intend to publish updates or revisions of any forward-looking statements we make to reflect new information, future events or otherwise.

#### The Company

The Company is a financial holding company incorporated under the laws of Maryland and registered under the federal Bank Holding Company Act of 1956, as amended. First Mariner Bancorp is presently the fourth largest publicly held bank holding company headquartered in the state of Maryland. The Company was organized in 1994 and changed its name to First Mariner Bancorp in May 1995. Since 1995, the Company's

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strategy has involved building a network of banking branches, ATMs and other financial services outlets to capture market share and build a community franchise for stockholders, customers and employees. The Company is currently focused on growing assets and earnings by capitalizing on the broad network of bank branches, mortgage offices, consumer finance offices, and ATMs established during its infrastructure expansion phase.

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The Company's business is conducted primarily through its wholly owned subsidiaries, First Mariner Bank (the "Bank"), Finance Maryland LLC ("Finance Maryland"), and FM Appraisals, LLC ("FM Appraisals"). The Bank is the largest operating subsidiary of the Company with assets exceeding \$1.2 billion as of September 30, 2006. The Bank was formed in 1995 through the merger of several small financial institutions. The Bank's primary market area for its core banking operations, which consist of traditional commercial and consumer lending, as well as retail and commercial deposit operations, is central Maryland as well as portions of Maryland's eastern shore. The Bank anticipates opening a branch in Pennsylvania during the first quarter of 2007. The Bank is an independent community bank, and its deposits are insured by the Federal Deposit Insurance Corporation ("FDIC").

The Bank is engaged in the general commercial banking business, with particular attention and emphasis on the needs of individuals and small to mid-sized businesses, and delivers a wide range of financial products and services that are offered by many larger competitors. Products and services include traditional deposit products, a variety of consumer and commercial loans, residential and commercial mortgage and construction loans, wire transfer services, non-deposit investment products, and internet banking and similar services. Most importantly, the Bank provides customers with access to local Bank officers who are empowered to act with flexibility to meet customers' needs in an effort to foster and develop long-term loan and deposit relationships.

First Mariner Mortgage, a division of the Bank, engages in mortgage-banking activities, providing mortgages and associated products to customers and selling most of those mortgages on the secondary market. During the first quarter of 2006, First Mariner Mortgage expanded its secondary marketing activities significantly and began hedging the interest rate risk associated with mortgage-banking activities.

Finance Maryland was formed in July 2002, and engages in traditional consumer finance activities, making small direct cash loans to individuals, the purchase of installment loan sales contracts from local merchants and retail dealers of consumer goods, and loans to individuals via direct mail solicitations. Finance Maryland currently operates 17 branches, including a central approval office, in the State of Maryland and four branches in the state of Delaware, which operate under the trade name "Finance Delaware." Finance Maryland had total assets of \$61.3 million as of September 30, 2006.

FM Appraisals, which commenced operations in the fourth quarter of 2003, is a residential real estate appraisal preparation and management company that is headquartered in Baltimore City. FM Appraisals offers appraisal services for residential real estate lenders, including appraisal preparation, the compliance oversight of sub-contracted appraisers, appraisal ordering and administration, and appraisal review services. FM Appraisals has historically provided these services to First Mariner Mortgage and began marketing appraisal management services to outside lenders in 2006.

#### Critical Accounting Policies

The Company's financial statements are prepared in accordance with generally accepted accounting principles ("GAAP") in the United States of America and follow general practices within the industry in which it operates. Application of these principles requires management to make estimates, assumptions, and judgments that affect the amounts reported in the financial statements and accompanying notes. These estimates, assumptions, and judgments are based on information available as of the date of the financial statements; accordingly, as this information changes, the financial statements could reflect different estimates, assumptions, and judgments. Certain policies inherently have a greater reliance on the use of estimates, assumptions, and judgments and, as such, have a greater possibility of producing results that could be materially different than originally reported. Estimates, assumptions, and judgments are necessary when assets and liabilities are required to be recorded at fair value, when a decline in the value of an asset not carried on the financial statements at fair value warrants an impairment write-down or valuation reserve to be established, or when an asset or liability needs to be recorded contingent upon a future event. Carrying assets and liabilities at fair value inherently results in more financial statement volatility. When applying accounting policies in such areas that are subjective in nature, management must use its best judgment to arrive at the carrying value of certain assets and liabilities. Below is a discussion of our critical accounting policies.

#### *Allowance for loan losses*

A variety of estimates impact the carrying value of the loan portfolio including the calculation of the allowance for loan losses, valuation of underlying collateral and the timing of loan charge-offs.

The allowance is established and maintained at a level that management believes is adequate to cover losses resulting from the inability of borrowers to make required payments on loans. Estimates for loan losses are arrived at by analyzing risks associated with specific loans and the loan portfolio. Current trends in delinquencies and charge-offs, the views of Bank regulators, changes in the size and composition of the loan portfolio and peer comparisons are also factors. The analysis also requires consideration of the economic climate and direction and change in

the interest rate environment, which may impact a borrower's ability to pay, legislation

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impacting the banking industry and environmental and economic conditions specific to the Bank's service areas. Because the calculation of the allowance for loan losses relies on estimates and judgments relating to inherently uncertain events, results may differ from our estimates.

#### *Investment securities*

Securities are evaluated periodically to determine whether a decline in their value is other than temporary. The term "other than temporary" is not intended to indicate a permanent decline in value. Rather, it means that the prospects for near term recovery of value are not necessarily favorable, or that there is a lack of evidence to support fair values equal to, or greater than, the carrying value of the investment. Management reviews criteria such as the magnitude and duration of the decline, as well as the reasons for the decline, to predict whether the loss in value is other than temporary. Once a decline in value is determined to be other than temporary, the value of the security is reduced and a corresponding charge to earnings is recognized.

#### *Deferred income taxes*

Under the liability method, deferred tax assets and liabilities are determined based on the difference between the financial statement and tax bases of assets and liabilities. Deferred tax assets are subject to management's judgment based upon available evidence that future realization is more likely than not. For financial reporting purposes, a valuation allowance for a portion of the deferred tax asset has been recognized to offset the deferred tax assets related to state tax loss carryforwards. If management determines that we may be able to realize all or part of the state deferred tax asset in the future, a credit to income tax expense may be required to increase the recorded value of the state net deferred tax asset to the expected realizable amount.

#### *Loan income recognition*

Interest income on loans is accrued at the contractual rate based on the principal outstanding. Loan origination fees and certain direct loan origination costs are deferred and amortized as a yield adjustment over the contractual loan terms. Accrual of interest is discontinued when its receipt is in doubt, which typically occurs when a loan becomes 90 days past due as to principal or interest. Any interest accrued to income in the year when interest accruals are discontinued is reversed. Management may elect to continue the accrual of interest when a loan is in the process of collection and the estimated fair value of the collateral is sufficient to satisfy the principal balance and accrued interest. Loans are returned to accrual status once the doubt concerning collectibility has been removed and the borrower has demonstrated the ability to pay and remain current. Payments on nonaccrual loans are generally applied to principal.

#### Financial Condition

The Company's total assets were \$1.387 billion at September 30, 2006, compared to \$1.362 billion at December 31, 2005, increasing \$24.158 million or 1.8% for the first nine months of 2006. Earning assets increased \$14.790 million or 1.2% to \$1.255 billion from \$1.240 billion. The increase in assets was primarily due to increases in short-term investments (+\$9.461 million), loans held for sale (+\$14.018 million), and net loans outstanding (+\$7.698 million), partially offset by declines in cash and due from banks (-\$6.498 million) and securities available for sale (-\$13.943 million). The growth in assets was funded by increases in deposits (+\$41.006 million), offset by decreases in short-term (-\$20.562 million) and long-term (-\$2.906 million) borrowings.

#### *Investment securities available for sale*

We utilize the investment portfolio as part of our overall asset/liability management practices to enhance interest revenue while providing necessary liquidity for the funding of loan growth or deposit withdrawals. Total investment securities declined \$13.943 million due to normal principal payments on mortgage-backed securities and scheduled maturities of other investments, offset by an increase in market values and net of additional purchases of securities of \$6.284 million and sales of securities of \$90,000. At September 30, 2006, our unrealized loss on securities classified as available for sale totaled \$5.179 million, compared to \$5.402 million at December 31, 2005. The improvement resulted from decreases in short-term and long-term interest rates from December 31, 2005 to September 30, 2006, which resulted in higher market valuation of our fixed income investments. We consider the loss in the market valuation to be temporary and do not expect to realize losses on any of the securities currently in the investment portfolio.





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The investment portfolio composition is as follows:

| (dollars in thousands)                          | September 30,<br>2006 |                     | December 31,<br>2005 |                     |
|---|-----------------------|---------------------|----------------------|---------------------|
|   | Balance               | Percent<br>of Total | Balance              | Percent<br>of Total |
| Investment securities available for sale:       |                       |                     |                      |                     |
| Mortgage-backed securities                      | \$ 141,540            | 53.8%               | \$ 161,112           | 58.2%               |
| Trust preferred securities                      | 38,821                | 14.8%               | 34,087               | 12.3%               |
| US government agency notes                      | 68,720                | 26.1%               | 68,271               | 24.7%               |
| US Treasury securities                          | 994                   | 0.4%                | 986                  | 0.3%                |
| Obligations of state and municipal subdivisions | 2,973                 | 1.1%                | 2,969                | 1.1%                |
| Corporate obligations                           | 1,946                 | 0.7%                | 1,777                | 0.6%                |
| Equity securities                               | 1,270                 | 0.5%                | 1,310                | 0.5%                |
| Foreign government bonds                        | 1,750                 | 0.7%                | 1,481                | 0.5%                |
| Other investment securities                     | 4,982                 | 1.9%                | 4,946                | 1.8%                |
| Total investment securities available for sale  | \$ 262,996            | 100.0%              | \$ 276,939           | 100.0%              |

*Loans*

Total loans increased \$7.952 million during the first nine months of 2006. Growth was realized in our residential mortgage loan portfolio (+\$10.912 million), commercial construction portfolio (+\$22.737 million), commercial portfolio (+\$2.907 million), consumer loan portfolio (+\$10.564 million) and second mortgages on real estate portfolio (+\$9.448 million). Our loans secured by deposits and other also increased by \$364,000. The growth in these loan types was offset by decreases in our commercial real estate portfolio (-\$29.053 million) and consumer residential construction portfolio (-\$20.057 million). The total loan portfolio was comprised of the following:

| (dollars in thousands)                           | September 30,<br>2006 |                     | December 31,<br>2005 |                     |
|--|-----------------------|---------------------|----------------------|---------------------|
|  | Balance               | Percent<br>of Total | Balance              | Percent<br>of Total |
| Loans secured by first mortgages on real estate: |                       |                     |                      |                     |
| Residential                                      | \$ 51,840             | 6.0%                | \$ 40,928            | 4.8%                |
| Commercial                                       | 321,175               | 37.3%               | 350,228              | 41.1%               |
| Consumer residential construction                | 106,435               | 12.4%               | 126,492              | 14.8%               |
| Commercial/residential construction              | 136,132               | 15.8%               | 113,395              | 13.3%               |
| Commercial                                       | 615,582               | 71.5%               | 631,043              | 74.0%               |
| Loans secured by second mortgages on real estate | 70,725                | 8.2%                | 67,818               | 8.0%                |
| Consumer loans                                   | 106,194               | 12.4%               | 96,746               | 11.4%               |
| Loans secured by deposits and other              | 66,183                | 7.7%                | 55,619               | 6.5%                |
| Total loans                                      | 1,457                 | 0.2%                | 1,093                | 0.1%                |
| Unamortized loan discounts                       | 860,141               | 100.0%              | 852,319              | 100.0%              |
| Unearned loan fees, net                          | (217 )                |                     | (121 )               |                     |
|  | (386 )                |                     | (612 )               |                     |
|  | \$ 859,538            |                     | \$ 851,586           |                     |

*Allowance for Loan Losses and Credit Risk Management*

We attempt to manage the risk characteristics of the loan portfolio through various control processes, such as credit evaluation of borrowers, establishment of lending limits and application of lending procedures, including the holding of adequate collateral and the maintenance of compensating balances. However, we seek to rely primarily on the cash flow of our borrowers as the principal source of repayment. Although credit policies are designed to minimize risk, management recognizes that loan losses will occur and the amount of these losses will fluctuate depending on the risk characteristics of the loan portfolio as well as general and regional economic conditions.

We provide for loan losses through the establishment of an allowance for loan losses (the allowance) by provisions charged against earnings. Based upon management's evaluation, provisions are made to maintain the allowance as a best estimate of inherent losses within the portfolio.

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The provision for loan losses was \$261,000 and \$1.306 million for the three and nine months ended September 30, 2006, respectively, as compared to \$1.116 million and \$2.511 million for the same periods in 2005, respectively. The provision for loan losses decreased in an amount proportionate to the incremental inherent risk associated with the growth and

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decline in the various loan types as well as a reduction in qualitative factors management uses in establishing the unallocated portion of the allowance for loan losses. We recorded net charge-offs of \$1.052 million during the first nine months of 2006 compared to net charge-offs of \$822,000 for the same period in 2005. This increase was primarily attributable to increases in net charge-offs of consumer loans.

The allowance consists of three elements: (1) specific reserves for individual credits; (2) general reserves for types or portfolios of loans based on historical loan loss experience, judgmentally adjusted for current conditions and credit risk concentrations; and (3) unallocated reserves. Combined specific reserves and general reserves by loan type are considered allocated reserves. All outstanding portfolio loans are considered in evaluating the adequacy of the allowance. Loans held for sale are not included in the allowance as they are recorded at lower of cost or market. The allowance does not provide for estimated losses stemming from uncollectible interest because we generally require all accrued but unpaid interest to be reversed once a loan is placed on nonaccrual status.

The process of establishing the allowance with respect to our commercial and commercial real estate loan portfolios begins when a loan officer initially assigns each loan a risk grade, using established credit criteria. A significant portion of the risk grades are reviewed and validated annually by an independent consulting firm, as well as periodically by the our internal credit review function. Management reviews, on a quarterly basis, current conditions that affect various lines of business and may warrant adjustments to historical loss experience in determining the required allowance. Adjustment factors that are considered include: the level and trends in past-due and nonaccrual loans; trends in loan volume; effects of any changes in lending policies and procedures or underwriting standards; and the experience and depth of lending management. Management also includes an economic environmental element to its analysis for loans which could be affected by economic environmental conditions. Historical factors by product type are adjusted each quarter based on actual loss history. Management also evaluates credit risk concentrations, including trends in large dollar exposures to related borrowers, and industry concentrations. All nonaccrual loans in the commercial and non-residential real estate portfolios, as well as other loans in the portfolios identified as having the potential for further deterioration, are analyzed individually to confirm the appropriate risk grading and accrual status and to determine the need for a specific reserve.

Consumer and residential mortgage loans are segregated into homogeneous pools with similar risk characteristics. Trends and current conditions in retail and residential mortgage pools are analyzed and historical loss experience is adjusted accordingly. Adjustment factors for the retail and residential mortgage portfolios are consistent with those for the commercial portfolios.

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The unallocated portion of the allowance is intended to provide for losses that are not identified when establishing the specific and general portions of the allowance. We have risk management practices designed to ensure timely identification of changes in loan risk profiles; however, undetected losses may inherently exist within the loan portfolios. The judgmental aspects involved in applying the risk grading criteria, analyzing the quality of individual loans, and assessing collateral values can also contribute to undetected, but probable, losses. The allowance at September 30, 2006 is considered by management to be sufficient to address the credit losses inherent in the current loan portfolio. The changes in the allowance are presented in the following table:

| (dollars in thousands)                               | Nine Months Ended  |            |
|--|--------------------|------------|
|  | September 30, 2006 | 2005       |
| Allowance for loan losses, beginning of year         | \$ 11,743          | \$ 9,580   |
| Loans charged off:                                   |                    |            |
| Commercial   |                    | (15 )      |
| Commercial/residential construction                  |                    |            |
| Commercial mortgages                                 |                    |            |
| Residential construction - consumer                  | (9 )               |            |
| Residential mortgages                                |                    |            |
| Consumer   | (1,330 )           | (1,072 )   |
| Total loans charged off                              | (1,339 )           | (1,087 )   |
| Recoveries:  |                    |            |
| Commercial   |                    |            |
| Commercial/residential construction                  |                    |            |
| Commercial mortgages                                 |                    |            |
| Residential construction - consumer                  | 22                 | 34         |
| Residential mortgages                                |                    |            |
| Consumer   | 265                | 231        |
| Total recoveries                                     | 287                | 265        |
| Net charge-offs                                      | (1,052 )           | (822 )     |
| Provision for loan losses                            | 1,306              | 2,511      |
| Allowance for loan losses, end of period             | \$ 11,997          | \$ 11,269  |
| Loans (net of premiums and discounts):               |                    |            |
| Period-end balance                                   | \$ 859,538         | \$ 834,380 |
| Average balance during period                        | 854,872            | 792,263    |
| Allowance as a percentage of period-end loan balance | 1.40%              | 1.35%      |
| Percent of average loans:                            |                    |            |
| Provision for loan losses (annualized)               | 0.20%              | 0.42%      |
| Net charge-offs (annualized)                         | 0.16%              | 0.14%      |

During the first nine months of 2006, annualized net charge-offs as compared to average loans outstanding increased slightly to 0.16%, as compared to 0.14% during the same period of 2005, mostly due to a relatively large charge-off (\$99,000) taken on a home equity loan in the second quarter of 2006 and increased charge-offs in our consumer portfolio consistent with the increase in our consumer loan portfolio balances. Nonperforming assets, expressed as a percentage of total assets, totaled 0.40% at September 30, 2006, 0.29% at December 31, 2005 and 0.32% at September 30, 2005. The increase as compared to September 30, 2005 reflects an increase in both residential real estate acquired by foreclosure and nonaccrual loans. At September 30, 2006, there were a larger percentage of residential mortgage loans and lot loans classified as nonaccrual as compared to September 30, 2005, when a larger percentage consisted of commercial loans. Loans past due 90 days or more and still accruing totaled \$7.996 million as of September 30, 2006 compared to \$860,000 at December 31, 2005 and \$1.275 million as of September 30, 2005. Of the \$7.996 million total, \$3.704 million is for three commercial construction loans, \$1.477 is for two commercial mortgage loans, \$1.145 million is for five residential construction loans, and \$1.664 million is for first-lien position residential mortgages, all of which are well-collateralized and in the process of collection. The remainder of the loans past due 90 days or more of \$6,000 are consumer loans.

Loans are placed on nonaccrual status when they are past-due 90 days or more as to either principal or interest or when, in the opinion of management, the collection of all interest and/or principal is in doubt. Management may grant a waiver from nonaccrual status for a past-due loan that is both well secured and in the process of collection. A loan remains on nonaccrual status until the loan is current as to payment of both principal and interest and the borrower demonstrates the ability to pay and remain current.



The following table provides information concerning nonperforming assets and past-due loans:

| (dollars in thousands)                      | September 30,<br>2006 | December 31,<br>2005 | September 30,<br>2005 |
|---|-----------------------|----------------------|-----------------------|
| Nonaccrual loans                            | \$ 4,461              | \$ 3,019             | \$ 3,441              |
| Real estate acquired by foreclosure         | 1,134                 | 931                  | 931                   |
| Total nonperforming assets                  | \$ 5,595              | \$ 3,950             | \$ 4,372              |
| Loans past-due 90 days or more and accruing | \$ 7,996              | \$ 860               | \$ 1,275              |

A loan is determined to be impaired when, based on current information and events, it is probable that we will be unable to collect all amounts due according to the contractual terms of the loan agreement. A loan is not considered impaired during a period of delay in payment if we expect to collect all amounts due, including past-due interest. We generally consider a period of delay in payment to include delinquency up to 90 days. Commercial loans are evaluated individually for impairment. Pools of smaller-balance homogeneous loans such as consumer installment, residential first and second mortgage loans and credit card loans are collectively evaluated for impairment.

As of September 30, 2006, we had impaired loans of \$1.158 million. The valuation allowance for impaired loans was approximately \$556,000 as of September 30, 2006.

At September 30, 2006, the allowance for loan losses represented 214.4% of nonperforming assets compared to 297.3% at December 31, 2005. Management believes the allowance for loan losses is adequate as of September 30, 2006.

On October 26, 2006, we repurchased \$6.884 million in delinquent loans from an investor in accordance with a covenant in our sales agreement. Although the loans were not in our portfolio as of September 30, 2006, we had provided for a fair market value adjustment for them, amounting to \$193,000, in our operating results. All of the loans are 90 days past due. Of the \$6.884 million, \$385,000 have been placed on nonaccrual.

#### Deposits

Deposits totaled \$917.016 million as of September 30, 2006, increasing \$41.006 million or 4.7% from the December 31, 2005 balance of \$876.010 million. The increase in deposits is attributable to continued marketing, promotion and cross selling of existing customers into additional products. The mix of deposits has changed somewhat during 2006, with a higher percentage of NOW & money market savings deposits and less time deposits as of September 30, 2006 compared to December 31, 2005. Continued successful marketing and promotional campaigns have maintained a strong mix of noninterest checking accounts, NOW and money market accounts. The deposit breakdown is as follows:

| (dollars in thousands)              | September 30, 2006 |                     | December 31, 2005 |                     |
|-------------------------------------|--------------------|---------------------|-------------------|---------------------|
|                                     | Balance            | Percent<br>of Total | Balance           | Percent<br>of Total |
| NOW & money market savings deposits | \$ 268,834         | 29.3%               | \$ 218,694        | 25.0%               |
| Regular savings deposits            | 64,535             | 7.0%                | 69,647            | 7.9%                |
| Time deposits                       | 391,569            | 42.7%               | 405,620           | 46.3%               |
| Total interest-bearing deposits     | 724,938            | 79.0%               | 693,961           | 79.2%               |
| Noninterest-bearing demand deposits | 192,078            | 21.0%               | 182,049           | 20.8%               |
| Total deposits                      | \$ 917,016         | 100.0%              | \$ 876,010        | 100.0%              |

Core deposits represent deposits that we believe will not be affected by changes in interest rates and therefore, will be retained regardless of the movement of interest rates. We consider our core deposits to be all noninterest-bearing, NOW, money market accounts less than \$100,000, and saving deposits, as well as all time deposits less than \$100,000 that mature in greater than one year. As of September 30, 2006, our core deposits were \$533.820 million. The remainder of our deposits could be susceptible to attrition due to interest rate movements.

#### Borrowings

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Our borrowings consist of short-term promissory notes issued to certain qualified investors, short-term and long-term advances from the Federal Home Loan Bank at Atlanta ( FHLB ), a mortgage warehouse line of credit, a mortgage loan, a long-term line of credit, and junior subordinated deferrable interest debentures. Our short-term promissory notes are in the form of commercial paper, which reprice daily and have maturities of 270 days or less. Our advances from the FHLB may be in the form of short-term or long-term obligations. Short-term advances have maturities for one year or less and can be paid without penalty. Long-term borrowings through the FHLB have original maturities up to 15 years and generally contain prepayment penalties and call provisions.

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Long-term borrowings consist of advances from the FHLB, a mortgage loan on our former headquarters building, and a line of credit and totaled \$128.094 million and \$131.000 million at September 30, 2006 and December 31, 2005, respectively. The long-term line of credit is used to fund Finance Maryland's lending business. As of September 30, 2006, total borrowings under this line were \$33.500 million, down from \$36.290 million at December 31, 2005. In March of 2005, we purchased our former headquarters building and assumed the existing mortgage loan on the property. As of September 30, 2006, the balance on the loan was \$9.594 million compared to \$9.710 million as of December 31, 2005. FHLB long-term advances remained unchanged at \$85.000 million.

Short-term borrowings consist of short-term promissory notes, short-term advances from the FHLB, and a mortgage warehouse line of credit secured by certain loans held for sale. Short-term borrowings decreased \$20.562 million, from \$199.376 million at December 31, 2005 to \$178.814 million at September 30, 2006, as deposit growth exceeded the uses of funds for lending activities and borrowings were reduced.

As an ongoing part of our funding and capital planning, we issue trust preferred securities from statutory trusts ( Trust Preferred Securities ), which are wholly owned by First Mariner Bancorp. The proceeds from the sales of Trust Preferred Securities (\$71.500 million), combined with our equity investment in these trusts (\$2.224 million), are exchanged for subordinated deferrable interest debentures. We currently maintain seven of these trusts with aggregated debentures of \$73.724 million as of both September 30, 2006 and December 31, 2005.

The Trust Preferred Securities are mandatorily redeemable, in whole or in part, upon repayment of their underlying subordinated debt at their respective maturities or their earlier redemption. The subordinated debt is redeemable prior to maturity at our option on or after its optional redemption dates.

The junior subordinated deferrable interest debentures are the sole assets of the trusts. First Mariner has fully and unconditionally guaranteed all of the obligations of the trusts.

Under applicable regulatory guidelines, a portion of the Trust Preferred Securities will qualify as Tier I capital, and the remaining portion will qualify as Tier II capital. Under applicable regulatory guidelines, \$27.780 million of the outstanding Trust Preferred Securities qualify as Tier I capital and the remaining \$43.720 million of the Trust Preferred Securities qualify as Tier II capital at September 30, 2006.

#### Capital Resources

Stockholders' equity increased \$7.786 million in the first nine months of 2006 to \$80.161 million from \$72.375 million as of December 31, 2005. Retained earnings grew by the retention of net income of \$5.904 million for the first nine months of 2006. Common stock and additional paid-in-capital increased by \$1.745 million due to the sale of stock through the exercise of options and warrants (\$1.410 million), shares issued through the employee stock purchase plan (\$284,000), and stock compensation awards (\$51,000). Accumulated other comprehensive loss improved by \$137,000 due to the increase in estimated fair values of the securities portfolio.

Banking regulatory authorities have implemented strict capital guidelines directly related to the credit risk associated with an institution's assets. Banks and bank holding companies are required to maintain capital levels based on their risk adjusted assets so that categories of assets with higher defined credit risks will require more capital support than assets with lower risk. Additionally, capital must be maintained to support certain off-balance sheet instruments.

Capital is classified as Tier 1 capital (common stockholders' equity less certain intangible assets plus a portion of the trust preferred securities) and Total Capital (Tier 1 plus the allowed portion of the allowance for loan losses plus any off-balance sheet reserves and the portion of trust preferred securities not included in Tier 1 capital). Minimum required levels must at least equal 4% for Tier 1 capital and 8% for Total Capital. In addition, institutions must maintain a minimum of 4% leverage capital ratio (Tier 1 capital to average total assets for the previous quarter).



The Company and the Bank have exceeded their capital adequacy requirements to date. We regularly monitor the Company's capital adequacy ratios to assure that the Bank exceeds its regulatory capital requirements. The regulatory capital ratios are shown below:

|  | September 30,<br>2006 | December 31,<br>2005 | Minimum<br>Regulatory<br>Requirements |
|--|-----------------------|----------------------|---------------------------------------|
| <b>Regulatory capital ratios:</b>              |                       |                      |                                       |
| <b>Leverage:</b>                               |                       |                      |                                       |
| Consolidated                                   | 8.1%                  | 7.4%                 | 4.0%                                  |
| The Bank                                       | 7.3%                  | 6.8%                 | 4.0%                                  |
| <b>Tier 1 capital to risk-weighted assets:</b> |                       |                      |                                       |
| Consolidated                                   | 10.3%                 | 9.5%                 | 4.0%                                  |
| The Bank                                       | 9.5%                  | 9.0%                 | 4.0%                                  |
| <b>Total capital to risk-weighted assets:</b>  |                       |                      |                                       |
| Consolidated                                   | 15.4%                 | 14.9%                | 8.0%                                  |
| The Bank                                       | 11.2%                 | 10.7%                | 8.0%                                  |

## Results of Operations

### *Net Income*

#### Nine Months Ended September 30, 2006:

For the nine months ended September 30, 2006, net income totaled \$5.904 million compared to \$5.315 million for the nine month period ended September 30, 2005. Basic earnings per share for the first nine months of 2006 totaled \$0.94 compared to \$0.88 per share for the same period of 2005, while diluted earnings per share totaled \$0.89 for the first nine months of 2006 compared to \$0.82 for the first nine months of 2005. Earnings for the nine months ended September 30, 2006 were driven by higher net interest income and noninterest income and a lower provision for loan losses; offset somewhat by growth in noninterest expenses.

Return on average assets and return on average equity are key measures of a bank's performance. Return on average assets, the product of net income divided by total average assets, measures how effectively we utilize the Company's assets to produce income. Our return on average assets for the nine months ended September 30, 2006 was 0.58% compared to 0.54% for the corresponding period in 2005. Return on average equity, the product of net income divided by average equity, measures how effectively we invest the Company's capital to produce income. Return on average equity for the nine months ended September 30, 2006 was 10.55% compared to 10.56% for the corresponding period in 2005.

#### Three Months Ended September 30, 2006:

For the three months ended September 30, 2006, net income totaled \$2.043 million compared to \$2.213 million for the three month period ended September 30, 2005. Basic earnings per share for the three months ended September 30, 2006 totaled \$0.32 compared to \$0.35 per share for the same period of 2005, while diluted earnings per share totaled \$0.31 for the three months ended September 30, 2006 compared to \$0.34 for the same period of 2005. Earnings for the three months ended September 30, 2006 reflected lower net interest income, lower noninterest income, higher noninterest expense and a lower provision for loan losses. Our return on average assets for the three months ended September 30, 2006 was 0.59% compared to 0.63% for the corresponding period in 2005 and our return on average equity for the three months ended September 30, 2006 was 10.49% compared to 12.55% for the corresponding period in 2005. The decline in these ratios was due to lower net income in the third quarter of 2006.

### *Net Interest Income*

#### Nine Months Ended September 30, 2006:

Net interest income, the amount by which interest income on interest-earning assets exceeds interest expense on interest-bearing liabilities, is the most significant component of our earnings. Net interest income is a function of several factors, including changes in the volume and mix of interest-earning assets and funding sources, and market interest rates. While management policies influence these factors, external forces, including customer needs and demands, competition, the economic policies of the federal government and the monetary policies of the Federal

Reserve Board, are also determining factors.

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Net interest income for the first nine months of 2006 totaled \$37.288 million, an increase of 4.7% over \$35.599 million for the nine months ended September 30, 2005. The improvement in net interest income during 2006 was due to an increase in the average balance of earning assets, from \$1.221 billion for the nine months ended September 30, 2005 to \$1.247 billion for the nine months ended September 30, 2006, and an improvement in the mix of funding sources, with a higher percentage of non-interest bearing funding sources. The benefit realized from the increased volume of earning assets was partially offset by higher average balances of interest-bearing deposits and borrowings, which increased from \$1.076 billion for the nine months ended September 30, 2005 to \$1.098 billion for the nine months ended September 30, 2006.

The yield on average earning assets increased from 6.52% for the nine months ended September 30, 2005 to 7.60% for the nine months ended September 30, 2006, while the rates on average interest-bearing liabilities increased as well from 3.03% for the nine months ended September 30, 2005 to 4.14% as of September 30, 2006. Rates on earning assets and interest-bearing liabilities increased due to increased market interest rates. As the yields on interest-earning assets increased more than the rates on funding sources, the net interest margin increased to 3.95% for the nine months ended September 30, 2006, as compared to 3.85% for the comparable period in 2005.

*Interest income.* Total interest income increased by \$11.280 million due to both increased rates on interest-earning assets and growth in average earning assets. Overall earning asset growth has moderated in 2006, as higher interest rates have dampened loan demand, loan principal prepayments have increased, and a flat treasury yield curve has discouraged the purchase of investment securities due to the narrow spread between investment yields and funding sources. Average loans outstanding increased by \$62.609 million, with increases in commercial loans and lines of credit (+\$2.694 million), commercial/residential construction (+\$36.478 million), commercial mortgages (+\$13.350 million), residential mortgages (+\$1.433 million) and consumer loans (+\$22.512 million), offset by decreases in consumer residential construction loans (-\$13.858 million). Average loans held for sale increased \$1.789 million and average investment securities decreased by \$37.401 million. Yields on earning assets for the period increased to 7.60% from 6.52% due primarily to the higher rate environment in 2006. The yield on total loans increased from 7.55% to 8.52%, driven by increased rates on most loan types.

*Interest expense.* Interest expense increased by \$9.591 million, due primarily to increases in the average rate paid on interest-bearing liabilities, which increased from 3.03% for the nine months ended September 30, 2005 to 4.14% for the nine months ended September 30, 2006, primarily as a result of the higher interest rate environment in 2006. The increase in the rate paid on deposits from 2.34% for the nine months ended September 30, 2005 to 3.25% for the nine months ended September 30, 2006 was driven primarily by increases in the rates on money market accounts and time deposits. Average interest-bearing deposits increased by \$18.442 million primarily due to an increase in the volume of money market deposits. An increase in average borrowings of \$3.710 million was due to increased average short-term advances from the FHLB, subordinated debt issued late in 2005, and increased borrowings on the mortgage loan warehouse line of credit.

#### Three Months Ended September 30, 2006:

Net interest income for the first three months of 2006 remained relatively stable at \$12.404 million compared to \$12.415 million for the three months ended September 30, 2005. The yield on average earning assets increased from 6.68% for the three months ended September 30, 2005 to 7.77% for the three months ended September 30, 2006 and the rates on average interest-bearing liabilities increased from 3.26% for the three months ended September 30, 2005 to 4.40% as of September 30, 2006. Average earning assets decreased from \$1.289 billion for the three months ended September 30, 2005 to \$1.258 billion for the three months ended September 30, 2006 and average interest-bearing liabilities decreased from \$1.143 billion for the three months ended September 30, 2005 to \$1.115 billion for the three months ended September 30, 2006. Rates on earning assets and interest-bearing liabilities increased due to increased market interest rates. As the yields on interest-earning assets increased more than the rates on funding sources, the net interest margin increased to 3.87% for the three months ended September 30, 2006, as compared to 3.79% for the comparable period in 2005.

*Interest income.* Total interest income increased by \$2.969 million due primarily to increased rates on interest-earning assets. Yields on earning assets for the period increased to 7.77% from 6.68% due to the higher rate environment in 2006. Average loans outstanding increased by \$22.045 million, with increases in commercial loans and lines of credit (+\$8.011 million), commercial/residential construction loans (+\$34.079 million), residential mortgages (+\$921,000), and consumer loans (+22.782 million), offset by decreases in commercial mortgages (-\$19.918 million) and residential construction loans (-\$23.830 million). Average loans held for sale decreased \$22.621 million and average investment securities decreased by \$29.626 million. The yield on total loans increased from 7.66% to 8.72%, driven by increased rates on almost all loan types.

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*Interest expense.* Interest expense increased by \$2.980 million, due primarily to increases in the average rate paid on interest-bearing liabilities, which increased from 3.26% for the three months ended September 30, 2005 to 4.40% for the three months ended September 30, 2006. The increases in average interest-bearing deposits of \$17.809 million and in the rate paid on deposits from 2.51% for the three months ended September 30, 2005 to 3.57% for the three months ended September 30, 2006 were driven primarily by increases in the volume and rates on money market accounts and by increases in the rates on time deposits. A decrease in average borrowings of \$45.001 million was due to pay-offs of short-term advances from the FHLB and repurchase agreements, offset by additional subordinated debt issued late in 2005, and increased borrowings on the mortgage loan warehouse line of credit. The increase in the average rate paid on interest-bearing liabilities was primarily a result of the higher interest rate environment in 2006.

The following tables set forth, for the periods indicated, information regarding the average balances of interest-earning assets and interest-bearing liabilities and the resulting yields on average interest-earning assets and rates paid on average interest-bearing liabilities. Average balances are also provided for noninterest-earning assets and noninterest-bearing liabilities.

|  | For the Nine Months Ended September 30,<br>2006 |          |                | 2005                  |          |                |
|--|---|----------|----------------|-----------------------|----------|----------------|
|  | Average<br>Balance(1)                           | Interest | Yield/<br>Rate | Average<br>Balance(1) | Interest | Yield/<br>Rate |
|  | (dollars in thousands)                          |          |                |                       |          |                |
| <b>ASSETS</b>                                |   |          |                |                       |          |                |
| Loans:                                       |   |          |                |                       |          |                |
| Commercial loans and lines of credit         | \$ 70,078                                       | \$ 3,489 | 6.56%          | \$ 67,384             | \$ 2,795 | 5.47%          |
| Comm/res construction                        | 119,121   | 7,878    | 8.72%          | 82,643                | 4,767    | 7.61%          |
| Commercial mortgages                         | 341,101   | 18,668   | 7.22%          | 327,751               | 16,889   | 6.80%          |
| Residential construction - consumer          | 117,184   | 6,854    | 7.82%          | 131,042               | 6,938    | 7.07%          |
| Residential mortgages                        | 43,934  | 1,886    | 5.72%          | 42,501                | 1,881    | 5.90%          |
| Consumer                                     | 163,454   | 16,232   | 13.16%         | 140,942               | 11,908   | 11.20%         |
| Total loans                                  | 854,872   | 55,007   | 8.52%          | 792,263               | 45,178   | 7.55%          |
| Loans held for sale                          | 101,479   | 5,927    | 8.05%          | 99,690                | 4,430    | 5.93%          |
| Securities available for sale, at fair value | 268,393   | 9,461    | 4.70%          | 305,794               | 9,811    | 4.28%          |
| Interest-bearing deposits                    | 9,947   | 348      | 4.66%          | 8,987                 | 177      | 2.63%          |
| Restricted stock investments, at cost        | 12,774  | 538      | 5.61%          | 13,806                | 405      | 3.91%          |
| Total earning assets                         | 1,247,465                                       | 71,281   | 7.60%          | 1,220,540             | 60,001   | 6.52%          |
| Allowance for loan losses                    | (11,978 )                                       |          |                | (10,151 )             |          |                |
| Cash and other nonearning assets             | 125,922   |          |                | 111,998               |          |                |
| Total assets                                 | \$ 1,361,409                                    | 71,281   |                | \$ 1,322,387          | 60,001   |                |
| <b>LIABILITIES AND STOCKHOLDERS EQUITY</b>   |   |          |                |                       |          |                |
| Interest-bearing deposits:                   |   |          |                |                       |          |                |
| NOW deposits                                 | \$ 11,155                                       | 18       | 0.22%          | \$ 13,200             | 20       | 0.20%          |
| Savings deposits                             | 69,324  | 158      | 0.31%          | 72,265                | 165      | 0.31%          |
| Money market deposits                        | 234,396   | 5,450    | 3.11%          | 203,603               | 2,093    | 1.37%          |
| Time deposits                                | 384,612   | 11,402   | 3.96%          | 391,977               | 9,618    | 3.28%          |
| Total interest-bearing deposits              | 699,487   | 17,028   | 3.25%          | 681,045               | 11,896   | 2.34%          |
| Borrowings                                   | 398,783   | 16,965   | 5.69%          | 395,073               | 12,506   | 4.23%          |
| Total interest-bearing liabilities           | 1,098,270                                       | 33,993   | 4.14%          | 1,076,118             | 24,402   | 3.03%          |
| Noninterest-bearing demand deposits          | 179,273   |          |                | 172,517               |          |                |
| Other noninterest-bearing liabilities        | 9,082   |          |                | 6,454                 |          |                |
| Stockholders equity                          | 74,784  |          |                | 67,298                |          |                |
| Total liabilities and stockholders equity    | \$ 1,361,409                                    | 33,993   |                | \$ 1,322,387          | 24,402   |                |

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|   |           |       |           |       |
|---|-----------|-------|-----------|-------|
| Net interest income/net interest spread | \$ 37,288 | 3.46% | \$ 35,599 | 3.49% |
| Net interest margin                     |           | 3.95% |           | 3.85% |

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(1) Nonaccrual loans are included in average loans.

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| ASSETS   | For the Three Months Ended September 30,<br>2006 |               |                | 2005                  |               |                |
|--|--|---------------|----------------|-----------------------|---------------|----------------|
|  | Average<br>Balance(1)<br>(dollars in thousands)  | Interest      | Yield/<br>Rate | Average<br>Balance(1) | Interest      | Yield/<br>Rate |
| <b>Loans:</b>                                    |  |               |                |                       |               |                |
| Commercial loans and lines of credit             | \$ 73,518  | \$ 1,265      | 6.73%          | \$ 65,507             | \$ 879        | 5.25%          |
| Comm/res construction                            | 127,503  | 2,877         | 8.83%          | 93,424                | 1,909         | 8.00%          |
| Commercial mortgages                             | 329,806  | 6,131         | 7.27%          | 349,724               | 6,087         | 6.81%          |
| Residential construction - consumer              | 108,331  | 2,237         | 8.19%          | 132,161               | 2,367         | 7.11%          |
| Residential mortgages                            | 45,219   | 611           | 5.41%          | 44,298                | 663           | 5.98%          |
| Consumer   | 170,719  | 5,852         | 13.50%         | 147,937               | 4,340         | 11.54%         |
| Total loans                                      | 855,096  | 18,973        | 8.72%          | 833,051               | 16,245        | 7.66%          |
| Loans held for sale                              | 114,441  | 2,265         | 7.92%          | 137,062               | 2,177         | 6.35%          |
| Securities available for sale, at fair value     | 265,426  | 3,218         | 4.85%          | 295,052               | 3,196         | 4.33%          |
| Interest-bearing deposits                        | 11,601   | 146           | 5.04%          | 7,461                 | 60            | 3.23%          |
| Restricted stock investments, at cost            | 11,920   | 176           | 5.92%          | 16,080                | 131           | 3.26%          |
| <b>Total earning assets</b>                      | <b>1,258,484</b>                                 | <b>24,778</b> | <b>7.77%</b>   | <b>1,288,706</b>      | <b>21,809</b> | <b>6.68%</b>   |
| Allowance for loan losses                        | (12,169 )  |               |                | (10,753 )             |               |                |
| Cash and other nonearning assets                 | 132,142  |               |                | 123,453               |               |                |
| <b>Total assets</b>                              | <b>\$ 1,378,457</b>                              | <b>24,778</b> |                | <b>\$ 1,401,406</b>   | <b>21,809</b> |                |
| <b>LIABILITIES AND STOCKHOLDERS EQUITY</b>       |  |               |                |                       |               |                |
| <b>Interest-bearing deposits:</b>                |  |               |                |                       |               |                |
| NOW deposits                                     | \$ 9,667   | 5             | 0.22%          | \$ 13,726             | 8             | 0.22%          |
| Savings deposits                                 | 66,310   | 51            | 0.30%          | 72,661                | 56            | 0.30%          |
| Money market deposits                            | 252,521  | 2,270         | 3.57%          | 204,346               | 845           | 1.64%          |
| Time deposits                                    | 382,398  | 4,070         | 4.22%          | 402,354               | 3,475         | 3.43%          |
| Total interest-bearing deposits                  | 710,896  | 6,396         | 3.57%          | 693,087               | 4,384         | 2.51%          |
| Borrowings                                       | 404,518  | 5,978         | 5.86%          | 449,519               | 5,010         | 4.42%          |
| <b>Total interest-bearing liabilities</b>        | <b>1,115,414</b>                                 | <b>12,374</b> | <b>4.40%</b>   | <b>1,142,606</b>      | <b>9,394</b>  | <b>3.26%</b>   |
| Noninterest-bearing demand deposits              | 176,415  |               |                | 180,733               |               |                |
| Other noninterest-bearing liabilities            | 9,376  |               |                | 8,136                 |               |                |
| Stockholders equity                              | 77,252   |               |                | 69,931                |               |                |
| <b>Total liabilities and stockholders equity</b> | <b>\$ 1,378,457</b>                              | <b>12,374</b> |                | <b>\$ 1,401,406</b>   | <b>9,394</b>  |                |
| Net interest income/net interest spread          |  | \$ 12,404     | 3.37%          |                       | \$ 12,415     | 3.42%          |
| Net interest margin                              |  |               | 3.87%          |                       |               | 3.79%          |

(1) Nonaccrual loans are included in average loans.

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A rate/volume analysis, which demonstrates changes in interest income and expense for significant assets and liabilities, appears below. Changes attributable to mix (rate and volume) are allocated to volume and rate based on the relative size of the variance that can be separately identified with each.

|  | For the Nine Months Ended<br>September 30, 2006<br>Due to Variances in |          |          | For the Three Months Ended<br>September 30, 2006<br>Due to Variances in |            |         |
|--|--|----------|----------|---|------------|---------|
|  | Rate   | Volume   | Total    | Rate  | Volume     | Total   |
| <b>Interest earned on:</b>                   |  |          |          |   |            |         |
| <b>Loans:</b>                                |  |          |          |   |            |         |
| Commercial loans and lines of credit         | \$ 579   | \$ 115   | \$ 694   | \$ 269  | \$ 117     | \$ 386  |
| Comm/res construction                        | 773  | 2,338    | 3,111    | 215   | 753        | 968     |
| Commercial mortgages                         | 1,069  | 710      | 1,779    | 1,501   | (1,457)    | 44      |
| Residential construction - consumer          | 936  | (1,020)  | (84)     | 1,493   | (1,623)    | (130)   |
| Residential mortgages                        | (77)   | 82       | 5        | (133)   | 81         | (52)    |
| Consumer                                     | 2,262  | 2,062    | 4,324    | 793   | 719        | 1,512   |
| Total loans                                  | 5,542  | 4,287    | 9,829    | 4,138   | (1,410)    | 2,728   |
| Loans held for sale                          | 1,426  | 71       | 1,497    | 1,774   | (1,686)    | 88      |
| Securities available for sale, at fair value | 1,270  | (1,620)  | (350)    | 1,408   | (1,386)    | 22      |
| Interest-bearing deposits                    | 150  | 21       | 171      | 43  | 43         | 86      |
| Restricted stock investments, at cost        | 182  | (49)     | 133      | 240   | (195)      | 45      |
| Total interest income                        | 8,570  | 2,710    | 11,280   | 7,603   | (4,634)    | 2,969   |
| <b>Interest paid on:</b>                     |  |          |          |   |            |         |
| <b>Interest-bearing deposits:</b>            |  |          |          |   |            |         |
| NOW deposits                                 | 2  | (4)      | (2)      | 1   | (4)        | (3)     |
| Savings deposits                             | (2)  | (5)      | (7)      | 5   | (10)       | (5)     |
| Money market deposits                        | 3,000  | 357      | 3,357    | 1,187   | 238        | 1,425   |
| Time deposits                                | 2,080  | (296)    | 1,784    | 1,616   | (1,021)    | 595     |
| Total interest-bearing deposits              | 5,080  | 52       | 5,132    | 2,809   | (797)      | 2,012   |
| Borrowings                                   | 4,341  | 118      | 4,459    | 3,786   | (2,818)    | 968     |
| Total interest expense                       | 9,421  | 170      | 9,591    | 6,595   | (3,615)    | 2,980   |
| Net interest income                          | \$ (851)   | \$ 2,540 | \$ 1,689 | \$ 1,008  | \$ (1,019) | \$ (11) |

*Noninterest Income*

Noninterest income for the nine months ended September 30, 2006 was \$19.886 million, an increase of \$3.046 million or 18.1% for the comparable period of 2005. Contributing to the higher noninterest income was an increase in gains on sale of mortgage loans and other mortgage-banking revenue of \$2.465 million, or 46.4%. Beginning in January 2006, management expanded its secondary marketing activities for selling mortgage loans to include selling loans in bulk, on a mandatory delivery basis. Prior to that time, all loans originated for sale were sold into the secondary market individually, on a best efforts basis (see discussion in Note 1 to the consolidated financial statements under the heading *Derivative Loan Commitments Hedging Activities*). Since the inception of the bulk sale strategy, approximately 36% of loans sold have been sold on a bulk-delivery basis. Thus far, we have experienced significantly wider profit margins on loans sold in bulk, compared to the profit margin previously experienced under the best efforts approach. Approximately \$1.766 million of the increase in gains on sales of mortgage loans is attributable to this strategy. This estimate includes gains realized while hedging our interest rate risk during the period in which loans are in the application and approval process (pipeline), and loans settled and awaiting sale (warehouse). Profit margins experienced during the first six months of



2006 were significantly higher than we anticipated, as prices paid were inflated by higher demand and diminished supply for certain mortgage products we originate. The profit margins shrunk to a more normal anticipated level in the third quarter of 2006 and may continue to shrink or to expand moving forward as demand changes or overall supplies fluctuate, which would affect the price we receive on sold loans. A lower profit margin could reduce our noninterest income growth as, conversely, a higher profit margin could increase its growth. Mortgages sold into the secondary market increased 3.5% during the first nine months of 2006, compared to the same period of 2005 and pricing spreads decreased. Loans originated for sale increased 1.4%, increasing origination and appraisal income.

ATM fees increased by \$74,000 or 3.2%, as a result of increased volume of ATM and debit card transactions. As of September 30, 2006, the Bank had 33 ATM locations that it owns and operates and 138 ATM's through third party agreements. Commissions on sales of other insurance products grew by \$372,000 due to increased sales volume of insurance products sold through Finance Maryland. Deposit service charges declined slightly to \$5.202 million for the nine months ended September 30, 2006 from \$5.338 million for the nine months ended September 30, 2005 due to reduced overdraft fee income. Commissions on sales of nondeposit investment products increased slightly by \$12,000 due to higher sales of annuities and mutual funds, for which we receive a higher commission percentage than on other products. We also recognized \$26,000 in gains on sales of investment securities in 2006. Other sources of noninterest income increased \$270,000 primarily due to rental income from third party tenants in our headquarters building, which we purchased in March 2005.

Noninterest income for the three months ended September 30, 2006 decreased \$204,000 or 3.0% to \$6.503 million compared to \$6.707 million for the same period of 2005, reflecting lower levels of revenue in most major categories. Commissions on nondeposit investment products increased by \$88,000 or 80.7%, as compared to the same period in 2005 due to higher sales of annuities and mutual funds. Insurance sales commissions increased \$8,000 or 1.3%, as compared to the same period of 2005, due to increased insurance sales of Finance Maryland. Gains on sales of mortgage loans and other mortgage-banking revenue decreased \$132,000 or 5.1% due to the volume of loans sold into the secondary market. The volume of loans sold declined by 24%, which was significantly offset by the positive impact of the hedging program. Deposit service charges declined by \$112,000 or 6.0% due to lower levels of overdraft income. We recognized \$26,000 in gains on sales of investment securities in 2006.

#### *Noninterest expenses*

For the nine months ended September 30, 2006, noninterest expenses increased \$5.392 million or 12.7% to \$47.863 million compared to \$42.471 million for the same period of 2005. Salary and employee benefits expenses increased \$2.606 million due to additional personnel costs for new positions supporting the increase in the number of loans and deposits, staffing hired to support the expansion of the consumer finance company and wholesale mortgage activities, and increased cost of employer provided health care. Occupancy expenses increased \$1.003 million to \$5.761 million for the nine months ended September 30, 2006 from \$4.758 million for the nine months ended September 30, 2005 due to additional space occupied during the quarter for the new executive and administrative offices and accelerated amortization of leasehold improvements on our old operations center. Additionally, we realized an increase in lease expense due to additional bank branch, mortgage loan and consumer loan office locations, slightly offset by a decrease in lease expense due to our purchase of our old headquarters building in March of 2005. Service and maintenance expense also increased (\$270,000) due to increased locations. Professional services decreased \$196,000 due to lower legal fees and audit expense. Other expenses increased \$487,000 due in part to costs associated with the move of executive and administrative offices during the quarter. Additionally, we recorded a valuation allowance of \$450,000 through other operating expenses to reflect the declines in fair market value incurred during the quarter for certain residential mortgage loans transferred from loans held for sale during the third quarter and to increase our reserves for potential loan repurchases.

For the three months ended September 30, 2006, noninterest expenses increased \$1.196 million or 8.0% to \$16.061 million from \$14.865 million for the same period of 2005. Increases in salary and employee benefit expenses of \$131,000 are due to additional personnel costs for new positions, increased cost of employer provided health care, offset by lower performance-based incentive costs. Occupancy expense increased \$425,000 or 25.0% to \$2.126 million for the three months ended September 30, 2006 compared to \$1.701 million for the three months ended September 30, 2005 due to increased lease expense related to the headquarters move and accelerated amortization of leasehold improvements on our old operations center.

The following table shows the breakout of noninterest expense:

| (dollars in thousands)                  | Three Months Ended<br>September 30, |           | Nine Months Ended<br>September 30, |           |
|---|-------------------------------------|-----------|------------------------------------|-----------|
|   | 2006                                | 2005      | 2006                               | 2005      |
| Salaries and employee benefits          | \$ 8,185                            | \$ 8,054  | \$ 25,623                          | \$ 23,017 |
| Occupancy                               | 2,126                               | 1,701     | 5,761                              | 4,758     |
| Furniture, fixtures and equipment       | 789                                 | 779       | 2,339                              | 2,296     |
| Loans held for sale valuation allowance | 450                                 |           | 450                                |           |
| Professional services                   | 207                                 | 219       | 666                                | 862       |
| Advertising                             | 218                                 | 300       | 1,081                              | 1,090     |
| Data processing                         | 430                                 | 490       | 1,347                              | 1,529     |
| Service and maintenance                 | 544                                 | 501       | 1,610                              | 1,340     |
| Office supplies                         | 195                                 | 161       | 568                                | 537       |
| ATM servicing expenses                  | 237                                 | 311       | 762                                | 869       |
| Printing                                | 147                                 | 128       | 467                                | 400       |
| Corporate insurance                     | 160                                 | 138       | 381                                | 315       |
| OREO expense                            | 100                                 | 16        | 101                                | 25        |
| FDIC premiums                           | 28                                  | 28        | 83                                 | 85        |
| Consulting fees                         | 274                                 | 182       | 610                                | 490       |
| Marketing/promotion                     | 218                                 | 252       | 835                                | 674       |
| Postage                                 | 196                                 | 156       | 682                                | 579       |
| Overnight delivery/courier              | 233                                 | 211       | 678                                | 591       |
| Security                                | 46                                  | 19        | 137                                | 68        |
| Dues and memberships                    | 138                                 | 120       | 454                                | 320       |
| Loan collection expenses                | 155                                 | 125       | 459                                | 344       |
| Other                                   | 985                                 | 974       | 2,769                              | 2,282     |
|   | \$ 16,061                           | \$ 14,865 | \$ 47,863                          | \$ 42,471 |

### *Income Taxes*

We recorded income tax expense of \$2.101 million on income before taxes of \$8.005 million, resulting in an effective tax rate of 26.2% for the nine month period ended September 30, 2006 in comparison to income tax expense of \$2.142 million on income before taxes of \$7.457 million, resulting in an effective tax rate of 28.7% for the nine month period ended September 30, 2005. The decrease in the effective tax rate includes a credit to income tax expense to increase the recorded value of the net deferred tax asset related to state loss carryforwards to the amount expected to be realized based upon management's most recent projections of state taxable income. There were no changes in the statutory income tax rates in 2006.

We recorded income tax expense of \$542,000 on income before taxes of \$2.585 million, resulting in an effective tax rate of 21.0% for the three month period ended September 30, 2006 in comparison to income tax expense of \$928,000 on income before taxes of \$3.141 million, resulting in an effective tax rate of 29.5% for the three month period ended September 30, 2005. The decrease in the effective tax rate reflects the credit to income tax expense for the adjustment to the state deferred tax asset.

### *Liquidity*

Liquidity describes our ability to meet financial obligations, including lending commitments and contingencies, that arise during the normal course of business. Liquidity is primarily needed to meet the borrowing and deposit withdrawal requirements of our customers, as well as to meet current and planned expenditures. These cash requirements are met on a daily basis through the inflow of deposit funds, and the maintenance of short-term overnight investments, maturities and calls in our investment portfolio and available lines of credit with the FHLB, which requires pledged collateral. Fluctuations in deposit and short-term borrowing balances may be influenced by the interest rates paid, general consumer confidence and the overall economic environment. There can be no assurances that deposit withdrawals and loan fundings will not exceed all available sources of liquidity on a short-term basis. Such a situation would have an adverse effect on our ability to originate new loans and maintain reasonable loan and deposit interest rates, which would negatively impact earnings.

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The borrowing requirements of customers include commitments to extend credit and the unused portion of lines of credit (collectively commitments ), which totaled \$301.624 million at September 30, 2006. Historically, many of the commitments expire without being fully drawn; therefore, the total commitment amounts do not necessarily represent future cash requirements. Commitments for real estate development and construction, which totaled \$135.737 million, or 45.0% of the \$301.624 million, are generally short-term in nature, satisfying cash requirements with principal repayments as construction properties financed are generally repaid with permanent financing. Available credit lines represent the unused portion of credit previously extended and available to the customer as long as there is no violation of material contractual conditions. Commitments to extend credit for residential mortgage loans of \$51.945 million, or 17.2% of the \$301.624 million at September 30, 2006, generally expire within 60 days. Commercial commitments to extend credit and unused lines of credit of \$22.814 million, or 7.6% of the \$301.624 million at September 30, 2006, generally do not extend for more than 12 months. Consumer commitments to extend credit and unused lines of credit of \$14.665 million, or 4.9% of the \$301.624 million at September 30, 2006, are generally open ended. At September 30, 2006, available home equity lines totaled \$76.463 million. Home equity credit lines generally extend for a period of 10 years.

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Capital expenditures for various branch locations and equipment can be a significant use of liquidity. As of September 30, 2006, we plan on expending approximately \$3.500 million in the next 12 months on our premises and equipment. During the first nine months of 2006, we expended approximately \$9.806 million for premises and equipment, approximately half of which was on the construction of our new headquarters offices located in a high-rise tower adjacent to our former headquarters building. Of the \$4.708 million expended on the new headquarters location, we have been reimbursed by the landlord for \$1.852 million in leasehold improvement allowances. We moved into the new location during the third quarter of 2006.

Customer withdrawals are also a principal use of liquidity, but are generally mitigated by growth in customer funding sources, such as deposits and short-term borrowings. While balances may fluctuate up and down in any given period, historically we have experienced a steady increase in total customer funding sources.

The Bank's principal sources of liquidity are cash and cash equivalents (which are cash on hand or amounts due from financial institutions, federal funds sold, money market mutual funds, and interest bearing deposits), available for sale securities, deposit accounts and borrowings. The levels of such sources are dependent on the Bank's operating, financing and investing activities at any given time. Cash and cash equivalents totaled \$48.798 million at September 30, 2006 compared to \$45.835 million as of December 31, 2005. Our loan to deposit ratio stood at 93.7% as of September 30, 2006 and 97.2% at December 31, 2005.

We also have the ability to utilize established credit lines as additional sources of liquidity. To utilize the vast majority of our credit lines, we must pledge certain loans and/or investment securities before advances can be obtained. As of September 30, 2006, we maintained lines of credit totaling \$517.905 million, with available borrowing capacity of \$204.761 million based upon loans and investments available for pledging.

#### Inflation

Inflation may be expected to have an impact on our operating costs and thus on net income. A prolonged period of inflation could cause interest rates, wages, and other costs to increase and could adversely affect our results of operations unless the fees we charge could be increased correspondingly. However, we believe that the impact of inflation was not material for 2006 or 2005.

#### Off-Balance Sheet Arrangements

We enter into off-balance sheet arrangements in the normal course of business. These arrangements consist primarily of commitments to extend credit, lines of credit and letters of credit. In addition, the Company has certain operating lease obligations.

Credit commitments are agreements to lend to a customer as long as there is no violation of any condition to the contract. Loan commitments generally have interest rates fixed at current market amounts, fixed expiration dates, and may require payment of a fee. Lines of credit generally have variable interest rates. Such lines do not represent future cash requirements because it is unlikely that all customers will draw upon their lines in full at any time. Letters of credit are commitments issued to guarantee the performance of a customer to a third party.

Our exposure to credit loss in the event of nonperformance by the borrower is the contract amount of the commitment. Loan commitments, lines of credit, and letters of credit are made on the same terms, including collateral, as outstanding loans. We are not aware of any accounting loss we would incur by funding our commitments.

#### *Notional Amount of Derivatives*

The Bank, through First Mariner Mortgage, enters into interest rate lock commitments, which are commitments to originate loans whereby the interest rate on the loan is determined prior to funding and the customers have locked into that interest rate. The Bank also has corresponding forward sales commitments related to these interest rate lock commitments. The market value of rate lock commitments and best efforts contracts is not readily ascertainable with precision because rate lock commitments and best efforts contracts are not actively traded in stand-alone markets. The Bank determines the fair value of rate lock commitments and best efforts contracts by measuring the change in the value of the underlying asset, while taking into consideration the probability that the rate lock commitments will close.

Information pertaining to the notional amounts of our derivative financial instruments follows as of September 30, 2006. The fair values of these derivative financial instruments are recorded in our consolidated balance sheet in accordance with Statement 133.

| (dollars in thousands)   | Notional<br>Amount | Estimated<br>Fair Value |
|--|--------------------|-------------------------|
| Interest rate lock commitments                                       | \$ 59,967          | \$ 60,067               |
| Open hedge positions:  |                    |                         |
| Forward sales commitments on loan pipeline and funded loans          | \$ 106,489         | \$ 106,388              |
| Forward contracts to sell mortgage-backed securities and Eurodollars | \$ 91,750          | \$ 91,592               |

The net effect on our income statement from marking to market the forward contracts, the interest rate lock commitments and mortgage loans held for sale are not considered material to the overall operations of the consolidated company.

Changes in interest rates could materially affect the fair value of derivative loan commitments on our consolidated financial statements. In reality, one would not expect all other assumptions to remain constant. Changes in one factor may result in changes in another (for example, changes in interest rates could result in changes in the fallout factor), which might magnify or counteract the sensitivities. This is because the impact of an interest rate shift on the fallout ratio is non-symmetrical and non-linear.

### Item 3 Quantitative and Qualitative Disclosures About Market Risk

Results of operations for financial institutions, including us, may be materially and adversely affected by changes in prevailing economic conditions, including declines in real estate values, rapid changes in interest rates and the monetary and fiscal policies of the federal government. Our loan portfolio is concentrated primarily in central Maryland and portions of Maryland's eastern shore and is, therefore, subject to risks associated with these local economies.

#### Interest Rate Risk

Our profitability is in part a function of the spread between the interest rates earned on assets and the interest rates paid on deposits and other interest-bearing liabilities (net interest income), including advances from the FHLB and other borrowings. Interest rate risk arises from mismatches (i.e., the interest sensitivity gap) between the dollar amount of repricing or maturing assets and liabilities and is measured in terms of the ratio of the interest rate sensitivity gap to total assets. More assets repricing or maturing than liabilities over a given time period is considered asset-sensitive and is reflected as a positive gap, and more liabilities repricing or maturing than assets over a given time period is considered liability-sensitive and is reflected as negative gap. An asset-sensitive position (i.e., a positive gap) will generally enhance earnings in a rising interest rate environment and will negatively impact earnings in a falling interest rate environment, while a liability-sensitive position (i.e., a negative gap) will generally enhance earnings in a falling interest rate environment and negatively impact earnings in a rising interest rate environment. Fluctuations in interest rates are not predictable or controllable. We have attempted to structure our asset and liability management strategies to mitigate the impact on net interest income of changes in market interest rates. However, there can be no assurance that we will be able to manage interest rate risk so as to avoid significant adverse effects on net interest income. At September 30, 2006, we had a one year cumulative positive gap of approximately \$185.190 million.

In addition to the use of interest rate sensitivity reports, we test our interest rate sensitivity through the deployment of a simulation analysis. Earnings simulation models are used to estimate what effect specific interest rate changes would have on our projected net interest income. Derivative financial instruments, such as interest rate caps, are included in the analysis. Changes in prepayments have been included where changes in behavior patterns are assumed to be significant to the simulation, particularly mortgage related assets. Call features on certain securities and borrowings are based on their call probability in view of the projected rate change. At September 30, 2006, the simulation model provided the following profile of our interest rate risk measured over a one-year time horizon, assuming a parallel shift in a yield curve based off the U.S. dollar forward swap curve adjusted for certain pricing assumptions:

|                     | Immediate Rate Change |   |        |   |
|---------------------|-----------------------|---|--------|---|
|                     | +200BP                | % | -200BP | % |
| Net interest income | 0.62                  | % | -0.72  | % |



Both of the above tools used to assess interest rate risk have strengths and weaknesses. Because the gap analysis reflects a static position at a single point in time, it is limited in quantifying the total impact of market rate changes which do not affect all earning assets and interest-bearing liabilities equally or simultaneously. In addition, gap reports depict the existing structure, excluding exposure arising from new business. While the simulation process is a powerful tool in analyzing interest rate sensitivity, many of the assumptions used in the process are highly qualitative and subjective and are subject to the risk that past historical activity may not generate accurate predictions of the future. The model also assumes parallel movements in interest rates, which means both short-term and long-term rates will change equally. Nonparallel changes in interest rates (short-term rates changing differently from long-term rates) could result in significant differences in projected income amounts when compared to parallel tests. Both measurement tools taken together, however, provide an effective evaluation of our exposure to changes in interest rates, enabling management to better control the volatility of earnings.

We are party to mortgage rate lock commitments to fund mortgage loans at interest rates previously agreed (locked) by both us and the borrower for specified periods of time. When the borrower locks an interest rate, we effectively extend a put option to the borrower, whereby the borrower is not obligated to enter into the loan agreement, but we must honor the interest rate for the specified time period. We are exposed to interest rate risk during the accumulation of interest rate lock commitments and loans prior to sale. We utilize either a best efforts sell forward commitment or a mandatory sell forward commitment to economically hedge the changes in fair value of the loan due to changes in market interest rates. Failure to effectively monitor, manage and hedge the interest rate risk associated with the mandatory commitments subjects us to potentially significant market risk.

Throughout the lock period the changes in the market value of interest rate lock commitments, mandatory sell forward commitments are recorded as unrealized gains and losses and are included in the statement of operations in mortgage-banking revenue. Management has made complex judgments in the recognition of gains and losses in connection with this activity. We utilize a third party and its proprietary simulation model to assist in identifying and managing the risk associated with this activity.

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

(a) Evaluation of disclosure controls and procedures. The Company maintains disclosure controls and procedures that are designed to ensure that information required to be disclosed in our reports filed under the Securities Exchange Act of 1934, such as this Quarterly Report, is recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission rules and forms, and that such information is accumulated and communicated to the Company's management, including the Chief Executive Officer ( CEO ) and Chief Financial Officer ( CFO ), 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 the end of the period covered by this Quarterly Report on Form 10-Q, was carried out under the supervision and with the participation of the Company's management, including the CEO and CFO. Based on that evaluation, the Company's management, including the CEO and CFO, has concluded that the Company's disclosure controls and procedures are effective.

(b) Changes in Internal Control Over Financial Reporting. In July of 2006, Finance Maryland converted from the Megasyms system to the FPS Gold system for loan and accounting processing. Under the old Megasyms system, we had to contract for a review of the system's internal controls by an independent consultant as no SAS 70 review was performed on Megasyms. The new FPS Gold system is subject to an annual SAS 70 review. We believe that conversion to the new system strengthens our internal control structure.

There were no significant changes in our internal control over financial reporting or in other factors during our last fiscal quarter, other than as disclosed in the preceding paragraph, that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

## **PART II OTHER INFORMATION**

### **Item 1 Legal Proceedings**

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We are party to legal actions that are routine and incidental to our business. In management's opinion, the outcome of these matters, individually or in the aggregate, will not have a material effect on our results of operations or financial position.

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**Item 1a Risk Factors**

The following information sets forth material changes from the risk factors we disclosed in our Annual Report on Form 10-K for the year ended December 31, 2005. The following risks could cause our actual results to differ materially from those contained in forward-looking statements we have made in this Quarterly Report and those we may make from time to time. If any of the following risks actually occur, our business, results of operations, prospects or financial condition could be harmed. These are not the only risks we face. Additional risks including those previously disclosed in our Annual Report on Form 10-K for the year ended December 31, 2005, those not presently known to us or those that we currently deem immaterial, may also affect our business operations.

*We Experience Interest Rate Risk On Our Loans Held For Sale Portfolio*

We are exposed to interest rate risk in both our pipeline of mortgage originations (loans that have yet to close with the borrower) and in our warehouse loans (those loans that have closed with the borrower but have yet to be funded by investors). We now manage this interest rate risk primarily in two ways. On the majority of the loans we originate, we enter into agreements to sell our loans through the use of best efforts forward delivery contracts. Under this type of agreement we commit to sell a loan at an agreed price to an investor at the point in time the borrower commits to an interest rate on the loan, with the intent that the buyer assumes the interest rate risk on the loan. Beginning in January 2006, the remainder of our mortgage originations were hedged utilizing forward sales of mortgage-backed securities and Eurodollars for loans to be sold under mandatory delivery contracts on a pooled or bulk basis. We expect that these derivative financial instruments (forward sales of mortgage-backed securities and Eurodollars) will experience changes in fair value opposite to the change in fair value of the derivative loan commitments. However, the process of selling loans on a bulk basis and use of forward sales of mortgage-backed securities and Eurodollars to hedge interest rate risk associated with customer interest rate lock commitments involves greater risk than selling loans on an individual basis through best efforts forward delivery commitments. Hedging interest rate risk in bulk sales requires management to estimate the expected fallout (rate lock commitments with customers that do not complete the loan process). Additionally, the fair value of the hedge may not correlate precisely with the change in fair value of the rate lock commitments with the customer due to changes in market conditions, such as demand for loan products, or prices paid for differing types of loan products. Variances from management's estimates for customer fallout or market changes making the forward sale of mortgage-backed securities and/or Eurodollars non-effective may result in higher volatility in our profits from selling mortgage loans originated for sale. We have engaged an experienced third party to assist us in managing our activities in hedging and marketing our bulk sales delivery strategy.

*We Experience Credit Risk Related To Our Residential Mortgage Production Activities*

We also face credit risk related to our residential mortgage production activities. Credit risk is the potential for financial loss resulting from the failure of a borrower or an institution to honor its contractual obligations to us, including the risk that an investor will fail to honor its obligation under a best efforts forward delivery contract to purchase the loan from us. We manage mortgage credit risk principally by selling substantially all of the mortgage loans that we produce, limiting credit recourse to the Bank in those transactions, and by retaining high credit quality mortgages in our loan portfolio. We also limit our risk of loss on mortgage loan sales by establishing limits on activity to any one investor and by entering into contractual relationships with only those financial institutions that are approved by our Secondary Marketing Committee. Also, the period of time between closing on a loan commitment with the borrower and funding by the investor ranges from between 15 and 90 days.

*We Experience Risk Related To Covenants In Our Loan Sales Agreements With Investors*

Our sales agreements with investors who buy our loans generally contain covenants which may require us to repurchase loans under certain provisions, including delinquencies or return premiums paid by these investors should the loan be paid off early. Any loans we are required to repurchase may be considered impaired loans, with the potential for charge-offs and/or loss provision charges. The addition of these repurchased loans to our portfolio could adversely affect our asset quality ratios.

Loans sold that pay off prior to 90 days after the date of the sale are also subject to repurchase from the investor, with the related risk of forgoing the premium we would have earned on the loans if they had not paid off.

There may be certain loans in our portfolio that were originated for sale, but for various reasons, are unable to be sold. These loans could also be subject to impairment and contain the same risks described above for repurchased loans.

*We Have A High Percentage Of Commercial, Commercial Real Estate, And Real Estate Acquisition And Development Loans In Relation To Our Total Loans And Total Assets*

Our loan portfolio contains a high percentage of commercial, commercial real estate, real estate acquisition and development loans in relation to our total loans and total assets. The Federal Deposit Insurance Corporation recently issued a pronouncement alerting banks to their concern

about banks with a heavy concentration of commercial real estate loans. These types of loans also typically are larger than residential real estate loans and other commercial loans. Because the loan portfolio contains a number of

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commercial and commercial real estate loans with relatively large balances, the deterioration of one or a few of these loans may cause a significant increase in nonperforming loans. An increase in nonperforming loans could result in a loss of earnings from these loans, an increase in the provision for loan losses, or an increase in loan charge-offs, which could have an adverse impact on financial results.

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

On July 18, 2006, the Company announced that its Board of Directors approved an extension to its share repurchase program, originally approved on July 20, 2004, of up to 300,000 shares (approximately 5%) of our outstanding common stock, which provides for open market or private purchases of stock over the next 24 months. During the three and nine months ended September 30, 2006, we did not repurchase any shares of our common stock.

**Item 3 Defaults Upon Senior Securities**

None

**Item 4 Submission of Matters to a Vote of Security Holders**

None

**Item 5 Other Information**

Subsequent Event

On October 26, 2006, we repurchased \$6.884 million in delinquent loans from an investor in accordance with a covenant in our sales agreement. Although the loans were not in our portfolio as of September 30, 2006, we had provided for a fair market value adjustment for them in our operating results. All of the loans are 90 days past due. Of the \$6.884 million, \$385,000 have been placed on nonaccrual.

**Item 6 Exhibits**

31.1 Certifications of Chief Executive Officer pursuant to Rule 13a-14(a) and Rule 15d-14(a), promulgated under the Securities Exchange Act of 1934, as amended, filed herewith

31.2 Certifications of Chief Financial Officer pursuant to Rule 13a-14(a) and Rule 15d-14(a), promulgated under the Securities Exchange Act of 1934, as amended, filed herewith

32.1 Certification of Chief Executive Officer pursuant to 18 U.S.C. Section 1350 as adopted pursuant to section 906 of the Sarbanes-Oxley Act of 2002, furnished herewith

32.2 Certification of Chief Financial Officer pursuant to 18 U.S.C. Section 1350 as adopted pursuant to section 906 of the Sarbanes-Oxley Act of 2002, furnished herewith

SIGNATURES

Pursuant to the requirements of Section 13 or 15 (d) 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.

FIRST MARINER BANCORP

Date: 11/9/06 By: /s/ Edwin F. Hale Sr.  
Edwin F. Hale Sr.  
Chairman and Chief Executive Officer

Date: 11/9/06 By: /s/ Mark A. Keidel  
Mark A. Keidel



Exhibit Index

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