SHORE BANCSHARES INC
Form 10-K
March 11, 2016

**UNITED STATES**

**SECURITIES AND EXCHANGE COMMISSION**

**Washington, D.C. 20549**

**FORM 10-K**

**ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE**

**SECURITIES EXCHANGE ACT OF 1934**

For the Year Ended December 31, 2015

Commission File No. 0-22345

**SHORE BANCSHARES, INC.**

(Exact name of registrant as specified in its charter)

| | |
|---|---|
| Maryland | 52-1974638 |
| (State or Other Jurisdiction of Incorporation or Organization) | (I.R.S. Employer Identification No.) |

| | |
|---|---|
| 28969 Information Lane, Easton, Maryland | 21601 |
| (Address of Principal Executive Offices) | (Zip Code) |

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

Securities Registered pursuant to Section 12(b) of the Act:

| Title of Each Class: | Name of Each Exchange on Which Registered: |
|---|---|
| Common stock, par value $.01 per share | Nasdaq Global Select Market |

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. ¨ Yes þ No

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 16(d) of the Act. ¨ Yes þ No

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

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

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of the registrant’s knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K ¨

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer (check one):

Large accelerated filer ¨ Accelerated filer þ Non-accelerated filer ¨ Smaller Reporting Company ¨

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

State the aggregate market value of the voting and non-voting common equity held by non-affiliates computed by reference to the price at which the common equity was last sold, or the average bid and asked price of such common equity, as of the last business day of the registrant’s most recently completed second fiscal quarter: $116,646,865.

The number of shares outstanding of the registrant’s common stock as of the latest practicable date: 12,640,134 as of February 29, 2016.

**Documents Incorporated by Reference**

Certain information required by Part III of this annual report is incorporated therein by reference to the definitive proxy statement for the 2016 Annual Meeting of Stockholders.

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**Cautionary note regarding forward-looking statements**

This Annual Report on Form 10-K of Shore Bancshares, Inc. (the “Company” and “we,” “our” or “us” on a consolidated basis) contains forward-looking statements within the meaning of The Private Securities Litigation Reform Act of 1995. These forward looking statements represent plans, estimates, objectives, goals, guidelines, expectations, intentions, projections and statements of our beliefs concerning future events, business plans, expected operating results and the assumptions upon which those statements are based. In some cases, you can identify these forward-looking statements by words like “may,” “will,” “should,” “expect,” “plan,” “anticipate,” “intend,” “believe,” “estimate,” “predict,” “potential,” or negative of those words and other comparable terminology, although not all forward-looking statements contain these words. Forward-looking statements are not a guarantee of future performance or results, and will not necessarily be accurate indications of the times at, or by, which such performance or results will be achieved. We caution that the forward-looking statements are based largely on our expectations and information available at the time the statements are made and are subject to a number of known and unknown risks and uncertainties that are subject to change based on factors which are in many instances, beyond our control. Actual results, performance or achievements could differ materially from those contemplated, expressed, or implied by the forward-looking statements. You should bear this in mind when reading this annual report and not place undue reliance on these forward-looking statements. The following factors, among others, could cause our financial performance to differ materially from that expressed in such forward-looking statements:

- general economic conditions, whether national or regional, and conditions in the lending markets in which we participate that may have an adverse effect on the demand for our loans and other products, our credit quality and related levels of nonperforming assets and loan losses, and the value and salability of the real estate that we own or that is the collateral for our loans;

- results of examinations of us by our regulators, including the possibility that our regulators may, among other things, require us to increase our reserve for loan losses or to write-down assets;

- changing bank regulatory conditions, policies or programs, whether arising as new legislation or regulatory initiatives, that could lead to restrictions on activities of banks generally, or our subsidiary banks in particular, more restrictive regulatory capital requirements, increased costs, including deposit insurance premiums, regulation or prohibition of certain income producing activities or changes in the secondary market for loans and other products;

- changes in market rates and prices may adversely impact the value of securities, loans, deposits and other financial instruments and the interest rate sensitivity of our balance sheet;

- our liquidity requirements could be adversely affected by changes in our assets and liabilities;

- the effect of legislative or regulatory developments, including changes in laws concerning taxes, banking, securities, insurance and other aspects of the financial services industry;

- competitive factors among financial services organizations, including product and pricing pressures and our ability to attract, develop and retain qualified banking professionals;

- the growth and profitability of non-interest or fee income being less than expected;

- the effect of changes in accounting policies and practices, as may be adopted by the Financial Accounting Standards Board, the Securities and Exchange Commission (the "SEC"), the Public Company Accounting Oversight Board and other regulatory agencies; and

- the effect of fiscal and governmental policies of the United States federal government.

You should also consider carefully the Risk Factors contained in Item 1A of Part I of this annual report, which address additional factors that could cause our actual results to differ from those set forth in the forward-looking statements and could materially and adversely affect our business, operating results and financial condition. The risks discussed in this annual report are factors that, individually or in the aggregate, management believes could cause our actual results to differ materially from expected and historical results. You should understand that it is not possible to predict or identify all such factors. Consequently, you should not consider such disclosures to be a complete discussion of all potential risks or uncertainties.

The forward-looking statements speak only as of the date on which they are made, and, except to the extent required by federal securities laws, we undertake no obligation to update any forward-looking statement to reflect events or circumstances after the date on which the statement is made or to reflect the occurrence of unanticipated events. In addition, we cannot assess the impact of each factor on our business or the extent to which any factor, or combination of factors, may cause actual results to differ materially from those contained in any forward-looking statements.

# PART I

## Item 1. Business.

## BUSINESS

### General

The Company was incorporated under the laws of Maryland on March 15, 1996 and is a financial holding company registered under the Bank Holding Company Act of 1956, as amended (the "BHC Act"). The Company is the largest independent financial holding company located on the Eastern Shore of Maryland. The Company's primary business is acting as the parent company to several financial institution and insurance entities. The Company engages in the banking business through CNB, a Maryland commercial bank with trust powers and The Talbot Bank of Easton, Maryland, a Maryland commercial bank ("Talbot Bank"). As used in this annual report, the term "Banks" refers to CNB and Talbot Bank and Felton Bank for periods prior to January 1, 2011 and to CNB and Talbot Bank for all other periods.

The Company engages in the insurance business through an insurance producer, The Avon-Dixon Agency, LLC, a Maryland limited liability company, with two specialty lines, trading as Elliot Wilson Insurance (Trucking) and Jack Martin & Associates (Marine); and an insurance premium finance company, Mubell Finance, LLC, a Maryland limited liability company, (all of the foregoing are collectively referred to as the "Insurance Subsidiaries").

The Company has two inactive subsidiaries, Wye Mortgage Group, LLC and Wye Financial Services, Inc. which were organized under Maryland law.

Talbot Bank owns all of the issued and outstanding securities of Dover Street Realty, Inc., a Maryland corporation that engages in the business of holding and managing real property acquired by Talbot Bank as a result of loan foreclosures.

We operate in two business segments: community banking and insurance products and services. Financial information related to our operations in these segments for each of the three years ended December 31, 2015 is provided in Note 27 to the Company's Consolidated Financial Statements included in Item 8 of Part II of this annual report.

**Banking Products and Services**

CNB is a Maryland chartered commercial bank with trust powers that commenced operations in 1876. CNB was originally chartered as a national banking association but converted to its present charter effective January 1, 2010. Talbot Bank is a Maryland chartered commercial bank that commenced operations in 1885 and was acquired by the Company in its December 2000 merger with Talbot Bancshares, Inc. The Banks operate 18 full service branches and 20 ATMs and provide a full range of commercial and consumer banking products and services to individuals, businesses, and other organizations in Kent County, Queen Anne’s County, Caroline County, Talbot County and Dorchester County in Maryland and in Kent County, Delaware. The Banks’ deposits are insured by the Federal Deposit Insurance Corporation (the “FDIC”).

The Banks are independent community banks that serve businesses and individuals in their respective market areas. Services offered are essentially the same as those offered by larger regional institutions that compete with the Banks. Services provided to businesses include commercial checking, savings, certificates of deposit and overnight investment sweep accounts. The Banks offer all forms of commercial lending, including secured and unsecured loans, working capital loans, lines of credit, term loans, accounts receivable financing, real estate acquisition and development, construction loans and letters of credit. Merchant credit card clearing services are available as well as direct deposit of payroll, internet banking and telephone banking services.

Services to individuals include checking accounts, various savings programs, mortgage loans, home improvement loans, installment and other personal loans, credit cards, personal lines of credit, automobile and other consumer financing, safe deposit boxes, debit cards, 24-hour telephone banking, internet banking, mobile banking, and 24-hour automatic teller machine services. The Banks also offer nondeposit products, such as mutual funds and annuities, and discount brokerage services to their customers. Additionally, the Banks have Saturday hours and extended hours on certain evenings during the week for added customer convenience.

*Lending Activities*

The Banks originate secured and unsecured loans for business purposes. Commercial loans are typically secured by real estate, accounts receivable, inventory, equipment and/or other assets of the business. Commercial loans generally involve a greater degree of credit risk than one to four family residential mortgage loans. Repayment is often dependent upon the successful operation of the business and may be affected by adverse conditions in the local economy or real estate market. The financial condition and cash flow of commercial borrowers is therefore carefully analyzed during the loan approval process, and continues to be monitored by obtaining business financial statements, personal financial statements and income tax returns. The frequency of this ongoing analysis depends upon the size and complexity of the credit and collateral that secures the loan. It is also the Banks' general policy to obtain personal guarantees from the principals of the commercial loan borrowers.

The Banks' commercial real estate loans are primarily secured by land for residential and commercial development, agricultural purpose properties, service industry buildings such as restaurants and motels, retail buildings and general purpose business space. The Banks attempt to mitigate the risks associated with these loans through thorough financial analyses, conservative underwriting procedures, including loan to value ratio standards, obtaining additional collateral, closely monitoring construction projects to control disbursement of funds on loans, and management's knowledge of the local economy in which the Banks lend.

The Banks provide residential real estate construction loans to builders and individuals for single family dwellings. Residential construction loans are usually granted based upon "as completed" appraisals and are secured by the property under construction. Additional collateral may be taken if loan to value ratios exceed 80%. Site inspections are performed to determine pre-specified stages of completion before loan proceeds are disbursed. These loans typically have maturities of six to 12 months and may have fixed or variable rate features. Permanent financing options for individuals include fixed and variable rate loans with three- and five-year balloon features and one-, three- and five-year adjustable rate mortgage loans. The risk of loss associated with real estate construction lending is controlled through conservative underwriting procedures such as loan to value ratios of 80% or less at origination, obtaining additional collateral when prudent, and closely monitoring construction projects to control disbursement of funds on loans.

The Banks originate fixed and variable rate residential mortgage loans. As with any consumer loan, repayment is dependent upon the borrower's continuing financial stability, which can be adversely impacted by job loss, divorce, illness, or personal bankruptcy, among other factors. Underwriting standards recommend loan to value ratios not to exceed 80% at origination based on appraisals performed by approved appraisers. The Banks rely on title insurance to protect their lien priorities and protect the property securing the loans by requiring fire and casualty insurance.

A variety of consumer loans are offered to customers, including home equity loans, credit cards and other secured and unsecured lines of credit and term loans. Careful analysis of an applicant's creditworthiness is performed before granting credit, and ongoing monitoring of loans outstanding is performed in an effort to minimize risk of loss by identifying problem loans early.

*Deposit Activitie*s

The Banks offer a full array of deposit products including checking, savings and money market accounts, and regular and IRA certificates of deposit. The Banks also offer the CDARS program, providing up to $50 million of FDIC insurance to our customers. In addition, we offer our commercial customers packages which include cash management services and various checking opportunities.

*Trust Services*

CNB has a trust department through which it markets trust, asset management and financial planning services to customers within our market areas using the trade name Wye Financial & Trust.

*Internet Access to Company Documents.* The Company provides access to its Securities and Exchange Commission ("SEC") filings through its web site at www.shorebancshares.com. After accessing the web site, the filings are available upon selecting "Investor Relations." Reports available include the annual reports on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K, and all amendments to those reports as soon as reasonably practicable after the reports are electronically filed with or furnished to the SEC.

**Insurance Products and Services**

The Insurance Subsidiaries offer a full range of insurance products and services to customers throughout the Delmarva Region. The insurance entity of Avon Dixon offers coverage under the categories of personal, business, benefits, commercial trucking, and marine which are provided below:

| | | | |
|---|---|---|---|
| *Personal* | | | |
| -Auto | -Health/Dental | -Long-Term Care | -Travel |
| -Boat/Yacht | -Home | -Motorcycle & ATV | -Umbrella |
| -Flood | -Life | -Recreational Vehicle | |
| | | | |
| *Business* | | | |
| -Auto | -Directors & Officers | -Foreign Liability | -Marine & Boat builders |
| -Contractors | -Excess Liability | -General Liability | -Local/Long-Haul Trucking |
| -Cyber Liability | -Farm | -Workers Compensation | |
| | | | |
| *Benefits* | | | |
| -Health/Dental | -Medicare & Supplemental | -Group Dental | |
| -Annuities | Prescription Plans | -Voluntary Benefits | |
| -Long-Term Care | -Group Health | -Life | |
| | | | |
| *Commercial Trucking* | | | |
| -Primary Liability | -Physical Damage | -Motor Truck Cargo | -Occupational/Accidental |
| -Non-Trucking Liability | (comprehensive & collision) | -Surety Bonds | |
| -Excess/Umbrella | -General Liability | -Workers Compensation | |
| | | | |
| *Marine* | | | |
| -Yachts | -Ocean Voyaging | | |
| -Boats | -Grand Prix Yacht Racing | | |
| -Charter | | | |

In addition, the Company offers insurance premium financing through a separate legal entity, Mubell, LLC.

**Seasonality**

Management does not believe that our business activities are seasonal in nature.

**Employees**

At February 29, 2016, we employed 293 persons, of which 275 were employed on a full-time basis. None of our employees are represented by any collective bargaining unit or are a party to a collective bargaining agreement. Management of the Company considers its employee relations to be excellent.

**COMPETITION**

Shore Bancshares, Inc. and its community of companies operate in a highly competitive environment. Our competitors include community banks, commercial banks, credit unions, thrifts, mortgage banking companies, credit card issuers, investment advisory firms, brokerage firms, mutual fund companies, insurance companies, and e-commerce and other internet based companies. We compete with our competitors on a local and regional basis as it relates to banking and investments, and on a national basis for our insurance products.

The primary factors when competing in the financial service market include personalized services, the quality and range of products and services, interest rates on loans and deposits, lending services, price, customer convenience, and our ability to attract and retain experienced employees.

To compete in our market areas, we utilize multiple media channels including print, online, social media, television, radio, direct mail, e-mail and digital signage. Our employees also play a significant role in maintaining existing relationships with customers while establishing new relationships to grow all areas of our businesses.

The following tables set forth deposit data for FDIC-insured institutions in Kent County, Queen Anne's County, Caroline County, Talbot County and Dorchester County in Maryland and in Kent County, Delaware as of June 30, 2015, the most recent date for which comparative information is available.

| Kent County, Maryland | Deposits (in thousands) | % of Total |
|---|---|---|
| PNC Bank, NA | $ 179,992 | 31.80 % |
| The Peoples Bank | 176,133 | 31.12 |
| Branch Banking & Trust | 71,845 | 12.69 |
| Chesapeake Bank & Trust Co. | 67,149 | 11.86 |
| CNB | 45,088 | 7.96 |
| SunTrust Bank | 25,846 | 4.57 |
| Total | $ 566,053 | 100.00 % |

*Source: FDIC DataBook*

| Queen Anne's County, Maryland | Deposits (in thousands) | % of Total |
|---|---|---|
| The Queenstown Bank of Maryland | $ 338,186 | 36.46 % |
| CNB | 242,495 | 26.15 |
| PNC Bank, NA | 86,415 | 9.32 |
| Bank of America, NA | 78,739 | 8.49 |
| M&T | 56,855 | 6.13 |
| First National Bank of Pennsylvania | 45,020 | 4.85 |
| Capital One Bank, NA* | 29,344 | 3.17 |
| Branch Banking & Trust | 25,621 | 2.76 |
| The Peoples Bank | 13,527 | 1.46 |
| Sun Trust Bank | 11,247 | 1.21 |
| Total | $ 927,449 | 100.00 % |

*Source: FDIC DataBook*

**Capital One Bank officially closed all branches within this county subsequent to the issuance of the data presented above at June 30, 2015.*

| Caroline County, Maryland | Deposits (in thousands) | % of Total |
|---|---|---|
| Provident State Bank, Inc. | $ 153,126 | 41.54 % |
| PNC Bank, NA | 84,187 | 22.84 |
| CNB | 62,907 | 17.07 |
| M&T | 35,246 | 9.56 |
| Branch Banking & Trust | 26,745 | 7.25 |
| The Queenstown Bank of Maryland | 6,420 | 1.74 |
| Total | $ 368,631 | 100.00 % |

*Source: FDIC DataBook*

| Talbot County, Maryland | Deposits (in thousands) | % of Total |
|---|---|---|
| The Talbot Bank of Easton, Maryland | $ 469,612 | 32.41 % |
| Capital One Bank, NA* | 323,464 | 22.33 |
| Bank of America, NA | 172,438 | 11.90 |
| PNC Bank, NA | 143,983 | 9.94 |
| 1880 Bank | 109,304 | 7.54 |
| Branch Banking & Trust | 67,154 | 4.63 |
| M&T | 54,648 | 3.77 |
| The Queenstown Bank of Maryland | 43,551 | 3.01 |
| SunTrust Bank | 34,235 | 2.36 |
| Provident State Bank, Inc. | 30,533 | 2.11 |
| Total | $ 1,448,922 | 100.00 % |

*Source: FDIC DataBook*

**Capital One Bank officially closed all branches within this county subsequent to the issuance of the data presented above at June 30, 2015.*

| Dorchester County, Maryland | % of Deposits (in thousands) | Total |
|---|---|---|
| 1880 Bank | $ 166,257 | 30.94 % |
| Hebron Savings Bank | 115,251 | 21.45 |
| Provident State Bank, Inc. | 63,721 | 11.86 |
| Branch Banking & Trust | 60,686 | 11.29 |
| M&T | 36,555 | 6.80 |
| The Talbot Bank of Easton, Maryland | 35,558 | 6.62 |
| Bank of America, NA | 32,354 | 6.02 |
| SunTrust Bank | 26,984 | 5.02 |
| Total | $ 537,366 | 100.00 % |

*Source: FDIC DataBook*

| Kent County, Delaware | Deposits (in thousands) | % of Total |
|---|---|---|
| M&T | $ 495,186 | 27.59 % |
| PNC Bank, NA | 364,010 | 20.28 |

| | | |
|---|---|---|
| Wilmington Savings Fund Society, FSB | 304,209 | 16.95 |
| Citizens Bank, NA | 191,451 | 10.67 |
| Wells Fargo Bank, NA | 170,980 | 9.53 |
| CNB | 80,626 | 4.49 |
| TD Bank, NA | 71,293 | 3.97 |
| Artisans' Bank | 47,886 | 2.67 |
| County Bank | 39,991 | 2.23 |
| MidCoast Community Bank | 20,513 | 1.15 |
| The Fort Sill National Bank | 8,496 | 0.47 |
| Total | $ 1,794,641 | 100.00% |

*Source: FDIC DataBook*

For further information about competition in our market areas, see the Risk Factor entitled "We operate in a highly competitive market and our inability to effectively compete in our markets could have an adverse impact on our financial condition and results of operations" in Item 1A of Part I of this annual report.

**SUPERVISION AND REGULATION**

The following is a summary of the material regulations and policies applicable to us and is not intended to be a comprehensive discussion. Changes in applicable laws and regulations may have a material effect on our business, financial condition and results of operations.

**General**

The Company is a financial holding company registered with the Board of Governors of the Federal Reserve System (the "FRB") under the BHC Act and, as such, is subject to the supervision, examination and reporting requirements of the BHC Act and the regulations of the FRB.

CNB and Talbot Bank are Maryland chartered commercial banks subject to the banking laws of Maryland and to regulation by the Commissioner of Financial Regulation of Maryland, who is required by statute to make at least one examination in each calendar year (or at 18-month intervals if the Commissioner determines that an examination is unnecessary in a particular calendar year). The primary federal regulator of CNB is the FRB. The primary federal regulator of Talbot Bank is the FDIC, which is also entitled to conduct regular examinations. The deposits of the Banks are insured by the FDIC, so certain laws and regulations administered by the FDIC also govern their deposit taking operations. In addition to the foregoing, the Banks are subject to numerous state and federal statutes and regulations that affect the business of banking generally.

Nonbank affiliates of the Company are subject to examination by the FRB, and, as affiliates of the Banks, may be subject to examination by the Banks' regulators from time to time. In addition, the Insurance Subsidiaries are each subject to licensing and regulation by the insurance authorities of the states in which they do business. Retail sales of insurance products by the Insurance Subsidiaries to customers of the Banks are also subject to the requirements of the Interagency Statement on Retail Sales of Nondeposit Investment Products promulgated in 1994, as amended, by the FDIC, the FRB and the other federal banking agencies.

**Regulation of Financial Holding Companies**

In November 1999, the Gramm-Leach-Bliley Act (the "GLB Act") was signed into law. The GLB Act revised the BHC Act and repealed the affiliation provisions of the Glass-Steagall Act of 1933, which, taken together, limited the securities, insurance and other non-banking activities of any company that controls an FDIC insured financial institution. Under the GLB Act, a bank holding company can elect, subject to certain qualifications, to become a "financial holding company." The GLB Act provides that a financial holding company may engage in a full range of financial activities, including insurance and securities underwriting and agency activities, merchant banking, and insurance company portfolio investment activities, with new expedited notice procedures. The Company is a financial holding company.

Under FRB policy, the Company is expected to act as a source of strength to its subsidiary banks, and the FRB may charge the Company with engaging in unsafe and unsound practices for failure to commit resources to a subsidiary bank when required. This support may be required at times when the bank holding company may not have the resources to provide the support. Under the prompt corrective action provisions, if a controlled bank is undercapitalized, then the regulators could require the bank holding company to guarantee the bank's capital restoration plan. In addition, if the FRB believes that a bank holding company's activities, assets or affiliates represent a significant risk to the financial safety, soundness or stability of a controlled bank, then the FRB could require the bank holding company to terminate the activities, liquidate the assets or divest the affiliates. The regulators may require these and other actions in support of controlled banks even if such actions are not in the best interests of the bank holding company or its stockholders. Because the Company is a bank holding company, it is viewed as a source of financial and managerial strength for any controlled depository institutions, like the Banks.

On July 21, 2010, President Obama signed into law the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"), which made sweeping changes to the financial regulatory landscape that impacts all financial institutions, including the Company and the Banks. The Dodd-Frank Act directs federal bank regulators to require that all companies that directly or indirectly control an insured depository institution serve as sources of financial strength for the institution. The term "source of financial strength" is defined under the Dodd-Frank Act as the ability of a company to provide financial assistance to its insured depository institution subsidiaries in the event of financial distress. The appropriate federal banking agency for such a depository institution may require reports from companies that control the insured depository institution to assess their abilities to serve as sources of strength and to enforce compliance with the source-of-strength requirements. The appropriate federal banking agency may also require a holding company to provide financial assistance to a bank with impaired capital. Under this requirement, the Company could be required to provide financial assistance to the Banks should they experience financial distress.

In addition, under the Financial Institutions Reform, Recovery and Enforcement Act of 1989 (“FIRREA”), depository institutions insured by the FDIC can be held liable for any losses incurred by, or reasonably anticipated to be incurred by, the FDIC in connection with (i) the default of a commonly controlled FDIC-insured depository institution or (ii) any assistance provided by the FDIC to a commonly controlled FDIC-insured depository institution in danger of default. Accordingly, in the event that any insured subsidiary of the Company causes a loss to the FDIC, other insured subsidiaries of the Company could be required to compensate the FDIC by reimbursing it for the estimated amount of such loss. Such cross guaranty liabilities generally are superior in priority to obligations of a financial institution to its stockholders and obligations to other affiliates.

**Federal Regulation of Banks**

Federal and state banking regulators may prohibit the institutions over which they have supervisory authority from engaging in activities or investments that the agencies believe are unsafe or unsound banking practices. These banking regulators have extensive enforcement authority over the institutions they regulate to prohibit or correct activities that violate law, regulation or a regulatory agreement or which are deemed to be unsafe or unsound practices. Enforcement actions may include the appointment of a conservator or receiver, the issuance of a cease and desist order, the termination of deposit insurance, the imposition of civil money penalties on the institution, its directors, officers, employees and institution-affiliated parties, the issuance of directives to increase capital, the issuance of formal and informal agreements, the removal of or restrictions on directors, officers, employees and institution-affiliated parties, and the enforcement of any such mechanisms through restraining orders or other court actions.

The Banks are subject to the provisions of Section 23A and Section 23B of the Federal Reserve Act. Section 23A limits the amount of loans or extensions of credit to, and investments in, the Company and its nonbank affiliates by the Banks. Section 23B requires that transactions between any of the Banks and the Company and its nonbank affiliates be on terms and under circumstances that are substantially the same as with non-affiliates.

The Banks are also subject to certain restrictions on extensions of credit to executive officers, directors, and principal stockholders or any related interest of such persons, which generally require that such credit extensions be made on substantially the same terms as are available to third parties dealing with the Banks and not involve more than the normal risk of repayment. Other laws tie the maximum amount that may be loaned to any one customer and its related interests to capital levels.

As part of the Federal Deposit Insurance Company Improvement Act of 1991 (“FDICIA”), each federal banking regulator adopted non-capital safety and soundness standards for institutions under its authority. These standards include internal controls, information systems and internal audit systems, loan documentation, credit underwriting, interest rate exposure, asset growth, and compensation, fees and benefits. An institution that fails to meet those standards may be required by the agency to develop a plan acceptable to meet the standards. Failure to submit or implement such a plan may subject the institution to regulatory sanctions. The Company, on behalf of the Banks, believes that the Banks meet substantially all standards that have been adopted. FDICIA also imposes capital standards on insured depository institutions.

The Community Reinvestment Act ("CRA") requires that, in connection with the examination of financial institutions within their jurisdictions, the federal banking regulators evaluate the record of the financial institution in meeting the credit needs of their communities including low and moderate income neighborhoods, consistent with the safe and sound operation of those banks. These factors are also considered by all regulatory agencies in evaluating mergers, acquisitions and applications to open a branch or facility. As of the date of its most recent examination report, each of the Banks has a CRA rating of "Satisfactory."

The Banks are also subject to a variety of other laws and regulations with respect to the operation of their businesses, including, but not limited to, the Truth in Lending Act, the Truth in Savings Act, the Equal Credit Opportunity Act, the Electronic Funds Transfer Act, the Fair Housing Act, the Home Mortgage Disclosure Act, the Fair Debt Collection Practices Act, the Fair Credit Reporting Act, Expedited Funds Availability (Regulation CC), Reserve Requirements (Regulation D), Privacy of Consumer Information (Regulation P), Margin Stock Loans (Regulation U), the Right To Financial Privacy Act, the Flood Disaster Protection Act, the Homeowners Protection Act, the Servicemembers Civil Relief Act, the Real Estate Settlement Procedures Act, the Telephone Consumer Protection Act, the CAN-SPAM Act, the Children's Online Privacy Protection Act, and the John Warner National Defense Authorization Act.

**The Dodd-Frank Act**

The Dodd-Frank Act significantly changed the bank regulatory structure and affected the lending, investment, trading and operating activities of financial institutions and their holding companies. The Dodd-Frank Act requires the FRB to set minimum capital levels for bank holding companies that are as stringent as those required for insured depository institutions. The legislation also establishes a floor for capital of insured depository institutions and directs the federal banking regulators to implement new leverage and capital requirements. The new leverage and capital requirements must take into account off-balance sheet activities and other risks, including risks relating to securitized products and derivatives. Pursuant to the Dodd-Frank Act, the FDIC has backup enforcement authority over a depository institution holding company, such as the Company, if the conduct or threatened conduct of such holding company poses a risk to the Deposit Insurance Fund ("DIF"), although such authority may not be used if the holding company is generally in sound condition and does not pose a foreseeable and material risk to the DIF. In addition, the Dodd-Frank Act contains a wide variety of provisions (many of which are not yet effective) affecting the regulation of depository institutions, including restrictions related to mortgage originations, risk retention requirements as to securitized loans and the establishment of the Consumer Financial Protection Bureau ("CFPB").

The full impact of the Dodd-Frank Act on our business and operations will not be known for years until all regulations implementing the statute are written and adopted. The Dodd-Frank Act will increase our regulatory compliance burden and costs and may restrict the financial products and services we offer to our customers. In particular, the Dodd-Frank Act will require us to invest significant management attention and resources so that we can evaluate the impact of this law and its regulations and make any necessary changes to our product offerings and operations. These impacts may be material.

**Capital Requirements**

***General***

FDICIA established a system of prompt corrective action to resolve the problems of undercapitalized institutions. Under this system, the federal banking regulators are required to rate supervised institutions on the basis of five capital categories: "well capitalized," "adequately capitalized," "undercapitalized," "significantly undercapitalized," and "critically undercapitalized;" and to take certain mandatory actions (and are authorized to take other discretionary actions) with respect to institutions in the three undercapitalized categories. The severity of the actions will depend upon the category in which the institution is placed. A depository institution is "well capitalized" if it has a total risk based capital ratio of 10% or greater, a Tier 1 risk based capital ratio of 6% or greater, and a leverage ratio of 5% or greater and is not subject to any order, regulatory agreement, or written directive to meet and maintain a specific capital level for any capital measure. An "adequately capitalized" institution is defined as one that has a total risk based capital ratio of 8% or greater, a Tier 1 risk based capital ratio of 4% or greater and a leverage ratio of 4% or greater (or 3% or greater in the case of a bank with a composite CAMEL rating of 1).

FDICIA generally prohibits a depository institution from making any capital distribution, including the payment of cash dividends, or paying a management fee to its holding company if the depository institution would thereafter be undercapitalized. Undercapitalized depository institutions are subject to growth limitations and are required to submit capital restoration plans. For a capital restoration plan to be acceptable, the depository institution’s parent holding company must guarantee (subject to certain limitations) that the institution will comply with such capital restoration plan.

Significantly undercapitalized depository institutions may be subject to a number of other requirements and restrictions, including orders to sell sufficient voting stock to become adequately capitalized and requirements to reduce total assets and stop accepting deposits from correspondent banks. Critically undercapitalized depository institutions are subject to the appointment of a receiver or conservator; generally within 90 days of the date such institution is determined to be critically undercapitalized.

As of December 31, 2015, both The Talbot Bank and CNB were categorized as “well capitalized.” For more information regarding the capital condition of the Company, see Note 17 to the Consolidated Financial Statements appearing in Item 8 of Part II of this annual report.

***Basel III***

The Basel Committee on Banking Supervision (“Basel”) has drafted frameworks for the regulation of capital and liquidity of internationally active banking organizations, generally referred to as “Basel III.” On June 7, 2012, the FRB issued a notice of proposed rulemaking that would implement elements of Sections 165 and 166 of the Dodd-Frank Act that encompass certain aspects of Basel III with respect to capital and liquidity. In July 2013, the U.S. federal banking agencies published the final rules (the “Basel III Capital Rules”) establishing a new comprehensive capital framework for U.S. banking organizations.

Capital Requirements

The Basel III Capital Rules implement the Basel III capital standards and establish minimum capital levels required under the Dodd-Frank Act, which apply to all U.S. banks, subject to various transition periods. The Basel III Capital Rules substantially revise the risk-based capital requirements applicable to bank holding companies and depository institutions compared to the current U.S. risk-based capital rules. The Basel III Capital Rules define the components of capital and address other issues affecting the numerator in banking institutions’ regulatory capital ratios. The Basel III Capital Rules also address risk weights and other issues affecting the denominator in banking institutions’ regulatory capital ratios and replace the existing risk-weighting approach with a more risk-sensitive approach. The Basel III Capital Rules were effective for the Company on January 1, 2015 and will be fully phased in on January 1, 2019.

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

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

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

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

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

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

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

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

Liquidity Requirements

Historically, regulation and monitoring of bank and bank holding company liquidity has been addressed as a supervisory matter, without required formulaic measures. The Basel III liquidity framework, however, requires banks and bank holding companies to measure their liquidity against specific liquidity tests that, although similar in some respects to liquidity measures historically applied by banks and regulators for management and supervisory purposes, going forward would be required by regulation. Current rules and proposals from the U.S. federal banking agencies do not specifically address the Basel III liquidity requirements.

**Deposit Insurance**

The Banks are members of the FDIC and pay an insurance premium on a quarterly basis. Deposits are insured by the FDIC through the DIF and such insurance is backed by the full faith and credit of the United States Government. Under the Dodd-Frank Act, a permanent increase in deposit insurance to $250,000 was authorized. The coverage limit is per depositor, per insured depository institution, for each account ownership category.

The Dodd-Frank Act also set a new minimum DIF reserve ratio at 1.35% of estimated insured deposits. The FDIC is required to attain this ratio by September 30, 2020. The Dodd-Frank Act required the FDIC to redefine the deposit insurance assessment base for an insured depository institution. Prior to the Dodd-Frank Act, an institution's assessment base has historically been its domestic deposits, with some adjustments. As redefined pursuant to the Dodd-Frank Act, an institution's assessment base is now an amount equal to the institution's average consolidated total assets during the assessment period minus average tangible equity. Institutions with $1.0 billion or more in assets at the end of a fiscal quarter must report their average consolidated total assets on a daily basis and report their average tangible equity on an end-of-month balance basis. Institutions with less than $1.0 billion in assets at the end of a fiscal quarter may opt to report average consolidated total assets and average tangible equity on a weekly and end-of-quarter basis, respectively.

The Federal Deposit Insurance Reform Act of 2005, which created the DIF, gave the FDIC greater latitude in setting the assessment rates for insured depository institutions which could be used to impose minimum assessments. Deposit insurance assessments are based on average consolidated total assets minus average tangible equity. Under the FDIC's risk-based assessment system, insured institutions with less than $10 billion in assets are assigned to one of four risk categories based on supervisory evaluations, regulatory capital level, and certain other factors, with less risky institutions paying lower assessments. An institution's assessment rate depends upon the category to which it is assigned and certain other factors. The Banks expensed a total of $1.2 million in FDIC premiums during 2015. The FDIC has the flexibility to adopt actual deposit assessment rates that are higher or lower than the total base assessment rates adopted without notice and comment, if certain conditions are met.

DIF-insured institutions pay a Financing Corporation ("FICO") assessment in order to fund the interest on bonds issued in the 1980s in connection with the failures in the thrift industry. For the fourth quarter of 2015, the FICO assessment was equal to 0.145 basis points computed on assets as required by the Dodd-Frank Act. These assessments will continue until the bonds mature in 2019.

The FDIC is authorized to conduct examinations of and require reporting by FDIC-insured institutions. It is also authorized to terminate a depository bank's deposit insurance upon a finding by the FDIC that the bank's financial condition is unsafe or unsound or that the institution has engaged in unsafe or unsound practices or has violated any applicable rule, regulation, order or condition enacted or imposed by the bank's regulatory agency. The termination of deposit insurance for either of the Banks would have a material adverse effect on our earnings, operations and financial condition.

**Bank Secrecy Act/Anti-Money Laundering**

The Bank Secrecy Act ("BSA"), which is intended to require financial institutions to develop policies, procedures, and practices to prevent and deter money laundering, mandates that every national bank have a written, board-approved program that is reasonably designed to assure and monitor compliance with the BSA.

The program must, at a minimum: (i) provide for a system of internal controls to assure ongoing compliance; (ii) provide for independent testing for compliance; (iii) designate an individual responsible for coordinating and monitoring day-to-day compliance; and (iv) provide training for appropriate personnel. In addition, state-chartered banks are required to adopt a customer identification program as part of its BSA compliance program. State-chartered banks are also required to file Suspicious Activity Reports when they detect certain known or suspected violations of federal law or suspicious transactions related to a money laundering activity or a violation of the BSA.

In addition to complying with the BSA, the Banks are subject to the Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism Act of 2001 (the “USA Patriot Act”). The USA Patriot Act is designed to deny terrorists and criminals the ability to obtain access to the United States’ financial system and has significant implications for depository institutions, brokers, dealers, and other businesses involved in the transfer of money. The USA Patriot Act mandates that financial service companies implement additional policies and procedures and take heightened measures designed to address any or all of the following matters: (i) customer identification programs; (ii) money laundering; (iii) terrorist financing; (iv) identifying and reporting suspicious activities and currency transactions; (v) currency crimes; and (vi) cooperation between financial institutions and law enforcement authorities.

**Ability-to-Repay and Qualified Mortgage Rule**

Pursuant to the Dodd Frank Act, the CFPB issued a final rule on January 10, 2013 (effective on January 10, 2014), amending Regulation Z, as implemented by the Truth in Lending Act, that requires mortgage lenders to make a reasonable and good faith determination based on verified and documented information that a consumer applying for a mortgage loan has a reasonable ability to repay the loan according to its terms. Mortgage lenders are required to determine consumers’ ability to repay in one of two ways. The first alternative requires the mortgage lender to consider the following eight underwriting factors when making the credit decision: (i) current or reasonably expected income or assets; (ii) current employment status; (iii) the monthly payment on the covered transaction; (iv) the monthly payment on any simultaneous loan; (v) the monthly payment for mortgage-related obligations; (vi) current debt obligations, alimony, and child support; (vii) the monthly debt-to-income ratio or residual income; and (viii) credit history. Alternatively, the mortgage lender can originate “qualified mortgages,” which are entitled to a presumption that the creditor making the loan satisfied the ability-to-repay requirements. In general, a “qualified mortgage” is a mortgage loan without negative amortization, interest-only payments, balloon payments, or terms exceeding 30 years. In addition, to be a qualified mortgage the points and fees paid by a consumer cannot exceed three percent of the total loan amount. Qualified mortgages that are “higher-priced” (e.g. subprime loans) garner a rebuttable presumption of compliance with the ability-to-repay rules, while qualified mortgages that are not “higher-priced” (e.g. prime loans) are given a safe harbor of compliance.

**Volcker Rule**

The Dodd-Frank Act prohibits insured depository institutions from engaging in proprietary trading except in limited circumstances, and prohibits them from owning equity interests in excess of three percent (3%) of Tier 1 Capital in private equity and hedge funds (known as the “Volcker Rule”). The FRB released a final rule on February 9, 2011 (effective on April 1, 2011) which requires a “banking entity,” a term that is defined to now include banks like the Banks, to bring its proprietary trading activities and investments into compliance with the Dodd-Frank Act restrictions.

On December 10, 2013, the U.S. federal banking agencies, including the FRB, adopted a final rule implementing the Volcker Rule. Although the final rule provides some tiering of compliance and reporting obligations based on size, the fundamental prohibitions of the Volcker Rule apply to banking entities of any size. Banking entities with total assets of $10 billion or more that engage in activities subject to the Volcker Rule will be required to establish a six-element compliance program to address the prohibitions of, and exemptions from, the Volcker Rule. The final rule became effective April 1, 2014; however, at the time the agencies released the final Volcker Rule, the FRB announced an extension of the conformance period for all banking entities until July 21, 2015. In response to industry questions regarding the final Volcker Rule, the U.S. federal banking agencies, the SEC, and the Commodity Futures Trading Commission issued a clarifying interim final rule on January 14, 2014, permitting banking entities to retain interests in certain collateralized debt obligations (“CDOs”) backed by trust preferred securities if the CDO meets certain requirements.

The Banks do not, nor intend to, engage in proprietary trading or own equity interests in private equity and hedge funds restricted by the Dodd-Frank Act. However, the Banks intend to review the implications of the interagency rules on their investments once those rules are issued and will plan for any adjustments of their activities or their holdings so that they will be in compliance by the announced compliance date.

**Federal Securities Laws**

The shares of the Company’s common stock are registered with the SEC under Section 12(b) of the Securities Exchange Act of 1934, as amended (the “Exchange Act”), and listed on the NASDAQ Global Select Market. The Company is subject to information reporting requirements, proxy solicitation requirements, insider trading restrictions and other requirements of the Exchange Act, including the requirements imposed under the federal Sarbanes-Oxley Act of 2002 and the rules of The NASDAQ Stock Market, LLC. Among other things, loans to and other transactions with insiders are subject to restrictions and heightened disclosure, directors and certain committees of the Board must satisfy certain independence requirements, and the Company is generally required to comply with certain corporate governance requirements.

**Governmental Monetary and Credit Policies and Economic Controls**

The earnings and growth of the banking industry and ultimately of the Company are affected by the monetary and credit policies of governmental authorities, including the FRB. An important function of the FRB is to regulate the national supply of bank credit in order to control recessionary and inflationary pressures. Among the instruments of monetary policy used by the FRB to implement these objectives are open market operations in U.S. Government securities, changes in the federal funds rate, changes in the discount rate of member bank borrowings, and changes in reserve requirements against member bank deposits. These means are used in varying combinations to influence overall growth of bank loans, investments and deposits and may also affect interest rates charged on loans or paid for deposits. The monetary policies of the FRB authorities have had a significant effect on the operating results of commercial banks in the past and are expected to continue to have such an effect in the future. In view of changing conditions in the national economy and in the money markets, as well as the effect of actions by monetary and fiscal authorities, including the FRB, no prediction can be made as to possible future changes in interest rates, deposit levels, loan demand or their effect on the business and earnings of the Company and its subsidiaries.

**REGULATORY ENFORCEMENT ACTIONS**

Talbot Bank entered into a Stipulation and Consent to the Issuance of a Consent Order (the “Consent Agreement”) with the FDIC, a Stipulation and Consent to the Issuance of a Consent Order (the “Maryland Consent Agreement” and together with the Consent Agreement, the “Consent Agreements”) with the Maryland Commissioner of Financial Regulation (the “Commissioner”) and an Acknowledgement of Adoption of the Order by the Commissioner (the “Acknowledgement”). The FDIC and the Commissioner issued the related Consent Order (the “Order”), effective May 24, 2013. On May 11, 2015, the FDIC and the Commissioner terminated the Order.

While the Order has been terminated, Talbot Bank will be required to continue to adhere to certain requirements and restrictions based on commitments made to the FDIC and the Commissioner in connection with the termination of the Order, which include, among other things, continued reduction of classified assets and maintenance of capital in excess of regulatory minimums.

**AVAILABLE INFORMATION**

The Company maintains an Internet site at www.shorebancshares.com on which it makes available, free of charge, its Annual Report on Form 10-K, Quarterly Reports on Form 10-Q, Current Reports on Form 8-K, and all amendments to the foregoing as soon as reasonably practicable after these reports are electronically filed with, or furnished to, the SEC. In addition, stockholders may access these reports and documents on the SEC’s web site at www.sec.gov.

**Item 1A. RISK FACTORS.**

An investment in our common stock involves significant risks. You should consider carefully the risk factors included below together with all of the information included in or incorporated by reference into this annual report, as the same may be updated from time to time by our future filings with the SEC under the Exchange Act, before making a decision to invest in our common stock. The risks and uncertainties described below are not the only ones we face. Additional risks and uncertainties not presently known to us or that we currently deem immaterial may also have a material adverse effect on our business, financial condition and results of operations. If any of the matters included in the following information about risk factors were to occur, our business, financial condition, results of operations, cash flows or prospects could be materially and adversely affected. In such case, you may lose all or a substantial part of your investment. To the extent that any of the information contained in this document constitutes forward-looking statements, the risk factors below should be reviewed as cautionary statements identifying important factors that could cause actual results to differ materially from those expressed in any forward-looking statements made by us or on our behalf. See “Cautionary note regarding forward-looking statements.”

**Risks Relating to Our Business**

**The current economic environment poses significant challenges for us and could adversely affect our financial condition and results of operations.**

The Banks are operating in an economic climate which is still recovering from one of the largest financial crisis in U.S. history. Although national indexes reflect modest overall increases in the housing market, home prices, and the unemployment rate, the local environment in which the Banks operate have continued to lag national averages. While conditions appear to have begun to improve, the post crisis regulatory environment has remained stringent on the Banks, coupled with low interest rates which limit the profitability on lending opportunities. New stringent regulatory policies or a return to declines in the real estate market and constrained financial markets could have an adverse effect on the Banks' borrowers or their customers, which would adversely affect our financial condition and results of operations. For example, deterioration in local economic conditions in our markets could drive losses beyond that which is provided for in our allowance for loan losses. We may also face the following risks in connection with these events:

- Economic conditions that negatively affect housing prices and the job market may result in deterioration in credit quality of our loan portfolio, and such deterioration in credit quality could have a negative impact on our business;

- Market developments may affect consumer confidence levels and may cause adverse changes in payment patterns, causing increases in delinquencies and default rates on loans and other credit facilities;

- Demand for our products and services may decline;

- Collateral for loans made by us may decline in value, in turn reducing a client's borrowing power, and reducing the value of assets and collateral associated with our loans held for investment;

- Our loan customers may not repay their loans according to their terms and any collateral securing payment may be insufficient to fully compensate us for the outstanding balance of the loan plus the costs we incur disposing of the collateral;

- The processes we use to estimate the allowance for loan losses may no longer be reliable because they rely on complex judgments, including forecasts of economic conditions, which may no longer be capable of accurate estimation;

- A reduction in the size, spending or employment levels of the federal, state and/or local governments in the Washington, DC metropolitan area could have a negative effect on the economy of the region, on our customers, and on real estate prices;

- Continued erratic fluctuations in the market, and loss of confidence in the banking system, could require the Banks to pay higher interest rates to obtain deposits to meet the needs of their customers, resulting in reduced margins and net interest income. If conditions worsen significantly, it is possible that banks such as the Banks may be unable to meet the needs of their depositors and borrowers, which could, in the worst case, result in either or both of the Banks being placed into receivership; and

- Compliance with increased regulation of the banking industry may increase our costs, limit our ability to pursue business opportunities, and divert management efforts.

As these conditions or similar ones continue to exist or worsen, we could experience continuing or increased adverse effects on our financial condition and results of operations.

**A majority of our business is concentrated in Maryland and Delaware, a significant amount of which is concentrated in real estate lending, so a decline in the local economy and real estate markets could adversely impact our financial condition and results of operations.**

Because most of our loans are made to customers who reside on the Eastern Shore of Maryland and in Delaware, a decline in local economic conditions may have a greater effect on our earnings and capital than on the earnings and capital of larger financial institutions whose loan portfolios are geographically diverse. Further, a significant portion of our loan portfolio is secured by real estate, including construction and land development loans, all of which are in greater demand when interest rates are low and economic conditions are good. Accordingly, a decline in local economic conditions would likely have an adverse impact on our financial condition and results of operations, and the impact on us would likely be greater than the impact felt by larger financial institutions whose loan portfolios are geographically diverse. We cannot guarantee that any risk management practices that we implement to address our geographic and loan concentrations will be effective in preventing losses relating to our loan portfolio.

In the case of real estate acquisition, construction and development projects that we have financed, challenging economic conditions caused some of our borrowers to default on their loans. Because of the deterioration in the market values of real estate collateral caused by the recession, banks, including the Banks, have been unable to recover the full amount due under their loans when forced to foreclose on and sell real estate collateral. As a result, the Banks have realized significant impairments and losses in their loan portfolios, which materially and adversely impacted our financial condition and results of operations. Management cannot predict the extent to which these conditions may cause future impairments or losses, nor can it provide any assurances as to when, or if, economic conditions will improve.

**Our concentrations of commercial real estate loans could subject us to increased regulatory scrutiny and directives, which could force us to preserve or raise capital and/or limit our future commercial lending activities.**

The FRB and the FDIC, along with the other federal banking regulators, issued guidance in December 2006 entitled "Concentrations in Commercial Real Estate Lending, Sound Risk Management Practices" directed at institutions that have particularly high concentrations of commercial real estate loans within their lending portfolios. This guidance suggests that these institutions face a heightened risk of financial difficulties in the event of adverse changes in the economy and commercial real estate markets. Accordingly, the guidance suggests that institutions whose concentrations exceed certain percentages of capital should implement heightened risk management practices appropriate to their concentration risk. The guidance provides that banking regulators may require such institutions to reduce their concentrations and/or maintain higher capital ratios than institutions with lower concentrations in commercial real estate. Based on our concentration of commercial real estate and construction lending as of December 31, 2015, we may be subject to heightened supervisory scrutiny during future examinations and/or be required to take steps to address our concentration and capital levels. Management cannot predict the extent to which this guidance will impact our operations or capital requirements. Further, we cannot guarantee that any risk management practices we implement will be effective in preventing losses resulting from concentrations in our commercial real estate portfolio.

**Interest rates and other economic conditions will impact our results of operations.**

Our results of operations 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 results of operations are significantly impacted by the spread between the interest rates earned on assets and the interest rates paid on deposits and other interest-bearing liabilities (i.e., net interest income), including advances from the Federal Home Loan Bank (the "FHLB") of Atlanta. Interest rate risk arises from mismatches (i.e., the interest sensitivity gap) between the dollar amount of repricing or maturing assets and liabilities. If more assets reprice or mature than liabilities during a falling interest rate environment, then our earnings could be negatively impacted. Conversely, if more liabilities reprice or mature than assets during a rising interest rate environment, then our earnings could be negatively impacted. Fluctuations in interest rates are not predictable or controllable.

Changes in interest rates, particularly by the FRB, which implements national monetary policy in order to mitigate recessionary and inflationary pressures, also affect the value of our loans. In setting its policy, the FRB may utilize techniques such as: (i) engaging in open market transactions in United States government securities; (ii) setting the discount rate on member bank borrowings; and (iii) determining reserve requirements. These techniques may have an adverse effect on our deposit levels, net interest margin, loan demand or our business and operations. In addition, an increase in interest rates could adversely affect borrowers' ability to pay the principal or interest on existing loans or reduce their desire to borrow more money. This may lead to an increase in our nonperforming assets, a decrease in loan originations, or a reduction in the value of and income from our loans, any of which could have a material and negative effect on our results of operations. We try to minimize our exposure to interest rate risk, but we are unable to completely eliminate this risk. Fluctuations in market rates and other market disruptions are neither predictable nor controllable and may have a material and negative effect on our business, financial condition and results of operations.

**The Banks may experience credit losses in excess of their allowances, which would adversely impact our financial condition and results of operations.**

The risk of credit losses on loans varies with, among other things, general economic conditions, the type of loan being made, the creditworthiness of the borrower over the term of the loan and, in the case of a collateralized loan, the value and marketability of the collateral for the loan. Management of each of the Banks bases the allowance for credit losses upon, among other things, historical experience, an evaluation of economic conditions and regular reviews of delinquencies and loan portfolio quality. If management's assumptions and judgments prove to be incorrect and the allowance for credit losses is inadequate to absorb future losses, or if the bank regulatory authorities, as a part of their examination process, require our bank subsidiaries to increase their respective allowance for credit losses, our earnings and capital could be significantly and adversely affected. Material additions to the allowance for credit losses of one of the Banks would result in a decrease in that Bank's net income and capital and could have a material adverse effect on our financial condition.

Although we believe that our allowance for credit losses is maintained at a level adequate to absorb any inherent losses in our loan portfolio, these estimates of loan losses are necessarily subjective and their accuracy depends on the outcome of future events.

While we strive to carefully monitor credit quality and to identify loans that may become nonperforming, at any time there are loans included in the portfolio that have not been identified as nonperforming or potential problem loans, but that will result in losses. We cannot be sure that we will be able to identify deteriorating loans before they become nonperforming assets, or that we will be able to limit losses on those loans that are identified. As a result, future additions to the allowance may be necessary.

Economic conditions and increased uncertainty in the financial markets could adversely affect our ability to accurately assess our allowance for credit losses. Our ability to assess the creditworthiness of our customers or to estimate the values of our assets and collateral for loans will be reduced if the models and approaches we use become less predictive of future behaviors, valuations, assumptions or estimates. We estimate losses inherent in our loan portfolio, the adequacy of our allowance for credit losses and the values of certain assets by using estimates based on difficult, subjective, and complex judgments, including estimates as to the effects of economic conditions and how those economic conditions might affect the ability of our borrowers to repay their loans or the value of assets.

**We may not be successful if we are not able to grow our subsidiaries and their businesses.**

Our primary business activity for the foreseeable future will be to act as the holding company of CNB, Talbot Bank, and our other subsidiaries. Therefore, our future profitability will depend on the success and growth of these subsidiaries.

**The market value of our investments might decline.**

As of December 31, 2015, we had classified 98% of our investment securities as available-for-sale pursuant to the Accounting Standards Codification ("ASC") Topic 320 ("ASC 320") of the Financial Accounting Standards Board ("FASB") relating to accounting for investments. ASC 320 requires that unrealized gains and losses in the estimated value of the available-for-sale portfolio be "marked to market" and reflected as a separate item in stockholders' equity (net of tax) as accumulated other comprehensive income (loss). The remaining investment securities are classified as held-to-maturity in accordance with ASC 320 and are stated at amortized cost.

In the past, gains on sales of investment securities have not been a significant source of income for us. There can be no assurance that future market performance of our investment portfolio will enable us to realize income from sales of securities. Stockholders' equity will continue to reflect the unrealized gains and losses (net of tax) of these investments. There can be no assurance that the market value of our investment portfolio will not decline, causing a corresponding decline in stockholders' equity.

CNB and Talbot Bank are members of the FHLB of Atlanta. A member of the FHLB system is required to purchase stock issued by the relevant FHLB bank based on how much it borrows from the FHLB and the quality of the collateral pledged to secure that borrowing. Accordingly, our investments include stock issued by the FHLB of Atlanta. These investments could be subject to future impairment charges and there can be no guaranty of future dividends.

Management believes that several factors will affect the market values of our investment portfolio. These include, but are not limited to, changes in interest rates or expectations of changes, the degree of volatility in the securities markets, inflation rates or expectations of inflation and the slope of the interest rate yield curve (the yield curve refers to the differences between shorter-term and longer-term interest rates; a positively sloped yield curve means shorter-term rates are lower than longer-term rates). Also, the passage of time will affect the market values of our investment securities, in that the closer they are to maturing, the closer the market price should be to par value. These and other factors may impact specific categories of the portfolio differently, and management cannot predict the effect these factors may have on any specific category.

**Impairment of investment securities, goodwill, other intangible assets, or deferred tax assets could require charges to earnings, which could result in a negative impact on our results of operations.**

We are required to record a non-cash charge to earnings when management determines that an investment security is other-than-temporarily impaired. In assessing whether the impairment of investment securities is other-than-temporary, management considers the length of time and extent to which the fair value has been less than cost, the financial condition and near-term prospects of the issuer, and the intent and ability to retain our investment in the security for a period of time sufficient to allow for any anticipated recovery in fair value in the near term.

Under current accounting standards, goodwill is not amortized but, instead, is subject to impairment tests on at least an annual basis or more frequently if an event occurs or circumstances change that reduce the fair value of a reporting unit below its carrying amount. Intangible assets other than goodwill are also subject to impairment tests at least annually. A decline in the price of the Company's common stock or occurrence of a triggering event following any of our quarterly earnings releases and prior to the filing of the periodic report for that period could, under certain circumstances, cause us to perform goodwill and other intangible assets impairment tests and result in an impairment charge being recorded for that period which was not reflected in such earnings release. In the event that we conclude that all or a portion of our goodwill or other intangible assets may be impaired, a non-cash charge for the amount of such impairment would be recorded to earnings. At December 31, 2015, we had recorded goodwill of $11.9 million and other intangible assets of $1.2 million, representing approximately 8.1% and 0.82% of stockholders' equity, respectively.

In assessing the realizability of deferred tax assets, management considers whether it is more likely than not that some portion or all of the deferred tax assets will not be realized. Assessing the need for, or the sufficiency of, a valuation allowance requires management to evaluate all available evidence, both negative and positive, including the recent trend of quarterly earnings. Positive evidence necessary to overcome the negative evidence includes whether future taxable income in sufficient amounts and character within the carryback and carry forward periods is available under the tax law, including the use of tax planning strategies. When negative evidence (e.g., cumulative losses in recent years, history of operating loss or tax credit carry forwards expiring unused) exists, more positive evidence than negative evidence will be necessary. At December 31, 2015, our deferred tax assets were approximately $12.1 million. There was no valuation allowance for deferred taxes recorded at December 31, 2015 as management believes it is more likely than not that all of the deferred taxes will be realized because they were supported by positive evidence such as the expected generation of a sufficient level of future taxable income from operations and tax planning strategies.

The impact of each of these impairment matters could have a material adverse effect on our business, results of operations, and financial condition. See Note 1 to the Consolidated Financial Statements included in Item 8 of Part II of this annual report for further information.

**The change of control rules under Section 382 of the Internal Revenue Code may limit our ability to use our net operating loss carryforwards (“NOLs”) and other tax attributes to reduce future tax payments which may have an adverse impact on our results of operations.**

We have NOLs for federal and state income tax purposes that can be utilized to offset future taxable income. Our use of the NOLs would be limited, however, under Section 382 of the IRC, if we were to undergo a change in ownership of more than 50% of our capital stock over a three-year period as measured under Section 382 of the IRC. The annual limit generally would equal the product of the applicable federal long term tax exempt rate and the value of our capital stock immediately before the ownership change. Due to the stock sale in June, 2014 and other ownership changes by shareholders owning 5% or more of our common stock, we estimate that we have experienced an ownership change of approximately 40% within the three-year period ended December 31, 2015.

If we experience an ownership change, the resulting annual limit on the use of its NOLs could result in a meaningful increase in our federal and state income tax liability in future years. Whether an ownership change occurs by reason of public trading in our stock is largely outside our control, and the determination of whether an ownership change has occurred is complex. No assurance can be given that we will not in the future undergo an ownership change that would have an adverse effect on its results of operations and the value of our stock.

**Our future success will depend on our ability to compete effectively in the highly competitive financial services industry.**

We face substantial competition in all phases of our operations from a variety of different competitors. We compete with commercial banks, credit unions, savings and loan associations, mortgage banking firms, consumer finance companies, securities brokerage firms, insurance companies, money market funds and other mutual funds, as well as other local and community, super-regional, national and international financial institutions that operate offices in our primary market areas and elsewhere. Our future growth and success will depend on our ability to compete effectively in this highly competitive financial services environment.

Many of our competitors are well-established, larger financial institutions and many offer products and services that we do not. Many have substantially greater resources, name recognition and market presence that benefit them in attracting business. Some of our competitors are not subject to the same regulations that are imposed on us, including credit unions that do not pay federal income tax, and, therefore, have regulatory advantage over us in accessing funding and in providing various services. While we believe we compete effectively with these other financial institutions in our primary markets, we may face a competitive disadvantage as a result of our smaller size, smaller asset base, lack of geographic diversification and inability to spread our marketing costs across a broader market. If we have to raise interest rates paid on deposits or lower interest rates charged on loans to compete effectively, our net interest margin and income could be negatively affected. Failure to compete effectively to attract new or to retain existing, clients may reduce or limit our net income and our market share and may adversely affect our results of operations, financial condition and growth.

**Our funding sources may prove insufficient to replace deposits and support our future growth.**

We rely on customer deposits, advances from the FHLB, and lines of credit at other financial institutions to fund our operations. Although we have historically been able to replace maturing deposits and advances if desired, no assurance can be given that we would be able to replace such funds in the future if our financial condition or the financial condition of the FHLB or market conditions were to change. Our financial flexibility will be severely constrained and/or our cost of funds will increase if we are unable to maintain our access to funding or if financing necessary to accommodate future growth is not available at favorable interest rates. Finally, if we are required to place greater reliance on more expensive funding sources to support future growth, our revenues may not increase proportionately to cover our costs. In this case, our profitability would be adversely affected.

In addition, the FRB has issued rules pursuant to the Dodd-Frank Act governing debit card interchange fees that apply to institutions with greater than $10 billion in assets. Although we are not subject to these rules, market forces may effectively require all banks to adopt debit card interchange fee structures that comply with these rules, in which case our non-interest income for future periods could be materially and adversely affected.

**The loss of key personnel could disrupt our operations and result in reduced earnings.**

Our growth and profitability will depend upon our ability to attract and retain skilled managerial, marketing and technical personnel. Competition for qualified personnel in the financial services industry is intense, and there can be no assurance that we will be successful in attracting and retaining such personnel. Our current executive officers provide valuable services based on their many years of experience and in-depth knowledge of the banking industry. Due to the intense competition for financial professionals, these key personnel would be difficult to replace and an unexpected loss of their services could result in a disruption to the continuity of operations and a possible reduction in earnings.

**Our lending activities subject us to the risk of environmental liabilities.**

A significant portion of our loan portfolio is secured by real property. During the ordinary course of business, we may foreclose on and take title to properties securing certain loans. In doing so, there is a risk that hazardous or toxic substances could be found on these properties. If hazardous or toxic substances are found, we may be liable for remediation costs, as well as for personal injury and property damage. Environmental laws may require us to incur substantial expenses and may materially reduce the affected property's value or limit our ability to use or sell the affected property. In addition, future laws or more stringent interpretations of enforcement policies with respect to existing laws may increase our exposure to environmental liability. Although we have policies and procedures to perform an environmental review before initiating any foreclosure action on real property, these reviews may not be sufficient to detect all potential environmental hazards. The remediation costs and any other financial liabilities associated with an environmental hazard could have a material adverse effect on our financial condition and results of operations.

**We may be subject to other adverse claims.**

We may from time to time be subject to claims from customers for losses due to alleged breaches of fiduciary duties, errors and omissions of employees, officers and agents, incomplete documentation, the failure to comply with applicable laws and regulations, or many other reasons. Also, our employees may knowingly or unknowingly violate laws and regulations. Management may not be aware of any violations until after their occurrence. This lack of knowledge may not insulate us or our subsidiaries from liability. Claims and legal actions may result in legal expenses and liabilities that may reduce our profitability and hurt our financial condition.

**Our exposure to operational, technological and organizational risk may adversely affect us.**

We are exposed to many types of operational risks, including reputation, legal and compliance risk, the risk of fraud or theft by employees or outsiders, unauthorized transactions by employees or operational errors, clerical or record-keeping errors, and errors resulting from faulty or disabled computer or telecommunications systems.

Certain errors may be repeated or compounded before they are discovered and successfully rectified. Our necessary dependence upon automated systems to record and process transactions may further increase the risk that technical system flaws or employee tampering or manipulation of those systems will result in losses that are difficult to detect. We may also be subject to disruptions of our operating systems arising from events that are wholly or partially beyond our control (for example, computer viruses or electrical or telecommunications outages), which may give rise to disruption of service to customers and to financial loss or liability. We are further exposed to the risk that our external vendors may be unable to fulfill their contractual obligations (or will be subject to the same risk of fraud or operational errors by their respective employees as are we) and to the risk that our (or our vendors') business continuity and data security systems prove to be inadequate.

**We depend on the accuracy and completeness of information about customers and counterparties and our financial condition could be adversely affected if we rely on misleading information.**

In deciding whether to extend credit or to enter into other transactions with customers and counterparties, we may rely on information furnished to us by or on behalf of customers and counterparties, including financial statements and other financial information, which we do not independently verify. We also may rely on representations of customers and counterparties as to the accuracy and completeness of that information and, with respect to financial statements, on reports of independent auditors. For example, in deciding whether to extend credit to customers, we may assume that a customer's audited financial statements conform with accounting principles generally accepted in the U.S. ("GAAP") and present fairly, in all material respects, the financial condition, results of operations and cash flows of the customer. Our financial condition and results of operations could be negatively impacted to the extent we rely on financial statements that do not comply with GAAP or are materially misleading.

**We rely on other companies to provide key components of our business infrastructure.**

Third parties provide key components of our business operations such as data processing, recording and monitoring transactions, online banking interfaces and services, internet connections and network access. While we have selected these third party vendors carefully, we do not control their actions. Any problem caused by these third parties, including poor performance of services, failure to provide services, disruptions in communication services provided by a vendor and failure to handle current or higher volumes, could adversely affect our ability to deliver products and services to our customers and otherwise conduct our business, and may harm our reputation. Financial or operational difficulties of a third party vendor could also hurt our operations if those difficulties interface with the vendor's ability to serve us. Replacing these third party vendors could also create significant delay and expense. Accordingly, use of such third parties creates an unavoidable inherent risk to our business operations.

**Our information systems may experience an interruption or breach in security.**

We rely heavily on communications and information systems to conduct business. Any failure, interruption, or breach in security of these systems could result in failures or disruptions in our internet banking, deposit, loan and other systems. While to date we have not been subject to material cyber-attacks or other cyber incidents, we cannot guarantee all our systems are free from vulnerability to attack, despite safeguards we and our vendors have instituted. While we have policies and procedures designed to prevent or limit the effect of such failure, interruption or security breach of our information systems, there can be no assurance that they will not occur or, if they do occur, that they will be adequately addressed. The occurrence of any failure, interruption or security breach of our communications and information systems could damage our reputation, result in a loss of customer business, subject us to additional regulatory scrutiny or expose us to civil litigation and possible financial liability.

**Technological changes affect our business, and we may have fewer resources than many competitors to invest in technological improvements.**

The financial services industry is undergoing rapid technological changes with frequent introductions of new technology-driven products and services. In addition to serving customers better, the effective use of technology may increase efficiency and may enable financial institutions to reduce costs. Our future success will depend, in part, upon our ability to use technology to provide products and services that provide convenience to customers and to create additional efficiencies in operations. We may need to make significant additional capital investments in technology in the future, and we may not be able to effectively implement new technology-driven products and services. Many of our competitors have substantially greater resources to invest in technological improvements.

**Risks Relating to the Regulation of our Industry**

**We operate in a highly regulated environment, which could restrain our growth and profitability.**

We are subject to extensive laws and regulations that govern almost all aspects of our operations. These laws and regulations, and the supervisory framework that oversees the administration of these laws and regulations, are primarily intended to protect depositors, the Deposit Insurance Fund and the banking system as a whole, and not shareholders and consumers. These laws and regulations, among other matters, affect our lending practices, capital structure, investment practices, dividend policy, operations and growth. Compliance with the myriad laws and regulations applicable to our organization can be difficult and costly. In addition, these laws, regulations and policies are subject to continual review by governmental authorities, and changes to these laws, regulations and policies, including changes in interpretation or implementation of these laws, regulations and policies, could affect us in substantial and unpredictable ways and often impose additional compliance costs. Further, any new laws, rules and regulations, such as the Dodd-Frank Act and regulatory capital rules, could make compliance more difficult or expensive. All of these laws and regulations, and the supervisory framework applicable to our industry, could have a material adverse effect on our business, financial condition and results of operations.

**Federal and state regulators periodically examine our business, and we may be required to remediate adverse examination findings.**

The FRB, the FDIC and the Commissioner periodically examine our business, including our compliance with laws and regulations. If, as a result of an examination, the FRB, the FDIC or the Commissioner were to determine that our financial condition, capital resource, asset quality, earnings prospects, management, liquidity or other aspects of any of our operations had become unsatisfactory, or that we were in violation of any law or regulation, it may take a number of different remedial actions as it deems appropriate. These actions include the power to enjoin “unsafe or unsound” practices, to require affirmative action to correct any conditions resulting from any violation or practice, to issue an administrative order that can be judicially enforced, to direct an increase in our capital, to restrict our growth, to assess civil monetary penalties against our officers or directors, to remove officers and directors and, if it is concluded that such conditions cannot be corrected or there is an imminent risk of loss to depositors, to terminate our deposit insurance and place us into receivership or conservatorship. Any regulatory action against us could have a material adverse effect on our business, financial condition and results of operations. For more information, see “Business-Regulatory Enforcement Actions.”

**Our FDIC deposit insurance premiums and assessments may increase.**

The deposits of the Banks are insured by the FDIC up to legal limits and, accordingly, subject to the payment of FDIC deposit insurance assessments. The Banks’ regular assessments are determined by their risk classifications, which are based on their regulatory capital levels and the level of supervisory concern that they pose. High levels of bank failures since the beginning of the financial crisis and increases in the statutory deposit insurance limits have increased resolution costs to the FDIC and put significant pressure on the Deposit Insurance Fund. In order to maintain a strong funding position and restore the reserve ratios of the Deposit Insurance Fund, the FDIC increased deposit insurance assessment rates and charged a special assessment to all FDIC-insured financial institutions. Further increase in assessment rates or special assessments may occur in the future, especially if there are significant additional financial institution failures. Any future special assessments, increases in assessment rates or required prepayments in FDIC insurance premiums could reduce our profitability or limit our ability to pursue certain business opportunities, which could have a material adverse effect on our business, financial condition and results of operations. The FDIC deposit insurance assessments for Talbot Bank decreased $390 thousand, or 30.3%, for 2015 when compared to 2014 due to the regulatory upgrade in 2015.

**The short-term and long-term impact of the Basel III Capital Rules is uncertain and a significant increase in our capital requirements could have an adverse effect on our business and profitability.**

In July 2013, the federal banking agencies approved rules that will significantly change the regulatory capital requirements of all banking institutions in the United States. The new rules are designed to implement the recommendations with respect to regulatory capital standards, commonly known as Basel III, approved by the International Basel Committee on Bank Supervision. We became subject to the Basel III Capital Rules over a multi-year transition period commencing January 1, 2015. The Basel III Capital Rules establish a new regulatory capital standard based on tier 1 common equity and increase the minimum leverage and risk-based capital ratios. The Basel III Capital Rules also change how a number of the regulatory capital components are calculated. The Basel III Capital Rules will generally require us and the Banks to maintain greater amounts of regulatory capital. The application of more stringent capital requirements for the Banks and the Company could, among other things, result in lower returns on equity, require the raising of additional capital, and result in regulatory actions constraining us from paying dividends or repurchasing shares if we were to be unable to comply with such requirements, any of which could have a material adverse effect on our business and profitability.

**We are subject to numerous laws designed to protect consumers, including the Community Reinvestment Act and fair lending laws, and failure to comply with these laws could lead to a wide variety of sanctions.**

The Community Reinvestment Act, the Equal Credit Opportunity Act, the Fair Housing Act and other fair lending laws and regulations impose nondiscriminatory lending requirements on financial institutions. The Department of Justice and other federal agencies are responsible for enforcing these laws and regulations. A successful regulatory challenge to an institution's performance under the Community Reinvestment Act or fair lending laws and regulations could result in a wide variety of sanctions, including damages and civil money penalties, injunctive relief, restrictions on mergers and acquisition activity, restrictions on expansion and restrictions on entering new business lines. Private parties may also have the ability to challenge an institution's performance under fair lending laws in private class action litigation. Such actions could have a material adverse effect on our business, financial condition and results of operations.

**We are subject to evolving and extensive regulations and requirements. Our failure to adhere to these requirements or the failure or circumvention of our controls and procedures could seriously harm our business.**

We are subject to extensive regulation as a financial institution and are also required to follow the corporate governance and financial reporting practices and policies required of a company whose stock is registered under the Exchange Act and listed on the NASDAQ Global Select Market. Compliance with these requirements means we incur significant legal, accounting and other expenses. Compliance also requires a significant diversion of management time and attention, particularly with regard to disclosure controls and procedures and internal control over financial reporting. Although we have reviewed, and will continue to review, our disclosure controls and procedures in order to determine whether they are effective, our controls and procedures may not be able to prevent errors or frauds in the future. Faulty judgments, simple errors or mistakes, or the failure of our personnel to adhere to established controls and procedures may make it difficult for us to ensure that the objectives of the control system will be met. A failure of our controls and procedures to detect other than inconsequential errors or fraud could seriously harm our business and results of operations.

**We face a risk of noncompliance and enforcement action with the BSA and other anti-money laundering statues and regulations.**

The BSA, the USA PATRIOT Act of 2001 and other laws and regulations require financial institutions, among other duties, to institute and maintain an effective anti-money laundering program and file suspicious activity and currency transaction reports as appropriate. The federal Financial Crimes Enforcement Network is authorized to impose significant civil money penalties for violations of those requirements and has recently engaged in coordinated enforcement efforts with the individual federal banking regulators, as well as the U.S. Department of Justice, Drug Enforcement Administration and Internal Revenue Service. We are also subject to increased scrutiny of compliance with the rules enforced by the Office of Foreign Assets Control. If our policies, procedures and systems are deemed deficient, we would be subject to liability, including fines and regulatory actions, which may include restrictions on our ability to pay dividends and the necessity to obtain regulatory approvals to proceed with certain aspects of our business plan, including our acquisition plans. Failure to maintain and implement adequate programs to combat money laundering and terrorist financing could also have serious reputational consequences for us. Any of these results could have a material adverse effect on our business, financial condition and results of operations.

**Risks Relating to the Company’s Securities**

**Our common stock is not insured by any governmental entity.**

Our common stock is not a deposit account or other obligation of any bank and is not insured by the FDIC or any other governmental entity. Investment in our common stock is subject to risk, including possible loss.

**Our ability to pay dividends is limited.**

Our ability to pay dividends is subject to the requirements of Maryland corporate laws, federal and state banking laws, and the policies and actions of our regulators. Moreover, our ability to pay dividends to stockholders is largely dependent upon its earnings in future periods and upon the receipt of dividends from the Banks. Under corporate law, stockholders are entitled to dividends on their shares of common stock if, when, and as declared by our board of directors out of funds legally available for that purpose. FRB guidance requires a bank holding company, like us, to consult with the FRB before paying dividends if our earnings do not exceed the aggregate amount of the proposed dividend. The FRB has the ability to prohibit a dividend in such a situation. Both federal and state laws impose restrictions on the ability of the Banks to pay dividends. Federal law prohibits the payment of a dividend by an insured depository institution if the depository institution is considered “undercapitalized” or if the payment of the dividend would make the institution “undercapitalized.” Maryland banking law provides that a state-chartered bank may pay dividends out of undivided profits or, with the prior approval of the Commissioner, from surplus in excess of 100% of required capital stock. If, however, the surplus of a Maryland bank is less than 100% of its required capital stock, then cash dividends may not be paid in excess of 90% of net earnings. In addition to these specific restrictions, bank regulatory agencies also have the ability to prohibit proposed dividends by a financial institution that would otherwise be permitted under applicable regulations if the regulatory body determines that such distribution would constitute an unsafe or unsound practice. Both the Company and Talbot Bank are currently prohibited from paying any dividends without the consent of the FRB or the FDIC and the Commissioner, respectively. Thus, even if the Company and/or Talbot Bank had cash sufficient under corporate and banking laws to lawfully pay dividends, the FRB and/or the FDIC and the Commissioner could deny a request to do so. Because of these limitations, there can be no guarantee that our board will declare dividends in any fiscal quarter.

**The shares of our common stock are not heavily traded.**

Shares of our common stock are listed on the NASDAQ Global Select Market, but are not heavily traded. Securities that are not heavily traded can be more volatile than stock trading in an active public market. Stock price volatility may make it more difficult for you to resell your common stock when you want and at prices you find attractive. Our stock price can fluctuate significantly and may decline in response to a variety of factors including:

- Actual or anticipated variations in quarterly results of operations;
- Developments in our business or the financial sector generally;
- Recommendations by securities analysts;
- Operating and stock price performance of other companies that investors deem comparable to us;
- News reports relating to trends, concerns and other issues in the financial services industry;
- Perceptions in the marketplace regarding us or our competitors;
- New technology used or services offered by competitors;
- Significant acquisitions or business combinations, strategic partnerships, joint venture or capital commitments by or involving us or our competitors;
- Failure to integrate acquisitions or realize anticipated benefits from acquisitions;
- Regulatory changes affecting our industry generally or our business or operations; or
- Geopolitical conditions such as acts or threats of terrorism or military conflicts.

Management cannot predict the extent to which an active public market for the shares of the common stock will develop or be sustained in the future. Accordingly, holders of shares of our common stock may not be able to sell them at the volumes, prices, or times that they desire. General market fluctuations, industry factors and general economic and political conditions and events, such as economic slowdowns or recessions, interest rate changes or credit loss trends, could also cause our stock price to decrease regardless of operating results. We urge you to obtain current market quotations for our common stock when you consider investing in our common stock.

**Our Articles of Incorporation and By-Laws and Maryland law may discourage a corporate takeover which may make it more difficult for stockholders to receive a change in control premium.**

Our Amended and Restated Articles of Incorporation, as supplemented (the "Charter"), and Amended and Restated By-Laws, as amended (the "By-Laws"), contain certain provisions designed to enhance the ability of the board of directors to deal with attempts to acquire control of us. The Charter and By-Laws provide for the classification of the board into three classes; directors of each class generally serve for staggered three-year periods. No director may be removed except for cause and then only by a vote of at least two-thirds of the total eligible stockholder votes. The Charter gives the board certain powers in respect of our securities. First, the board has the authority to classify and reclassify unissued shares of stock of any class or series of stock by setting, fixing, eliminating, or altering in any one or more respects the preferences, rights, voting powers, restrictions and qualifications of, dividends on, and redemption, conversion, exchange, and other rights of, such securities. Second, a majority of the board, without action by the stockholders, may amend the Charter to increase or decrease the aggregate number of shares of stock or the number of shares of stock of any class that we have authority to issue. The board could use these powers, along with its authority to authorize the issuance of securities of any class or series, to issue securities having terms favorable to management to persons affiliated with or otherwise friendly to management.

Maryland law also contains anti-takeover provisions that apply to us. The Maryland Business Combination Act generally prohibits, subject to certain limited exceptions, corporations from being involved in any "business combination" (defined as a variety of transactions, including a merger, consolidation, share exchange, asset transfer or issuance or reclassification of equity securities) with any "interested shareholder" for a period of five years following the most recent date on which the interested shareholder became an interested shareholder. An interested shareholder is defined generally as a person who is the beneficial owner of 10% or more of the voting power of the outstanding voting stock of the corporation after the date on which the corporation had 100 or more beneficial owners of its stock or who is an affiliate or associate of the corporation and was the beneficial owner, directly or indirectly, of 10% or more of the voting power of the then outstanding stock of the corporation at any time within the two-year period immediately prior to the date in question and after the date on which the corporation had 100 or more beneficial owners of its stock. The Maryland Control Share Acquisition Act applies to acquisitions of "control shares," which, subject to certain exceptions, are shares the acquisition of which entitle the holder, directly or indirectly, to exercise or direct the exercise of the voting power of shares of stock of the corporation in the election of directors within any of the following ranges of voting power: one-tenth or more, but less than one-third of all voting power; one-third or more, but less than a majority of all voting power or a majority or more of all voting power. Control shares have limited voting rights. The By-Laws exempt our capital securities from the Maryland Control Share Acquisition Act, but the board has the authority to eliminate the exemption without stockholder approval.

Although these provisions do not preclude a takeover, they may have the effect of discouraging, delaying or deferring a tender offer or takeover attempt that a stockholder might consider in his or her best interest, including those attempts that might result in a premium over the market price for the common stock. Such provisions will also render the removal of the board of directors and of management more difficult and, therefore, may serve to perpetuate current management. These provisions could potentially adversely affect the market price of our common stock.

**We may issue debt and equity securities that are senior to the common stock as to distributions and in liquidation, which could negatively affect the value of the common stock.**

In the future, we may increase our capital resources by entering into debt or debt-like financing or issuing debt or equity securities, which could include issuances of senior notes, subordinated notes, preferred stock or common stock. In the event of our liquidation, our lenders and holders of our debt or preferred securities would receive a distribution of our available assets before distributions to the holders of our common stock. Our decision to incur debt and issue securities in future offerings will depend on market conditions and other factors beyond our control. We cannot predict or estimate the amount, timing or nature of its future offerings and debt financings. Future offerings could reduce the value of shares of our common stock and dilute a stockholder's interest in us.

**Item 1B. Unresolved Staff Comments.**

None.

## Item 2. Properties.

Our offices are listed in the tables below. The address of the Company's main office is 28969 Information Lane in Easton, Maryland. The Company owns the real property at this location, which also houses the Operations, Information Technology and Finance departments of the Company and its subsidiaries, and certain operations of The Avon-Dixon Agency, LLC.

***The Talbot Bank of Easton, Maryland***

| | | |
|---|---|---|
| | **Branches** | |
| Main Office | Elliott Road Branch | Tred Avon Square Branch |
| 18 East Dover Street | 8275 Elliott Road | 212 Marlboro Road |
| Easton, Maryland 21601 | Easton, Maryland 21601 | Easton, Maryland 21601 |
| St. Michaels Branch | Sunburst Branch | Tilghman Branch |
| 1013 South Talbot Street | 424 Dorchester Avenue | 5804 Tilghman Island Road |
| St. Michaels, Maryland 21663 | Cambridge, Maryland 21613 | Tilghman, Maryland 21671 |
| | **ATMs** | |
| Memorial Hospital at Easton | Talbottown | |
| 219 South Washington Street | 218 North Washington Street | |
| Easton, Maryland 21601 | Easton, Maryland 21601 | |

***CNB***

| | | |
|---|---|---|
| | **Branches** | |
| Main Office | Route 213 South Branch | Chester Branch |
| 109 North Commerce Street | 2609 Centreville Road | 300 Castle Marina Road |
| Centreville, Maryland 21617 | Centreville, Maryland 21617 | Chester, Maryland 21619 |
| Denton Branch | Grasonville Branch | Stevensville Branch |
| 850 South 5th Avenue | 202 Pullman Crossing | 408 Thompson Creek Road |
| Denton, Maryland 21629 | Grasonville, Maryland 21638 | Stevensville, Maryland 21666 |
| Tuckahoe Branch | Washington Square Branch | Felton Branch |
| 22151 WES Street | 899 Washington Avenue | 120 West Main Street |

Ridgely, Maryland 21660

Chestertown, Maryland 21620

Felton, Delaware 19943

Milford Branch

698-A North Dupont Boulevard

Milford, Delaware 19963

Camden Branch

4580 South DuPont Highway

Camden, Delaware 19934

Dover Branch

800 S. Governors Avenue

Dover, Delaware 19904

**Offices**

Division Office - Wye Financial & Trust

16 North Washington Street, Suite 1

Easton, Maryland 21601

Loan Production Office – Middletown

651 North Broad Street

Suite 201

Middletown, Delaware 19709

***The Avon-Dixon Agency, LLC***

Headquarters

106 North Harrison Street

Easton, Maryland 21601

Benefits Office

28969 Information Lane

Easton, Maryland 21601

Centreville Office

105 Lawyers Row

Centreville, Maryland 21617

Elliott-Wilson Insurance

106 North Harrison Street

Easton, Maryland 21601

Jack Martin & Associates

135 Old Solomon's Island Road

Annapolis, Maryland 21401

***Mubell Finance, LLC***

Headquarters

106 North Harrison Street

Easton, Maryland 21601

Talbot Bank owns the real property on which all of its offices are located, except that it operates under leases at its St. Michaels, and Tilghman branches. CNB owns the real property on which all of its Maryland offices are located, except that it operates under a lease at the office of Wye Financial and Trust in Easton. CNB leases the real property on which all of its Delaware offices are located, except that it owns the real property on which the Camden Branch is located. The Insurance Subsidiaries do not own any real property, but operate under leases. For information about rent expense for all leased premises, see Note 4 to the Consolidated Financial Statements appearing in Item 8 of Part II of this annual report.

**Item 3. Legal Proceedings.**

We are at times, in the ordinary course of business, subject to legal actions. Management, upon the advice of counsel, believes that losses, if any, resulting from current legal actions will not have a material adverse effect on our financial condition or results of operations.

**Item 4. Mine Safety Disclosures.**

This item is not applicable.

## PART II

### Item 5. Market for Registrant's Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities.

### MARKET PRICE, HOLDERS AND CASH DIVIDENDS

The shares of the Company's common stock are listed on the NASDAQ Global Select Market under the symbol "SHBI". As of February 29, 2016, the Company had approximately 1,403 registered holders of record. The high and low sales prices for the shares of common stock of the Company, as reported on the NASDAQ Global Select Market, and the cash dividends declared on those shares for each quarterly period of 2015 and 2014 are set forth in the table below.

| | 2015 | | | 2014 | | |
|---|---|---|---|---|---|---|
| | Price Range | | Dividends | Price Range | | Dividends |
| | High | Low | Paid | High | Low | Paid |
| First Quarter | $9.30 | $9.03 | $ - | $9.99 | $9.02 | $ - |
| Second Quarter | 9.55 | 9.43 | - | 10.49 | 6.88 | - |
| Third Quarter | 9.72 | 9.37 | 0.02 | 9.25 | 8.61 | - |
| Fourth Quarter | 11.00 | 10.64 | 0.02 | 9.78 | 8.87 | - |
| | | | $ 0.04 | | | $ - |

On February 29, 2016, the closing sales price for the shares of common stock as reported on the NASDAQ Global Select Market was $11.27 per share.

The Company declared and paid dividends in the third and fourth quarters of 2015 of $0.02 per common share. As a general matter, the payment of dividends is at the discretion of the Company's Board of Directors, based on such factors as operating results, financial condition, capital adequacy, regulatory requirements, and stockholder return. The Company's ability to pay dividends is limited by federal banking and state corporate law and is generally dependent on the ability of the Company's subsidiaries, particularly the Banks, to declare dividends to the Company. Further, our regulators have the ability to prohibit the payment of dividends even if dividends could otherwise be paid under applicable law if they determine that such payment would not be in our best interests. As noted above, the Company and Talbot Bank are currently prohibited from paying any dividends without the prior consent of their respective regulators. For more information regarding these dividend limitations, see "Risk Factors - Our ability to pay dividends is limited".

The transfer agent for the Company's common stock is:

Broadridge

51 Mercedes Way

Edgewood, NY 11717

Investor Relations: 1-800-353-0103

E-mail for investor inquiries: shareholder@broadridge.com.

www.broadridge.com

The performance graph below compares the cumulative total stockholder return on the common stock of the Company with the cumulative total return on the equity securities included in the NASDAQ Composite Index (reflecting overall stock market performance), the NASDAQ Bank Index (reflecting changes in banking industry stocks), and the SNL Small Cap Bank Index (reflecting changes in stocks of banking institutions of a size similar to the Company) assuming in each case an initial $100 investment on December 31, 2010 and reinvestment of dividends as of the end of each of the Company's fiscal years between December 31, 2010 and December 31, 2015. Returns are shown on a total return basis. The performance graph represents past performance and should not be considered to be an indication of future performance.

| | Period Ending | | | | | |
|---|---|---|---|---|---|---|
| Index | 12/31/10 | 12/31/11 | 12/31/12 | 12/31/13 | 12/31/14 | 12/31/15 |
| Shore Bancshares, Inc. | 100.00 | 49.41 | 51.80 | 88.61 | 89.78 | 104.99 |
| NASDAQ Composite | 100.00 | 99.21 | 116.82 | 163.75 | 188.03 | 201.40 |
| NASDAQ Bank | 100.00 | 89.50 | 106.23 | 150.55 | 157.95 | 171.92 |
| SNL Small Cap Bank | 100.00 | 95.51 | 111.26 | 155.17 | 163.56 | 179.12 |

**EQUITY COMPENSATION PLAN INFORMATION**

Pursuant to the SEC's Regulation S-K Compliance and Disclosure Interpretation 106.01, the information regarding the Corporation's equity compensation plans required by this Item pursuant to Item 201(d) of Regulation S-K is located in Item 12 of Part III of this annual report and is incorporated herein by reference.

**Item 6. Selected Financial Data.**

The following table sets forth certain selected financial data for each of the five years ended December 31, 2015, and is qualified in its entirety by the detailed statistical and other information contained in this annual report, including "Management's Discussion and Analysis of Financial Condition and Results of Operations" appearing in Item 7 of Part II of this annual report and the financial statements and notes thereto appearing in Item 8 of Part II of this annual report.

| | Years Ended December 31, | | | | |
|---|---|---|---|---|---|
| (Dollars in thousands, except per share data) | 2015 | 2014 | 2013 | 2012 | 2011 |
| RESULTS OF OPERATIONS: | | | | | |
| Interest income | $38,871 | $38,289 | $41,351 | $45,901 | $50,852 |
| Interest expense | 3,346 | 4,247 | 6,475 | 10,562 | 11,088 |
| Net interest income | 35,525 | 34,042 | 34,876 | 35,339 | 39,764 |
| Provision for credit losses | 2,075 | 3,350 | 27,784 | 27,745 | 19,470 |
| Net interest income after provision for credit losses | 33,450 | 30,692 | 7,092 | 7,594 | 20,294 |
| Noninterest income | 15,416 | 16,781 | 17,459 | 15,758 | 17,318 |
| Noninterest expense | 37,350 | 39,361 | 40,686 | 39,555 | 39,167 |
| Income (loss) before income taxes | 11,516 | 8,112 | (16,135) | (16,203) | (1,555) |
| Income tax expense (benefit) | 4,408 | 3,061 | (6,501) | (6,565) | (658) |
| Net income (loss) | $7,108 | $5,051 | $(9,634) | $(9,638) | $(897) |
| | | | | | |
| PER COMMON SHARE DATA: | | | | | |
| Net income (loss) – basic | $0.56 | $0.46 | $(1.14) | $(1.14) | $(0.11) |
| Net income (loss) – diluted | 0.56 | 0.46 | (1.14) | (1.14) | (0.11) |
| Dividends paid | 0.04 | - | - | 0.01 | 0.09 |
| Book value (at year end) | 11.64 | 11.13 | 12.19 | 13.48 | 14.34 |
| Tangible book value (at year end)[1] | 10.59 | 10.08 | 10.31 | 11.56 | 12.37 |
| | | | | | |
| FINANCIAL CONDITION (at year end): | | | | | |
| Loans | $795,114 | $710,746 | $711,919 | $785,082 | $841,050 |
| Assets | 1,135,143 | 1,100,402 | 1,054,124 | 1,185,807 | 1,158,193 |
| Deposits | 975,464 | 949,004 | 933,468 | 1,049,273 | 1,009,919 |
| Long-term debt | - | - | - | - | 455 |
| Stockholders' equity | 146,967 | 140,469 | 103,299 | 114,026 | 121,249 |
| | | | | | |
| PERFORMANCE RATIOS (for the year): | | | | | |
| Return on average total assets | 0.64% | 0.47% | (0.89)% | (0.82)% | (0.08)% |
| Return on average stockholders' equity | 4.93 | 4.04 | (8.64) | (8.07) | (0.74) |
| Net interest margin | 3.43 | 3.43 | 3.48 | 3.23 | 3.74 |
| Efficiency ratio[2] | 73.21 | 77.45 | 77.59 | 77.17 | 68.35 |
| Dividend payout ratio | 7.14 | - | - | (0.88) | (81.82) |
| Average stockholders' equity to average total assets | 13.04 | 11.66 | 10.31 | 10.18 | 10.66 |

ASSET QUALITY RATIOS (for the year):

| | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| Nonperforming assets to total assets | 1.44 | % | 1.57 | % | 2.11 | % | 3.76 | % | 5.48 | % |
| Nonperforming assets and accruing TDRs to total assets | 2.81 | | 3.09 | | 4.58 | | 8.18 | | 7.66 | |
| Allowance for credit losses to average loans | 1.06 | | 1.09 | | 1.40 | | 1.96 | | 1.64 | |
| Allowance for credit losses to nonaccrual loans | 68.77 | | 57.14 | | 59.10 | | 43.84 | | 27.81 | |
| Allowance for credit losses to nonaccrual loans and TDRs | 30.14 | | 25.53 | | 24.25 | | 18.00 | | 18.66 | |

[1]Total stockholders' equity, net of goodwill and other intangible assets, divided by the number of shares of common stock outstanding at year end.

[2]Noninterest expense as a percentage of total revenue (net interest income plus total noninterest income). Lower ratios indicate improved productivity.

**Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations.**

The following discussion compares the Company's financial condition at December 31, 2015 to its financial condition at December 31, 2014 and the results of operations for the years ended December 31, 2015, 2014, and 2013. This discussion should be read in conjunction with the Consolidated Financial Statements and the Notes thereto appearing in Item 8 of Part II of this annual report.

## PERFORMANCE OVERVIEW

The Company recorded net income of $7.11 million for 2015, net income of $5.05 million for 2014, and a net loss of $9.6 million for 2013. The basic and diluted income per share was $0.56 for 2015, $0.46 for 2014, and a diluted loss per common share of $1.14 for 2013. When comparing 2015 to 2014 and 2013, earnings were significantly improved due to an increase in net interest income, a decline in the provision for credit losses, and the reduction of noninterest expenses.

Total assets were $1.135 billion at December 31, 2015, a $34.7 million, or 3.2%, increase when compared to the $1.100 billion at December 31, 2014. The increase in total assets was mainly the result of significant loan growth of $84.4 million. Investment securities decreased $24.4 million and cash and cash equivalents decreased $22.4 million to partially fund the loan growth for 2015.

Total deposits increased $26.5 million, or 2.8%, to $975 million at December 31, 2015. The increase in deposits was mainly due to an increase in noninterest-bearing deposits of $35.9 million as well as an increase in interest-bearing transaction accounts of $14.0 million and money market and savings accounts of $18.4 million, offset by a decline in time deposits of $41.8 million. Total stockholders' equity increased $6.5 million, or 4.6%, to $147.0 million, or 12.95% of total assets at December 31, 2015.

## CRITICAL ACCOUNTING POLICIES

The Company's consolidated financial statements are prepared in accordance with GAAP and follow general practices within the industries 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. The fair values and the information used to record valuation adjustments for certain assets and liabilities are based on quoted market prices, collateral value or are provided by other third-party sources, when available.

The most significant accounting policies that the Company follows are presented in Note 1 to the Consolidated Financial Statements. These policies, along with the disclosures presented in the notes to the financial statements and in this discussion, provide information on how significant assets and liabilities are valued in the financial statements and how those values are determined. Based on the valuation techniques used and the sensitivity of financial statement amounts to the methods, assumptions, and estimates underlying those amounts, management has determined that the accounting policies with respect to the allowance for credit losses, goodwill and other intangible assets, deferred tax assets, and fair value are critical accounting policies. These policies are considered critical because they relate to accounting areas that require the most subjective or complex judgments, and, as such, could be most subject to revision as new information becomes available.

The allowance for credit losses represents management’s estimate of credit losses inherent in the loan portfolio as of the balance sheet date. Determining the amount of the allowance for credit losses is considered a critical accounting estimate because it requires significant judgment and the use of estimates related to the amount and timing of expected future cash flows on impaired loans, estimated losses on pools of homogeneous loans based on historical loss experience, and consideration of current economic trends and conditions, all of which may be susceptible to significant change. The loan portfolio also represents the largest asset type on the consolidated balance sheets. Note 1 to the Consolidated Financial Statements describes the methodology used to determine the allowance for credit losses. A discussion of the factors driving changes in the amount of the allowance for credit losses is included in the Asset Quality - Provision for Credit Losses and Risk Management section below.

Goodwill represents the excess of the cost of an acquisition over the fair value of the net assets acquired. Other intangible assets represent purchased assets that also lack physical substance but can be distinguished from goodwill because of contractual or other legal rights or because the asset is capable of being sold or exchanged either on its own or in combination with a related contract, asset or liability. Goodwill and other intangible assets are required to be recorded at fair value. Determining fair value is subjective, requiring the use of estimates, assumptions and management judgment. Goodwill and other intangible assets with indefinite lives are tested at least annually for impairment, usually during the third quarter, or on an interim basis if circumstances dictate. Intangible assets that have finite lives are amortized over their estimated useful lives and also are subject to impairment testing. Impairment testing requires that the fair value of each of the Company’s reporting units be compared to the carrying amount of its net assets, including goodwill. The Company’s reporting units were identified based on an analysis of each of its individual operating segments. If the fair value of a reporting unit is less than book value, an expense may be required to write down the related goodwill or purchased intangibles to record an impairment loss.

Deferred tax assets and liabilities are determined by applying the applicable federal and state income tax rates to cumulative temporary differences. These temporary differences represent differences between financial statement carrying amounts and the corresponding tax bases of certain assets and liabilities. Deferred taxes result from such temporary differences. A valuation allowance, if needed, reduces deferred tax assets to the expected amount most likely to be realized. Realization of deferred tax assets is dependent on the generation of a sufficient level of future taxable income, recoverable taxes paid in prior years and tax planning strategies. The Company evaluates all positive and negative evidence before determining if a valuation allowance is deemed necessary regarding the realization of deferred tax assets.

The Company measures certain financial assets and liabilities at fair value, with the measurements made on a recurring or nonrecurring basis. Significant financial instruments measured at fair value on a recurring basis are investment securities and interest rate caps. Impaired loans and other real estate owned are significant financial instruments measured at fair value on a nonrecurring basis. Fair value is defined as the exchange price that would be received for an asset or paid to transfer a liability (an exit price) in the principal or most advantageous market for the asset or liability in an orderly transaction between market participants on the measurement date. In determining fair value, the Company is required to maximize the use of observable inputs and minimize the use of unobservable inputs, reducing subjectivity.

**RECENT ACCOUNTING PRONOUNCEMENTS AND DEVELOPMENTS**

Note 1 to the Consolidated Financial Statements discusses new accounting policies that the Company adopted during 2015 and the expected impact of accounting policies recently issued or proposed but not yet required to be adopted. To the extent the adoption of new accounting standards materially affects our financial condition, results of operations or liquidity, the impacts are discussed in the applicable section(s) of this discussion and Notes to the Consolidated Financial Statements.

**RESULTS OF OPERATIONS**

**Net Interest Income and Net Interest Margin**

Net interest income remains the most significant factor affecting our results of operations. Net interest income represents the excess of interest and fees earned on total average earning assets (loans, investment securities, federal funds sold and interest-bearing deposits with other banks) over interest owed on average interest-bearing liabilities (deposits and borrowings). Tax-equivalent net interest income is net interest income adjusted for the tax-favored status of income from certain loans and investments. As shown in the table below, tax-equivalent net interest income for 2015 was $35.6 million. This represented a $1.5 million, or 4.3%, increase from 2014, and net interest income decreased $846 thousand, or 2.4%, for 2014 when compared to 2013. The increase in net interest income when comparing 2015 to 2014 was primarily the result of decreased interest expense on certificates of deposit and other time deposits coupled with an increase in interest income from taxable securities. Significant loan growth in 2015 also contributed to the overall increase in net interest income as the increase in average loans was able to offset a 27 basis point decline in yield between periods. The decrease when comparing 2014 to 2013 was due to a greater decline in interest income than the decline in interest expense. When comparing 2015 to 2014, interest income increased $571 thousand while interest expense decreased $901 thousand. When comparing 2014 to 2013, interest income decreased $3.1 million while interest expense decreased $2.2 million.

Our net interest margin (i.e., tax-equivalent net interest income divided by average earning assets) represents the net yield on earning assets. The net interest margin is managed through loan and deposit pricing and asset/liability strategies. The net interest margin was 3.43% for 2015 and 2014 which remained unchanged primarily due to lower balances and rates paid on certificate of deposits and other time deposits, the higher balance and yield on taxable investment securities and an increase on average interest earning assets. The net interest margin decreased 5 basis points in 2014 when compared to 2013 mainly due to the decline in the average balance of loans along with the decrease in rates. The net interest spread, which is the difference between the average yield on earning assets and the rate paid for interest-bearing liabilities, was 3.31% for 2015, 3.30% for 2014 and 3.31% for 2013.

The following table sets forth the major components of net interest income, on a tax-equivalent basis, for the years ended December 31, 2015, 2014, and 2013.

| (Dollars in thousands) | 2015 Average Balance | Interest (1) | Yield/ Rate | 2014 Average Balance | Interest (1) | Yield/ Rate | 2013 Average Balance | Interest (1) | Yield /Rate |
|---|---|---|---|---|---|---|---|---|---|
| Earning assets | | | | | | | | | |
| Loans (2) (3) | $748,101 | $35,201 | 4.71% | $707,381 | $35,225 | 4.98% | $768,516 | $39,152 | 5.09% |
| Investment securities: | | | | | | | | | |
| Taxable | 231,960 | 3,602 | 1.55 | 198,207 | 2,957 | 1.49 | 138,701 | 2,072 | 1.49 |
| Tax-exempt | 328 | 15 | 4.54 | 432 | 18 | 4.20 | 540 | 26 | 4.84 |
| Federal funds sold | 2,991 | 3 | 0.10 | 1,883 | 1 | 0.06 | 3,850 | 4 | 0.10 |
| Interest-bearing deposits | 53,459 | 130 | 0.24 | 86,995 | 179 | 0.21 | 94,704 | 200 | 0.21 |
| Total earning assets | 1,036,839 | 38,951 | 3.76% | 994,898 | 38,380 | 3.86% | 1,006,311 | 41,454 | 4.12% |
| Cash and due from banks | 18,497 | | | 22,973 | | | 22,603 | | |
| Other assets | 58,502 | | | 64,200 | | | 67,724 | | |
| Allowance for credit losses | (8,172) | | | (9,449) | | | (15,511) | | |
| Total assets | $1,105,666 | | | $1,072,622 | | | $1,081,127 | | |
| | | | | | | | | | |
| Interest-bearing liabilities | | | | | | | | | |
| Demand deposits | $180,810 | 229 | 0.13% | $177,828 | 247 | 0.14% | $171,244 | 266 | 0.16% |
| Money market and savings deposits (4) | 243,731 | 336 | 0.14 | 225,616 | 275 | 0.12 | 221,808 | 1,086 | 0.49 |
| Certificates of deposit, $100,000 or more | 149,181 | 1,382 | 0.93 | 170,252 | 1,881 | 1.10 | 202,053 | 2,580 | 1.28 |
| Other time deposits | 164,239 | 1,384 | 0.84 | 180,848 | 1,826 | 1.01 | 195,045 | 2,516 | 1.29 |
| Interest-bearing deposits | 737,961 | 3,331 | 0.45 | 754,544 | 4,229 | 0.56 | 790,150 | 6,448 | 0.82 |
| Short-term borrowings | 6,226 | 15 | 0.24 | 8,061 | 18 | 0.22 | 10,980 | 27 | 0.24 |
| Long-term debt | - | - | - | - | - | - | - | - | - |
| Total interest-bearing liabilities | 744,187 | 3,346 | 0.45% | 762,605 | 4,247 | 0.56% | 801,130 | 6,475 | 0.81% |
| | | | | | | | | | |
| Noninterest-bearing deposits | 211,171 | | | 178,002 | | | 160,182 | | |
| Other liabilities | 6,132 | | | 6,921 | | | 8,370 | | |
| Stockholders' equity | 144,176 | | | 125,094 | | | 111,445 | | |
| Total liabilities and stockholders' equity | $1,105,666 | | | $1,072,622 | | | $1,081,127 | | |
| | | | | | | | | | |
| Net interest spread | | $35,605 | 3.31% | | $34,133 | 3.30% | | $34,979 | 3.31% |
| Net interest margin | | | 3.43% | | | 3.43% | | | 3.48% |

(1) All amounts are reported on a tax-equivalent basis computed using the statutory federal income tax rate of 34.0%, exclusive of the alternative minimum tax rate and nondeductible interest expense. The tax-equivalent adjustment amounts used in the above table to compute yields aggregated $80 thousand in 2015, $91 thousand in 2014 and $103 thousand in 2013.

(2) Average loan balances include nonaccrual loans.

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

(4) In 2013, interest on money market and savings deposits includes an adjustment to expense related to interest rate caps and the hedged deposits from the Promontory Insured Network Deposits Program associated with them. This adjustment increased interest expense by $695 thousand for 2013. The interest rate caps were terminated in June of 2013.

On a tax-equivalent basis, total interest income was $39.0 million for 2015 compared to $38.4 million for 2014. The increase in interest income for 2015 compared to 2014 was primarily due to the increase in the average balance and yield on taxable investment securities. Interest income on taxable securities increased $645 thousand or 21.8% in 2015 compared to 2014 due to an increase in the average balance of $33.8 million as well as an increase in the average rate of 6 basis points. These increases were due to the redeployment of lower yielding interest bearing deposits. For 2015 compared to 2014, average loans increased $40.7 million and the yield earned on loans decreased 27 basis points. As a result of these counterbalancing changes, interest income on loans remained relatively unchanged between 2015 and 2014. Excluding average nonaccrual loans, the yield on loans would have been 4.97%, 5.07% and 5.30% for 2015, 2014, and 2013, respectively.

On a tax equivalent basis, total interest income was $38.4 million for 2014 compared to $41.5 million for 2013. The decrease in 2014 compared to 2013 was due to a decrease in average balance and yield earned on loans due to weak loan demand despite a low rate environment. The decrease in interest income on loans was partially offset by an increase in the average balance of taxable investment securities resulting from the investment proceeds from the Company's common stock offering in the second quarter of 2014.

As a percentage of total average earning assets, loans, investment securities, federal funds sold and interest-bearing deposits were 72.2%, 22.4%, 0.3% and 5.1%, respectively, for 2015 which reflected an increase in higher-yielding earning assets when compared to 2014. The comparable percentages for 2014 were 71.1%, 20.0%, 0.2%, and 8.7%, respectively, and for 2013 were 76.4%, 13.8%, 0.4% and 9.4%, respectively. When comparing 2015 to 2014, the overall increase in average balances of earning assets produced $2.4 million more in interest income and the decrease in yields on earning assets produced $1.8 million less in interest income, as seen in the Rate/Volume Variance Analysis below. When comparing 2014 to 2013, the overall decrease in average balances of earning assets produced $2.2 million less in interest income and the decrease in yields on earning assets produced $844 thousand less in interest income, as seen in the Rate/Volume Variance Analysis below.

The following table sets forth the average balance of the components of average earning assets as a percentage of total average earning assets for the year ended December 31.

| | 2015 | 2014 | 2013 | 2012 | 2011 |
|---|---|---|---|---|---|
| Loans | 72.2 % | 71.1 % | 76.0 % | 74.2 % | 81.7 % |
| Loans held for sale | - | - | 0.4 | - | - |
| Investment securities | 22.4 | 20.0 | 13.8 | 12.5 | 10.6 |
| Federal funds sold | 0.3 | 0.2 | 0.4 | 0.9 | 2.2 |
| Interest-bearing deposits with other banks | 5.1 | 8.7 | 9.4 | 12.4 | 5.5 |
| | 100.0% | 100.0% | 100.0% | 100.0% | 100.0% |

Interest expense was $3.3 million for 2015 compared to $4.2 million for 2014. The decline in interest expense for 2015 was primarily due to lower expense on certificates of deposit and other time deposits. Interest expense on certificates of deposit and other time deposits declined $941 thousand in 2015 when compared to 2014, the result of a decrease of $37.7 million in average balances and a decline of 18 basis points on rates paid on these deposits. The decrease in average certificates of deposit and other time deposits reflected a decrease in the Company's liquidity needs and the lower rates reflected current market conditions. The decrease in average certificates of deposit and other time deposits was mostly transitioned to non-interest bearing and money market and savings deposits which reflected average increases of $33.2 million and $18.1 million, respectively.

Interest expense was $4.2 million for 2014 compared to $6.5 million for 2013. The decline in interest expense for 2014 relative to 2013 was primarily due to lower expense on money market and savings deposits certificates of deposit and other time deposits. Interest expense on money market and savings deposits declined $811 thousand in

2014 when compared to 2013, even with an increase of $3.8 million in average balances, due to a decrease of 37 basis points on rates paid on these deposits. The increase in balances of money market and savings deposits was primarily due to the decline in certificates of deposit and other time deposits, and the lower rates on all interest bearing liabilities were primarily due to current market conditions which reflects depositors finding more value in liquidity as non-interest bearing deposits also increased $17.8 million. Interest expense on certificates of deposit and other time deposits declined $1.4 million when compared to 2013 due to a decrease of $46 million in average certificates of deposit and other time deposits and a decrease of 46 basis points on rates paid on these deposits.

During 2015, lower rates on interest-bearing liabilities produced $545 thousand less in interest expense and decreased volume produced $354 thousand less in interest expense, as shown in the table below. In 2014, lower rates on interest-bearing liabilities produced $1.7 million less in interest expense and decreased volume produced $518 thousand less in interest expense.

The following Rate/Volume Variance Analysis identifies the portion of the changes in tax-equivalent net interest income attributable to changes in volume of average balances or to changes in the yield on earning assets and rates paid on interest-bearing liabilities. The rate and volume variance for each category has been allocated on a consistent basis between rate and volume variances, based on a percentage of rate, or volume, variance to the sum of the absolute two variances.

| | 2015 over (under) 2014 | | | 2014 over (under) 2013 | | |
|---|---|---|---|---|---|---|
| | Total | Caused By | | Total | Caused By | |
| (Dollars in thousands) | Variance | Rate | Volume | Variance | Rate | Volume |
| Interest income from earning assets: | | | | | | |
| Loans and loans held for sale | $(24) | $(1,979) | $1,955 | $(3,927) | $(839) | $(3,088) |
| Taxable investment securities | 645 | 112 | 533 | 885 | - | 885 |
| Tax-exempt investment securities | (3) | 1 | (4) | (8) | (3) | (5) |
| Federal funds sold | 2 | 1 | 1 | (3) | (2) | (1) |
| Interest-bearing deposits | (49) | 29 | (78) | (21) | - | (21) |
| Total interest income | 571 | (1,836) | 2,407 | (3,074) | (844) | (2,230) |
| | | | | | | |
| Interest expense on deposits and borrowed funds: | | | | | | |
| Interest-bearing demand deposits | (18) | (21) | 3 | (19) | (31) | 12 |
| Money market and savings deposits | 61 | 33 | 28 | (812) | (831) | 19 |
| Time deposits | (941) | (563) | (378) | (1,389) | (847) | (542) |
| Short-term borrowings | (3) | 3 | (6) | (9) | (2) | (7) |
| Long-term debt | - | - | - | - | - | - |
| Total interest expense | (901) | (548) | (353) | (2,229) | (1,711) | (518) |
| Net interest income | $1,472 | $(1,288) | $2,760 | $(845) | $867 | $(1,712) |

**Noninterest Income**

Noninterest income decreased $1.4 million, or 8.1%, in 2015 when compared to 2014 and decreased $678 thousand, or 3.9%, in 2014 when compared to 2013. The decrease in noninterest income in 2015 when compared to 2014 was primarily due to the loss of wholesale insurance commissions and fees of $2.0 million from the formerly owned Tri-State General Insurance Agency ("Tri-State") which was sold late in the second quarter of 2014 for a gain of $114 thousand. Excluding Tri-State, noninterest income increased $777 thousand over 2014 with increases in retail insurance commissions of $504 thousand and service charges on deposit accounts of $460 thousand due to an initiative to raise bank fees, offset by a decrease in trust and investment fee income of $233 thousand.

The decrease in noninterest income in 2014 when compared to 2013 was mainly due to the loss of wholesale insurance commissions and fees of $1.9 million from Tri-State and a gain on investment securities of $913 thousand in 2013. Partially offsetting the decreases were increases in retail commissions of $493 thousand, the gain on sale of Tri-State of $114 thousand and increased trust and fee income of $247 thousand. In addition, during 2013, the Company incurred a loss of $1.3 million related to the termination of a cash flow hedge. As a result of the termination in 2013, no loss was incurred in 2014.

The following table summarizes our noninterest income for the years ended December 31.

| | Years Ended | | | Change from Prior Year | | | |
|---|---|---|---|---|---|---|---|
| | | | | 2015/14 | | 2014/13 | |
| (Dollars in thousands) | 2015 | 2014 | 2013 | Amount | Percent | Amount | Percent |
| Service charges on deposit accounts | $2,867 | $2,407 | $2,371 | $460 | 19.1 % | $36 | 1.5 % |
| Trust and investment fee income | 1,627 | 1,860 | 1,613 | (233 ) | (12.5 ) | 247 | 15.3 |
| Gains on sales of investment securities | - | 23 | 913 | (23 ) | (100.0) | (890 ) | (97.5 ) |
| Insurance agency commissions income | 8,274 | 9,525 | 10,647 | (1,251) | (13.1 ) | (1,122) | (10.5 ) |
| Loss on termination of cash flow hedge | - | - | (1,306 ) | - | - | 1,306 | 100.0 |
| Other noninterest income | 2,648 | 2,966 | 3,221 | (318 ) | (10.7 ) | (255 ) | (7.9 ) |
| Total | $15,416 | $16,781 | $17,459 | $(1,365) | (8.1 ) | $(678 ) | (3.9 ) |

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**Noninterest Expense**

Noninterest expense decreased $2.0 million, or 5.1%, in 2015 when compared to 2014 and decreased $1.3 million, or 3.3%, in 2014 when compared to 2013. The decrease in noninterest expense in 2015 when compared to 2014 was largely due to the sale of Tri-State which resulted in the decrease of $1.9 million of expenses, most significantly insurance agency commissions. In addition, decreased expenses were due to lower write-downs on other real estate property owned, lower FDIC insurance premium expense due to the upgrade of The Talbot Bank in the second quarter of 2015, decreased salary and employee benefits and lower cost associated with credit costs, partially offset by increases in data processing and legal and professional fees.

The decrease in noninterest expense in 2014 when compared to 2013 was primarily due to lower write-downs of other real estate owned of $660 thousand and decreased insurance agency commission expense of $892 thousand, which were partially offset by increases in salary and wage expense of $254 thousand, data processing of $106 thousand, legal and professional fees of $233 thousand and directors' fees of $120 thousand.

We had 283 full-time equivalent employees at December 31, 2015, 292 full-time equivalent employees at December 31, 2014 and 312 full-time equivalent employees at December 31, 2013.

The following table summarizes our noninterest expense for the years ended December 31.

| | Years Ended | | | Change from Prior Year | | | |
|---|---|---|---|---|---|---|---|
| | | | | 2015/14 | | 2014/13 | |
| (Dollars in thousands) | 2015 | 2014 | 2013 | Amount | Percent | Amount | Percent |
| Salaries and wages | $17,540 | $17,600 | $17,346 | $(60) | (0.3)% | $254 | 1.5 % |
| Employee benefits | 3,905 | 4,092 | 4,094 | (187) | (4.6) | (2) | (0.0) |
| Occupancy expense | 2,420 | 2,339 | 2,344 | 81 | 3.5 | (5) | (0.2) |
| Furniture and equipment expense | 926 | 975 | 1,020 | (49) | (5.0) | (45) | (4.4) |
| Data processing | 3,260 | 3,006 | 2,900 | 254 | 8.4 | 106 | 3.7 |
| Directors' fees | 470 | 474 | 354 | (4) | (0.8) | 120 | 33.9 |
| Amortization of intangible assets | 133 | 201 | 296 | (68) | (33.8) | (95) | (32.1) |
| Insurance agency commissions expense | - | 906 | 1,798 | (906) | (100.0) | (892) | (49.6) |
| FDIC insurance premium expense | 1,214 | 1,636 | 1,813 | (422) | (25.8) | (177) | (9.8) |
| Write-downs of other real estate owned | 127 | 658 | 1,318 | (531) | (80.7) | (660) | (50.1) |
| Legal and professional fees | 2,380 | 2,048 | 1,539 | 332 | 16.2 | 509 | 33.1 |
| Other noninterest expenses | 4,975 | 5,426 | 5,864 | (451) | (8.3) | (438) | (7.5) |
| Total | $37,350 | $39,361 | $40,686 | $(2,011) | (5.1) | $(1,325) | (3.3) |

Income Taxes

The Company reported an income tax expense of $4.4 million for 2015, compared to an income tax expense of $3.1 million for 2014 and an income tax benefit of $6.5 million for 2013. The effective tax rate was 38.2% for 2015, 37.7% for 2014 and 40.3% for 2013. In 2015 and 2014, the Company was able to utilize a portion of their Federal and State Net Operating Loss (NOL) carryforwards which reduced income taxes payable for the year. The Company believes it will be able to continue utilizing its NOL's without the need for a valuation allowance. See the discussion in Note 15, Income Taxes, in the Notes to Consolidated Financial Statements for additional information on the evaluation of the Company's NOL's.

## REVIEW OF FINANCIAL CONDITION

Asset and liability composition, capital resources, asset quality, market risk, interest sensitivity and liquidity are all factors that affect our financial condition. The following sections discuss each of these factors.

### <u>Assets</u>

### Interest-Bearing Deposits with Other Banks and Federal Funds Sold

We invest excess cash balances (i.e., the excess cash remaining after funding loans and investing in securities with deposits and borrowings) in interest-bearing accounts and federal funds sold offered by our correspondent banks. These liquid investments are maintained at a level that management believes is necessary to meet current liquidity needs. Total interest-bearing deposits with other banks and federal funds sold decreased $13.3 million from $72.0 million at December 31, 2014 to $58.7 million at December 31, 2015. Average interest-bearing deposits with other banks and federal funds sold decreased $32.4 million in 2015 and decreased $9.7 million in 2014. The decline in both the 2015 and 2014 period-end and average balances for these assets reflected a reduction in excess liquidity.

**Investment Securities**

The investment portfolio is structured to provide us with liquidity and also plays an important role in the overall management of interest rate risk. Investment securities available for sale are stated at estimated fair value based on quoted prices and may be sold as part of the asset/liability management strategy or which may be sold in response to changing interest rates. Net unrealized holding gains and losses on these securities are reported net of related income taxes as accumulated other comprehensive income, a separate component of stockholders' equity. Investment securities in the held to maturity category are stated at cost adjusted for amortization of premiums and accretion of discounts. We have the intent and current ability to hold such securities until maturity. At December 31, 2015 and 2014, 98% of the portfolio was classified as available for sale and 2% as held to maturity. The percentage of securities designated as available for sale reflects the amount that management believes is needed to support our anticipated growth and liquidity needs. With the exception of municipal securities, our general practice is to classify all newly-purchased securities as available for sale. We do not typically invest in structured notes or other derivative securities. Total investment securities decreased $24.4 million from $240.7 million at December 31, 2014 to $216.4 million at December 31, 2015. Average investment securities increased $33.6 million in 2015, less than the $59.4 million increase in 2014 from 2013 due to proceeds from the second quarter of 2014 capital raise which were primarily invested in available for sale investment securities.

Investment securities available for sale were $212.2 million at the end of 2015 and $236.1 million at the end of 2014. Investment activity for 2015 included purchases of $32.1 million in mortgage-backed securities and $14.0 million in purchases of U.S. Government agencies, while investment activity for 2014 included purchases of $96.1 million in mortgage-backed securities and $36.9 million in purchases of U.S. Government agencies. At year-end 2015, 25.2% of the securities in the portfolio were U.S. Government agencies and 72.5% of the securities were mortgage-backed securities, compared to 31.7% and 65.8%, respectively, at year-end 2014, reflecting a shift in the composition of the portfolio to mortgage-backed securities which provide higher yields. As seen in the table below, 18% of the available-for-sale portfolio will mature in over one through five years and 70% will mature in over ten years based on contractual maturities. The comparable amounts for 2014 were 32% and 63%, respectively. Our investments in mortgage-backed securities are issued or guaranteed by U.S. Government agencies or government-sponsored agencies.

Investment securities held to maturity totaled $4.2 million at December 31, 2015. The comparable amount was $4.6 million at December 31, 2014.

The following table sets forth the maturities and weighted average yields of the bond investment portfolio as of December 31, 2015.

| | 1 Year or Less | | 1-5 Years | | 5-10 Years | | Over 10 Years | |
|---|---|---|---|---|---|---|---|---|
| | Carrying | Average | Carrying | Average | Carrying | Average | Carrying | Average |
| (Dollars in thousands) | Amount | Yield | Amount | Yield | Amount | Yield | Amount | Yield |
| Available for sale: | | | | | | | | |

| | | | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| U.S. Treasury and Government agencies | $14,703 | 0.75 | % | $37,044 | 1.10 | % | $274 | 4.34 | % | $2,587 | 1.73 | % |
| Mortgage-backed | - | - | | 48 | 4.42 | | 10,996 | 1.56 | | 145,872 | 2.00 | |
| Total available for sale | $14,703 | 0.75 | | $37,092 | 1.11 | | $11,270 | 1.63 | | $148,459 | 2.00 | |
| | | | | | | | | | | | | |
| Held to maturity: | | | | | | | | | | | | |
| U.S. Government agencies | $- | - | % | $- | - | % | $- | - | % | $2,574 | 2.10 | % |
| States and political subdivisions[1] | - | - | | 711 | 4.60 | | 403 | 5.00 | | 503 | 5.38 | |
| Total held to maturity | $- | - | | $711 | 4.60 | | $403 | 5.00 | | $3,077 | 2.64 | |

[1]Yields have been adjusted to reflect a tax equivalent basis assuming a federal tax rate of 34.0%.

**Loans**

The loan portfolio is the primary source of our income. Loans totaled $795.1 million at December 31, 2015, an increase of $84.4 million, or 11.9%, from 2014. Loans significantly increased for 2015 when compared to 2014 primarily due to a resurgence in both the residential and commercial lending markets in the Delmarva region. Most of our loans are secured by real estate and are classified as construction, residential or commercial real estate loans. The increase in loans was comprised of increases in residential real estate loans of $33.7 million, or 12.3%, commercial real estate loans of $24.5 million, or 8.0%, construction loans of $16.5 million, or 23.8% and commercial loans, which include financial and agricultural loans, of $12.2 million, or 23.2%. Consumer loans, which consist of a small percentage of the overall loan portfolio, decreased $2.5 million, or 25.9%, from the end of 2015 to the end of 2014.

At December 31, 2015, the real estate loan portfolio was comprised of 10.8% construction, 38.6% residential real estate and 41.5% commercial real estate. That compares to 9.7%, 38.5% and 43.0%, respectively, at December 31, 2014. Commercial and consumer loans were 8.2% and 0.9%, respectively, of the portfolio at December 31, 2015 and 7.4% and 1.4%, respectively, at December 31, 2014. At December 31, 2015, 74.4% of the loan portfolio had fixed interest rates and 25.6% had adjustable interest rates, compared to 71.3% and 28.7%, respectively, at December 31, 2014. See the discussion below under the caption "Asset Quality - Provision for Credit Losses and Risk Management" and Note 3, "Loans and Allowance for Credit Losses", in the Notes to Consolidated Financial Statements for additional information. At December 31, 2015 and 2014, the Company did not have any loans held for sale. We do not engage in foreign or subprime lending activities.

The table below sets forth trends in the composition of the loan portfolio over the past five years (including net deferred loan fees/costs).

| | December 31, | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| (Dollars in thousands) | 2015 | | 2014 | | 2013 | | 2012 | | 2011 | |
| Construction | $85,632 | 10.8% | $69,157 | 9.7 % | $64,591 | 9.1 % | $108,051 | 13.8% | $119,883 | 14.3% |
| Residential real estate | 307,063 | 38.6 | 273,336 | 38.5 | 274,857 | 38.6 | 288,011 | 36.7 | 321,604 | 38.2 |
| Commercial real estate | 330,253 | 41.5 | 305,788 | 43.0 | 304,605 | 42.8 | 314,941 | 40.1 | 315,439 | 37.5 |
| Commercial | 64,911 | 8.2 | 52,671 | 7.4 | 57,195 | 8.0 | 60,786 | 7.7 | 69,485 | 8.3 |
| Consumer | 7,255 | 0.9 | 9,794 | 1.4 | 10,671 | 1.5 | 13,293 | 1.7 | 14,639 | 1.7 |
| Total | $795,114 | **100 %** | $710,746 | 100 % | $711,919 | 100 % | $785,082 | 100 % | $841,050 | 100 % |

The table below sets forth the maturities and interest rate sensitivity of the loan portfolio at December 31, 2015.

| (Dollars in thousands) | Maturing within one year | Maturing after one but within five years | Maturing after five years | Total |
|---|---|---|---|---|
| Construction | $ 51,656 | $ 31,502 | $ 2,474 | $85,632 |
| Residential real estate | 44,203 | 130,254 | 132,606 | 307,063 |
| Commercial real estate | 40,061 | 218,243 | 71,949 | 330,253 |
| Commercial | 25,102 | 32,939 | 6,870 | 64,911 |
| Consumer | 3,448 | 3,115 | 692 | 7,255 |
| Total | $ 164,470 | $ 416,053 | $ 214,591 | $795,114 |
| Rate terms: | | | | |
| Fixed-interest rate loans | $ 106,160 | $ 382,472 | $ 103,134 | $591,766 |
| Adjustable-interest rate loans | 58,310 | 33,581 | 111,457 | 203,348 |
| Total | $ 164,470 | $ 416,053 | $ 214,591 | $795,114 |

**Liabilities**

**Deposits**

We use deposits primarily to fund loans and to purchase investment securities. Total deposits increased from $949.0 million at December 31, 2014 to $975.5 million at December 31, 2015. The increase in deposits was mainly due to an increase in noninterest-bearing deposits of $35.9 million as well as an increase in interest-bearing transaction accounts of $16.1 million, partially offset by a decline in certificates of deposit and other time deposits of $25.5 million. The increases in noninterest-bearing and interest-bearing transaction accounts reflected continuing growth in our customer base and a shift from certificates of deposit and other time deposits providing lower yields than in 2014. Average deposits increased $16.6 million, or 1.8%, in 2015, compared to a 1.9% decrease in 2014. Average certificates of deposit and other time deposits decreased $37.7 million, or 10.7%, for the same reasons as the decline in the period-end amounts. Partially offsetting this decrease, average money market and savings deposits, noninterest-bearing and interest-bearing demand deposits increased in aggregate $54.4 million, or 9.4%, during 2015. Deposits provided funding for approximately 91.5%, 93.7% and 94.4% of average earning assets for 2015, 2014 and 2013, respectively.

Average deposits declined for 2014 primarily in certificates of deposit and other time deposits which decreased $46 million, or 11.6%, partially offset by increases in noninterest bearing accounts of $17.8 million, or 11.1%, money market and savings deposits of $3.8 million, or 1.7% and interest-bearing transaction accounts of $6.6 million, or 3.8%. Similar to the trend in 2015, deposits in 2014 shifted from certificates of deposit and other time deposits bearing low interest rates to deposit accounts which provide more liquidity.

The following table sets forth the average balances of deposits and the percentage of each category to total average deposits for the years ended December 31.

| | Average Balances | | | | | |
|---|---|---|---|---|---|---|
| (Dollars in thousands) | 2015 | | 2014 | | 2013 | |
| Noninterest-bearing demand | $211,171 | 22.2 % | $178,002 | 19.1 % | $160,182 | 16.9 % |
| Interest-bearing deposits | | | | | | |
| Demand | 180,810 | 19.1 | 177,828 | 19.1 | 171,244 | 18.0 |
| Money market and savings | 243,731 | 25.7 | 225,616 | 24.2 | 221,808 | 23.3 |
| Certificates of deposit, $100,000 or more | 149,181 | 15.7 | 170,252 | 18.2 | 202,053 | 21.3 |
| Other time deposits | 164,239 | 17.3 | 180,848 | 19.4 | 195,045 | 20.5 |
| Total | $949,132 | 100.0% | $932,546 | 100.0% | $950,332 | 100.0% |

The following table sets forth the maturity ranges of certificates of deposit with balances of $250,000 or more as of December 31, 2015.

| (Dollars in thousands) | |
|---|---|
| Three months or less | $3,766 |
| Over three through 6 months | 2,337 |
| Over 6 through 12 months | 10,656 |
| Over 12 months | 12,379 |
| Total | $29,138 |

**Short-Term Borrowings**

Short-term borrowings generally consist of securities sold under agreements to repurchase and short-term borrowings from the FHLB. Securities sold under agreements to repurchase are issued in conjunction with cash management services for commercial depositors. We also borrow from the FHLB on a short-term basis and occasionally borrow from correspondent banks under federal fund lines of credit arrangements to meet short-term liquidity needs. At December 31, 2015 and 2014, short-term borrowings included only repurchase agreements.

The average balance of short-term borrowings decreased $1.8 million, or 22.8%, in 2015, while the average balance decreased $2.9 million, or 26.6%, in 2014. There was not a substantial need for short-term borrowings to supplement deposits as a funding source during 2015 and 2014.

The following table sets forth our position with respect to short-term borrowings.

| | 2015 | | 2014 | | 2013 | |
|---|---|---|---|---|---|---|
| (Dollars in thousands) | Balance | Interest Rate | Balance | Interest Rate | Balance | Interest Rate |
| Average outstanding for the year | $6,226 | 0.24 % | $8,061 | 0.22 % | $10,980 | 0.24 % |
| Outstanding at year end | 6,672 | 0.23 | 4,808 | 0.23 | 10,140 | 0.23 |
| Maximum outstanding at any month end | 10,423 | - | 10,836 | - | 12,662 | - |

**Long-Term Debt**

We use long-term borrowings to meet longer term liquidity needs, specifically to fund loan growth where liquidity from deposit growth is not sufficient. The Company had no long-term debt at the end of 2015 and 2014.

**Capital Resources Management**

Total stockholders' equity for the Company was $147.0 million at December 31, 2015, compared to $140.5 million at December 31, 2014. The increase in stockholders' equity in 2015 was primarily due to net earnings for the year.

In 2015, the Board of Directors of the Company voted to re-stablish the quarterly cash dividends on common stock pending the approval of the FRB. Dividends were paid to common stock holders on August 31, 2015 and November 30, 2015 of $0.02 per share. For both 2015 and 2014, the Company continued to maintain capital at levels in excess of the risk-based capital guidelines adopted by the federal banking agencies, as seen in the table below.

During the second quarter of 2014, the Company sold 4,140,000 shares of its common stock for a price of $8.25 per share (the "stock sale"). The Company received $31.3 million in net proceeds after deducting certain direct costs related to the stock sale, primarily underwriting discounts and commissions. The Company contributed $20.0 million of the net proceeds to Talbot Bank, to satisfy regulatory capital requirements, with the remaining proceeds used for general corporate purposes.

We record unrealized holding gains (losses), net of tax, on investment securities available for sale and on cash flow hedging activities as accumulated other comprehensive income (loss), a separate component of stockholders' equity. At December 31, 2015, the portion of the investment portfolio designated as "available for sale" had net unrealized holding (losses), net of tax, of ($71) thousand compared to net unrealized holding gains, net of tax, of $316 thousand at December 31, 2014. There were no net unrealized holding gains or losses on cash flow hedging activities at the end of 2015 and 2014.

The following table compares the Company's capital ratios to the minimum regulatory requirements as of December 31, 2015, 2014 and 2013.

| (Dollars in thousands) | 2015 | 2014 | 2013 | Minimum Regulatory Requirements |
|---|---|---|---|---|
| Common equity Tier 1 capital | $126,024 | n/a | n/a | |
| Tier 1 capital | 126,024 | $112,511 | $72,370 | |
| Tier 2 capital | 8,619 | 7,999 | 8,971 | |
| Total risk-based capital | 134,643 | 120,510 | 81,341 | |
| Net risk-weighted assets | 807,807 | 736,763 | 717,129 | |
| Adjusted average total assets | 1,116,692 | 1,075,674 | 1,028,957 | |
| Risk-based capital ratios: | | | | |
| Common equity Tier 1 | 15.60 % | n/a | n/a | 4.5 % |
| Tier 1 | 15.60 | 15.27 % | 10.09 % | 6.0 |
| Total capital | 16.67 | 16.36 | 11.34 | 8.0 |
| Tier 1 leverage ratio | 11.29 | 10.46 | 7.03 | 4.0 |

See Note 17 to the Consolidated Financial Statements for further information about the regulatory capital positions of the Company and the Banks.

In July 2013, U.S. federal banking agencies published the Basel III Capital Rules establishing a new comprehensive capital framework for U.S. banking organizations. The Basel III Capital Rules were effective for the Company on January 1, 2015 and will be fully phased in on January 1, 2019. When fully phased in on January 1, 2019, the Basel III Capital Rules will require the Company to maintain (i) a minimum ratio of CET1 to risk-weighted assets of at least 4.5%, plus a 2.5% "capital conservation buffer," (ii) a minimum ratio of Tier 1 capital to risk-weighted assets of at least 6.0% (increased from 4.0%), plus the capital conservation buffer, (iii) a minimum ratio of Total capital to risk-weighted assets of at least 8.0% (unchanged from current rules), plus the capital conservation buffer and (iv) a minimum leverage ratio of 4% (unchanged from current rules), calculated as the ratio of Tier 1 capital to average assets. The Basel III Capital Rules eliminate the inclusion of certain instruments, such as trust preferred securities, from Tier 1 capital. Instruments issued prior to May 19, 2010 will be grandfathered for companies with consolidated assets of $15 billion or less.

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

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

The Company currently meets all capital adequacy requirements under the Basel III Capital Rules as they became effective for the Company on January 1, 2015. For additional information regarding the Basel III Capital Rules, see “Business - Supervision and Regulation - Capital Requirements.”

**Asset Quality - Allowance for Credit Losses and Risk Management**

Originating loans involves a degree of risk that credit losses will occur in varying amounts according to, among other factors, the types of loans being made, the credit-worthiness of the borrowers over the terms of the loans, the quality of the collateral for the loans, if any, as well as general economic conditions. Through the Company’s and Banks’ Asset/Liability Management Committees and the Company’s Audit Committee, the Board actively reviews critical risk positions, including credit, market, liquidity and operational risk. The Company’s goal in managing risk is to reduce earnings volatility, control exposure to unnecessary risk, and ensure appropriate returns for risk assumed. Senior members of management actively manage risk at the product level, supplemented with corporate level oversight through the Asset/Liability Management Committee and internal audit function. The risk management structure is designed to identify risk through a systematic process, enabling timely and appropriate action to avoid and mitigate risk.

Credit risk is mitigated through loan portfolio diversification, limiting exposure to any single industry or customer, collateral protection, and prudent lending policies and underwriting criteria. The following discussion provides information and statistics on the overall quality of the Company’s loan portfolio. Note 1 to the Consolidated Financial Statements describes the accounting policies related to nonperforming loans (nonaccrual and delinquent 90 days or more), TDRs and loan charge-offs and describes the methodologies used to develop the allowance for credit losses, including the specific, formula and unallocated components (also discussed below). Management believes the policies governing nonperforming loans, TDRs and charge-offs are consistent with regulatory standards. The amount of the allowance for credit losses and the resulting provision are reviewed monthly by senior members of management and approved quarterly by the Board of Directors.

The allowance is increased by provisions for credit losses charged to expense and recoveries of loans previously charged off. It is decreased by loans charged off in the current period. Loans, or portions thereof, are charged off when considered uncollectible by management. Provisions for credit losses are made to bring the allowance for credit losses within the range of balances that are considered appropriate.

The adequacy of the allowance for credit losses is determined based on management’s estimate of the inherent risks associated with lending activities, estimated fair value of collateral, past experience and present indicators such as loan delinquency trends, nonaccrual loans and current market conditions. Management believes the current allowance is adequate to provide for probable losses inherent in our loan portfolio; however, future changes in the composition of the loan portfolio and financial condition of borrowers may result in additions to the allowance. Examination of the portfolio and allowance by various regulatory agencies and consultants engaged by the Company may result in the need for additional provisions based on information available at the time of the examination. Each of the Banks maintains a separate allowance for credit losses, which is only available to absorb losses from their respective loan portfolios. The allowance set by each of the Banks is subject to regulatory examination and determination as to its adequacy.

The allowance for credit losses is comprised of three parts: (i) the specific allowance; (ii) the formula allowance; and (iii) the unallocated allowance. The specific allowance is established against impaired loans until charge offs are made. Loans are considered impaired (i.e., nonaccrual loans and accruing TDRs) when it is probable that the Company will not collect all principal and interest payments according to the loan’s contractual terms. The formula allowance is determined based on management’s assessment of industry trends and economic factors in the markets in which we operate. The determination of the formula allowance involves a higher risk of uncertainty and considers current risk factors that may not have yet manifested themselves in our historical loss factors. The unallocated allowance captures losses that have impacted the portfolio but have yet to be recognized in either the specific or formula allowance.

The specific allowance is used to individually allocate an allowance to loans identified as impaired. An impaired loan may involve deficiencies in the borrower’s overall financial condition, payment history, support available from financial guarantors and/or the fair market value of collateral. If it is determined that there is a loss associated with an impaired loan, a specific allowance is established until a charge off is made. Impaired loans, or portions thereof, are charged off when deemed uncollectible.

The formula allowance is used to estimate the loss on internally risk-rated loans, exclusive of those identified as impaired. Loans are grouped by type (construction, residential real estate, commercial real estate, commercial or consumer). Each loan type is assigned allowance factors based on management's estimate of the risk, complexity and size of individual loans within a particular category. Loans that are identified as special mention, substandard and doubtful are adversely rated. These loans are assigned higher allowance factors than favorably rated loans due to management's concerns regarding collectability or management's knowledge of particular elements regarding the borrower.

The unallocated allowance is used to estimate the loss on loans stemming from more global factors such as delinquencies, loss history, trends in volume and terms of loans, effects of changes in lending policy, the experience and depth of management, national and local economic trends, concentrations of credit, the quality of the loan review system and the effect of external factors such as competition and regulatory requirements.

Because most of our loans are secured by real estate, the lack of a meaningful upturn in real estate related activities in our local real estate market and construction industry and slow improvement in general economic conditions had a material adverse effect on the performance of our loan portfolio and the value of the collateral securing that portfolio between 2009 and 2013. Factors impeding our loan performance and overall financial performance included our levels of loan charge-offs and provisions for credit losses**.** However, we believe that the proactive measures we took in 2011, 2012 and 2013 to critically review our loan portfolio, take the necessary charge-offs, provide prudent reserves and engage in difficult but timely asset sales allowed us to focus on loan growth and improved earnings beginning in 2014.

As seen in the table below, the provision for credit losses was $2.1 million for 2015, $3.4 million for 2014 and $27.8 million for 2013. The decrease in the level of provision for credit losses in 2015 was primarily due to a reduction in charge-offs as the result of the improved local economy compared to 2014. Net loan charge-offs totaled $1.5 million in 2015, $6.4 million in 2014 and $33.1 million in 2013. Real estate loans were 83%, 65% and 98% of total loans charged off during 2015, 2014 and 2013, respectively.

The allowance for credit losses was $8.3 million, or 1.11% of average outstanding loans at December 31, 2015, compared to an allowance of $7.7 million, or 1.09% of average outstanding loans at December 31, 2014. The higher allowance at the end of 2015 when compared to the end of 2014 was the result of significant growth in the loan portfolio. At December 31, 2013, the allowance for credit losses was $10.7 million, or 1.40% of average outstanding loans. The ratio of net charge-offs to average loans was 0.19% in 2015, 0.90% in 2014 and 4.32% in 2013.

The overall credit quality improved in 2015 compared to 2014 primarily due to continued workout efforts on outstanding problem loans many of which were TDRs and nonperforming assets. Management will continue to monitor and charge off nonperforming assets as rapidly as possible, and focus on the generation of healthy loan growth and new business development opportunities.

The following table sets forth a summary of our loan loss experience for the years ended December 31.

| (Dollars in thousands) | 2015 | 2014 | 2013 | 2012 | 2011 |
|---|---|---|---|---|---|
| Balance, beginning of year | $7,695 | $10,725 | $15,991 | $14,288 | $14,227 |
| Loans charged off | | | | | |
| Construction | (1,058) | (725) | (20,695) | (7,826) | (4,236) |
| Residential real estate | (283) | (2,407) | (7,163) | (9,838) | (7,693) |
| Commercial real estate | (920) | (1,648) | (6,162) | (2,954) | (5,037) |
| Commercial | (396) | (2,389) | (665) | (5,451) | (3,388) |
| Consumer | (67) | (163) | (113) | (576) | (202) |
| Total | (2,724) | (7,332) | (34,798) | (26,645) | (20,556) |
| Recoveries | | | | | |
| Construction | 125 | 149 | 161 | 6 | 49 |
| Residential real estate | 398 | 376 | 545 | 102 | 120 |
| Commercial real estate | 379 | 58 | 161 | 166 | 361 |
| Commercial | 319 | 341 | 839 | 304 | 549 |
| Consumer | 49 | 28 | 42 | 25 | 68 |
| Total | 1,270 | 952 | 1,748 | 603 | 1,147 |
| Net loans charged off | (1,454) | (6,380) | (33,050) | (26,042) | (19,409) |
| Provision for credit losses | 2,075 | 3,350 | 27,784 | 27,745 | 19,470 |

| | | | | | |
|---|---|---|---|---|---|
| Balance, end of year | $8,316 | $7,695 | $10,725 | $15,991 | $14,288 |
| Average loans outstanding | $748,101 | $707,381 | $768,516 | $814,167 | $873,155 |
| Percentage of net charge-offs to average loans outstanding during the year | 0.19 % | 0.90 % | 4.30 % | 3.20 % | 2.22 % |
| Percentage of allowance for credit losses at year end to average loans | 1.11 % | 1.09 % | 1.40 % | 1.96 % | 1.64 % |

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During 2015, there was no significant change in the processes or assumptions affecting the allowance methodology. Included in the balance of the allowance for credit losses were specific reserves of $1.4 million and $1.3 million primarily for real estate loans at the end of 2015 and 2014, respectively. As seen in the table below, the unallocated portion of the allowance for credit losses has historically been a fairly small amount of the total allowance.

The following table sets forth the allocation of the allowance for credit losses and the percentage of loans in each category to total loans for the years ended December 31.

| | 2015 | | 2014 | | 2013 | | 2012 | | 2011 | |
|---|---|---|---|---|---|---|---|---|---|---|
| (Dollars in thousands) | Amount | % of Loans | Amount | % of Loans | Amount | % of Loans | Amount | % of Loans | Amount | % of Loans |
| Construction | $1,646 | 10.8 % | $1,303 | 9.7 % | $1,960 | 9.1 % | $4,387 | 13.8 % | $3,745 | 14.3 % |
| Residential real estate | 2,181 | 38.6 | 2,834 | 38.5 | 3,854 | 38.6 | 5,194 | 36.7 | 5,014 | 38.2 |
| Commercial real estate | 2,999 | 41.5 | 2,379 | 43.0 | 3,029 | 42.8 | 4,134 | 40.1 | 3,415 | 37.5 |
| Commercial | 558 | 8.2 | 448 | 7.4 | 1,266 | 8.0 | 1,682 | 7.7 | 1,498 | 8.3 |
| Consumer | 156 | 0.9 | 229 | 1.4 | 243 | 1.5 | 407 | 1.7 | 594 | 1.7 |
| Unallocated | 776 | - | 502 | - | 373 | - | 187 | - | 22 | - |
| Total | $8,316 | 100.0% | $7,695 | 100.0% | $10,725 | 100.0% | $15,991 | 100.0% | $14,288 | 100.0% |

At December 31, 2015, nonperforming assets, excluding nonaccrual loans held for sale, were $16.4 million, a decrease of $892 thousand, or 5.2%, when compared to December 31, 2014. Similarly, accruing TDRs were $15.5 million at December 31, 2015, a decrease of $1.2 million, or 7.1%, when compared to December 31, 2014. At December 31, 2015, the ratio of nonaccrual loans, excluding nonaccrual loans held for sale, to total assets was 1.07%, improving from 1.22% at December 31, 2014. Likewise, the ratio of accruing TDRs to total assets at December 31, 2015 was 1.37%, decreasing from 1.52% at December 31, 2014. When comparing December 31, 2015 to December 31, 2014, the positive trend in nonperforming assets and TDRs, as well as the corresponding asset quality ratios, was due to continued work-out efforts and loan charge-offs.

The Company continues to focus on the resolution of its nonperforming and problem loans. The efforts to accomplish this goal include frequently contacting borrowers until the delinquency is cured or until an acceptable payment plan has been agreed upon; obtaining updated appraisals; provisioning for credit losses; charging off loans; transferring loans to other real estate owned; aggressively marketing other real estate owned; and selling loans. The reduction of nonperforming and problem loans is and will continue to be a high priority for the Company.

The following table summarizes our nonperforming assets and accruing TDRs as of December 31.

| (Dollars in thousands) | 2015 | 2014 | 2013 | 2012 | 2011 |
|---|---|---|---|---|---|
| Nonperforming assets | | | | | |
| Nonaccrual loans excluding nonaccrual loans held for sale ("hfs") | | | | | |
| Construction | $7,529 | $6,046 | $3,949 | $9,694 | $15,555 |
| Residential real estate | 2,259 | 4,035 | 5,166 | 11,532 | 20,106 |
| Commercial real estate | 2,022 | 3,121 | 4,671 | 14,567 | 14,012 |
| Commercial | 161 | 141 | 792 | 594 | 1,669 |
| Consumer | 122 | 123 | 48 | 87 | 28 |
| Total nonaccrual loans excluding nonaccrual loans hfs | 12,093 | 13,466 | 14,626 | 36,474 | 51,370 |
| | | | | | |
| Loans 90 days or more past due and still accruing | | | | | |
| Construction | - | - | - | - | 325 |
| Residential real estate | - | 83 | 20 | 290 | 2,331 |
| Commercial real estate | - | - | - | 165 | - |
| Commercial | - | - | 250 | - | 66 |
| Consumer | 7 | 4 | - | 5 | 1 |
| Total loans 90 days or more past due and still accruing | 7 | 87 | 270 | 460 | 2,723 |
| Other real estate owned | 4,252 | 3,691 | 3,779 | 7,659 | 9,385 |
| Total nonperforming assets excluding nonaccrual loans hfs | 16,352 | 17,245 | 18,675 | 44,593 | 63,478 |
| Nonaccrual loans hfs | - | - | 3,521 | - | - |
| Total nonperforming assets including nonaccrual loans hfs | $16,352 | $17,245 | $22,196 | $44,593 | $63,478 |
| | | | | | |
| Accruing TDRs | | | | | |
| Construction | $4,069 | $4,022 | $1,620 | $27,335 | $11,781 |
| Residential real estate | 5,686 | 6,368 | 14,582 | 7,017 | 3,792 |
| Commercial real estate | 5,740 | 6,237 | 9,791 | 17,880 | 9,566 |
| Commercial | - | 47 | 95 | 121 | 69 |
| Consumer | - | - | - | - | - |
| Total accruing TDRs | $15,495 | $16,674 | $26,088 | $52,353 | $25,208 |
| | | | | | |
| As a percent of total loans: | | | | | |
| Nonaccrual loans excluding nonaccrual loans hfs | 1.52 % | 1.89 % | 2.05 % | 4.65 % | 6.11 % |
| Accruing TDRs | 1.95 % | 2.35 % | 3.66 % | 6.67 % | 3.00 % |
| Nonaccrual loans and accruing TDRs excluding nonaccrual loans hfs | 3.47 % | 4.24 % | 5.71 % | 11.32 % | 9.11 % |
| | | | | | |
| As a percent of total loans and other real estate owned: | | | | | |
| Nonperforming assets excluding nonaccrual loans hfs | 2.05 % | 2.41 % | 2.61 % | 5.63 % | 7.46 % |
| Nonperforming assets and accruing TDRs excluding nonaccrual loans hfs | 3.98 % | 4.75 % | 6.25 % | 12.23 % | 10.43 % |
| | | | | | |
| As a percent of total assets: | | | | | |
| Nonaccrual loans excluding nonaccrual loans hfs | 1.07 % | 1.22 % | 1.39 % | 3.08 % | 4.44 % |

| | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| Nonaccrual loans including nonaccrual loans hfs | 1.07 | % | 1.22 | % | 1.72 | % | 3.08 | % | 4.44 | % |
| Nonperforming assets excluding nonaccrual loans hfs | 1.44 | % | 1.57 | % | 1.77 | % | 3.76 | % | 5.48 | % |
| Nonperforming assets including nonaccrual loans hfs | 1.44 | % | 1.57 | % | 2.11 | % | 3.76 | % | 5.48 | % |
| Accruing TDRs | 1.37 | % | 1.52 | % | 2.47 | % | 4.41 | % | 2.18 | % |
| Nonperforming assets and accruing TDRs excluding nonaccrual loans hfs | 2.81 | % | 3.08 | % | 4.25 | % | 8.18 | % | 7.66 | % |
| Nonperforming assets and accruing TDRs including nonaccrual loans hfs | 2.81 | % | 3.08 | % | 4.58 | % | 8.18 | % | 7.66 | % |

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**Market Risk Management and Interest Sensitivity**

The Company's net income is largely dependent on its net interest income.  Net interest income is susceptible to interest rate risk to the extent that interest-bearing liabilities mature or re-price on a different basis than interest-earning assets.  When interest-bearing liabilities mature or re-price more quickly than interest-earning assets in a given period, a significant increase in market rates of interest could adversely affect net interest income. Similarly, when interest-earning assets mature or re-price more quickly than interest-bearing liabilities, falling interest rates could result in a decrease in net interest income. Net interest income is also affected by changes in the portion of interest-earning assets that are funded by interest-bearing liabilities rather than by other sources of funds, such as noninterest-bearing deposits and stockholders' equity.

The Company's interest rate risk management goals are (1) to increase net interest income at a growth rate consistent with the growth rate of total assets, and (2) to minimize fluctuations in net interest margin as a percentage of interest-earning assets.  Management attempts to achieve these goals by balancing, within policy limits, the volume of floating-rate liabilities with a similar volume of floating-rate assets; by keeping the average maturity of fixed-rate asset and liability contracts reasonably matched; by maintaining a pool of administered core deposits; and by adjusting pricing rates to market conditions on a continuing basis.

The Company's Board of Directors has established a comprehensive asset liability management policy, which is administered by management's Asset Liability Management Committee's ("ALCO"). The policy establishes limits on risk, which are quantitative measures of the percentage change in net interest income (a measure of net interest income at risk) and the fair value of equity capital (a measure of economic value of equity or "EVE" at risk) resulting from a hypothetical change in the yield curve of U.S. Treasury interest rates for maturities from one day to thirty years. The Company evaluates the potential adverse impacts that changing interest rates may have on its short-term earnings, long-term value, and liquidity by outsourcing simulation analysis through the use of computer modeling. The simulation model captures optionality factors such as call features and interest rate caps and floors imbedded in investment and loan portfolio contracts. As with any method of gauging interest rate risk, there are certain shortcomings inherent in the interest rate modeling methodology used by the Company. When interest rates change, actual movements in different categories of interest-earning assets and interest-bearing liabilities, loan prepayments, and withdrawals of time and other deposits, may deviate significantly from assumptions used in the model. As an example, certain money market deposit accounts are assumed to reprice at 50% of the interest rate change in each of the up rate shock scenarios even though this is not a contractual requirement. As a practical matter, management would likely lag the impact of any upward movement in market rates on these accounts as a mechanism to manage the Company's net interest margin.  Finally, the methodology does not measure or reflect the impact that higher rates may have on adjustable-rate loan customers' ability to service their debts, or the impact of rate changes on demand for loan, lease, and deposit products.

The Company presents a current base case and several alternative simulations at least once a quarter and reports the analysis to the Board of Directors.  In addition, more frequent forecasts could be produced when interest rates are particularly uncertain or when other business conditions so dictate.

The statement of condition is subject to quarterly testing for six alternative interest rate shock possibilities to indicate the inherent interest rate risk.  Average interest rates are shocked by +/- 100, 200, and 300 basis points ("bp"), although the Company may elect not to use particular scenarios that it determines are impractical in a current rate environment. It is management's goal to structure the balance sheet so that net interest earnings at risk over a twelve-month period and the economic value of equity at risk do not exceed policy guidelines at the various interest rate shock levels.

During 2015 the Company changed its outsourced vendors for interest rate risk modeling. This change in vendors resulted in changes in assumptions and approaches in estimating interest rate risk. The Company augments its quarterly interest rate shock analysis with alternative external rate scenarios on a quarterly basis. These alternative interest rate scenarios may include non-parallel rate ramps and non-parallel yield curve twists.

Measures of net interest income at risk produced by simulation analysis are indicators of an institution's short-term performance in alternative rate environments.  These measures are typically based upon a relatively brief period, usually one year.  They do not necessarily indicate the long-term prospects or economic value of the institution.

Estimated Changes in Net Interest Income

| Change in Interest Rates: | + 300 bp | + 200 bp | + 100bp | - 100 bp | - 200 bp | -300 bp |
|---|---|---|---|---|---|---|
| Policy Limit | 20.00 % | 20.00 % | 10.00 % | -10.00 % | -20.00 % | -20.00 % |
| December 31, 2015 | 6.1 % | 4.3 % | 2.7 % | (5.5 %) | (10.2 %) | **N/A** |
| December 31, 2014 | 2.4 % | 1.9 % | 0.9 % | (4.6 %) | (13.3 %) | N/A |

Based on our net interest income simulation as of December 31, 2015, net interest income is expected to increase as interest rates rise and are well within the policy limits adopted by the Company. This is due in part to our strategy to maintain short investment portfolio durations. In addition, rising interest rates would drive higher rates on loans. However, lower interest rates would likely cause a decline in net interest income as lower rates would lead to lower yields on loans and investment securities. Since deposit costs are already at low levels, lower interest rates are unlikely to significantly impact our funding costs. Based on our net interest income simulation as of December 31, 2015, net interest income sensitivity to changes in interest rates for the twelve months subsequent to December 31, 2015 was more sensitive compared to the sensitivity profile for the twelve months subsequent to December 31, 2014. The increase in sensitivity was partially due to changes in our balance sheet mix, including increases in federal funds sold, floating rate commercial loans, and a shift from certificates of deposit and other time deposits to noninterest bearing deposits which drove down the Company's cost of funds and interest expense.

The measures of equity value at risk indicate the ongoing economic value of the Company by considering the effects of changes in interest rates on all of the Company's cash flows, and by discounting the cash flows to estimate the present value of assets and liabilities. The difference between these discounted values of the assets and liabilities is the economic value of equity ("EVE"), which, in theory, approximates the fair value of the Company's net assets.

Estimated Changes in Economic Value of Equity (EVE)

| Change in Interest Rates: | + 300 bp | + 200 bp | + 100bp | - 100 bp | - 200 bp | -300 bp |
|---|---|---|---|---|---|---|
| Policy Limit | 15.00 % | 15.00 % | 10.00 % | -20.00 % | -35.00 % | N/A |
| December 31, 2015 | 1.4 % | 1.2 % | 0.3 % | (12.3 )% | (26.5 )% | **N/A** |
| December 31, 2014 | 20.7 % | 14.8 % | 7.4 % | (0.6 %) | 3.6 % | N/A |

Based on our economic value of portfolio equity ("EVE") simulation as of December 31, 2015, equity is expected to increase as interest rates rise and will decline as interest rates decrease. The results of the simulation are well within the policy limits adopted by the Company. The decrease in the EVE at risk from December 31, 2014 to December 31, 2015 primarily resulted from the variations in assumptions between the outsourced vendors. In addition, changes in the shape of the yield curve caused by the December 2015 Fed Funds interest rate increase, as well as strong loan growth for both Banks partially funded by the short duration of investment securities resulted in the decrease in the change in EVE.

**Off-Balance Sheet Arrangements**

In the normal course of business, to meet the financing needs of its customers, the Banks are parties to financial instruments with off-balance sheet risk. These financial instruments include commitments to extend credit and standby letters of credit. The Banks' exposure to credit loss in the event of nonperformance by the other party to these financial instruments is represented by the contractual amount of the instruments. The Banks use the same credit policies in making commitments and conditional obligations as they use for on-balance sheet instruments. The Banks generally require collateral or other security to support the financial instruments with credit risk. The amount of collateral or other security is determined based on management's credit evaluation of the counterparty. The Banks evaluate each customer's creditworthiness on a case-by-case basis.

Commitments to extend credit are agreements to lend to a customer as long as there is no violation of any condition established in the contract. Letters of credit are conditional commitments issued by the Banks to guarantee the performance of a customer to a third party. Letters of credit and other commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. Because many of the letters of credit and commitments are expected to expire without being drawn upon, the total commitment amount does not necessarily represent future cash requirements. Further information about these arrangements is provided in Note 22 to the Consolidated Financial Statements.

Management does not believe that any of the foregoing arrangements have or are reasonably likely to have a current or future effect on our financial condition, revenues or expenses, results of operations, liquidity, capital expenditures or capital resources that is material to investors.

**Liquidity Management**

Liquidity describes our ability to meet financial obligations that arise during the normal course of business. Liquidity is primarily needed to meet the borrowing and deposit withdrawal requirements of customers and to fund current and planned expenditures. Liquidity is derived through increased customer deposits, maturities in the investment portfolio, loan repayments and income from earning assets. To the extent that deposits are not adequate to fund customer loan demand, liquidity needs can be met in the short-term funds markets. We have arrangements with correspondent banks whereby we have $13 million available in federal funds lines of credit and a reverse repurchase agreement available to meet any short-term needs which may not otherwise be funded by the Banks' portfolio of readily marketable investments that can be converted to cash. The Banks are also members of the FHLB, which provides another source of liquidity, and had credit availability of approximately $130.2 million from the FHLB as of December 31, 2015.

At December 31, 2015, our loan to deposit ratio was approximately 81.5%, higher than the 74.9% at year-end 2014. Investment securities available for sale totaling $212.2 million at the end of 2015 were available for the management of liquidity and interest rate risk. The comparable amount was $236.1 million at December 31, 2014. Cash and cash equivalents were $73.8 million at December 31, 2015, a decline of $22.4 million, or 23.3%, compared to the $96.2 million at year-end 2014, which reflects management's efforts to reduce excess liquidity by funding loan growth. Management is not aware of any demands, commitments, events or uncertainties that will materially affect our ability to maintain liquidity at satisfactory levels.

We have various financial obligations, including contractual obligations and commitments that may require future cash payments. The following table presents significant fixed and determinable contractual obligations to third parties by payment date as of December 31, 2015.

| (Dollars in thousands) | Within one year | One to three years | Three to five years | Over five years | Total |
|---|---|---|---|---|---|
| Deposits without a stated maturity | $685,669 | $ - | $ - | $ - | $685,669 |
| Time Deposits | 163,220 | 86,719 | 39,803 | 52 | 289,794 |
| Operating leases | 547 | 816 | 630 | 1,021 | 3,014 |
| Purchase obligations | 3,390 | 4,805 | 1,680 | 1,469 | 11,344 |
| Total | $852,826 | $ 92,340 | $ 42,113 | $ 2,542 | $989,821 |

**Item 7A. Quantitative and Qualitative Disclosures About Market Risk.**

The information required by this item may be found in Item 7 of Part II of this annual report under the caption "Market Risk Management and Interest Sensitivity", which is incorporated herein by reference.

**Item 8. Financial Statements and Supplementary Data.**

**INDEX TO CONSOLIDATED FINANCIAL STATEMENTS**

**MANAGEMENT'S REPORT ON INTERNAL CONTROL OVER FINANCIAL REPORTING**

Management of Shore Bancshares, Inc. (the "Company") is responsible for the preparation, integrity and fair presentation of the consolidated financial statements included in this annual report. The Company's consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America and, as such, include some amounts that are based on the best estimates and judgments of management.

The Company's management is responsible for establishing and maintaining adequate internal control over financial reporting. This internal control system is designed to provide reasonable assurance to management and the Board of Directors regarding the reliability of the Company's financial reporting and the preparation and presentation of financial statements for external reporting purposes in conformity with accounting principles generally accepted in the United States of America, as well as to safeguard assets from unauthorized use or disposition. The system of internal control over financial reporting is evaluated for effectiveness by management and tested for reliability through a program of internal audit with actions taken to correct potential deficiencies as they are identified. Because of inherent limitations in any internal control system, no matter how well designed, misstatement due to error or fraud may occur and not be detected, including the possibility of the circumvention or overriding of controls. Accordingly, even an effective internal control system can provide only reasonable assurance with respect to financial statement preparation. Further, because of changes in conditions, internal control effectiveness may vary over time.

Management assessed the effectiveness of the Company's internal control over financial reporting as of December 31, 2015 based upon criteria set forth in Internal Control – Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (1992 COSO Framework).

Based on this assessment and on the foregoing criteria, management has concluded that, as of December 31, 2015, the Company's internal control over financial reporting is effective. Stegman & Company, the Company's independent registered public accounting firm that audited the financial statements included in this annual report, has issued a report on the Company's internal control over financial reporting, which appears on the following page.

March 11, 2016

| | |
|---|---|
| /s/ Lloyd L. Beatty, Jr. | /s/ George S. Rapp |
| Lloyd L. Beatty, Jr. | George S. Rapp |
| President and Chief Executive Officer | Vice President and Chief Financial Officer |
| (Principal Executive Officer) | (Principal Financial Officer) |

**REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM**

To the Board of Directors and
Stockholders of Shore Bancshares, Inc.

We have audited the accompanying consolidated balance sheets of Shore Bancshares, Inc. (the "Company") as of December 31, 2015 and 2014, and the consolidated statements of operations, comprehensive loss, changes in stockholders' equity and cash flows for each of the years in the three-year period ended December 31, 2015. We also have audited the Company's internal control over financial reporting as of December 31, 2015, based on criteria established in *Internal Control—Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (1992 COSO Framework). The Company's management is responsible for these financial statements, for maintaining effective internal control over financial reporting, and for its assessment of the effectiveness of internal control over financial reporting, included in the accompanying *Management's Report on Internal Control over Financial Reporting*. Our responsibility is to express an opinion on these consolidated financial statements and an opinion on the Company's internal control over financial reporting based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement and whether effective internal control over financial reporting was maintained in all material respects. Our audits of the consolidated financial statements included examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. Our audit of internal control over financial reporting included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, and testing and evaluating the design and operating effectiveness of internal control based on the assessed risk. Our audits also included performing such other procedures as we considered necessary in the circumstances. We believe that our audits provide a reasonable basis for our opinions.

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Shore Bancshares, Inc. as of December 31, 2015 and 2014, and the results of its operations and its cash flows for each of the years in the three-year period ended December 31, 2015 in conformity with accounting principles generally accepted in the United States of America. Also in our opinion, Shore Bancshares, Inc. maintained, in all material respects, effective internal control over financial reporting as of December 31, 2015, based on criteria established in *Internal Control—Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (1992 COSO Framework).

Baltimore, Maryland

March 11, 2016

**SHORE BANCSHARES, INC.**

**CONSOLIDATED BALANCE SHEETS**

December 31,

| (In thousands, except share data) | 2015 | 2014 |
|---|---|---|
| ASSETS | | |
| Cash and due from banks | $15,080 | $24,211 |
| Interest-bearing deposits with other banks | 54,223 | 68,460 |
| Federal funds sold | 4,508 | 3,552 |
| Cash and cash equivalents | 73,811 | 96,223 |
| Investment securities: | | |
| Available for sale, at fair value | 212,165 | 236,108 |
| Held to maturity, at amortized cost – fair value of $4,243 (2015) and $4,694 (2014) | 4,191 | 4,630 |
| | | |
| Loans | 795,114 | 710,746 |
| Less: allowance for credit losses | (8,316 ) | (7,695 ) |
| Loans, net | 786,798 | 703,051 |
| | | |
| Premises and equipment, net | 16,864 | 16,275 |
| Goodwill | 11,931 | 11,931 |
| Other intangible assets, net | 1,211 | 1,331 |
| Other real estate owned, net | 4,252 | 3,691 |
| Other assets | 23,920 | 27,162 |
| | | |
| Total assets | $1,135,143 | $1,100,402 |
| | | |
| LIABILITIES | | |
| Deposits: | | |
| Noninterest-bearing | $229,686 | $193,814 |
| Interest-bearing | 745,778 | 755,190 |
| Total deposits | 975,464 | 949,004 |
| | | |
| Short-term borrowings | 6,672 | 4,808 |
| Other liabilities | 6,040 | 6,121 |
| | | |
| Total liabilities | 988,176 | 959,933 |
| | | |
| STOCKHOLDERS' EQUITY | | |
| Common stock, par value $.01, authorized 35,000,000 shares; shares issued and outstanding–12,631,160 (2015) and 12,618,513 (2014) | 126 | 126 |
| Additional paid in capital | 63,815 | 63,532 |
| Retained earnings | 83,097 | 76,495 |
| Accumulated other comprehensive (loss) income | (71 ) | 316 |

| | | |
|---|---|---|
| Total stockholders' equity | 146,967 | 140,469 |
| Total liabilities and stockholders' equity | $1,135,143 | $1,100,402 |

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

**SHORE BANCSHARES, INC.**

**CONSOLIDATED STATEMENTS OF OPERATIONS**

For the Years Ended December 31,

| (Dollars in thousands, except per share data) | 2015 | 2014 | 2013 |
|---|---|---|---|
| INTEREST INCOME | | | |
| Interest and fees on loans | $35,126 | $35,140 | $39,058 |
| Interest and dividends on investment securities: | | | |
| Taxable | 3,602 | 2,957 | 2,072 |
| Tax-exempt | 10 | 12 | 17 |
| Interest on federal funds sold | 3 | 1 | 4 |
| Interest on deposits with other banks | 130 | 179 | 200 |
| Total interest income | 38,871 | 38,289 | 41,351 |
| | | | |
| INTEREST EXPENSE | | | |
| Interest on deposits | 3,331 | 4,229 | 6,448 |
| Interest on short-term borrowings | 15 | 18 | 27 |
| Total interest expense | 3,346 | 4,247 | 6,475 |
| | | | |
| NET INTEREST INCOME | 35,525 | 34,042 | 34,876 |
| | | | |
| Provision for credit losses | 2,075 | 3,350 | 27,784 |
| | | | |
| NET INTEREST INCOME AFTER PROVISION FOR CREDIT LOSSES | 33,450 | 30,692 | 7,092 |
| | | | |
| NONINTEREST INCOME | | | |
| Service charges on deposit accounts | 2,867 | 2,407 | 2,371 |
| Trust and investment fee income | 1,627 | 1,860 | 1,613 |
| Gains on sales of investment securities | - | 23 | 913 |
| Insurance agency commissions income | 8,274 | 9,525 | 10,647 |
| Loss on termination of cash flow hedge | - | - | (1,306 ) |
| Other noninterest income | 2,648 | 2,966 | 3,221 |
| Total noninterest income | 15,416 | 16,781 | 17,459 |
| | | | |
| NONINTEREST EXPENSE | | | |
| Salaries and wages | 17,540 | 17,600 | 17,346 |
| Employee benefits | 3,905 | 4,092 | 4,094 |
| Occupancy expense | 2,420 | 2,339 | 2,344 |
| Furniture and equipment expense | 926 | 975 | 1,020 |
| Data processing | 3,260 | 3,006 | 2,900 |
| Directors’ fees | 470 | 474 | 354 |
| Amortization of other intangible assets | 133 | 201 | 296 |
| Insurance agency commissions expense | - | 906 | 1,798 |
| FDIC insurance premium expense | 1,214 | 1,636 | 1,813 |

| | | | |
|---|---|---|---|
| Write-downs of other real estate owned | 127 | 658 | 1,318 |
| Legal and professional fees | 2,380 | 2,048 | 1,539 |
| Other noninterest expenses | 4,975 | 5,426 | 5,864 |
| Total noninterest expense | 37,350 | 39,361 | 40,686 |
| | | | |
| INCOME (LOSS) BEFORE INCOME TAXES | 11,516 | 8,112 | (16,135) |
| Income tax expense (benefit) | 4,408 | 3,061 | (6,501 ) |
| | | | |
| NET INCOME (LOSS) | $7,108 | $5,051 | $(9,634 ) |
| | | | |
| Basic income (loss) per common share | $0.56 | $0.46 | $(1.14 ) |
| Diluted income (loss) per common share | $0.56 | $0.46 | $(1.14 ) |
| Cash dividends paid per common share | $0.04 | $- | $- |

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

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**SHORE BANCSHARES, INC.**

**CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (LOSS)**

For the Years Ending December 31,

| (Dollars in thousands) | 2015 | 2014 | 2013 |
|---|---|---|---|
| Net income (loss) | $7,108 | $5,051 | $(9,634) |
| | | | |
| Other comprehensive income (loss) | | | |
| Securities available for sale: | | | |
| Unrealized holding (losses) gains on available-for-sale securities | (649) | 1,285 | (2,995) |
| Tax effect | 262 | (518) | 1,209 |
| Reclassification of gains recognized in net income (loss) | - | (23) | (913) |
| Tax effect | - | 9 | 368 |
| Net of tax amount | (387) | 753 | (2,331) |
| | | | |
| Cash flow hedging activities: | | | |
| Unrealized holding gains on cash flow hedging activities | - | - | 681 |
| Tax effect | - | - | (274) |
| Reclassification of losses recognized in net loss | - | - | 1,306 |
| Tax effect | - | - | (527) |
| Net of tax amount | - | - | 1,186 |
| Total other comprehensive (loss) income | (387) | 753 | (1,145) |
| Comprehensive income (loss) | $6,721 | $5,804 | $(10,779) |

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

**SHORE BANCSHARES, INC.**

CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY

For the Years Ended December 31, 2015, 2014, and 2013

| (Dollars in thousands, except per share data) | Common Stock | Additional Paid In Capital | Retained Earnings | Accumulated Other Comprehensive Income (Loss) | Total Stockholders' Equity |
|---|---|---|---|---|---|
| Balances, January 1, 2013 | $ 85 | $ 32,155 | $ 81,078 | $ 708 | $ 114,026 |
| Net loss | - | - | (9,634 ) | - | (9,634 ) |
| Unrealized loss on available-for-sale securities, net of reclassification adjustment, net of taxes | - | - | - | (2,331 ) | (2,331 ) |
| Unrealized gains on cash flow hedging activities, net of reclassification adjustment, net of taxes | - | - | - | 1,186 | 1,186 |
| Stock-based compensation | - | 52 | - | - | 52 |
| Balances, December 31, 2013 | 85 | 32,207 | 71,444 | (437 ) | 103,299 |
| Net income | - | - | 5,051 | - | 5,051 |
| Unrealized gain on available-for-sale securities, net of reclassification adjustment, net of taxes | - | - | - | 753 | 753 |
| Issuance of common stock through public offering, net | 41 | 31,238 | - | - | 31,279 |
| Stock-based compensation | - | 87 | - | - | 87 |
| Balances, December 31, 2014 | 126 | 63,532 | 76,495 | 316 | 140,469 |
| Net income | - | - | 7,108 | - | 7,108 |
| Unrealized losses on available-for-sale securities, net of taxes | - | - | - | (387 ) | (387 ) |
| Stock-based compensation | - | 283 | - | - | 283 |
| Cash dividends paid | - | - | (506 ) | - | (506 ) |
| Balances, December 31, 2015 | $ 126 | $ 63,815 | $ 83,097 | $ (71 ) | $ 146,967 |

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

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**SHORE BANCSHARES, INC.**

**CONSOLIDATED STATEMENTS OF CASH FLOWS**

For the Years Ended December 31,

| (Dollars in thousands) | 2015 | 2014 | 2013 |
|---|---|---|---|
| CASH FLOWS FROM OPERATING ACTIVITIES: | | | |
| Net income (loss) | $7,108 | $5,051 | $(9,634) |
| Adjustments to reconcile net income (loss) to net cash provided by operating activities: | | | |
| Provision for credit losses | 2,075 | 3,350 | 27,784 |
| Depreciation and amortization | 2,434 | 2,312 | 2,392 |
| Discount accretion on debt securities | (99) | (60) | (43) |
| Stock-based compensation expense | 283 | 87 | 78 |
| Excess tax benefit from stock-based arrangements | (3) | - | (26) |
| Deferred income tax expense (benefit) | 3,874 | 2,836 | (6,132) |
| Gains on sales of investment securities | - | (23) | (913) |
| Losses on disposals of premises and equipment | 18 | 82 | - |
| Losses on sales and write-downs of other real estate owned | 171 | 687 | 1,669 |
| Gain on sale of wholesale insurance subsidiary | - | (114) | - |
| Loss on termination of cash flow hedge | - | - | 1,306 |
| Net changes in: | | | |
| Accrued interest receivable | 205 | (102) | 235 |
| Other assets | (870) | 170 | 4,703 |
| Accrued interest payable | (66) | (53) | (114) |
| Other liabilities | (15) | (1,044) | (1,458) |
| Net cash provided by operating activities | 15,115 | 13,179 | 19,847 |
| CASH FLOWS FROM INVESTING ACTIVITIES: | | | |
| Proceeds from maturities and principal payments of investment securities available for sale | 68,395 | 43,418 | 38,512 |
| Proceeds from sales of investment securities available for sale | - | 988 | 40,351 |
| Proceeds from sales of investment securities held to maturity | - | 113 | - |
| Purchases of investment securities available for sale | (46,102) | (133,006) | (87,243) |
| Proceeds from maturities and principal payments of investment securities held to maturity | 432 | 443 | 439 |
| Net change in loans | (88,595) | (3,982) | 12,957 |
| Proceeds from sale of loans | - | - | 20,565 |
| Purchases of premises and equipment | (1,518) | (2,077) | (545) |
| Proceeds from sales of premises and equipment | - | - | 4 |
| Proceeds from sales of other real estate owned | 2,040 | 1,697 | 5,325 |
| Proceeds from sale of subsidiary | - | 2,878 | - |
| Return of investment unconsolidated subsidiary | - | - | 85 |

| | | | |
|---|---|---|---|
| Net cash (used in) provided by investing activities | (65,348) | (89,528) | 30,450 |
| | | | |
| CASH FLOWS FROM FINANCING ACTIVITIES: | | | |
| Net changes in: | | | |
| Noninterest-bearing deposits | 35,872 | 21,017 | 18,805 |
| Interest-bearing deposits | (9,412) | (5,482) | (134,610) |
| Short-term borrowings | 1,864 | (5,332) | (3,621) |
| Proceeds from issuance of common stock | - | 31,279 | - |
| Excess tax benefit from stock-based arrangements | 3 | - | 26 |
| Common stock dividends paid | (506) | - | - |
| | | | |
| Net cash provided by (used in) financing activities | 27,821 | 41,482 | (119,400) |

**SHORE BANCSHARES, INC.**

**CONSOLIDATED STATEMENTS OF CASH FLOWS (CONTINUED)**

For the Years Ended December 31,

| (Dollars in thousands) | 2015 | 2014 | 2013 |
|---|---|---|---|
| NET DECREASE IN CASH AND CASH EQUIVALENTS | (22,412) | (34,867 ) | (69,103 ) |
| CASH AND CASH EQUIVALENTS AT BEGINNING OF YEAR | 96,223 | 131,090 | 200,193 |
| CASH AND CASH EQUIVALENTS AT END OF YEAR | $73,811 | $96,223 | $131,090 |
| Supplemental cash flow information: | | | |
| Interest paid | $3,413 | $4,300 | $6,589 |
| Income taxes paid | $518 | $243 | $265 |
| Transfers from loans to other real estate owned | $2,773 | $2,295 | $3,071 |
| Transfers from loans to loans held for sale | $- | $- | $23,635 |
| Transfers from loans held for sale to loans | $- | $3,521 | $- |

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

**SHORE BANCSHARES, INC.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

For the Years Ended December 31, 2015, 2014, and 2013

## NOTE 1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

The consolidated financial statements include the accounts of Shore Bancshares, Inc. and its subsidiaries (collectively referred to in these Notes as the "Company"), with all significant intercompany transactions eliminated. The investments in subsidiaries are recorded on the Company's books (Parent only) on the basis of its equity in the net assets of the subsidiaries. The accounting and reporting policies of the Company conform to accounting principles generally accepted in the United States of America ("GAAP"). For purposes of comparability, certain reclassifications have been made to amounts previously reported to conform with the current period presentation.

### Nature of Operations

The Company engages in the banking business through CNB, a Maryland commercial bank with trust powers, and The Talbot Bank of Easton, Maryland, a Maryland commercial bank ("Talbot Bank"). Through December 31, 2010, the Company also engaged in the banking business through The Felton Bank, a Delaware commercial bank ("Felton Bank" and, together with CNB and Talbot Bank, the "Banks"), which was merged into CNB on January 1, 2011. The Company's primary source of revenue is interest earned on commercial, real estate and consumer loans made to customers located on the Delmarva Peninsula. The Company engages in the insurance business through an insurance producer firm, The Avon-Dixon Agency, LLC, ("Avon-Dixon") with two specialty lines, Elliott Wilson Insurance (Trucking) and Jack Martin Associates (Marine); and an insurance premium finance company, Mubell Finance, LLC ("Mubell") (Avon-Dixon and Mubell are collectively referred to as the "Insurance Subsidiaries"). Avon-Dixon and Mubell are wholly-owned subsidiaries of Shore Bancshares, Inc. The Company engages in the trust services business through the trust department at CNB under the trade name Wye Financial & Trust.

### Use of Estimates

The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and the disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

The allowance for credit losses is a material estimate that is particularly susceptible to significant changes in the near term. Management believes that the Company's current allowance for credit losses is sufficient to address the probable losses in the current portfolio. While management uses available information to recognize losses on loans, future additions to the allowance may be necessary based on changes in economic conditions. In addition, various regulatory agencies, as an integral part of their examination processes, periodically review the Company's allowance for credit losses. Such agencies may require the Company to recognize additions to the allowance based on their judgments about information available to them at the time of their examination.

**Investment Securities Available for Sale**

Investment securities available for sale are stated at estimated fair value based on quoted prices. They represent those securities which management may sell as part of its asset/liability management strategy or which may be sold in response to changing interest rates, changes in prepayment risk or other similar factors. Realized gains and losses are recorded in noninterest income and are determined on a trade date basis using the specific identification method. Premiums and discounts are amortized or accreted into interest income using the interest method over the expected lives of the individual securities. Interest and dividends on investment securities are recognized in interest income on an accrual basis. Net unrealized holding gains and losses on these securities are reported as accumulated other comprehensive income, a separate component of stockholders' equity, net of related income taxes. Declines in the fair value of individual available-for-sale securities below their cost that are other than temporary result in write-downs of the individual securities to their fair value and are reflected in earnings as realized losses. Factors affecting the determination of whether an other-than-temporary impairment has occurred include a downgrade of the security by a rating agency, a significant deterioration in the financial condition of the issuer, or a determination that management has the intent to sell the security or will be required to sell the security before recovery of its amortized cost.

**Investment Securities Held to Maturity**

Investment securities held to maturity are stated at cost adjusted for amortization of premiums and accretion of discounts. Purchase premiums and discounts are recognized in interest income using the interest method over the terms of the securities. The Company intends and has the ability to hold such securities until maturity. Declines in the fair value of individual held-to-maturity securities below their cost that are other than temporary result in write-downs of the individual securities to their fair value. Factors affecting the determination of whether an other-than-temporary impairment has occurred include a downgrade of the security by a rating agency, a significant deterioration in the financial condition of the issuer, or a determination that management has the intent to sell the security or will be required to sell the security before recovery of its amortized cost.

**Loans**

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

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

A loan is considered a troubled debt restructuring (“TDR”) if a borrower is experiencing financial difficulties and a creditor has granted a concession. Concessions may include interest rate reductions or below market interest rates, principal forgiveness, restructuring amortization schedules and other actions intended to minimize potential losses. Loans are identified to be restructured when signs of impairment arise such as borrower interest rate reduction request, slowness to pay, or when an inability to repay becomes evident. The terms being offered are evaluated to determine if they are more liberal than those that would be indicated by policy or industry standards for similar, untroubled credits. In those situations where the terms or the interest rates are considered to be more favorable than industry standards or the current underwriting guidelines of the Company’s banking subsidiaries, the loan is classified as a TDR. All loans designated as TDRs are considered impaired loans and may be on either accrual or nonaccrual status. In instances where the loan has been placed on nonaccrual status, six consecutive months of timely payments are required prior to returning the loan to accrual status.

All loans classified as TDRs which are restructured and accrue interest under revised terms require a full and comprehensive review of the borrower’s financial condition, capacity for repayment, realistic assessment of collateral values, and the assessment of risk entered into any workout agreement. Current financial information on the borrower, guarantor, and underlying collateral is analyzed to determine if it supports the ultimate collection of principal and interest. For commercial loans, the cash flows are analyzed, both for the underlying project and globally. For consumer loans, updated salary, credit history and cash flow information is obtained. Current market conditions are also considered. Following a full analysis, the determination of the appropriate loan structure is made. The Company does not participate in any specific government or Company sponsored loan modification programs. All TDR loan agreements are contracts negotiated with each of the borrowers.

**Allowance for Credit Losses**

The allowance for credit losses is maintained at a level believed adequate by management to absorb losses inherent in the loan portfolio as of the balance sheet date and is based on the size and current risk characteristics of the loan portfolio, an assessment of individual problem loans and actual loss experience, current economic events in specific industries and geographical areas, including unemployment levels, and other pertinent factors, including regulatory guidance and general economic conditions and other observable data. Determination of the allowance is inherently subjective as it requires significant estimates, including the amounts and timing of expected future cash flows or collateral value of impaired loans, estimated losses on pools of homogeneous loans that are based on historical loss experience, and consideration of current economic trends, all of which may be susceptible to significant change. Loans, or portions thereof, that are considered uncollectible are charged off against the allowance, while recoveries of amounts previously charged off are credited to the allowance. The criteria for charge offs are addressed in the Bank’s Collections and Workouts Policy. Per the policy, the recognition of the loss of loans or portions of loans will occur when there is a reasonable probability of loss. When the amount of loss can be readily calculated, the loss will be recognized. In cases where an amount cannot be calculated, specific reserves will be maintained. A provision for credit losses is charged to operations based on management’s periodic evaluation of the factors previously mentioned, as well as other pertinent factors. Evaluations are conducted at least quarterly and more often if deemed necessary.

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

The allowance for credit losses is comprised of three parts: (i) the specific allowance; (ii) the formula allowance; and (iii) the unallocated allowance. The specific allowance is established against impaired loans (i.e., nonaccrual loans and accruing TDRs) until charge offs are made. The formula allowance, described below, is determined based on management’s assessment of industry trends and economic factors in the markets in which we operate. The determination of the formula allowance involves a higher risk of uncertainty and considers current risk factors that may not have yet manifested themselves in our historical loss factors. The unallocated allowance captures losses that have impacted the portfolio but have yet to be recognized in either the specific or formula allowance.

The formula allowance is used to estimate the loss on internally risk-rated loans, exclusive of those identified as impaired. Loans are grouped by type (construction, residential real estate, commercial real estate, commercial or consumer). Each loan type is assigned allowance factors based on management’s estimate of the risk, complexity and size of individual loans within a particular category. Loans that are identified as special mention, substandard and doubtful are adversely rated. These loans are assigned higher allowance factors than favorably rated loans due to management’s concerns regarding collectability or management’s knowledge of particular elements regarding the borrower. A special mention loan has potential weaknesses that could result in a future loss to the Company if the weaknesses are realized. A substandard loan has certain deficiencies that could result in a future loss to the Company if these deficiencies are not corrected. A doubtful loan has enough risk that there is a high probability that the Company will sustain a loss.

Premises and Equipment

Premises and equipment are stated at cost less accumulated depreciation and amortization. Depreciation and amortization are calculated using the straight-line method over the estimated useful lives of the assets. Useful lives range from three to 10 years for furniture, fixtures and equipment; three to five years for computer hardware and data handling equipment; and 10 to 40 years for buildings and building improvements. Land improvements are amortized over a period of 15 years and leasehold improvements are amortized over the term of the respective lease. Sale-leaseback transactions are considered normal leasebacks and any realized gains are deferred and amortized to other income on a straight-line basis over the initial lease term. Maintenance and repairs are charged to expense as incurred, while improvements which extend the useful life of an asset are capitalized and depreciated over the estimated remaining life of the asset.

Long-lived assets are evaluated periodically for impairment when events or changes in circumstances indicate the carrying amount may not be recoverable. Impairment exists when the expected undiscounted future cash flows of a long-lived asset are less than its carrying value. In that event, the Company recognizes a loss for the difference between the carrying amount and the estimated fair value of the asset.

**Goodwill and Other Intangible Assets**

Goodwill represents the excess of the cost of an acquisition over the fair value of the net assets acquired. Other intangible assets represent purchased assets that also lack physical substance but can be distinguished from goodwill because of contractual or other legal rights or because the asset is capable of being sold or exchanged either on its own or in combination with a related contract, asset or liability. Goodwill and other intangible assets with indefinite lives are tested at least annually for impairment, usually during the third quarter, or on an interim basis if circumstances dictate. Intangible assets that have finite lives are amortized over their estimated useful lives and also are subject to impairment testing. The Company’s other intangible assets that have finite lives are amortized on a straight-line basis over varying periods not exceeding 21 years.

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

During the third quarter of 2015 and 2014, goodwill and other intangible assets were subjected to the annual assessment for impairment. As a result of the assessment, it was determined that it was not more likely than not that the fair values of the Company’s reporting units were less than their carrying amounts so no impairment was recorded.

**Other Real Estate Owned**

Other real estate owned represents assets acquired in satisfaction of loans either by foreclosure or deeds taken in lieu of foreclosure. Properties acquired are recorded at fair value less estimated selling costs at the time of acquisition, establishing a new cost basis. Thereafter, costs incurred to operate or carry the properties as well as reductions in value as determined by periodic appraisals are charged to operating expense. Gains and losses resulting from the final disposition of the properties are included in noninterest income.

**Short-Term Borrowings**

Short-term borrowings are comprised primarily of repurchase agreements. The repurchase agreements are securities sold to the Company's customers, at the customers' request, under a continuing "roll-over" contract that matures in one business day. The underlying securities sold are U.S. Government agency securities, which are segregated from the Company's other investment securities by its safekeeping agents.

**Income Taxes**

Shore Bancshares, Inc. and its subsidiaries file a consolidated federal income tax return. The Company accounts for income taxes using the liability method in accordance with required accounting guidance. Under this method, deferred tax assets and liabilities are determined by applying the applicable federal and state income tax rates to cumulative temporary differences. These temporary differences represent differences between financial statement carrying amounts and the corresponding tax bases of certain assets and liabilities. Deferred taxes result from such temporary differences.

Deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in the period that includes the enactment date. A valuation allowance, if needed, reduces deferred tax assets to the expected amount most likely to be realized. Realization of deferred tax assets is dependent on the generation of a sufficient level of future taxable income, recoverable taxes paid in prior years and tax planning strategies.

The Company recognizes accrued interest and penalties as a component of tax expense. The Company does not have any uncertain tax positions and did not recognize any adjustments for unrecognized tax benefits. The Company remains subject to examination for income tax returns ending after December 31, 2012.

Basic and Diluted Earnings Per Common Share

Basic earnings (loss) per share is calculated by dividing net income (loss) available to common stockholders by the weighted-average number of common shares outstanding and does not include the effect of any potentially dilutive common stock equivalents. Diluted earnings (loss) per share is calculated by dividing net income (loss) by the weighted-average number of shares outstanding, adjusted for the effect of any potentially dilutive common stock equivalents. There is no dilutive effect on the loss per share during loss periods.

Transfers of Financial Assets

Transfers of financial assets are accounted for as sales, when control over the assets has been surrendered. Control over transferred assets is deemed to be surrendered when (i) the assets have been isolated from the Company, (ii) the transferee obtains the right (free of conditions that constrain it from taking advantage of that right) to pledge or exchange the transferred assets, and (iii) the Company does not maintain effective control over the transferred assets through an agreement to repurchase them before their maturity.

**Statement of Cash Flows**

Cash and due from banks, interest-bearing deposits with other banks and federal funds sold are considered "cash and cash equivalents" for financial reporting purposes.

**Stock-Based Compensation**

Accounting guidance for stock-based compensation requires that expense relating to such transactions be recognized as compensation cost in the income statement. Stock-based compensation expense is recognized ratably over the requisite service period for all awards and is based on the grant date fair value. See Note 12 for a further discussion.

**Derivative Instruments and Hedging Activities**

Under accounting guidance for derivative instruments and hedging activities, all derivatives are recorded as other assets or other liabilities on the balance sheet at their respective fair values. When the purpose of a derivative is to hedge the variability of a floating rate asset or liability, the derivative is considered a "cash flow" hedge. To account for the effective portion of a cash flow hedge, unrealized gains and losses due to changes in the fair value of the derivative designated as a cash flow hedge are recorded in other comprehensive income. Ineffectiveness resulting from differences between the cash flows of the hedged item and changes in fair value of the derivative is recognized as other noninterest income. The net interest settlement on a derivative designated as a cash flow hedge is treated as an adjustment of the interest income or interest expense of the hedged asset or liability.

**Fair Value**

The Company measures certain financial assets and liabilities at fair value. Significant financial instruments measured at fair value on a recurring basis are investment securities. Impaired loans and other real estate owned are significant financial instruments measured at fair value on a nonrecurring basis. See Note 20 for a further discussion of fair value.

**Advertising Costs**

Advertising costs are generally expensed as incurred. The Company incurred advertising costs of approximately $495 thousand, $428 thousand and $848 thousand for the years ended December 31, 2015, 2014, and 2013, respectively.

**Recent Accounting Standards**

*ASU 2014-04, "Receivables (ASC Topic 310) – Troubled Debt Restructurings by Creditors, Reclassification of Residential Real Estate Collateralized Consumer Mortgage Loans upon Foreclosure."* ASU 2014-04 clarifies when an in substance repossession or foreclosure occurs which is defined as when a creditor should be considered to have received physical possession of residential real estate property collateralizing a consumer mortgage loan such that the loan receivable should be derecognized and the real estate property recognized. The ASU requires that the real property be recognized upon obtaining legal title to the real estate collateral, or the borrower voluntarily conveying all interest in the real estate property to the lender to satisfy the loan through a deed in lieu of foreclosure or similar legal agreement. ASU 2014-04 is effective for the Company for interim and annual periods beginning after December 15, 2014 and did not have a significant impact on the Company's financial statements.

*Accounting Standards Update ("ASU") 2014-14, "Receivables – Troubled Debt Restructurings by Creditors (Accounting Standards Codification ("ASC") Subtopic 310-40) – Classification of Certain Government-Guaranteed Mortgage Loans upon Foreclosure."* ASU 2014-14 the Financial Accounting Standards Board ("FASB") issued an amendment to clarify how creditors are to classify certain government-guaranteed mortgage loans upon foreclosure. This amendment requires that a mortgage loan be derecognized and a separate other receivable be recognized upon foreclosure if the following conditions are met: (1) The loan has a government guarantee that is not separate from the loan before foreclosure and (2) at the time of foreclosure, the creditor has the intent to convey the real estate property to the guarantor and make a claim on the guarantee, and the creditor has the ability to recover under the claim and (3) at the time of foreclosure, any amount of the claim that is determined on the basis of the fair value of the real estate is fixed. Upon foreclosure, the separate other receivable should be measured based on the amount of the loan balance (principal and interest) expected to be recovered from the guarantor. This amendment is effective for annual reporting periods, including interim periods within those annual periods, beginning after December 15, 2014. Early adoption is permitted. Entities may apply the amendments in this Update either (a) prospectively to foreclosures that occur after the date of adoption or (b) modified retrospective transition using a cumulative-effect adjustment (through a reclassification to a separate other receivable) as of the beginning of the annual period of adoption. Prior periods should not be adjusted. The Company adopted ASU No. 2014-14 effective January 1, 2015. The adoption of ASU No. 2014-14 did not have a material impact on the Company's Consolidated Financial Statements.

*ASU 2014-09, "Revenue from Contracts with Customers (Topic 606)"* – ASU 2014-09 amendment requires entities to recognize revenue to depict the transfer of promised goods or services to customers in amounts that reflect the consideration to which the entity expects to be entitled in exchange for those goods or services. ASU 2014-09 is effective for periods beginning after January 1, 2017. ASU 2015-14, "*Revenue from Contracts with Customers (Topic 606) Deferral of the Effective Date*" – ASU 2015-14 amendments defer the effective date of Update 2014-09 for all entities by one year. Public business entities, certain not-for-profit entities, and certain employee benefit plans should apply the guidance in ASU 2014-09 to annual reporting periods beginning after December 15, 2017, including interim reporting periods within that reporting period. Earlier application is permitted only as of annual reporting periods beginning after December 15, 2016, including interim reporting periods within that reporting period. The Company is evaluating the impact that ASU 2014-09 will have on our consolidated financial statements.

ASU 2014-12, *"Accounting for Share-Based Payments When the Terms of an Award Provide That a Performance Target Could Be Achieved after the Requisite Service Period."* The amendments in the ASU require that a performance target that affects vesting and that could be achieved after the requisite service period be treated as a performance condition. A reporting entity should apply existing guidance in Topic 718, *Compensation - Stock Compensation*, as it relates to awards with performance conditions that affect vesting to account for such awards. The performance target should not be reflected in estimating the grant-date fair value of the award. However, compensation cost should be recognized in the period in which it becomes probable that the performance target will be achieved and should represent the compensation cost attributable to the period(s) for which the requisite service has already been rendered. If the performance target becomes probable of being achieved before the end of the requisite service period, the remaining unrecognized compensation cost should be recognized prospectively over the remaining requisite service period. The total amount of compensation cost recognized during and after the requisite service period should reflect the number of awards that are expected to vest and should be adjusted to reflect those awards that ultimately vest. The requisite service period ends when the employee can cease rendering service and still be eligible to vest in the award if the performance target is achieved. The amendments in this ASU are effective for interim or annual reporting periods beginning after December 15, 2015; early adoption is permitted. Entities may apply the amendments in this ASU either: (1) prospectively to all awards granted or modified after the effective date; or (2) retrospectively to all awards with performance targets that are outstanding as of the beginning of the earliest annual period presented in the financial statements and to all new or modified awards thereafter. As of December 31, 2015, the Company has share-based payment awards that included performance targets that could be achieved after the requisite service period. The adoption of ASU No. 2014-12 did not have a material impact on the Company's Consolidated Financial Statements.

ASU No. 2015-05, *"Customer's Accounting for Fees Paid in a Cloud Computing Arrangement."* This ASU provides guidance to customers about whether a cloud computing arrangement includes a software license. If a cloud computing arrangement includes a software license, the customer should account for the software license element of the arrangement consistent with the acquisition of other software licenses. If a cloud computing arrangement does not include a software license, the customer should account for the arrangement as a service contract. The new guidance does not change the accounting for a customer's accounting for service contracts. ASU No. 2015-05 is effective for interim and annual reporting periods beginning after December 15, 2015. The Company is currently evaluating the provisions of ASU No. 2015-05 to determine the potential impact the new standard will have on the Company's Consolidated Financial Statements.

ASU No. 2016-1, *"Financial Instruments – Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities.* This ASU, among other things, (i) requires equity investments, with certain exceptions, to be measured at fair value with changes in fair value recognized in net income, (ii) simplifies the impairment assessment of equity investments without readily determinable fair values by requiring a qualitative assessment to identify impairment, (iii) eliminates the requirement for public business entities to disclose the methods and significant assumptions used to estimate the fair value that is required to be disclosed for financial instruments measured at amortized cost on the balance sheet, (iv) requires public business entities to use the exit price notion when measuring the fair value of financial instruments for disclosure purposes, (v) requires an entity to present separately in other comprehensive income the portion of the total change in the fair value of a liability resulting from a change in the instrument-specific credit risk when the entity has elected to measure the liability at fair value in accordance with the fair value option for financial instruments, (vi) requires separate presentation of financial assets and financial liabilities by measurement category and form of financial asset on the balance sheet or the accompanying notes to the financial statements and (viii) clarifies that an entity should evaluate the need for a valuation allowance on a deferred tax asset related to available-for-sale. ASU 2016-1 will be effective for us on January 1, 2018 and is not expected to have a significant impact on our financial statements.

**Regulatory Enforcement Actions**

Talbot Bank entered into a Stipulation and Consent to the Issuance of a Consent Order (the "Consent Agreement") with the Federal Deposit Insurance Corporation (the "FDIC"), a Stipulation and Consent to the Issuance of a Consent Order (the "Maryland Consent Agreement" and together with the Consent Agreement, the "Consent Agreements") with the Maryland Commissioner of Financial Regulation (the "Commissioner") and an Acknowledgement of Adoption of the Order by the Commissioner (the "Acknowledgement"). The FDIC and the Commissioner issued the related Consent Order (the "Order"), effective May 24, 2013. On May 11, 2015 the FDIC and the Commissioner terminated the Order.

While the Order has been terminated, Talbot Bank will be required to continue to adhere to certain requirements and restrictions based on commitments made to the FDIC and the Commissioner in connection with the termination of the Order, which include, among other things, continued reduction of classified assets and maintenance of capital in excess of regulatory minimums.

**NOTE 2. INVESTMENT SECURITIES**

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

| (Dollars in thousands) | Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses | Estimated Fair Value |
|---|---|---|---|---|
| Available-for-sale securities: | | | | |
| December 31, 2015: | | | | |
| U.S. Treasury | $ 5,078 | $ 1 | $ - | $ 5,079 |
| U.S. Government agencies | 49,630 | 89 | 190 | 49,529 |
| Residential mortgage-backed | 156,939 | 639 | 662 | 156,916 |
| Equity | 637 | 4 | - | 641 |
| Total | $ 212,284 | $ 733 | $ 852 | $ 212,165 |
| | | | | |
| December 31, 2014: | | | | |
| U.S. Treasury | $ 5,210 | $ 5 | $ - | $ 5,215 |
| U.S. Government agencies | 75,220 | 87 | 347 | 74,960 |
| Residential mortgage-backed | 154,525 | 1,230 | 452 | 155,303 |
| Equity | 624 | 6 | - | 630 |
| Total | $ 235,579 | $ 1,328 | $ 799 | $ 236,108 |
| | | | | |
| Held-to-maturity securities: | | | | |
| December 31, 2015: | | | | |
| U.S. Government agencies | $ 2,575 | $ - | $ 60 | $ 2,515 |
| States and political subdivisions | 1,616 | 112 | - | 1,728 |
| Total | $ 4,191 | $ 112 | $ 60 | $ 4,243 |
| | | | | |
| December 31, 2014: | | | | |
| U.S. Government agencies | $ 2,791 | $ - | $ 83 | $ 2,708 |
| States and political subdivisions | 1,839 | 147 | - | 1,986 |
| Total | $ 4,630 | $ 147 | $ 83 | $ 4,694 |

The following table provides information about gross unrealized losses and fair value by length of time that the individual securities have been in a continuous unrealized loss position at December 31, 2015.

| | Less than 12 Months | | More than 12 Months | | Total | |
|---|---|---|---|---|---|---|
| (Dollars in thousands) | Fair Value | Unrealized Losses | Fair Value | Unrealized Losses | Fair Value | Unrealized Losses |

| | | | | | | |
|---|---|---|---|---|---|---|
| Available-for-sale securities: | | | | | | |
| December 31, 2015 | | | | | | |
| U.S. Government agencies | $18,981 | $ 57 | $- | $ 133 | $18,981 | $ 190 |
| Residential mortgage-backed | 43,881 | 328 | 21,263 | 334 | 65,144 | 662 |
| Total | $62,862 | $ 385 | $21,263 | $ 467 | $84,125 | $ 852 |
| Held-to-maturity securities: | | | | | | |
| U.S. Government agencies | $- | $ - | $2,515 | $ 60 | $2,515 | $ 60 |

| (Dollars in thousands) | Less than 12 Months | | More than 12 Months | | Total | |
|---|---|---|---|---|---|---|
| | Fair Value | Unrealized Losses | Fair Value | Unrealized Losses | Fair Value | Unrealized Losses |
| Available-for-sale securities: | | | | | | |
| December 31, 2014 | | | | | | |
| U.S. Government agencies | $41,574 | $ 138 | $6,954 | $ 209 | $48,528 | $ 347 |
| Residential mortgage-backed | 12,933 | 44 | 26,828 | 408 | 39,761 | 452 |
| Total | $54,507 | $ 182 | $33,782 | $ 617 | $88,289 | $ 799 |
| Held-to-maturity securities: | | | | | | |
| U.S. Government agencies | $- | $ - | $2,708 | $ 83 | $2,708 | $ 83 |

All of the securities with unrealized losses in the portfolio have modest duration risk, low credit risk, and minimal losses when compared to total amortized cost. The unrealized losses on debt securities that exist are the result of market changes in interest rates since original purchase. Because the Company does not intend to sell these securities and it is not more likely than not that the Company will be required to sell these securities before recovery of their amortized cost bases, which may be at maturity for debt securities, the Company considers the unrealized losses to be temporary.

The following table provides information on the amortized cost and estimated fair values of investment securities by maturity date at December 31, 2015.

| | Available for sale | | Held to maturity | |
|---|---|---|---|---|
| (Dollars in thousands) | Amortized Cost | Estimated Fair Value | Amortized Cost | Estimated Fair Value |
| Due in one year or less | $ 14,695 | $ 14,703 | $ - | $ - |
| Due after one year through five years | 37,114 | 37,092 | 711 | 751 |
| Due after five years through ten years | 11,319 | 11,270 | 403 | 448 |
| Due after ten years | 148,519 | 148,459 | 3,077 | 3,044 |
| | 211,647 | 211,524 | 4,191 | 4,243 |
| Equity securities | 637 | 641 | - | - |
| Total | $ 212,284 | $ 212,165 | $ 4,191 | $ 4,243 |

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

The following table sets forth the amortized cost and estimated fair values of securities which have been pledged as collateral for obligations to federal, state and local government agencies, and other purposes as required or permitted by law, or sold under agreements to repurchase. All pledged securities are in the available-for-sale investment portfolio.

| | December 31, 2015 | | December 31, 2014 | |
|---|---|---|---|---|
| (Dollars in thousands) | Amortized Cost | Estimated Fair Value | Amortized Cost | Estimated Fair Value |
| Pledged available-for-sale securities | $ 121,142 | $ 121,207 | $ 115,162 | $ 115,458 |

There were no obligations of states or political subdivisions with carrying values, as to any issuer, exceeding 10% of stockholders' equity at December 31, 2015 or 2014.

Proceeds from sales of investment securities were $0, $988 thousand, and $40.4 million for the years ended December 31, 2015, 2014, and 2013, respectively. Gross gains from sales of investment securities were $0, $23 thousand and $913 thousand for the years ended December 31, 2015, 2014, and 2013, respectively. There were no gross losses in 2015, 2014 and 2013.

NOTE 3. LOANS AND ALLOWANCE FOR CREDIT LOSSES

The Company makes residential mortgage, commercial and consumer loans to customers primarily in Talbot County, Queen Anne's County, Kent County, Caroline County and Dorchester County in Maryland and in Kent County, Delaware. The following table provides information about the principal classes of the loan portfolio at December 31, 2015 and 2014.

| (Dollars in thousands) | 2015 | 2014 |
|---|---|---|
| Construction | $85,632 | $69,157 |
| Residential real estate | 307,063 | 273,336 |
| Commercial real estate | 330,253 | 305,788 |
| Commercial | 64,911 | 52,671 |
| Consumer | 7,255 | 9,794 |
| Total loans | 795,114 | 710,746 |
| Allowance for credit losses | (8,316 ) | (7,695 ) |
| Total loans, net | $786,798 | $703,051 |

In the normal course of banking business, loans are made to officers and directors and their affiliated interests. These loans are made on substantially the same terms and conditions as those prevailing at the time for comparable transactions with persons who are not related to the Company and are not considered to involve more than the normal risk of collectibility. As of December 31, 2015 and 2014, such loans outstanding, both direct and indirect (including guarantees), to directors, their associates and policy-making officers, totaled approximately $22.0 million and $18.7 million, respectively. During 2015 and 2014, loan additions were approximately $5.5 million and $1.8 million, respectively, and loan repayments were approximately $2.4 million and $6.2 million, respectively.

In the normal course of banking business, risks related to specific loan categories are as follows:

Construction loans – Construction loans generally finance the construction of residential real estate for builders and individuals for single family dwellings. In addition, the bank periodically finances the construction of commercial projects. Credit risk factors include the borrower's ability to successfully complete the construction on time and within budget, changing market conditions which could affect the value and marketability of projects, changes in the borrower's ability or willingness to repay the loan and potentially rising interest rates which can impact both the borrower's ability to repay and the collateral value.

Residential real estate – Residential real estate loans are typically made to consumers and are secured by residential real estate. Credit risk arises from the borrower's continuing financial stability, which can be adversely impacted by job loss, divorce, illness, or personal bankruptcy, among other factors. Also impacting credit risk would be a shortfall in the value of the residential real estate in relation to the outstanding loan balance in the event of a default or subsequent liquidation of the real estate collateral.

Commercial real estate – Commercial real estate loans consist of both loans secured by owner occupied properties and non-owner occupied where an established banking relationship exists and involves investment properties for warehouse, retail, and office space with a history of occupancy and cash flow. These loans are subject to adverse changes in the local economy and commercial real estate markets. Credit risk associated with owner occupied properties arises from the borrower's financial stability and the ability of the borrower and the business to repay the loan. Non-owner occupied properties carry the risk of a tenant's deteriorating credit strength, lease expirations in soft markets and sustained vacancies which can adversely impact cash flow.

Commercial – Commercial loans are secured or unsecured loans for business purposes. Loans are typically secured by accounts receivable, inventory, equipment and/or other assets of the business. Credit risk arises from the successful operation of the business which may be affected by competition, rising interest rates, regulatory changes and adverse conditions in the local and regional economy.

Consumer – Consumer loans include home equity loans and lines, installment loans and personal lines of credit. Credit risk is similar to residential real estate loans above as it is subject to the borrower's continuing financial stability and the value of the collateral securing the loan.

The following tables include impairment information relating to loans and the allowance for credit losses as of December 31, 2015 and 2014.

| (Dollars in thousands) | Construction | Residential real estate | Commercial real estate | Commercial | Consumer | Unallocated | Total |
|---|---|---|---|---|---|---|---|
| December 31, 2015 | | | | | | | |
| Loans individually evaluated for impairment | $ 11,598 | $ 7,945 | $ 7,762 | $ 161 | $ 122 | $ - | $ 27,588 |
| Loans collectively evaluated for impairment | 74,034 | 299,118 | 322,491 | 64,750 | 7,133 | - | 767,526 |
| Total loans | $ 85,632 | $ 307,063 | $ 330,253 | $ 64,911 | $ 7,255 | $ - | $ 795,114 |
| | | | | | | | |
| Allowance for credit losses allocated to: | | | | | | | |
| Loans individually evaluated for impairment | $ 619 | $ 435 | $ 340 | $ - | $ 7 | $ - | $ 1,401 |
| Loans collectively evaluated for impairment | 1,027 | 1,746 | 2,659 | 558 | 149 | 776 | 6,915 |
| Total allowance for credit losses | $ 1,646 | $ 2,181 | $ 2,999 | $ 558 | $ 156 | $ 776 | $ 8,316 |

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| (Dollars in thousands) | Construction | Residential real estate | Commercial real estate | Commercial | Consumer | Unallocated | Total |
|---|---|---|---|---|---|---|---|
| December 31, 2014 | | | | | | | |
| Loans individually evaluated for impairment | $ 10,067 | $ 10,403 | $ 9,359 | $ 188 | $ 124 | $ - | $ 30,141 |
| Loans collectively evaluated for impairment | 59,090 | 262,933 | 296,429 | 52,483 | 9,670 | - | 680,605 |
| Total loans | $ 69,157 | $ 273,336 | $ 305,788 | $ 52,671 | $ 9,794 | $ - | $ 710,746 |
| | | | | | | | |
| Allowance for credit losses allocated to: | | | | | | | |
| Loans individually evaluated for impairment | $ 41 | $ 1,099 | $ 129 | $ 1 | $ 3 | $ - | $ 1,273 |
| Loans collectively evaluated for impairment | 1,262 | 1,735 | 2,250 | 447 | 226 | 502 | 6,422 |
| Total allowance for credit losses | $ 1,303 | $ 2,834 | $ 2,379 | $ 448 | $ 229 | $ 502 | $ 7,695 |

The following tables provide information on impaired loans and any related allowance by loan class as of December 31, 2015 and 2014. The difference between the unpaid principal balance and the recorded investment is the amount of partial charge-offs that have been taken.

| (Dollars in thousands) | Unpaid principal balance | Recorded investment with no allowance | Recorded investment with an allowance | Related allowance | Average recorded investment | Interest income recognized |
|---|---|---|---|---|---|---|
| December 31, 2015 | | | | | | |
| Impaired nonaccrual loans: | | | | | | |
| Construction | $ 11,850 | $ 4,647 | $ 2,882 | $ 588 | $ 8,176 | $ - |
| Residential real estate | 2,563 | 1,773 | 487 | 208 | 2,767 | - |
| Commercial real estate | 2,988 | 1,813 | 209 | 9 | 2,159 | - |
| Commercial | 175 | 161 | - | - | 126 | - |
| Consumer | 128 | 98 | 23 | 7 | 122 | - |
| Total | 17,704 | 8,492 | 3,601 | 812 | 13,350 | - |
| | | | | | | |
| Impaired accruing TDRs: | | | | | | |
| Construction | 4,069 | 3,266 | 803 | 31 | 4,080 | 84 |
| Residential real estate | 5,686 | 2,380 | 3,306 | 227 | 6,947 | 312 |
| Commercial real estate | 5,740 | 1,702 | 4,038 | 331 | 5,943 | 254 |
| Commercial | - | - | - | - | 27 | 1 |
| Consumer | - | - | - | - | - | - |
| Total | 15,495 | 7,348 | 8,147 | 589 | 16,997 | 651 |
| | | | | | | |
| Total impaired loans: | | | | | | |
| Construction | 15,919 | 7,913 | 3,685 | 619 | 12,256 | 84 |
| Residential real estate | 8,249 | 4,153 | 3,793 | 435 | 9,714 | 312 |

| | | | | | | |
|---|---|---|---|---|---|---|
| Commercial real estate | 8,728 | 3,515 | 4,247 | 340 | 8,102 | 254 |
| Commercial | 175 | 161 | - | - | 153 | 1 |
| Consumer | 128 | 98 | 23 | 7 | 122 | - |
| Total | $ 33,199 | $ 15,840 | $ 11,748 | $ 1,401 | $ 30,347 | $ 651 |

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| (Dollars in thousands) | Unpaid principal balance | Recorded investment with no allowance | Recorded investment with an allowance | Related allowance | Average recorded investment | Interest income recognized |
|---|---|---|---|---|---|---|
| December 31, 2014 | | | | | | |
| Impaired nonaccrual loans: | | | | | | |
| Construction | $ 9,277 | $ 6,045 | $ - | $ - | $ 7,739 | $ - |
| Residential real estate | 4,664 | 1,053 | 2,982 | 799 | 3,322 | - |
| Commercial real estate | 4,703 | 2,842 | 280 | 100 | 3,889 | - |
| Commercial | 1,372 | 136 | 5 | 1 | 437 | - |
| Consumer | 129 | 99 | 25 | 3 | 79 | - |
| Total | 20,145 | 10,175 | 3,292 | 903 | 15,466 | - |
| | | | | | | |
| Impaired accruing TDRs: | | | | | | |
| Construction | 4,022 | 3,196 | 826 | 41 | 2,743 | 68 |
| Residential real estate | 6,368 | 668 | 5,700 | 300 | 15,123 | 372 |
| Commercial real estate | 6,237 | 4,774 | 1,463 | 29 | 6,574 | 254 |
| Commercial | 47 | 47 | - | - | 55 | 2 |
| Consumer | - | - | - | - | - | - |
| Total | 16,674 | 8,685 | 7,989 | 370 | 24,495 | 696 |
| | | | | | | |
| Total impaired loans: | | | | | | |
| Construction | 13,299 | 9,241 | 826 | 41 | 10,482 | 68 |
| Residential real estate | 11,032 | 1,721 | 8,682 | 1,099 | 18,445 | 372 |
| Commercial real estate | 10,940 | 7,616 | 1,743 | 129 | 10,463 | 254 |
| Commercial | 1,419 | 183 | 5 | 1 | 492 | 2 |
| Consumer | 129 | 99 | 25 | 3 | 79 | - |
| Total | $ 36,819 | $ 18,860 | $ 11,281 | $ 1,273 | $ 39,961 | $ 696 |

The following tables provide a roll-forward for troubled debt restructurings as of December 31, 2015 and December 31, 2014.

| (Dollars in thousands) | 1/1/15 TDR Balance | New TDRs | Disbursements (Payments) | Charge offs | Reclassification/ Transfers In/(Out) | Payoffs | 12/31/15 TDR Balance | Related Allowance |
|---|---|---|---|---|---|---|---|---|
| For the year ended 12/31/2015 | | | | | | | | |
| Accruing TDRs | | | | | | | | |
| Construction | $4,022 | $- | $ (95) | $- | $ 142 | $ - | $4,069 | $ 31 |
| Residential Real Estate | 6,368 | 1,837 | (1,195) | - | (1,324) | - | 5,686 | 227 |
| Commercial Real Estate | 6,237 | - | (497) | - | - | - | 5,740 | 331 |
| Commercial | 47 | - | (6) | - | (41) | - | - | - |
| Consumer | - | - | - | - | - | - | - | - |
| Total | $16,674 | $1,837 | $ (1,793) | $- | $ (1,223) | $ - | $15,495 | $ 589 |
| | | | | | | | | |
| Nonaccrual TDRs | | | | | | | | |
| Construction | $3,321 | $- | $ (214) | $(1,058) | $ 2,911 | $ - | $4,960 | $ 588 |
| Residential Real Estate | 3,382 | - | (26) | - | (2,911) | - | 445 | 141 |
| Commercial Real Estate | 346 | - | (4) | (40) | (302) | - | - | - |
| Commercial | - | - | - | - | - | - | - | - |
| Consumer | 25 | - | (2) | - | - | - | 23 | 7 |
| Total | $7,074 | $- | $ (246) | $(1,098) | $ (302) | $ - | $5,428 | $ 736 |
| | | | | | | | | |
| Total TDRs | $23,748 | $1,837 | $ (2,039) | $(1,098) | $ *(1,525) | $ - | $20,923 | $ 1,325 |

| (Dollars in thousands) | 1/1/14 TDR Balance | New TDRs | Disbursements (Payments) | Charge offs | Reclassification/ Transfers In/(Out) | Payoffs | 12/31/14 TDR Balance | Related Allowance |
|---|---|---|---|---|---|---|---|---|
| For the year ended 12/31/2014 | | | | | | | | |
| Accruing TDRs | | | | | | | | |
| Construction | $1,620 | $ - | $ (186) | $ (538) | $ 3,396 | $(270) | $4,022 | $ 41 |
| Residential Real Estate | 14,582 | - | (1,150) | (3,614) | (3,136) | (314) | 6,368 | 300 |
| Commercial Real Estate | 9,791 | - | (99) | (549) | (1,805) | (1,101) | 6,237 | 29 |
| Commercial | 95 | - | (24) | - | - | (24) | 47 | - |
| Consumer | - | - | - | - | - | - | - | - |
| Total | $26,088 | $ - | $ (1,459) | $ (4,701) | $ (1,545) | $(1,709) | $16,674 | $ 370 |
| | | | | | | | | |
| Nonaccrual TDRs | | | | | | | | |
| Construction | $3,561 | $ - | $ (12) | $ (235) | $ 7 | $- | $3,321 | $ - |
| Residential Real Estate | 1,884 | - | (50) | (203) | 1,874 | (123) | 3,382 | 724 |
| Commercial Real Estate | 842 | - | (95) | (65) | (336) | - | 346 | 100 |
| Commercial | - | - | - | - | - | - | - | - |
| Consumer | 26 | - | (1) | - | - | - | 25 | 3 |

| | | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| Total | $6,313 | $ - | $ (158 ) | $ (503 ) | $ 1,545 | $(123 ) | $7,074 | $ 827 |
| Total TDRs | $32,401 | $ - | $ (1,617 ) | $ (5,204 ) | $ - | $(1,832) | $23,748 | $ 1,197 |

* $1.3 million in subsequently modified TDRs were transferred from accruing TDR classification to accrual status during the third quarter of 2015, thus removing the TDR designation. In accordance with ASC 310-40-50-2 “Creditor Disclosure of Troubled Debt Restructurings,” an impaired loan that has been subsequently restructured in a troubled debt restructuring involving modification of terms need not be included in the disclosures in years after the restructuring if both of the following conditions exist: a) the subsequent restructuring agreement specifies an interest rate equal to or greater than the rate that the creditor was willing to accept at the time of the restructuring for a new loan with comparable risk; and b) the loan is not impaired based on the terms specified by the restructuring agreement. During the period ended December 31, 2015, three loans totaling $1.3 million met the conditions stipulated in

ASC 310-40-50-2, and after a careful evaluation of well supported documentation by management, these loans were upgraded to accrual status.

The following tables provide information on loans that were modified and considered TDRs during 2015 and 2014.

| (Dollars in thousands) | Number of contracts | Premodification outstanding recorded investment | Postmodification outstanding recorded investment | Related allowance |
|---|---|---|---|---|
| TDRs: | | | | |
| For the year ended December 31, 2015 | | | | |
| Construction | - | $ - | $ - | $ - |
| Residential real estate | 10 | 1,835 | 1,837 | 19 |
| Commercial real estate | 1 | 2,262 | 2,347 | - |
| Commercial | - | - | - | - |
| Consumer | - | - | - | - |
| Total | 11 | $ 4,097 | $ 4,184 | $ 19 |
| | | | | |
| For the year ended December 31, 2014 | | | | |
| Construction | - | $ - | $ - | $ - |
| Residential real estate | - | - | - | - |
| Commercial real estate | - | - | - | - |
| Commercial | - | - | - | - |
| Consumer | - | - | - | - |
| Total | - | $ - | $ - | $ - |

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The following tables provide information on TDRs that defaulted during 2015 and 2014. Generally, a loan is considered in default when principal or interest is past due 90 days or more.

| (Dollars in thousands) | Number of contracts | Recorded investment | Related allowance |
|---|---|---|---|
| TDRs that subsequently defaulted: | | | |
| For the year ended December 31, 2015 | | | |
| Construction | - | $ - | $ - |
| Residential real estate | - | - | - |
| Commercial real estate | 2 | 279 | - |
| Commercial | - | - | - |
| Consumer | - | - | - |
| Total | 2 | $ 279 | $ - |
| | | | |
| TDRs that subsequently defaulted: | | | |
| For the year ended December 31, 2014 | | | |
| Construction | - | $ - | $ - |
| Residential real estate | - | - | - |
| Commercial real estate | - | - | - |
| Commercial | - | - | - |
| Consumer | - | - | - |
| Total | - | $ - | $ - |

Management uses risk ratings as part of its monitoring of the credit quality in the Company's loan portfolio. Loans that are identified as special mention, substandard or doubtful are adversely rated. They are assigned higher risk ratings than favorably rated loans in the calculation of the formula portion of the allowance for credit losses. At December 31, 2015, there were no nonaccrual loans classified as special mention or doubtful and $12.1 million of nonaccrual loans were identified as substandard. The comparable amounts at December 31, 2014 were special mention $0, substandard $13.4 million and doubtful $89 thousand, respectively.

The following tables provide information on loan risk ratings as of December 31, 2015 and 2014.

| (Dollars in thousands) | Pass/Performing | Special mention | Substandard | Doubtful | Total |
|---|---|---|---|---|---|
| December 31, 2015 | | | | | |
| Construction | $ 70,214 | $ 3,903 | $ 11,515 | $ - | $ 85,632 |
| Residential real estate | 290,857 | 8,837 | 7,369 | - | 307,063 |
| Commercial real estate | 302,438 | 18,699 | 9,116 | - | 330,253 |
| Commercial | 63,628 | 1,075 | 208 | - | 64,911 |
| Consumer | 7,107 | 26 | 122 | - | 7,255 |
| Total | $ 734,244 | $ 32,540 | $ 28,330 | $ - | $ 795,114 |

| (Dollars in thousands) | Pass/Performing | Special mention | Substandard | Doubtful | Total |
|---|---|---|---|---|---|
| December 31, 2014 | | | | | |
| Construction | $ 52,241 | $ 5,643 | $ 11,273 | $ - | $ 69,157 |
| Residential real estate | 252,643 | 6,675 | 14,018 | - | 273,336 |
| Commercial real estate | 275,573 | 20,040 | 10,175 | - | 305,788 |
| Commercial | 50,583 | 1,885 | 114 | 89 | 52,671 |
| Consumer | 9,658 | 13 | 123 | - | 9,794 |
| Total | $ 640,698 | $ 34,256 | $ 35,703 | $ 89 | $ 710,746 |

The following tables provide information on the aging of the loan portfolio as of December 31, 2015 and 2014.

| (Dollars in thousands) | Accruing Current | 30-59 days past due | 60-89 days past due | 90 days or more past due | Total past due | Non-accrual | Total |
|---|---|---|---|---|---|---|---|
| December 31, 2015 | | | | | | | |
| Construction | $78,082 | $ 21 | $ - | $ - | $ 21 | $7,529 | $85,632 |
| Residential real estate | 300,563 | 2,139 | 2,102 | - | 4,241 | 2,259 | 307,063 |
| Commercial real estate | 327,370 | - | 861 | - | 861 | 2,022 | 330,253 |
| Commercial | 64,670 | 49 | 31 | - | 80 | 161 | 64,911 |
| Consumer | 7,107 | 13 | 6 | 7 | 26 | 122 | 7,255 |
| Total | $777,792 | $ 2,222 | $ 3,000 | $ 7 | $ 5,229 | $12,093 | $795,114 |
| Percent of total loans | 97.8 % | 0.3 % | 0.4 % | - % | 0.7 % | 1.5 % | 100 % |

| (Dollars in thousands) | Accruing Current | 30-59 days past due | 60-89 days past due | 90 days or more past due | Total past due | Non-accrual | Total |
|---|---|---|---|---|---|---|---|
| December 31, 2014 | | | | | | | |
| Construction | $61,325 | $ 1,786 | $ - | $ - | $ 1,786 | $6,046 | $69,157 |
| Residential real estate | 263,165 | 3,351 | 2,702 | 83 | 6,136 | 4,035 | 273,336 |
| Commercial real estate | 301,695 | 459 | 513 | - | 972 | 3,121 | 305,788 |
| Commercial | 52,352 | 47 | 131 | - | 178 | 141 | 52,671 |
| Consumer | 9,619 | 11 | 37 | 4 | 52 | 123 | 9,794 |
| Total | $688,156 | $ 5,654 | $ 3,383 | $ 87 | $ 9,124 | $13,466 | $710,746 |
| Percent of total loans | 96.8 % | 0.8 % | 0.5 % | - % | 1.3 % | 1.9 % | 100 % |

The following tables provide a summary of the activity in the allowance for credit losses allocated by loan class for 2015 and 2014.

Allocation of a portion of the allowance to one loan class does not preclude its availability to absorb losses in other loan classes.

| (Dollars in thousands) | Construction | Residential real estate | Commercial real estate | Commercial | Consumer | Unallocated | Total |
|---|---|---|---|---|---|---|---|
| 2015 | | | | | | | |
| Allowance for credit losses: | | | | | | | |
| Beginning balance | $ 1,303 | $ 2,834 | $ 2,379 | $ 448 | $ 229 | $ 502 | $7,695 |
| Charge-offs | (1,058 ) | (283 ) | (920 ) | (396 ) | (67 ) | - | (2,724) |
| Recoveries | 125 | 398 | 379 | 319 | 49 | - | 1,270 |

| | | | | | | | |
|---|---|---|---|---|---|---|---|
| Net charge-offs | (933) | 115 | (541) | (77) | (18) | - | (1,454) |
| Provision | 1,276 | (768) | 1,161 | 187 | (55) | 274 | 2,075 |
| Ending balance | $ 1,646 | $ 2,181 | $ 2,999 | $ 558 | $ 156 | $ 776 | $8,316 |

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| (Dollars in thousands) | Construction | Residential real estate | Commercial real estate | Commercial | Consumer | Unallocated | Total |
|---|---|---|---|---|---|---|---|
| 2014 | | | | | | | |
| Allowance for credit losses: | | | | | | | |
| Beginning balance | $ 1,960 | $ 3,854 | $ 3,029 | $ 1,266 | $ 243 | $ 373 | $10,725 |
| Charge-offs | (725 ) | (2,407 ) | (1,648 ) | (2,389 ) | (163 ) | - | (7,332 ) |
| Recoveries | 149 | 376 | 58 | 341 | 28 | - | 952 |
| Net charge-offs | (576 ) | (2,031 ) | (1,590 ) | (2,048 ) | (135 ) | - | (6,380 ) |
| Provision | (81 ) | 1,011 | 940 | 1,230 | 121 | 129 | 3,350 |
| Ending balance | $ 1,303 | $ 2,834 | $ 2,379 | $ 448 | $ 229 | $ 502 | $7,695 |

Foreclosure Proceedings

Consumer mortgage loans collateralized by residential real estate property that are in the process of foreclosure totaled $581 thousand and $54 thousand as of December 31, 2015 and 2014.

**NOTE 4. PREMISES AND EQUIPMENT**

The following table provides information on premises and equipment at December 31, 2015 and 2014.

| (Dollars in thousands) | 2015 | 2014 |
|---|---|---|
| Land | $5,818 | $5,818 |
| Buildings and land improvements | 15,982 | 13,537 |
| Furniture and equipment | 6,710 | 9,273 |
| | 28,510 | 28,628 |
| Accumulated depreciation | (11,646) | (12,353) |
| Total | $16,864 | $16,275 |

Depreciation expense totaled $912 thousand, $867 thousand and $936 thousand for 2015, 2014, and 2013, respectively.

The Company leases facilities under operating leases. Rental expense for the years ended December 31, 2015, 2014, and 2013 was $650 thousand, $700 thousand and $744 thousand, respectively. Future minimum annual rental payments are approximately as follows:

| (Dollars in thousands) | |
|---|---|
| 2016 | $547 |
| 2017 | 426 |
| 2018 | 390 |
| 2019 | 380 |
| 2020 | 250 |
| Thereafter | 1,021 |
| Total minimum lease payments | $3,014 |

**NOTE 5. INVESTMENT IN UNCONSOLIDATED SUBSIDIARIES**

The Avon-Dixon Agency, LLC ("Avon-Dixon"), a wholly-owned insurance subsidiary of the Company, owns a 40% interest in a segregated portfolio of Eastern Re Ltd., SPC ("Eastern"), a specialty reinsurance company. This investment is carried at cost, adjusted for Avon-Dixon's equity ownership in Eastern's net income or loss. At December 31, 2015 and 2014, the carrying value of the investment in Eastern was $320 thousand and $432 thousand, respectively. During 2015 and 2014, (loss) income recognized from the investment in Eastern was ($112) thousand and $104 thousand, respectively.

During 2012, the Company terminated its mortgage brokerage activities which were conducted through a minority series investment in an unrelated Delaware limited liability company under the name "Wye Mortgage Group". This investment was carried at cost, adjusted for the Company's 49.0% equity ownership in Wye Mortgage Group's net income or loss. At December 31, 2015 and 2014, the carrying value of the investment in Wye Mortgage Group was $0 and $0, respectively. The Company recognized no income or loss in 2015 and 2014 from its investment in Wye Mortgage Group, and a loss of $9 thousand in 2013.

NOTE 6. GOODWILL AND OTHER INTANGIBLE ASSETS

The following table provides information on the significant components of goodwill and other acquired intangible assets at December 31, 2015 and 2014. The Community Banking segment had goodwill of $2.5 million at the end of both 2015 and 2014. The Insurance segment had goodwill of $9.4 million at the end of 2015 and 2014. See Note 27 for further information regarding the Company’s business segments.

| | December 31, 2015 | | | | | December 31, 2014 | | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| (Dollars in thousands) | Gross Carrying Amount | Accumulated Impairment Charges | Accumulated Amortization | Net Carrying Amount | Weighted Average Remaining Life (in years) | Gross Carrying Amount | Accumulated Impairment Charges | Accumulated Amortization | Net Carrying Amount | Weighted Average Remaining Life (in years) |
| Goodwill | $15,235 | $(2,637) | $(667) | $11,931 | - | $15,235 | $(2,637) | $(667) | $11,931 | - |
| Other intangible assets | | | | | | | | | | |
| Amortizable | | | | | | | | | | |
| Employment agreements | $440 | $- | $(440) | $- | - | $440 | $- | $(440) | $- | - |
| Insurance expirations | 1,270 | - | (1,148) | 122 | 1.4 | 1,270 | - | (1,063) | 207 | 2.4 |
| Customer relationships | 795 | (95) | (391) | 309 | 6.4 | 782 | (95) | (343) | 344 | 7.0 |
| | 2,505 | (95) | (1,979) | 431 | | 2,492 | (95) | (1,846) | 551 | |
| Unamortizable | | | | | | | | | | |
| Carrier relationships | - | - | - | - | - | - | - | - | - | - |
| Trade name | 780 | - | - | 780 | - | 780 | - | - | 780 | - |
| | 780 | - | - | 780 | | 780 | - | - | 780 | |
| Total other intangible assets | $3,285 | $(95) | $(1,979) | $1,211 | | $3,272 | $(95) | $(1,846) | $1,331 | |

The aggregate amortization expense was $133 thousand, $201 thousand, and $296 thousand for the years ended December 31, 2015, 2014, and 2013 respectively.

The following table provides information on current period and estimated future amortization expense for amortizable other intangible assets.

| (Dollars in thousands) | Amortization Expense |
|---|---|

| | | |
|---|---|---|
| Estimate for years ended December 31, | 2016 | $ 131 |
| | 2017 | 84 |
| | 2018 | 47 |
| | 2019 | 47 |
| | 2020 | 47 |

**NOTE 7. OTHER ASSETS**

The Company had the following other assets at December 31, 2015 and 2014.

| (Dollars in thousands) | 2015 | 2014 |
|---|---|---|
| Nonmarketable investment securities | $1,621 | $1,586 |
| Accrued interest receivable | 2,458 | 2,663 |
| Deferred income taxes (1) | 12,132 | 15,744 |
| Prepaid expenses | 1,039 | 750 |
| Other assets | 6,670 | 6,419 |
| Total | $23,920 | $27,162 |

(1) See Note 15 for further discussion.

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**NOTE 8. OTHER LIABILITIES**

The Company had the following other liabilities at December 31, 2015 and 2014.

| (Dollars in thousands) | 2015 | 2014 |
|---|---|---|
| Accrued interest payable | $106 | $172 |
| Other accounts payable | 2,775 | 2,435 |
| Deferred compensation liability | 1,464 | 1,503 |
| Other liabilities | 1,695 | 2,011 |
| Total | $6,040 | $6,121 |

**NOTE 9. DEPOSITS**

The approximate amount of certificates of deposit of $250,000 or more was $29.1 million and $35.5 million at December 31, 2015 and 2014, respectively.

The following table provides information on the approximate maturities of total time deposits at December 31, 2015 and 2014.

| (Dollars in thousands) | 2015 | 2014 |
|---|---|---|
| Due in one year or less | $163,220 | $181,847 |
| Due in one to three years | 86,719 | 101,811 |
| Due in three to five years | 39,855 | 47,969 |
| Total | $289,794 | $331,627 |

As of December 31, 2015 and 2014, deposits, both direct and indirect, to directors, their associates and policy-making officers, totaled approximately $5.6 million and $5.3 million, respectively.

NOTE 10. SHORT-TERM BORROWINGS

The following table summarizes certain information on short-term borrowings for the years ended December 31, 2015 and 2014.

| | 2015 | | 2014 | |
|---|---|---|---|---|
| (Dollars in thousands) | Amount | Rate | Amount | Rate |
| Average for the Year | | | | |
| Retail repurchase agreements | $6,226 | 0.24% | $8,061 | 0.22% |
| | | | | |
| At Year End | | | | |
| Retail repurchase agreements | $6,672 | 0.23% | $4,808 | 0.23% |

Securities sold under agreements to repurchase are securities sold to customers, at the customers' request, under a "roll-over" contract that matures in one business day. The underlying securities sold are U.S. Government agency securities, which are segregated in the Company's custodial accounts from other investment securities.

The Company may periodically borrow from a correspondent federal funds line of credit arrangement, under a secured reverse repurchase agreement, or from the Federal Home Loan Bank to meet short-term liquidity needs.

NOTE 11. BENEFIT PLANS

**401(k) and Profit Sharing Plan**

The Company has a 401(k) and profit sharing plan covering substantially all full-time employees. The plan calls for matching contributions by the Company, and the Company makes discretionary contributions based on profits. Company contributions to this plan included in expense totaled $491 thousand, $545 thousand, and $520 thousand for 2015, 2014, and 2013, respectively.

**NOTE 12. STOCK-BASED COMPENSATION**

As of December 31, 2015, the Company maintained the Shore Bancshares, Inc. 2006 Stock and Incentive Compensation Plan (“2006 Equity Plan”) under which it may issue shares of common stock or grant other equity-based awards. Stock-based awards granted to date generally are time-based, vest in equal installments on each anniversary of the grant date over a three- to five-year period of time, and, in the case of stock options, expire 7 years from the grant date. On July 1, 2015, the Company's board of directors (the "Board") also adopted a form of performance share/restricted stock unit award agreement that will be used to grant performance equity incentive awards pursuant to and subject to the provisions of the 2006 Equity Plan. Stock-based compensation expense is recognized ratably over the requisite service period for all awards, is based on the grant-date fair value and reflects forfeitures as they occur. The 2006 Equity Plan originally reserved 631,972 shares of common stock for grant, and 456,182 shares remained available for grant at December 31, 2015.

The following tables provide information on stock-based compensation expense for 2015, 2014, and 2013.

| (Dollars in thousands) | 2015 | 2014 | 2013 |
|---|---|---|---|
| Stock-based compensation expense | $283 | $ 87 | $ 78 |
| Excess tax expense related to stock-based compensation | 3 | - | 26 |

| | December 31, | | |
|---|---|---|---|
| (Dollars in thousands) | 2015 | 2014 | 2013 |
| Unrecognized stock-based compensation expense | $14 | $59 | $136 |
| Weighted average period unrecognized expense is expected to be recognized | **0.3 years** | 0.8 years | 1.7 years |

The following table summarizes restricted stock award activity for the Company under the 2006 Equity Plan for the three years ended December 31, 2015.

| | Year Ended December 31, 2015 | | Year Ended December 31, 2014 | | Year Ended December 31, 2013 | |
|---|---|---|---|---|---|---|
| | Number of Shares | Weighted Average Grant Date Fair Value | Number of Shares | Weighted Average Grant Date Fair Value | Number of Shares | Weighted Average Grant Date Fair Value |
| Nonvested at beginning of year | 14,251 | $ 8.51 | 13,930 | $ 8.33 | 6,548 | $ 14.89 |
| Granted | 12,647 | 9.21 | 3,654 | 9.57 | 13,930 | 8.33 |
| Vested | (14,410) | 8.93 | (3,333) | 8.93 | (6,548) | 14.89 |
| Cancelled | - | - | - | - | - | - |
| | 12,488 | $ 8.74 | 14,251 | $ 8.51 | 13,930 | $ 8.33 |

Nonvested at end of year

The total fair value of restricted stock awards that vested was $129 thousand in 2015, $30 thousand in 2014, and $36 thousand in 2013.

The following table summarizes stock option activity for the Company under the 2006 Equity Plan for the three years ended December 31, 2015.

| | Year Ended December 31, 2015 | | Year Ended December 31, 2014 | | Year Ended December 31, 2013 | |
|---|---|---|---|---|---|---|
| | Number of shares | Weighted Average Exercise Price | Number of shares | Weighted Average Exercise Price | Number of shares | Weighted Average Exercise Price |
| Outstanding at beginning of year | 27,108 | $ 6.64 | 40,662 | $ 6.64 | 54,216 | $ 6.64 |
| Granted | 34,219 | 9.18 | - | - | - | - |
| Exercised | - | - | (3,593) | 6.64 | - | - |
| Expired/Cancelled | - | - | (9,961) | 6.64 | (13,554) | 6.64 |
| Outstanding at end of year | 61,327 | $ 8.05 | 27,108 | $ 6.64 | 40,662 | $ 6.64 |
| Exercisable at end of year | 44,218 | $ 7.62 | - | $ - | - | $ - |

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The weighted average fair value of stock options granted during 2015 was $3.44. The Company estimates the fair value of options using the Black-Scholes valuation model with weighted average assumptions for dividend yield, expected volatility, risk-free interest rate and expected lives (in years). The expected dividend yield is calculated by dividing the total expected annual dividend payout by the average stock price. The expected volatility is based on historical volatility of the underlying securities. The risk-free interest rate is based on the Federal Reserve Bank's constant maturities daily interest rate in effect at grant date. The expected contract life of the options represents the period of time that the Company expects the awards to be outstanding based on historical experience with similar awards. The following weighted average assumptions were used as inputs to the Black-Scholes valuation model for options granted in 2015.

| | | |
|---|---|---|
| Dividend yield | 0 | % |
| Expected volatility | 32 | % |
| Risk-free interest rate | 1.97 | % |
| Expected contract life (in years) | 7 | |

At December 31, 2015, the aggregate intrinsic value of the options outstanding under the 2006 Equity Plan was $173 thousand based on the $10.88 market value per share of Shore Bancshares, Inc.'s common stock at December 31, 2015. Since there were no options exercised during 2015, there was no intrinsic value associated with stock options exercised and no cash received on exercise of options. For 2015 and 2014 the amount of stock options vested totaled 44,218 and 13,554, respectively. At December 31, 2015, the weighted average remaining contract life of options outstanding was 6.3 years.

NOTE 13. DEFERRED COMPENSATION

The Shore Bancshares, Inc. Executive Deferred Compensation Plan (the "Plan") is for members of management and highly compensated employees of Shore Bancshares, Inc. and its subsidiaries. The Plan permits a participant to elect, each year, to defer receipt of up to 100% of his or her salary and bonus to be earned in the following year. The Plan also permits the participant to defer the receipt of performance-based compensation not later than six months before the end of the period for which it is to be earned. The deferred amounts are credited to an account maintained on behalf of the participant and are invested at the discretion of each participant in certain deemed investment options selected from time to time by the Compensation Committee of the Board of Shore Bancshares, Inc. Shore Bancshares, Inc. may also make matching, mandatory and discretionary contributions for certain participants. A participant is fully vested at all times in the amounts that he or she elects to defer. Any contributions by Shore Bancshares, Inc. will vest over a five-year period. There were no elective deferrals made by plan participants during 2015, 2014 or 2013.

The following table provides information on Shore Bancshares, Inc.'s contributions to the Plan for 2015, 2014, and 2013 and the related deferred compensation liability at December 31, 2015 and 2014.

| (Dollars in thousands) | 2015 | 2014 | 2013 |
|---|---|---|---|
| Deferred compensation contribution | $ - | $ - | $ 9 |

| | December 31, | |
|---|---|---|
| (Dollars in thousands) | 2015 | 2014 |
| Deferred compensation liability | $ 444 | $ 445 |

CNB has agreements with certain of its directors under which they have deferred part of their fees and compensation. The amounts deferred are invested in insurance policies, owned by CNB, on the lives of the respective individuals. Amounts available under the policies are to be paid to the individuals as retirement benefits over future years. The following table includes information on the cash surrender value and the accrued benefit obligation included in other assets and other liabilities at December 31, 2015 and 2014.

| (Dollars in thousands) | 2015 | 2014 |
|---|---|---|
| Cash surrender value | $ 3,448 | $ 3,360 |
| Accrued benefit obligation | 1,020 | 1,058 |

**NOTE 14. OTHER EXPENSES**

The following table summarizes the Company’s other noninterest expenses for the years ended December 31:

| (Dollars in thousands) | 2015 | 2014 | 2013 |
|---|---|---|---|
| Advertising and marketing | $495 | $428 | $848 |
| Other customer expense | 172 | 396 | 414 |
| Other expense | 2,168 | 2,070 | 2,152 |
| Other loan expense | 515 | 894 | 934 |
| Software expense | 697 | 664 | 613 |
| Travel and entertainment expense | 303 | 288 | 287 |
| Trust professional fees | 625 | 686 | 616 |
| Total noninterest expense | $4,975 | $5,426 | $5,864 |

**NOTE 15. INCOME TAXES**

The following table provides information on components of income tax expense for each of the three years ended December 31.

| (Dollars in thousands) | 2015 | 2014 | 2013 |
|---|---|---|---|
| Current tax expense (benefit): | | | |
| Federal | $247 | $- | $(459) |
| State | 287 | 225 | 90 |
| | 534 | 225 | (369) |
| Deferred income tax expense (benefit): | | | |
| Federal | 3,369 | 2,516 | (4,592) |
| State | 505 | 320 | (1,540) |
| | 3,874 | 2,836 | (6,132) |
| Total income tax expense (benefit) | $4,408 | $3,061 | $(6,501) |

The following table provides a reconciliation of tax computed at the statutory federal tax rate of 34.0% to the actual tax expense (benefit) for each of the three years ended December 31.

| (Dollars in thousands) | 2015 | 2014 | 2013 |
|---|---|---|---|

| | | | |
|---|---|---|---|
| Tax at federal statutory rate | 34.0% | 34.0% | (34.0)% |
| Tax effect of: | | | |
| Tax-exempt income | (0.4 ) | (0.9 ) | (0.4 ) |
| Other non-deductible expenses | 0.2 | 0.3 | 0.2 |
| State income taxes, net of federal benefit | 4.5 | 4.4 | (5.9 ) |
| Other | (0.1 ) | (0.1 ) | (0.2 ) |
| Actual income tax expense (benefit) rate | 38.2% | 37.7% | (40.3)% |

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The following table provides information on significant components of the Company’s deferred tax assets and liabilities as of December 31.

| (Dollars in thousands) | 2015 | 2014 |
|---|---|---|
| Deferred tax assets: | | |
| Allowance for credit losses | $3,316 | $3,072 |
| Reserve for off-balance sheet commitments | 121 | 121 |
| Net operating loss carry forward | 9,069 | 13,265 |
| Write-downs of other real estate owned | 308 | 355 |
| Deferred income | 1,155 | 1,132 |
| Unrealized gains on available-for-sale securities | 48 | - |
| Accrued expenses | 946 | 918 |
| Other | 191 | 80 |
| Total deferred tax assets | 15,154 | 18,943 |
| Deferred tax liabilities: | | |
| Depreciation | 271 | 372 |
| Amortization on loans FMV adjustment | 140 | - |
| Purchase accounting adjustments | 1,988 | 1,751 |
| Deferred capital gain on branch sale | 411 | 425 |
| Unrealized gains on available-for-sale securities | - | 214 |
| Other | 212 | 437 |
| Total deferred tax liabilities | 3,022 | 3,199 |
| Net deferred tax assets | $12,132 | $15,744 |

The Company’s deferred tax assets primarily consist of net operating loss carryovers that will be used to offset taxable income in future periods through their statutory period of 20 years for federal tax purposes. As of December 31, 2015 18 years of the statutory period remain available to offset future taxable income. No valuation allowance on these deferred tax assets was recorded at December 31, 2015 and December 31, 2014 as management believes it is more likely than not that all deferred tax assets will be realized based on the following positive material factors: 1) The Company was profitable for all four quarters of 2015 and 2014 on a GAAP basis. The net operating loss was originally created in the third quarter of 2013 and was solely attributable to Talbot Bank’s sale of loans and other real estate owned (the “Asset Sale”), which is considered non-recurring. 2) The Company had pre-tax income of $11.5 million and $8.1 million for the years ended December 31, 2015 and 2014, providing further evidence that the Asset Sale was producing positive results and confirming the expectation of utilizing the deferred tax assets. 3) As a contingent opportunity, the Company has had discussions with certain investors about entering into a sales leaseback transaction for some of its branch locations which would generate a material taxable gain. The decision to act on this has been deferred; however, it would become a very viable option as a tax planning strategy if there was a risk that the net operating loss carryovers would expire before they were fully utilized. Alternatively, the Company has reviewed negative factors which would influence the conclusion of realizing the deferred tax assets. These factors include the following: 1) The Company could be subject to Section 382 of the Internal Revenue Code (“IRC”), which could further limit the realization of the net operating loss-related deferred tax asset (“NOL-DTA”). 2) Although the local economy of the market in which the Company operates has been showing continued signs of improvement over the past three years, if this trend flattens or reverses, there is a potential that this potential negative evidence could outweigh the prevailing positive factors.

Based on the aforementioned considerations, the Company has concluded that the predominance of observable positive evidence outweighs the future potential of negative evidence and therefore it is more likely than not that the Company will be able to realize in the future all of the net deferred tax assets.

**NOTE 16. EARNINGS/(LOSS) PER COMMON SHARE**

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

| (In thousands, except per share data) | 2015 | 2014 | 2013 |
|---|---|---|---|
| Net income (loss) | $7,108 | $5,051 | $(9,634) |
| Weighted average shares outstanding – basic | 12,629 | 10,945 | 8,461 |
| Dilutive effect of common stock equivalents | 10 | 8 | - |
| Weighted average shares outstanding – diluted | 12,639 | 10,953 | 8,461 |
| Income (loss) per common share – basic | $0.56 | $0.46 | $(1.14) |
| Income (loss) per common share – diluted | $0.56 | $0.46 | $(1.14) |

The calculations of diluted income (loss) per share excluded weighted average common stock equivalents of 0 for 2015, 0 for 2014, and 51 thousand for 2013 because the effect of including them would have been antidilutive.

**NOTE 17. REGULATORY CAPITAL REQUIREMENTS**

Shore Bancshares, Inc. and each of the Banks are subject to various regulatory capital requirements administered by the federal banking agencies. Failure to meet minimum capital requirements can initiate certain mandatory - and possibly additional discretionary - actions by regulators that, if undertaken, could have a direct material effect on the Company's financial statements. Under capital adequacy guidelines and the regulatory framework for prompt corrective action, the Banks must meet specific capital guidelines that involve quantitative measures of the Banks' assets, liabilities, and certain off-balance sheet items as calculated under regulatory accounting practices. The Banks' capital amounts and classification are also subject to qualitative judgments by the regulators about components, risk weightings, and other factors.

*Basel III*

The FRB and the FDIC approved the final rules implementing the Basel Committee on Banking Supervision's (“BCBS”) capital guidelines for U.S. banks. Under the final rules, minimum requirements will increase for both the quantity and quality of capital held by the Company. The rules include a new common equity Tier 1 capital to risk-weighted assets minimum ratio of 4.5%, raise the minimum ratio of Tier 1 capital to risk-weighted assets from 4.0% to 6.0%, require a minimum ratio of Total Capital to risk-weighted assets of 8.0%, and require a minimum Tier 1 leverage ratio of 4.0%. A new capital conservation buffer, comprised of common equity Tier 1 capital, is also established above the regulatory minimum capital requirements. This capital conservation buffer will be phased in beginning January 1, 2016 at 0.625% of risk-weighted assets and increase each subsequent year by an additional 0.625% until reaching its final level of 2.5% on January 1, 2019. Strict eligibility criteria for regulatory capital instruments were also implemented under the final rules. The final rules also revise the definition and calculation of Tier 1 capital, Total Capital, and risk-weighted assets.

The phase-in period for the final rules became effective for the Company on January 1, 2015, with full compliance with all of the final rules’ requirements phased in over a multi-year schedule, to be fully phased-in by January 1, 2019.

Quantitative measures established by regulation to ensure capital adequacy require the Banks to maintain amounts and ratios (set forth in the table below) of Tier 1 and total capital (as defined in the regulations) to risk-weighted assets (as defined), and of Tier 1 capital (as defined) to average assets (leverage ratio). As of December 31, 2015, management believes that Shore Bancshares, Inc., The Talbot Bank and CNB met all capital adequacy requirements to which they are subject.

As of December 31, 2015, the most recent notification from the Federal Deposit Insurance Corporation categorized Talbot Bank and CNB as well capitalized under the regulatory framework for prompt corrective action. To be categorized as well capitalized, the Banks must maintain minimum common equity Tier 1, Tier 1 risk-based and total risk-based capital ratios, and Tier 1 leverage ratios, which are described below.

The minimum ratios for capital adequacy purposes are 4.50%, 6.00%, 8.00% and 4.00% for the common equity Tier 1, Tier 1 risk-based capital, total risk-based capital and leverage ratios, respectively. To be categorized as well capitalized, a bank must maintain minimum ratios of 6.50%, 8.00%, 10.00% and 5.00% for its common equity Tier 1, Tier 1 risk-based capital, total risk-based capital and leverage ratios, respectively. Shore Bancshares, Inc., as a financial holding company, is subject to the well-capitalized requirement.

The following tables present the capital amounts and ratios for Shore Bancshares, Inc., Talbot Bank and CNB as of December 31, 2015 and 2014.

| **December 31, 2015 (1)** (Dollars in thousands) | Common Equity/ Tier 1 Capital | Total Risk-Based Capital | Net Risk-Weighted Assets | Adjusted Average Total Assets | Common Equity Tier 1 ratio (2) | Tier 1 Risk-Based Capital Ratio | Total Risk-Based Capital Ratio | Tier 1 Leverage Ratio |
|---|---|---|---|---|---|---|---|---|
| Company | $ 126,024 | $ 134,643 | $ 807,807 | $ 1,116,692 | 15.60 % | 15.60 % | 16.67 % | 11.29 % |
| Talbot Bank | 59,692 | 64,405 | 448,634 | 613,945 | 13.31 | 13.31 | 14.36 | 9.72 |
| CNB | 48,051 | 51,957 | 354,278 | 486,404 | 13.56 | 13.56 | 14.67 | 9.88 |

| December 31, 2014 (1) (Dollars in thousands) | Tier 1 Capital | Total Risk-Based Capital | Net Risk-Weighted Assets | Adjusted Average Total Assets | Common Equity Tier 1 ratio (2) | Tier 1 Risk-Based Capital Ratio | Total Risk-Based Capital Ratio | Tier 1 Leverage Ratio |
|---|---|---|---|---|---|---|---|---|
| Company | $ 112,511 | $ 120,510 | $ 736,763 | $ 1,075,674 | n/a | 15.27 % | 16.36 % | 10.46 % |
| Talbot Bank | 51,637 | 55,910 | 394,788 | 579,781 | n/a | 13.08 | 14.16 | 8.91 |
| CNB | 44,869 | 48,594 | 331,089 | 485,042 | n/a | 13.55 | 14.68 | 9.25 |

(1) The capital ratios as of December 31, 2015 reflect the adoption of Basel III in effect beginning January 1, 2015 while ratios for the prior period represent the previous capital rules under Basel I.

(2) The Common Equity Tier 1 ratio is a new ratio under Basel III and represents common equity, less goodwill and intangible assets net of any deferred tax liabilities, divided by risk-weighted assets.

Federal and state laws and regulations applicable to banks and their holding companies impose certain restrictions on dividend payments by the Banks, as well as restricting extensions of credit and transfers of assets between the Banks and Shore Bancshares, Inc. Talbot Bank is currently prohibited from paying dividends to Shore Bancshares, Inc. without the prior consent of its banking regulators. CNB paid dividends of $280 thousand to Shore Bancshares, Inc. during 2015. At December 31, 2015, CNB could have paid additional dividends to Shore Bancshares, Inc. of approximately $7.7 million without the prior consent and approval of its regulatory agencies. Shore Bancshares, Inc. had no outstanding receivables from subsidiaries at December 31, 2015 or 2014.

**NOTE 18. ACCUMULATED OTHER COMPREHENSIVE INCOME**

The Company records unrealized holding gains (losses), net of tax, on investment securities available for sale and on cash flow hedging activities as accumulated other comprehensive income (loss), a separate component of stockholders' equity. The following table provides information on the changes in the components of accumulated other comprehensive income (loss) for 2015 and 2014.

| (Dollars in thousands) | Accumulated net unrealized holding gains (losses) on available for sale securities | Accumulated other comprehensive income (loss) |
|---|---|---|
| Balance, December 31, 2014 | $ 316 | $ 316 |
| Other comprehensive (loss) income | (387) | (387) |
| Reclassification of (gains) losses recognized | - | - |
| Balance, December 31, 2015 | $ (71) | $ (71) |
| | | |
| Balance, December 31, 2013 | $ (437) | $ (437) |
| Other comprehensive income | 767 | 767 |
| Reclassification of (gains) losses recognized | (14) | (14) |
| Balance, December 31, 2014 | $ 316 | $ 316 |

The following table presents the amounts reclassified out of each component of accumulated comprehensive income (loss) for the years ended December 31, 2015, 2014, and 2013.

| Details about Accumulated Other Comprehensive Income Components (dollars in thousands) | Amount Reclassified from Accumulated Other Comprehensive Income (Loss) Year Ended December 31, | | | Affected Line Item in the Statement Where Net Income is Presented |
|---|---|---|---|---|
| | 2015 | 2014 | 2013 | |
| Realized gain on sale of investment securities | **$ -** | $ 14 | $ 545 | Gain on sale of investment securities |
| Total Reclassification for the Period | $ - | $ 14 | $ 545 | |

**NOTE 19. LINES OF CREDIT**

The Banks had $13.0 million and $15.5 million in federal funds lines of credit and a reverse repurchase agreement available on a short-term basis from correspondent banks at December 31, 2015 and 2014. In addition, the Banks had credit availability of approximately $130.2 million and $70.9 million from the Federal Home Loan Bank at December 31, 2015 and 2014, respectively. These lines of credit are paid for monthly on a fee basis of 0.10%. The Banks have pledged as collateral, under a blanket lien, all qualifying residential loans under borrowing agreements with the Federal Home Loan Bank. The Banks had no short-term borrowings from the Federal Home Loan Bank at December 31, 2015 or 2014.

NOTE 20. FAIR VALUE MEASUREMENTS

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

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

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

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

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

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

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

<u>Investment Securities Available for Sale</u>

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

The tables below present the recorded amount of assets measured at fair value on a recurring basis at December 31, 2015 and 2014. No assets were transferred from one hierarchy level to another during 2015 or 2014.

| (Dollars in thousands) | Fair Value | Quoted Prices (Level 1) | Significant Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) |
|---|---|---|---|---|
| December 31, 2015 | | | | |
| Securities available for sale: | | | | |
| U.S. Treasury | $ 5,079 | $ 5,079 | $ - | $ - |
| U.S. Government agencies | 49,529 | - | 49,529 | - |
| Mortgage-backed | 156,916 | - | 156,916 | - |
| Equity | 641 | - | 641 | - |
| Total | $ 212,165 | $ 5,079 | $ 207,086 | $ - |

| (Dollars in thousands) | Fair Value | Quoted Prices (Level 1) | Significant Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) |
|---|---|---|---|---|
| December 31, 2014 | | | | |
| Securities available for sale: | | | | |
| U.S. Treasury | $ 5,215 | $ 5,215 | $ - | $ - |
| U.S. Government agencies | 74,960 | - | 74,960 | - |
| Mortgage-backed | 155,303 | - | 155,303 | - |
| Equity | 630 | - | 630 | - |
| Total | $ 236,108 | $ 5,215 | $ 230,893 | $ - |

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

Loans

The Company does not record loans at fair value on a recurring basis; however, from time to time, a loan is considered impaired and a valuation allowance may be established if there are losses associated with the loan. Loans are considered impaired if it is probable that payment of interest and principal will not be made in accordance with contractual terms. The fair value of impaired loans can be estimated using one of several methods, including the collateral value, market value of similar debt, liquidation value and discounted cash flows. At December 31, 2015 and 2014, substantially all impaired loans were evaluated based on the fair value of the collateral and were classified as Level 2 in the fair value hierarchy.

Loans held for sale

Loans held for sale are adjusted for fair value upon transfer of loans to loans held for sale. Subsequently, loans held for sale are carried at the lower of carrying value and fair value. Fair value is based on independent market prices, appraised value of the collateral or management's estimation of the value of the collateral. At December 31, 2015 and 2014, the Company had no loans held for sale.

Other Real Estate Owned (Foreclosed Assets)

Foreclosed assets are adjusted for fair value upon transfer of loans to foreclosed assets. Subsequently, foreclosed assets are carried at the lower of carrying value and fair value. Fair value is based on independent market prices, appraised value of the collateral or management's estimation of the value of the collateral. At December 31, 2015 and 2014, foreclosed assets were classified as Level 2 in the fair value hierarchy.

The tables below present the recorded amount of assets measured at fair value on a nonrecurring basis at December 31, 2015 and 2014. No assets were transferred from one hierarchy level to another during 2015 or 2014.

| (Dollars in thousands) | Fair Value | Quoted Prices (Level 1) | Significant Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) |
|---|---|---|---|---|
| December 31, 2015 | | | | |
| Impaired loans | | | | |
| Construction | $ 10,979 | $ - | $ 10,979 | $ - |
| Residential real estate | 7,510 | - | 7,510 | - |
| Commercial real estate | 7,422 | - | 7,422 | - |
| Commercial | 161 | - | 161 | - |
| Consumer | 115 | - | 115 | - |
| Total impaired loans | 26,187 | - | 26,187 | - |
| Other real estate owned | 4,252 | - | 4,252 | - |
| Total assets measured at fair value on a nonrecurring basis | $ 30,439 | $ - | $ 30,439 | $ - |

| (Dollars in thousands) | Fair Value | Quoted Prices (Level 1) | Significant Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) |
|---|---|---|---|---|
| December 31, 2014 | | | | |
| Impaired loans | | | | |
| Construction | $ 10,026 | $ - | $ 10,026 | $ - |
| Residential real estate | 9,304 | - | 9,304 | - |
| Commercial real estate | 9,230 | - | 9,230 | - |
| Commercial | 187 | - | 187 | - |
| Consumer | 121 | - | 121 | - |
| Total impaired loans | 28,868 | - | 28,868 | - |
| Other real estate owned | 3,691 | - | 3,691 | - |
| Total assets measured at fair value on a nonrecurring basis | $ 32,559 | $ - | $ 32,559 | $ - |

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

Cash and Cash Equivalents

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

Investment Securities Held to Maturity

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

Loans

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

Deposits and Short-Term Borrowings

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

Commitments to Extend Credit and Standby Letters of Credit

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

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

| | December 31, 2015 | | December 31, 2014 | |
|---|---|---|---|---|
| (Dollars in thousands) | Carrying Amount | Estimated Fair Value | Carrying Amount | Estimated Fair Value |
| Financial assets | | | | |
| Level 2 inputs | | | | |
| Cash and cash equivalents | $73,811 | $73,811 | $96,223 | $96,223 |
| Investment securities held to maturity | 4,191 | 4,243 | 4,630 | 4,694 |
| Loans, net | 786,798 | 788,187 | 703,051 | 724,771 |
| Financial liabilities | | | | |
| Level 2 inputs | | | | |
| Deposits | $975,464 | $922,161 | $949,004 | $948,605 |
| Short-term borrowings | 6,672 | 6,672 | 4,808 | 4,808 |

NOTE 21. DERIVATIVE INSTRUMENTS AND HEDGING ACTIVITIES

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

During the second quarter of 2009, the Company purchased interest rate caps for $7.1 million to effectively fix the interest rate at 2.97% for five years on $70 million of the Company's money market deposit accounts related to our participation in the IND Program. In the fourth quarter of 2012, the Company decided to partially exit the IND

Program in an effort to reduce its excess liquidity and a portion of the interest rate caps used to hedge the interest rates on these deposits was terminated. In the second quarter of 2013, the Company fully exited the IND Program and the remainders of the interest rate caps were terminated. Because the interest rate caps qualified for hedge accounting, a $1.3 million loss on the ineffective portion of the cash flow hedge was recognized in both the second quarter of 2013 and the fourth quarter of 2012.

The aggregate fair value of the interest rate caps was $14 thousand at December 31, 2012. The adjustments that reduced the balance to $0 at December 31, 2013 included an increase of $681 thousand to reflect unrealized holding gains on the interest rate caps and a decrease of $695 thousand to reflect the charge to interest expense associated with the hedged money market deposit accounts. Interest expense for 2015 and 2014 did not reflect this adjustment because the interest rate caps were terminated in June of 2013.

By entering into derivative instrument contracts, the Company exposes itself, from time to time, to counterparty credit risk. Counterparty credit risk is the risk that the counterparty will fail to perform under the terms of the derivative contract. When the fair value of a derivative contract is in an asset position, the counterparty has a liability to the Company, which creates credit risk for the Company. The Company attempts to minimize this risk by selecting counterparties with investment grade credit ratings, limiting its exposure to any single counterparty and regularly monitoring its market position with each counterparty. Collateral required by the counterparties, recorded in other liabilities, was $0 at December 31, 2015 and 2014, respectively.

NOTE 22. FINANCIAL INSTRUMENTS WITH OFF-BALANCE SHEET RISK

In the normal course of business, to meet the financing needs of its customers, the Banks are parties to financial instruments with off-balance sheet risk. These financial instruments include commitments to extend credit and standby letters of credit. The Banks' exposure to credit loss in the event of nonperformance by the other party to these financial instruments is represented by the contractual amount of the instruments. The Banks use the same credit policies in making commitments and conditional obligations as they do for on-balance sheet instruments. The Banks generally require collateral or other security to support the financial instruments with credit risk. The amount of collateral or other security is determined based on management's credit evaluation of the counterparty. The Banks evaluate each customer's creditworthiness on a case-by-case basis.

Commitments to extend credit are agreements to lend to a customer as long as there is no violation of any condition established in the contract. Letters of credit are conditional commitments issued by the Banks to guarantee the performance of a customer to a third party. Letters of credit and other commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. Because many of the letters of credit and commitments are expected to expire without being drawn upon, the total commitment amount does not necessarily represent future cash requirements.

The following table provides information on commitments outstanding as of December 31, 2015 and 2014.

| (Dollars in thousands) | 2015 | 2014 |
|---|---|---|
| Commitments to extend credit | $166,931 | $127,080 |
| Letters of credit | 7,087 | 7,347 |
| Total | $174,018 | $134,427 |

NOTE 23. RELATED PARTY TRANSACTIONS

CNB bank leases office space for its trust department, Wye Financial & Trust, at an annual rent of $55 thousand for both 2015 and 2014, excluding certain pass through expenses, from a limited liability company in which the chief executive officer of Shore Bancshares Inc. holds a 50% interest. In January of 2016, the office space was sold by the limited liability company to an outside party.

Shore Bancshares Inc. and its bank and insurance subsidiaries on occasion rent ballroom space from the Tidewater Inn located in Easton Maryland, to hold company meetings and events. A director of the board of Shore Bancshares Inc.

holds a 61% interest in a limited liability company which owns the Tidewater Inn. During 2015 and 2014, approximately $38 thousand and $29 thousand in expenses were paid for rental and catering services.

## NOTE 24. CONTINGENCIES

In the normal course of business, Shore Bancshares, Inc. and its subsidiaries may become involved in litigation arising from banking, financial, and other activities. Management, after consultation with legal counsel, does not anticipate that the future liability, if any, arising out of current proceedings will have a material effect on the Company’s financial condition, operating results, or liquidity.

**NOTE 25. PARENT COMPANY FINANCIAL INFORMATION**

The following tables provide condensed financial information for Shore Bancshares, Inc. (Parent Company Only).

Condensed Balance Sheets

December 31,

| (Dollars in thousands) | 2015 | 2014 |
|---|---|---|
| Assets | | |
| Cash | $1,899 | $2,101 |
| Investment securities | 12,246 | 9,723 |
| Investment in subsidiaries | 129,353 | 126,857 |
| Premises and equipment, net | 3,598 | 3,158 |
| Other assets | 2,419 | 1,329 |
| Total assets | $149,515 | $143,168 |
| | | |
| Liabilities | | |
| Accrued interest payable | $1 | $1 |
| Other liabilities | 1,204 | 855 |
| Long-term debt | 1,343 | 1,843 |
| Total liabilities | 2,548 | 2,699 |
| | | |
| Stockholders’ equity | | |
| Common stock | 126 | 126 |
| Additional paid in capital | 63,815 | 63,532 |
| Retained earnings | 83,097 | 76,495 |
| Accumulated other comprehensive income (loss) | (71) | 316 |
| Total stockholders’ equity | 146,967 | 140,469 |
| | | |
| Total liabilities and stockholders’ equity | $149,515 | $143,168 |

Condensed Statements of Operations

For the Years Ended December 31,

| (Dollars in thousands) | 2015 | 2014 | 2013 |
|---|---|---|---|
| Income | | | |
| Dividends from subsidiaries | $1,045 | $200 | $2,163 |
| Management and other fees from subsidiaries | 8,723 | 7,933 | 6,226 |
| Other income | 228 | 110 | 31 |
| Total income | 9,996 | 8,243 | 8,420 |
| Expenses | | | |
| Interest expense | 61 | 80 | 88 |
| Salaries and employee benefits | 5,536 | 5,321 | 4,447 |
| Occupancy and equipment expense | 325 | 541 | 508 |
| Other operating expenses | 3,215 | 2,387 | 1,853 |
| Total expenses | 9,137 | 8,329 | 6,896 |
| Income (loss) before income tax benefit and equity in undistributed net income (loss) of subsidiaries | 859 | (86) | 1,524 |
| Income tax benefit | (65) | (107) | (61) |
| Income before equity in undistributed net income (loss) of subsidiaries | 924 | 21 | 1,585 |
| Equity in undistributed net income (loss) of subsidiaries | 6,184 | 5,030 | (11,219) |
| Net income (loss) | $7,108 | $5,051 | $(9,634) |

Condensed Statements of Cash Flows

For the Years Ended December 31,

| (Dollars in thousands) | 2015 | 2014 | 2013 |
|---|---|---|---|
| Cash flows from operating activities: | | | |
| Net income (loss) | $7,108 | $5,051 | $(9,634) |
| Adjustments to reconcile net (income) loss to cash provided by operating activities: | | | |
| Equity in undistributed net (income) loss of subsidiaries | (6,184) | (5,030) | 11,219 |
| Depreciation and amortization | 336 | 379 | 386 |
| Stock-based compensation expense | 283 | 87 | 78 |
| Excess tax benefit from stock-based arrangements | (3) | - | (26) |
| Net (increase) decrease in other assets | (1,108) | (121) | 128 |
| Net increase (decrease) in other liabilities | 328 | 271 | (53) |
| Net cash provided by operating activities | 760 | 637 | 2,098 |
| | | | |
| Cash flows from investing activities: | | | |
| Proceeds from maturities and principal payments of investment securities available for sale | 1,418 | 442 | - |
| Purchases of securities | (4,054) | (10,112) | - |
| Purchases of premises and equipment | (672) | (632) | (307) |
| Cash received from merged subsidiary | 3,349 | | |
| Investment in subsidiaries | - | (20,000) | (1,650) |
| Net cash provided by (used in) investing activities | 41 | (30,302) | (1,957) |
| | | | |
| Cash flows from financing activities: | | | |
| Repayment of long-term debt | (500) | (500) | - |
| Excess tax benefit from stock-based arrangements | 3 | - | 26 |
| Proceeds from issuance of common stock | - | 31,279 | - |
| Common stock dividends paid | (506) | - | - |
| Net cash (used in) provided by financing activities | (1,003) | 30,779 | 26 |
| | | | |
| Net (decrease) increase in cash and cash equivalents | (202) | 1,114 | 167 |
| Cash and cash equivalents at beginning of year | 2,101 | 987 | 820 |
| Cash and cash equivalents at end of year | $1,899 | $2,101 | $987 |

NOTE 26. QUARTERLY FINANCIAL RESULTS (unaudited)

The following table provides a summary of selected consolidated quarterly financial data for the three years ended December 31, 2015.

| (In thousands, except per share data) | First Quarter | Second Quarter | Third Quarter | Fourth Quarter |
|---|---|---|---|---|
| 2015 | | | | |
| Interest income | $9,445 | $9,542 | $9,837 | $10,047 |
| Net interest income | 8,539 | 8,683 | 9,010 | 9,293 |
| Provision for credit losses | 650 | 540 | 410 | 475 |
| Income (loss) before income taxes | 2,270 | 2,631 | 3,109 | 3,506 |
| Net income (loss) | 1,409 | 1,627 | 1,909 | 2,163 |
| | | | | |
| Basic earnings (loss) per common share | $0.11 | $0.13 | $0.15 | $0.17 |
| Diluted earnings (loss) per common share | $0.11 | $0.13 | $0.15 | $0.17 |
| | | | | |
| 2014 | | | | |
| Interest income | $9,455 | $9,523 | $9,686 | $9,625 |
| Net interest income | 8,323 | 8,447 | 8,636 | 8,636 |
| Provision for credit losses | 975 | 950 | 775 | 650 |
| (Loss) income before income taxes | 2,021 | 2,108 | 2,036 | 1,947 |
| Net (loss) income | 1,258 | 1,305 | 1,262 | 1,226 |
| | | | | |
| Basic (loss) earnings per common share | $0.15 | $0.13 | $0.10 | $0.10 |
| Diluted (loss) earnings per common share | $0.15 | $0.13 | $0.10 | $0.10 |
| | | | | |
| 2013 | | | | |
| Interest income | $10,607 | $10,755 | $10,182 | $9,807 |
| Net interest income | 8,477 | 9,001 | 8,828 | 8,570 |
| Provision for credit losses | 2,150 | 2,700 | 22,460 | 474 |
| (Loss) income before income taxes | 326 | 504 | (18,808) | 1,843 |
| Net (loss) income | 222 | 361 | (11,392) | 1,175 |
| | | | | |
| Basic (loss) earnings per common share | $0.03 | $0.04 | $(1.35) | $0.14 |
| Diluted (loss) earnings per common share | $0.03 | $0.04 | $(1.35) | $0.14 |

Earnings per share are based on quarterly results and may not be additive to the annual earnings per share amounts.

**NOTE 27. SEGMENT REPORTING**

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

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

Selected financial information by business segments is included in the following table.

| (Dollars in thousands) | Community Banking | Insurance Products and Services | Parent Company | Total |
|---|---|---|---|---|
| 2015 | | | | |
| Interest income | $38,652 | $ - | $219 | $38,871 |
| Interest expense | (3,346) | - | - | (3,346) |
| Provision for credit losses | (2,075) | - | - | (2,075) |
| Noninterest income | 7,135 | 8,297 | (16) | 15,416 |
| Noninterest expense | (21,480) | (6,984) | (8,886) | (37,350) |
| Net intersegment (expense) income | (7,718) | (781) | 8,499 | - |
| (Loss) income before income taxes | 11,168 | 532 | (184) | 11,516 |
| Income tax benefit (expense) | (4,274) | (204) | 70 | (4,408) |
| Net (loss) income | $6,894 | $ 328 | $(114) | $7,108 |
| | | | | |
| Total assets | $1,107,367 | $ 9,984 | $17,792 | $1,135,143 |
| | | | | |
| 2014 | | | | |
| Interest income | $38,202 | $ - | $87 | $38,289 |
| Interest expense | (4,247) | - | - | (4,247) |
| Provision for credit losses | (3,350) | - | - | (3,350) |
| Noninterest income | 6,482 | 10,305 | (6) | 16,781 |
| Noninterest expense | (22,776) | (8,527) | (8,058) | (39,361) |
| Net intersegment (expense) income | (7,010) | (680) | 7,690 | - |
| (Loss) income before income taxes | 7,301 | 1,098 | (287) | 8,112 |
| Income tax benefit (expense) | (2,755) | (414) | 108 | (3,061) |
| Net (loss) income | $4,546 | $ 684 | $(179) | $5,051 |
| | | | | |
| Total assets | $1,074,638 | $ 10,824 | $14,940 | $1,100,402 |
| | | | | |
| 2013 | | | | |
| Interest income | $41,310 | $ 41 | $- | $41,351 |
| Interest expense | (6,475) | - | - | (6,475) |
| Provision for credit losses | (27,784) | - | - | (27,784) |
| Noninterest income | 5,716 | 11,737 | 6 | 17,459 |
| Noninterest expense | (23,676) | (10,350) | (6,660) | (40,686) |
| Net intersegment (expense) income | (5,359) | (655) | 6,014 | - |
| (Loss) income before income taxes | (16,268) | 773 | (640) | (16,135) |
| Income tax benefit (expense) | 6,556 | (313) | 258 | 6,501 |
| Net (loss) income | $(9,712) | $ 460 | $(382) | $(9,634) |
| | | | | |
| Total assets | $1,036,098 | $ 15,759 | $2,267 | $1,054,124 |

**Item 9. Changes in and Disagreements with Accountants on Accounting and Financial Disclosure.**

None.

**Item 9A. Controls and Procedures.**

The Company maintains disclosure controls and procedures that are designed to ensure that information required to be disclosed in the Company’s reports filed under the Exchange Act with the SEC, such as this annual report, is recorded, processed, summarized and reported within the time periods specified in those rules and forms, and that such information is accumulated and communicated to the Company’s management, including the principal executive officer (the “PEO”) and the principal accounting officer (“PAO”), as appropriate, to allow for timely decisions regarding required disclosure. A control system, no matter how well conceived and operated, can provide only reasonable, not absolute, assurance that the objectives of the control system are met. Further, the design of a control system must reflect the fact that there are resource constraints, and the benefits of controls must be considered relative to their costs. These inherent limitations include the realities that judgments in decision-making can be faulty, and that breakdowns can occur because of simple error or mistake. Additionally, controls can be circumvented by the individual acts of some persons, by collusion of two or more people, or by management override of the control. The design of any system of controls also is based in part upon certain assumptions about the likelihood of future events, and there can be no assurance that any design will succeed in achieving its stated goals under all potential future conditions; over time, control 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 December 31, 2015 was carried out under the supervision and with the participation of the Company’s management, including the PEO and the PAO. Based on that evaluation, the Company’s management, including the CEO and the PAO, has concluded that the Company’s disclosure controls and procedures are, in fact, effective at the reasonable assurance level.

During the fourth quarter of 2015, there was no change in the Company’s internal control over financial reporting that has materially affected, or is reasonably likely to materially affect, the Company’s internal control over financial reporting.

As required by Section 404 of the Sarbanes-Oxley Act of 2002, management has performed an evaluation and testing of the Company’s internal control over financial reporting as of December 31, 2015. Management’s report on the Company’s internal control over financial reporting and the related attestation report of the Company’s independent registered public accounting firm are included in Item 8 of Part II of this annual report, and each such report is incorporated into this Item 9A by reference thereto.

**Item 9B. Other Information.**

None.

**PART III**

**Item 10. Directors, Executive Officers and Corporate Governance.**

The Company has adopted a Code of Ethics that applies to all of its directors, officers, and employees, including its principal executive officer, principal financial officer, principal accounting officer, or controller, or persons performing similar functions. A written copy of the Company's Code of Ethics will be provided to stockholders, free of charge, upon request to: W. David Morse, Secretary, Shore Bancshares, Inc., 18 E. Dover Street, Easton, Maryland 21601 or (410) 763-7800.

All other information required by this item is incorporated herein by reference to the following sections of the Company's definitive proxy statement to be filed in connection with the 2016 Annual Meeting of Stockholders:

- Election of Directors (Proposal 1);
- Continuing Directors;
- Executive Officers;
- Qualifications of Director Nominees and Continuing Directors;
- Section 16(a) Beneficial Ownership Reporting Compliance; and
- Corporate Governance Matters (under the heading, "Board Committees").

**Item 11. Executive Compensation.**

The information required by this item is incorporated herein by reference to the following sections of the Company's definitive proxy statement to be filed in connection with the 2016 Annual Meeting of Stockholders:

- Executive Compensation
- Director Compensation

**Item 12. Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters.**

The Company maintains the Shore Bancshares, Inc. 2006 Stock and Incentive Compensation Plan (the "2006 Plan") under which it may issue shares of common stock or grant other equity-based awards (stock options, stock appreciation rights, stock awards, stock units, and performance units) to directors, executive officers, and key employees at the discretion of the Compensation Committee of the Board of Shore Bancshares, Inc. The plan was approved by the Company's Board of Directors and its stockholders.

The following table contains information about these equity compensation plans as of December 31, 2015.

| Plan Category | Number of securities to be issued upon exercise of outstanding options, warrants and rights (a) | Weighted-average exercise price of outstanding options, warrants, and rights (b) | Number of securities remaining available for future issuance under equity compensation plans [excluding securities reflected in column (a)] (c) |
|---|---|---|---|
| Equity compensation plans approved by security holders (1) | 61,327 | $ 8.05 | 456,182 |
| Equity compensation plans not approved by security holders | - | - | - |
| Total | 61,327 | $ 8.05 | 456,182 |

(1) In addition to stock options and stock appreciation rights, the 2006 Plan permits the grant of stock awards, stock units, and performance units, and the shares available for issuance shown in column (c) may be granted pursuant to such awards. Subject to the anti-dilution provisions of the Omnibus Plan, the maximum number of shares of restricted stock that may be granted to any participant in any calendar year is 45,000; the maximum number of restricted stock units that may be granted to any one participant in any calendar year is 45,000; and the maximum

dollar value of performance units that may be granted to any one participant in any calendar year is $1,500,000. As of December 31, 2015, the Company has granted 100,909 shares of restricted stock that are not reflected in column (a) of this table.

All other information required by this item is incorporated herein by reference to the section of the Company's definitive proxy statement to be filed in connection with the 2016 Annual Meeting of Stockholders entitled "Beneficial Ownership of Common Stock".

**Item 13. Certain Relationships and Related Transactions, and Director Independence.**

The information required by this item is incorporated herein by reference to the sections of the Company's definitive proxy statement to be filed in connection with the 2016 Annual Meeting of Stockholders entitled "Certain Relationships and Related Transactions" and "Corporate Governance Matters" (under the heading, "Director Independence").

**Item 14. Principal Accounting Fees and Services.**

The information required by this item is incorporated herein by reference to the section of the Company's definitive proxy statement to be filed in connection with the 2016 Annual Meeting of Stockholders entitled "Audit Fees and Services".

**PART IV**

**Item 15. Exhibits, Financial Statement Schedules.**

(a)(1), (2) and (c) Financial statements and schedules:

Report of Independent Registered Public Accounting Firm
Consolidated Balance Sheets at December 31, 2015 and 2014
Consolidated Statements of Operations — Years Ended December 31, 2015, 2014, and 2013
Consolidated Statements of Comprehensive Loss — Years Ended December 31, 2015, 2014, and 2013
Consolidated Statements of Changes in Stockholders' Equity — Years Ended December 31, 2015, 2014, and 2013
Consolidated Statements of Cash Flows — Years Ended December 31, 2015, 2014, and 2013
Notes to Consolidated Financial Statements for the years ended December 31, 2015, 2014, and 2013

(a)(3) and (b) Exhibits required to be filed by Item 601 of Regulation S-K:

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

**SIGNATURES**

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the Registrant has caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

Shore Bancshares, Inc.

Date: March 11, 2016 By: /s/ Lloyd L. Beatty, Jr.
Lloyd L. Beatty, Jr.
*President and Chief Executive Officer*

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the Registrant and in the capacities and on the dates indicated.

| | |
|---|---|
| /s/ Blenda W. Armistead<br>Blenda W. Armistead, Director<br>March 11, 2016 | /s/ John H. Wilson<br>John H. Wilson, Director<br>March 11, 2016 |
| /s/David J. Bates<br>David J. Bates, Director<br>March 11, 2016 | /s/ Lloyd L. Beatty, Jr.<br>Lloyd L. Beatty, Jr.<br>Director, President, and Chief Executive Officer<br>(Principal Executive Officer)<br>March 11, 2016 |
| /s/ James A. Judge<br>James A. Judge, Director<br>March 11, 2016 | /s/ Christopher F. Spurry<br>Christopher F. Spurry, Director<br>March 11, 2016 |
| /s/ Frank E. Mason, III<br>Frank E. Mason, III, Director<br>March 11, 2016 | /s/ W. Moorhead Vermilye<br>W. Moorhead Vermilye, Director<br>March 11, 2016 |
| /s/ David W. Moore<br>David W. Moore, Director<br>March 11, 2016 | /s/ George S. Rapp<br>George S. Rapp<br>Vice President and Chief Financial Officer<br>(Principal Accounting Officer)<br>March 11, 2016 |

**EXHIBIT LIST**

| Exhibit No. | Description |
|---|---|
| 3.1(i) | Amended and Restated Articles of Incorporation (incorporated by reference to Exhibit 3.1 of the Company's Form 8-K filed on December 14, 2000) |
| 3.1(ii) | Articles Supplementary relating to the Fixed Rate Cumulative Perpetual Preferred Stock, Series A (incorporated by reference Exhibit 4.1 of the Company's Form 8-K filed on January 13, 2009) |
| 3.1(iii) | Articles Supplementary relating to the reclassification of Fixed Rate Cumulative Perpetual Preferred Stock, Series A, as common stock (incorporated by reference Exhibit 3.1(i) of the Company's Form 8-K filed on June 17, 2009) |
| 3.2(i) | Amended and Restated By-Laws (incorporated by reference to Exhibit 3.2(i) of the Company's Form 10-K for the year ended December 31, 2010) |
| 3.2(ii) | First Amendment to Amended and Restated By-Laws (incorporated by reference to Exhibit 3.2(ii) of the Company's Form 10-K for the year ended December 31, 2010) |
| 3.2(iii) | Second Amendment to Amended and Restated By-Laws (incorporated by reference to Exhibit 3.2(iii) of the Company's Form 10-K for the year ended December 31, 2010) |
| 3.2(iv) | Third Amendment to Amended and Restated By-Laws (incorporated by reference to Exhibit 3.2(iv) of the Company's Form 10-K for the year ended December 31, 2010) |
| 10.1 | Amended and Restated Employment Agreement, dated June 16, 2011, between the Company and W. Moorhead Vermilye (incorporated by reference to Exhibit 10.1 to the Company's Form 10-Q/A for the quarter ended June 30, 2011 filed on November 14, 2011). |
| 10.2 | Employment Agreement, dated June 16, 2011, between the Company and Lloyd L. Beatty, Jr. (incorporated by reference to Exhibit 10.2 of the Company's Form 10-Q/A for the quarter ended June 30, 2011 filed on November 14, 2011) |
| 10.3 | Amended Summary of Compensation Arrangement for William W. Duncan, Jr. (incorporated by reference to Exhibit 10.1 of the Company's Form 8-K filed on February 14, 2007, as amended by Form 8-K/A filed on May 3, 2007) |
| 10.4 | Summary of Compensation Arrangement between Centreville National Bank and F. Winfield Trice, Jr. (incorporated by reference to Exhibit 10.1 of the Company's Form 8-K filed on August 13, 2007) |
| 10.5 | Employment Agreement between The Avon-Dixon Agency, LLC and Mark M. Freestate (incorporated by reference to Exhibit 10.6 of the Company's Annual Report on Form 10-K for the year ended December 31, 2006) |

| | |
|---|---|
| 10.6 | Shore Bancshares, Inc. Management Incentive Plan (incorporated by reference to Exhibit 10.1 of the Company's Form 8-K filed on April 21, 2010) |
| 10.7 | Shore Bancshares, Inc. Amended and Restated Executive Deferred Compensation Plan (incorporated by reference to Exhibit 10.2 of the Company's Form 8-K filed on February 14, 2007) |
| 10.8 | Deferral Election, Investment Designation, and Beneficiary Designation Forms under the Shore Bancshares, Inc. Amended and Restated Executive Deferred Compensation Plan (incorporated herein by reference to Exhibit 10.1 to the Company's Form 8-K filed on October 2, 2006) |
| 10.9 | Form of Centreville National Bank of Maryland Director Indexed Fee Continuation Plan Agreement with Messrs. Freestate and Pierson (incorporated by reference to Exhibit 10.2 to the Company's Form 8-K filed on December 12, 2006) |
| 10.10 | Form of Amended and Restated Director Indexed Fee Continuation Plan Agreement between Centreville National Bank and Messrs. Freestate and Pierson (incorporated by reference to Exhibit 10.2 of the Company's Current Report on Form 8-K filed on January 7, 2009) |

| | |
|---|---|
| 10.11 | Form of Centreville National Bank Life Insurance Endorsement Split Dollar Plan Agreement with Messrs. Freestate and Pierson (incorporated by reference to Exhibit 10.3 to the Company's Form 8-K filed on December 12, 2006) |
| 10.12 | Talbot Bank of Easton, Maryland Supplemental Deferred Compensation Plan (incorporated by reference to Exhibit 10.7 of the Company's Quarterly Report on Form 10-Q for the period ended September 30, 2005) |
| 10.13 | First Amendment to The Talbot Bank of Easton, Maryland Supplemental Deferred Compensation Plan for the benefit of W. Moorhead Vermilye (incorporated by reference to Exhibit 10.1 of the Company's Current Report on Form 8-K filed on January 7, 2009) |
| 10.14 | Talbot Bank of Easton, Maryland Supplemental Deferred Compensation Plan Trust Agreement (incorporated by reference to Exhibit 10.7 of the Company's Quarterly Report on Form 10-Q for the period ended September 30, 2005) |
| 10.15 | 1998 Stock Option Plan (incorporated by reference to Exhibit 10 of the Company's Registration Statement on Form S-8 filed with the SEC on September 25, 1998 (Registration No. 333-64319)) |
| 10.16 | Talbot Bancshares, Inc. Employee Stock Option Plan (incorporated by reference to Exhibit 10 of the Company's Registration Statement on Form S-8 filed May 4, 2001 (Registration No. 333-60214)) |
| 10.17 | Shore Bancshares, Inc. 2006 Stock and Incentive Compensation Plan (incorporated by reference to Appendix A of the Company's 2006 definitive proxy statement filed on March 24, 2006) |
| 10.18 | Form of Restricted Stock Award Agreement under the 2006 Stock and Incentive Compensation Plan (incorporated by reference to Exhibit 10.1 to the Company's Form 8-K filed on April 11, 2007) |
| 10.19 | Form of Performance Share/Restricted Stock Unit Award Agreement (incorporated by reference to Exhibit 10.1 to the Company's Form 8-K filed on July 8, 2015). |
| 10.20 | Amended and Restated Employment Agreement, dated September 21, 2015, between the Company and Lloyd L. Beatty, Jr. (incorporated by reference to Exhibit 10.1 to the Company's Form 8-K filed on September 25, 2015). |
| 21 | Subsidiaries of the Company (included in the "BUSINESS—General" section of Item 1 of Part I of this Annual Report on Form 10-K) |
| 23 | Consent of Stegman & Company (filed herewith) |
| 31.1 | Certifications of the PEO pursuant to Section 302 of the Sarbanes-Oxley Act (filed herewith) |
| 31.2 | Certifications of the PAO pursuant to Section 302 of the Sarbanes-Oxley Act (filed herewith) |
| 32 | Certification pursuant to Section 906 of the Sarbanes-Oxley Act (furnished herewith) |
| 101.INS | XBRL Instance Document (filed herewith) |
| 101.SCH | XBRL Taxonomy Extension Schema (filed herewith) |

101.CAL XBRL Taxonomy Extension Calculation Linkbase (filed herewith)

101.DEF XBRL Taxonomy Extension Definition Linkbase (filed herewith)

101.LAB XBRL Taxonomy Extension Label Linkbase (filed herewith)

101.PRE XBRL Taxonomy Extension Presentation Linkbase (filed herewith)