

TRI COUNTY FINANCIAL CORP /MD/

Form 10-K

March 27, 2007

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**UNITED STATES SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON, DC 20549  
FORM 10-K**

**(Mark One)**

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

**For the fiscal year ended December 31, 2006**

**OR**

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

**For the transition period from \_\_\_\_\_ to \_\_\_\_\_**

**Commission File No. 0-18279  
TRI-COUNTY FINANCIAL CORPORATION  
(Exact name of registrant as specified in its charter)**

**Maryland**

**52-1652138**

(State or other jurisdiction of  
incorporation or organization)

(I.R.S. Employer  
Identification No.)

**3035 Leonardtown Road, Waldorf, Maryland**

**20601**

(Address of principal executive offices)

(Zip Code)

Registrant's telephone number, including area code: **(301) 645-5601**

Securities registered pursuant to Section 12(b) of the Act: **None**

Securities registered pursuant to Section 12(g) of the Act:

**Common Stock, par value \$.01 per share**

(Title of Class)

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

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes  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  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 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. See definitions of accelerated filer and large accelerated filer in Exchange Act Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer  Accelerated filer  Non-accelerated filer

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

The aggregate market value of voting stock held by non-affiliates of the registrant was approximately \$49.9 million based on the closing price (\$23.83 per share) at which the common stock, \$0.01 par value, was sold on the last business day of the Company's most recently completed second fiscal quarter. For purposes of this calculation only, the shares held by directors and executive officers of the registrant are deemed to be shares held by affiliates.

Number of shares of common stock outstanding as of March 15, 2007: 2,655,159

**DOCUMENTS INCORPORATED BY REFERENCE**

1. Portions of the Annual Report to Stockholders for the year ended December 31, 2006. (Part II)
  2. Portions of the Proxy Statement for the 2007 Annual Meeting of Stockholders. (Part III)
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**PART I**

*This report contains certain forward-looking statements within the meaning of the federal securities laws. These statements are not historical facts, rather statements based on Tri-County Financial Corporation's current expectations regarding its business strategies, intended results and future performance. Forward-looking statements are preceded by terms such as expects, believes, anticipates, intends and similar expressions.*

*Management's ability to predict results or the effect of future plans or strategies is inherently uncertain. Factors that could affect actual results include interest rate trends, the general economic climate in the market area in which Tri-County Financial Corporation operates, as well as nationwide, Tri-County Financial Corporation's ability to control costs and expenses, competitive products and pricing, loan delinquency rates and changes in federal and state legislation and regulation. These factors should be considered in evaluating the forward-looking statements and undue reliance should not be placed on such statements. Tri-County Financial Corporation assumes no obligation to update any forward-looking statements.*

**Item 1. Business**

Tri-County Financial Corporation (the Company) is a bank holding company organized in 1989 under the laws of the State of Maryland. It presently owns all the outstanding shares of capital stock of Community Bank of Tri-County (the Bank), a Maryland-chartered commercial bank. The Bank was originally organized in 1950 as Tri-County Building and Loan Association of Waldorf, a mutual savings and loan association, and in 1986 converted to a federal stock savings bank and adopted the name Tri-County Federal Savings Bank. In 1997, the Bank converted to a Maryland-chartered commercial bank and adopted its current corporate title. The Company engages in no significant activity other than holding the stock of the Bank and operating the business of the Bank. Accordingly, the information set forth in this report, including financial statements and related data, relates primarily to the Bank and its subsidiaries.

The Bank serves the southern Maryland counties of Charles, Calvert and St. Mary's, (the Tri-County area) through its main office and eight branches located in Waldorf, Bryans Road, Dunkirk, Leonardtown, La Plata, Charlotte Hall, Prince Frederick and California, Maryland. The Bank operates fifteen automated teller machines (ATMs) including six stand-alone locations in the Tri-County area. The Bank offers telephone and internet banking services. The Bank is engaged in the commercial and retail banking business as authorized by the banking statutes of the State of Maryland and applicable federal regulations, including the acceptance of deposits, and the origination of loans to individuals, associations, partnerships and corporations. The Bank's real estate financing consists of residential first and second mortgage loans, home equity lines of credit and commercial mortgage loans. Commercial lending consists of both secured and unsecured loans. The Bank is a member of the Federal Reserve and Federal Home Loan Bank (the FHLB) systems and its deposits are insured up to applicable limits by the Deposit Insurance Fund administered by the Federal Deposit Insurance Corporation (the FDIC).

The Company's executive offices are located at 3035 Leonardtown Road, Waldorf, Maryland. Its telephone number is (301) 645-5601.

**Available Information**

The Company's Annual Report on Form 10-K, Quarterly Reports on Form 10-Q, current reports on Form 8-K, and any amendments to such reports filed pursuant to Section 13(a) or 15(d) of the Securities Exchange Act of 1934, as amended, are made available free of charge on its website, [www.cbtc.com](http://www.cbtc.com), as soon as reasonably practicable after such reports are electronically filed with the Securities and Exchange Commission. Information on the website should not be considered a part of this Form 10-K.

**Market Area**

The Bank considers its principal lending and deposit market area to consist of the southern Maryland counties of Charles, Calvert and St. Mary's. These counties have experienced significant population growth during the past decade due to their proximity to the rapidly growing Washington, D.C. and Baltimore metropolitan areas. Southern Maryland is generally considered to have more affordable housing than many other Washington and

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Baltimore area suburbs. In addition, the area has experienced rapid growth in businesses and federal facilities located in the area. Major federal facilities include the Patuxent Naval Air Station in St. Mary's County. The Patuxent Naval Air Station has undergone significant expansion in the last several years and is projected to continue to expand for several more years.

Rapid growth in our market area has been constrained by certain government policies, as all three counties have attempted to limit growth in certain areas. These policies have created some uncertainty about zoning and land use regulations. In some cases, real estate development work has been delayed or cancelled as a result of these policies. For example, Charles County introduced a user fee system, which would involve upfront payments in real estate development, but would remove subsequent regulatory delays. This system has not had an appreciable effect on the pace of residential development. Future regulatory events may adversely affect the Bank's loan growth.

**Competition**

The Bank faces strong competition in the attraction of deposits and in the origination of loans. Its most direct competition for deposits and loans comes from other banks, savings and loan associations, and federal and state credit unions located in its primary market area. There are currently 14 FDIC-insured depository institutions operating in the Tri-County area including subsidiaries of several regional and super-regional bank holding companies. According to statistics compiled by the FDIC, the Bank was ranked third in deposit market share in the Tri-County area as of June 30, 2006, the latest date for which such data is available. The Bank faces additional significant competition for investors' funds from mutual funds, brokerage firms, and other financial institutions. The Bank competes for loans by providing competitive rates, flexibility of terms, and service. It competes for deposits by offering depositors a wide variety of account types, convenient office locations and competitive rates. Other services offered include tax-deferred retirement programs, brokerage services, safe deposit boxes and miscellaneous services. The Bank has used direct mail, billboard and newspaper advertising to increase its market share of deposits, loans and other services in its market area. It provides ongoing training for its staff in an attempt to ensure high-quality service.

**Lending Activities**

**General.** The Bank offers a wide variety of real estate, consumer and commercial loans. The Bank's lending activities include residential and commercial real estate loans, construction loans, land acquisition and development loans, equipment financing, and commercial and consumer loans. Most of the Bank's customers are residents of, or businesses located in, the Tri-County area. The Bank's primary market for commercial loans consists of small and medium-sized businesses located in southern Maryland. The Bank believes that this market is responsive to the Bank's ability to provide personal service and flexibility. The Bank attracts customers for its consumer lending products based upon its ability to offer service, flexibility, and competitive pricing, as well as by leveraging other banking relationships such as soliciting deposit customers for loans.

**Residential First Mortgage Loans.** Residential first mortgage loans made by the Bank are generally long-term loans, amortized on a monthly basis, with principal and interest due each month. The initial contractual loan payment period for residential loans typically ranges from ten to 30 years. The Bank's experience indicates that real estate loans remain outstanding for significantly shorter periods than their contractual terms. Borrowers may refinance or prepay loans at their option, without penalty. The Bank originates both fixed-rate and adjustable-rate residential first mortgages.

The Bank offers fixed-rate residential first mortgages on a variety of terms including loan periods from ten to 30 years and bi-weekly payment loans. Total fixed-rate loan products in our residential first mortgage portfolio amounted to \$69.5 million as of December 31, 2006. Fixed-rate loans may be packaged and sold to investors or retained in the Bank's loan portfolio. Depending on market conditions, the Bank may elect to retain the right to service the loans sold for a payment based upon a percentage (generally 0.25% of the outstanding loan balance). These servicing rights may be sold to other qualified servicers. As of December 31, 2006, the Bank serviced \$29.3 million in residential mortgage loans for others.

The Bank also offers mortgages that are adjustable on a one-, three-, and five-year basis generally with limitations on upward adjustments of two percentage points per repricing period and six percentage points over the

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life of the loan. The Bank primarily markets adjustable-rate loans with rate adjustments based upon a United States Treasury Bill Index. As of December 31, 2006, the Bank had \$11.3 million in adjustable-rate residential mortgage loans. The retention of adjustable-rate mortgage loans in the Bank's loan portfolio helps reduce the negative effects of increases in interest rates on the Bank's net interest income. Under certain conditions, however, the annual and lifetime limitations on interest rate adjustments may limit the increases in interest rates on these loans. There are also unquantifiable credit risks resulting from potential increased costs to the borrower as a result of repricing of adjustable-rate mortgage loans. During periods of rising interest rates, the risk of default on adjustable-rate mortgage loans may increase due to the upward adjustment of interest cost to the borrower. In addition, the initial interest rate on adjustable-rate loans is generally lower than that on a fixed-rate loan of similar credit quality and size.

The Bank makes residential first mortgage loans of up to 97% of appraised value or sales price of the property, whichever is less, to qualified owner-occupants upon the security of single-family homes. Non-owner occupied one- to four-family loans and loans secured by something other than residential real estate are generally permitted to a maximum 80% loan-to-value of the appraised value depending on the overall strength of the application. The Bank currently requires that substantially all residential first mortgage loans with loan-to-value ratios in excess of 80% carry private mortgage insurance to lower the Bank's exposure to approximately 80% of the value of the property. In certain cases, the borrower may elect to borrow amounts in excess of 80% loan-to-value in the form of a second mortgage. The second mortgage will generally have a higher interest rate and shorter repayment period than the first mortgage on the same property.

All improved real estate that serves as security for a loan made by the Bank must be insured, in the amount and by such companies as may be approved by the Bank, against fire, vandalism, malicious mischief and other hazards. Such insurance must be maintained through the entire term of the loan and in an amount not less than that amount necessary to pay the Bank's indebtedness in full.

***Commercial Real Estate and Other Non-Residential Real Estate Loans.*** The Bank has increased its emphasis on loans for the permanent financing of commercial and other improved real estate projects, including office buildings, retail locations, churches, and other special purpose buildings. As a result, commercial real estate loans increased to \$177.9 million, or 41.7%, of the loan portfolio at December 31, 2006. The primary security on a commercial real estate loan is the real property and the leases that produce income for the real property. The Bank generally limits its exposure to a single borrower to 15% of the Bank's capital and frequently participates with other lenders on larger projects. Loans secured by commercial real estate are generally limited to 80% of the lower of the appraised value or sales price and have an initial contractual loan payment period ranging from three to 20 years. Virtually all of the Bank's commercial real estate loans, as well as its construction loans discussed below, are secured by real estate located in the Bank's primary market area. At December 31, 2006, the largest outstanding commercial real estate loan was a \$3.8 million loan, which is secured by an apartment complex. This loan was performing according to its terms at December 31, 2006.

Loans secured by commercial real estate are larger and involve greater risks than one- to four-family residential mortgage loans. Because payments on loans secured by such properties are often dependent on the successful operation or management of the properties, repayment of such loans may be subject to a greater extent to adverse conditions in the real estate market or the economy. As a result of the greater emphasis that the Bank places on commercial real estate loans, the Bank is increasingly exposed to the risks posed by this type of lending. To monitor cash flows on income properties, the Bank requires borrowers and loan guarantors, if any, to provide annual financial statements on multi-family or commercial real estate loans. In reaching a decision on whether to make a multi-family or commercial real estate loan, the Bank considers the net operating income of the property, the borrower's expertise, credit history and profitability, and the value of the underlying property. Environmental surveys are generally required for commercial real estate loans over \$250,000.

***Construction and Land Development Loans.*** The Bank offers construction loans to individuals and building contractors for the construction of one- to four-family dwellings and commercial buildings. Construction loans totaled \$42.7 million at December 31, 2006. Loans to individuals primarily consist of construction/permanent loans, which have fixed rates, payable monthly for the construction period and are followed by a 30-year, fixed- or adjustable-rate permanent loan. The Bank also provides construction and land development loans to home building and real estate

development companies. Generally, these loans are secured by the real estate under construction as well as by guarantees of the principals involved. Draws are made upon satisfactory completion of predefined stages



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of construction or development. The Bank will typically lend up to the lower of 80% of the appraised value or purchase price.

In addition, the Bank offers loans for the purpose of acquisition and development of land, as well as loans on undeveloped, subdivided lots for home building by individuals. Land acquisition and development loans, included in construction loans discussed above, totaled \$15.2 million at December 31, 2006. Bank policy requires that zoning and permits must be in place prior to making development loans.

The Bank's ability to originate all types of construction and development loans is heavily dependent on the continued demand for single-family housing construction in the Bank's market areas. If the demand for new houses in the Bank's market areas were to decline, the Bank may be forced to shift a portion of its lending emphasis. There can be no assurance of the Bank's ability to continue growth and profitability in its construction lending activities in the event of such a decline.

Construction and land development loans are inherently riskier than providing financing on owner-occupied real estate. The Bank's risk of loss is dependent on the accuracy of the initial estimate of the market value of the completed project as well as the accuracy of the cost estimates made to complete the project. During the construction phase, a number of factors could result in delays and cost overruns. If the estimate of construction costs proves to be inaccurate, the Bank may be required to advance funds beyond the amount originally committed to permit completion of the development. If the estimate of value proves to be inaccurate, the Bank may be confronted, at or before the maturity of the loan, with a project having a value that is insufficient to assure full repayment. As a result of the foregoing, construction lending often involves the disbursement of substantial funds with repayment dependent, in part, on the success of the ultimate project rather than the ability of the borrower or guarantor to repay principal and interest. If the Bank is forced to foreclose on a project before or at completion due to a default, there can be no assurance that the Bank will be able to recover all of the unpaid balance of, and accrued interest on, the loan as well as related foreclosure and holding costs.

***Home Equity and Second Mortgage Loans.*** The Bank has maintained a portfolio of home equity and second mortgage loans. Home equity loans, which totaled \$15.2 million at December 31, 2006, are generally made in the form of lines of credit with minimum amounts of \$5,000, have terms of up to 20 years, variable rates priced at prime or some margin above prime, and require an 80% or 90% loan-to-value ratio (including any prior liens), depending on the specific loan program. Second mortgage loans, which totaled \$9.4 million at December 31, 2006 are fixed and variable-rate loans that have original terms between five and 15 years. Loan-to-value ratios of up to 80% or 95% are allowed depending on the specific loan program.

These products contain a higher risk of default than residential first mortgages as in the event of foreclosure, the first mortgage would need to be paid off prior to collection of the second. The Bank believes that its policies and procedures are sufficient to mitigate the additional risk.

***Commercial Loans.*** The Bank offers commercial loans to its business customers. The Bank offers a variety of commercial loan services including term loans and lines of credit. Such loans are generally made for terms of five years or less. The Bank offers both fixed-rate and adjustable-rate loans under these product lines. This portion of our portfolio has grown rapidly in the last several years, growing from \$15.0 million and 8.6% of the portfolio in 2000 to \$79.6 million and 18.7% of the overall loan portfolio at December 31, 2006. When making commercial business loans, the Bank considers the financial statements of the borrower, the borrower's payment history of both corporate and personal debt, the projected cash flow of the business, the viability of the industry in which the consumer operates, the value of the collateral, and the borrower's ability to service the debt from income. These loans are primarily secured by equipment, real property, accounts receivable, or other security as determined by the Bank. The higher interest rates and shorter loan terms available on commercial lending make these products attractive to the Bank. Commercial business loans, however, entail greater risk than residential mortgage loans. Unlike residential mortgage loans, which generally are made on the basis of the borrower's ability to make repayment from his or her employment or other income and which are secured by real property whose value tends to be more easily ascertainable, commercial loans are made on the basis of the borrower's ability to make repayment from the cash flow of the borrower's business. As a result, the availability of funds for the repayment of commercial loans may depend substantially on the success of the business itself. In the case of business failure, collateral would need to be liquidated

to provide repayment for the loan. In many cases, the highly specialized

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nature of collateral equipment would make full recovery from the sale of collateral problematic. The Bank attempts to control these risks by establishing guidelines that provide for over collateralization of the loans. At December 31, 2006, the largest outstanding commercial loan was \$4.8 million to Charles County, which was unsecured. This loan was performing according to its terms at December 31, 2006.

**Consumer Loans.** The Bank has developed a number of programs to serve the needs of its customers with primary emphasis upon direct loans secured by automobiles, boats, recreational vehicles, and trucks. The Bank also makes home improvement loans and offers both secured and unsecured personal lines of credit. The higher interest rates and shorter loan terms available on consumer lending make these products attractive to the Bank. Consumer loans entail greater risk than residential mortgage loans, particularly in the case of consumer loans, which are unsecured or secured by rapidly depreciable assets such as automobiles. In such cases, any repossessed collateral may not provide an adequate source of repayment of the outstanding loan balance. The remaining deficiency often does not warrant further substantial collection efforts against the borrower. In addition, consumer loan collections are dependent on the borrower's continuing financial stability and thus are more likely to be adversely affected by job loss, divorce, illness, or personal bankruptcy. Furthermore, the application of various federal and state laws including federal and state bankruptcy and insolvency laws, may limit the amount that can be recovered on such loans. Such loans may also give rise to claims and defenses by a consumer loan borrower against an assignee such as the Bank, and a borrower may be able to assert against such assignee claims and defenses that it has against the seller of the underlying collateral.

**Commercial Equipment Loans.** The Bank has also grown its commercial equipment financing. These loans consist primarily of fixed-rate, short-term loans collateralized by customers' equipment including trucks, cars, construction equipment, and other more specialized equipment. When making commercial equipment loans, the Bank considers the financial statements of the borrower, the borrower's payment history of both corporate and personal debt, the projected cash flows of the business, the viability of the industry in which the consumer operates, the value of the collateral and the borrower's ability to repay the loans from income. The higher interest rates and shorter loan terms available on commercial equipment lending make these products attractive to the Bank. These loans entail greater risk than loans such as residential mortgage loans. Unlike residential mortgage loans, which generally are made on the basis of the borrower's ability to make repayment from his or her employment or other income and which are secured by real property whose value tends to be more easily ascertainable, commercial loans are of higher risk and typically are made on the basis of the borrower's ability to make repayment from the cash flow of the borrower's business. As a result, the availability of funds for the repayment of commercial loans may depend substantially on the success of the business itself. In the case of business failure, collateral would need to be liquidated to provide repayment for the loan. In many cases, the highly specialized nature of collateral equipment would make full recovery from the sale of collateral problematic. The Bank attempts to control these risks by establishing guidelines that provide for over collateralization of the loans.

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**Loan Portfolio Analysis.** Set forth below is selected data relating to the composition of the Bank's loan portfolio by type of loan on the dates indicated.

	2006		2005		At December 31, 2004		2003		2002	
	Amount	%	Amount	%	Amount	%	Amount	%	Amount	%
Real estate loans:										
Commercial	\$ 177,924	41.69%	\$ 166,851	44.66%	\$ 136,342	46.51%	\$ 93,825	42.46%	\$ 74,292	37.0
Residential first mortgage	80,781	18.93	73,628	19.71	59,087	20.16	42,971	19.45	48,976	24.4
Construction and land development	42,746	10.01	32,608	8.73	17,598	6.00	19,599	8.87	14,579	7.2
Home equity and second mortgage	24,572	5.76	25,884	6.93	23,925	8.16	19,562	8.85	19,007	9.4
Commercial loans	79,630	18.66	54,738	14.65	39,137	13.35	30,436	13.77	29,947	14.9
Consumer loans	2,813	0.66	3,128	0.84	3,462	1.18	4,097	1.85	4,623	2.3
Commercial equipment	18,288	4.29	16,742	4.48	13,596	4.64	10,473	4.74	9,007	4.4
Total loans	426,754	100.00%	373,579	100.00%	293,147	100.00%	220,963	100.00%	200,431	100.0
Assets: Deferred loan fees, net	490		604		764		650		668	
Provision loss reserve	3,784		3,383		3,058		2,573		2,314	
Assets receivable, net	\$ 422,480		\$ 369,592		\$ 289,325		\$ 217,740		\$ 197,449	

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**Loan Originations, Purchases and Sales.** The Bank solicits loan applications through its branch network, directly through referrals from customers, and through marketing by commercial and residential mortgage loan officers. Loans are processed and approved according to guidelines deemed appropriate for each product type. Loan requirements such as income verification, collateral appraisal, and credit reports vary by loan type. Loan processing functions are generally centralized except for small consumer loans.

**Loan Approvals, Procedures and Authority.** Loan approval authority is established by Board policy and delegated as deemed necessary and appropriate. Loan approval authorities vary by individual with the President having approval authority up to \$1.25 million, executive vice presidents up to \$1.0 million, vice presidents up to \$300,000, and business development officers up to \$150,000. Authorities may be combined in an officers loan committee up to \$2.0 million. In cases where time is of the essence, the officers loan committee consisting of at least three senior officers may unanimously approve loans up to the legal limit with a later ratification by the Board loan committee. For residential mortgage loans, the residential loan underwriter may approve loans up to the conforming loan limit of \$417,000. Selected branch personnel may approve secured loans up to \$75,000, and unsecured loans up to \$50,000. A loan committee consisting of the President and two members of the Board (the Board loan committee) ratifies all commercial real estate loans and approves all loans in excess of \$2.0 million, except for those noted above that exceed the \$2.0 million limit in certain cases. Depending on the loan and collateral type, conditions for protecting the Bank's collateral are specified in the loan documents. Typically these conditions might include requirements to maintain hazard and title insurance and to pay property taxes.

Depending on market conditions, mortgage loans may be originated primarily with the intent to sell to third parties such as Fannie Mae or Freddie Mac. However, no mortgage loans were sold by the Bank in 2006. To comply with internal and regulatory limits on loans to one borrower, the Bank routinely sells portions of commercial and commercial real estate loans to other lenders. The Bank also routinely buys portions of loans, or participation certificates from other lenders. The Bank only purchases loans or portions of loans after reviewing loan documents, underwriting support, and other procedures, as necessary. The Bank purchased \$2.1 million in participations in 2006. Purchased loans are subject to the same regulatory and internal policy requirements as other loans in the Bank's portfolio.

**Loans to One Borrower.** Under Maryland law, the maximum amount that the Bank is permitted to lend to any one borrower and his or her related interests may generally not exceed 10% of the Bank's unimpaired capital and surplus, which is defined to include the Bank's capital, surplus, retained earnings and 50% of its reserve for possible loan losses. Under this authority, the Bank would have been permitted to lend up to \$6.8 million to any one borrower at December 31, 2006. By interpretive ruling of the Commissioner of Financial Regulation, Maryland banks have the option of lending up to the amount that would be permissible for a national bank, which is generally 15% of unimpaired capital and surplus (defined to include a bank's total capital for regulatory capital purposes plus any loan loss allowances not included in regulatory capital). Under this formula, the Bank would have been permitted to lend up to \$7.9 million to any one borrower at December 31, 2006. At December 31, 2006, the largest amount outstanding to any one borrower and his or her related interests was \$7.1 million.

**Loan Commitments.** The Bank does not normally negotiate standby commitments for the construction and purchase of real estate. Conventional loan commitments are granted for a one-month period. The Bank's outstanding commitments to originate loans at December 31, 2006 was approximately \$12.8 million, excluding undisbursed portions of loans in process. It has been the Bank's experience that few commitments expire unfunded.

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**Maturity of Loan Portfolio.** The following table sets forth certain information at December 31, 2006 regarding the dollar amount of loans maturing in the Bank's portfolio based on their contractual terms to maturity. Demand loans, loans having no stated schedule of repayments and no stated maturity, and overdrafts are reported as due in one year or less.

	<b>Due within one year after December 31, 2006</b>	<b>Due after one year through five years from December 31, 2006</b>	<b>Due more than five years from December 31, 2006</b>
	<b>(Dollars in thousands)</b>		
Real estate loans			
Commercial	\$ 22,700	\$ 25,548	\$ 129,676
Residential first mortgage	3,698	13,642	63,441
Construction and land development	39,032	3,714	
Home equity and second mortgage	15,990	3,165	5,417
Commercial loans	79,630		
Consumer loans	1,000	1,553	260
Commercial equipment	5,869	10,780	1,639
Total loans	\$ 167,919	\$ 58,402	\$ 200,433

The following table sets forth the dollar amount of all loans due after one year from December 31, 2006, which have predetermined interest rates and have floating or adjustable interest rates.

	<b>Fixed Rates</b>	<b>Floating or Adjustable Rates</b>	<b>Total</b>
	<b>(Dollars in thousands)</b>		
Real estate loans			
Commercial	\$ 15,348	\$ 139,876	\$ 155,224
Residential first mortgage	66,614	10,469	77,083
Construction and land development		3,714	3,714
Home equity and second mortgage	8,582		8,582
Commercial loans			
Consumer loans	1,813		1,813
Commercial equipment	12,419		12,419
Total Loans	\$ 104,776	\$ 154,059	\$ 258,835

**Delinquencies.** The Bank's collection procedures provide that when a loan is 15 days delinquent, the borrower is contacted by mail and payment is requested. If the delinquency continues, subsequent efforts will be made to contact the delinquent borrower and obtain payment. If these efforts prove unsuccessful, the Bank will pursue appropriate legal action including repossession of the collateral and other actions as deemed necessary. In certain instances, the Bank will attempt to modify the loan or grant a limited moratorium on loan payments to enable the borrower to reorganize his financial affairs.

***Non-Performing Assets and Asset Classification.*** Loans are reviewed on a regular basis and are placed on a non-accrual status when, in the opinion of management, the collection of additional interest is doubtful. Residential mortgage loans are placed on non-accrual status when either principal or interest is 90 days or more past due unless they are adequately secured and there is reasonable assurance of full collection of principal and interest. Consumer loans generally are charged off when the loan becomes more than 120 days delinquent. Commercial business and real estate loans are placed on non-accrual status when the loan is 90 days or more past due or when the loan's condition puts the timely repayment of principal and interest in doubt. Interest accrued and unpaid at the time a loan is placed on non-accrual status is charged against interest income. Subsequent payments are either

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applied to the outstanding principal balance or recorded as interest income, depending on management's assessment of the ultimate collectibility of the loan.

***Foreclosed Real Estate***

Real estate acquired by the Bank as a result of foreclosure or by deed in lieu of foreclosure is classified as foreclosed real estate until such time as it is sold. When such property is acquired, it is recorded at its fair market value. Subsequent to foreclosure, the property is carried at the lower of cost or fair value less selling costs. Additional write-downs as well as carrying expenses of the foreclosed properties are charged to expenses in the current period. The Bank had foreclosed real estate with a carrying value of approximately \$460,884 at December 31, 2006.

Foreclosed real estate is recorded net of a valuation allowance. The allowance is adjusted as circumstances require. These adjustments in the allowance include changes in the value of the property as well as the sale or disposal of the foreclosed property. There is currently one property in foreclosed real estate. This property is related to a development project. This project was acquired in July 2001 by deed in lieu of foreclosure. The project is being developed in two phases. Preliminary approvals have been obtained for phase 1 and this portion of the project was sold in 2002. Phase 2 is under contract to sell and will be sold when preliminary approval from Charles County is granted. Approvals for building permits are generally granted within a school district as public facilities become available. Rights are generally granted to projects based upon dates of meeting certain criteria. During 2005, the County granted numerous permits to projects within the same school district. These grants would tend to move our project up in priority. No firm date for granting approval is now known. Total sales price for Phase 2 is expected to be \$1.7 million. Under the terms of the agreement, the buyer is responsible for all development costs associated with both phases. The sales agreement provides for a minimal (\$25,000) payment to the Bank should the buyer decide to not complete its purchase of Phase 2. The Bank did not provide financing for the sales agreement or subsequent development work. Based upon these facts and circumstances, the Bank recognized the sale of Phase 1 for accounting purposes. The Bank determined that no sales recognition on the agreement to sell Phase 2 is appropriate at this time. The amount of the remaining allowance and total carrying value of Phase 2 is periodically evaluated for possible impairment.



**Table of Contents*****Delinquent and Nonaccrual Loans***

The following table sets forth information with respect to the Bank's non-performing loans for the dates indicated. At the dates shown, the Bank had no troubled debt restructuring or impaired loans within the meaning of Statement of Financial Accounting Standards No. 114, Accounting by Creditors for Impairment of a Loan and 118, Accounting by Creditors for Impairment of a Loan - Income Recognition and Disclosures and no accruing loans that are contractually past due 90 days or more.

	<b>At December 31,</b>				
	<b>2006</b>	<b>2005</b>	<b>2004</b>	<b>2003</b>	<b>2002</b>
	<b>(Dollars in thousands)</b>				
Loans accounted for on a nonaccrual basis:					
Real estate loans					
Commercial	\$ 390	\$	\$	\$	\$
Residential first mortgage	273	273	273	275	278
Construction and land development					
Home equity and second mortgage		53			49
Commercial loans	303	258	393	103	269
Consumer loans	80	7	9	1	1
Commercial equipment					
<b>Total</b>	<b>1,046</b>	<b>591</b>	<b>675</b>	<b>379</b>	<b>597</b>
<b>Total non-performing loans</b>	<b>\$ 1,046</b>	<b>\$ 591</b>	<b>\$ 675</b>	<b>\$ 379</b>	<b>\$ 597</b>

For a detailed discussion of foreclosed real estate at December 31, 2006 see the Foreclosed Real Estate section discussed previously. During the year ended December 31, 2006, gross interest income of \$75,480 would have been recorded on loans accounted for on a non-accrual basis if the loans had been current throughout the period. During 2006, the Company recognized \$18,121 in interest on these loans. The accrual of interest on mortgage and commercial loans is discontinued at the time the loan is 90 days delinquent unless the credit is well secured and in the process of collection. Consumer loans are charged-off no later than 180 days past due. In all cases, loans are placed on non-accrual or charged-off at an earlier date, if collection of principal or interest is considered doubtful. All interest accrued but not collected from loans that are placed on non-accrual or charged-off is reversed against interest income. The interest on these loans is accounted for on the cash-basis or cost-recovery method, until qualifying for return to accrual. Loans are returned to accrual status when all principal and interest amounts contractually due are brought current and future payments are reasonably assured.

At December 31, 2006, there were no loans outstanding not reflected in the above table as to which known information about possible credit problems of borrowers caused management to have serious doubts as to the ability of such borrowers to comply with present loan repayment terms.

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The following table sets forth an analysis of activity in the Bank's allowance for loan losses for the periods indicated.

	<b>At December 31,</b>				
	<b>2006</b>	<b>2005</b>	<b>2004</b>	<b>2003</b>	<b>2002</b>
	<b>(Dollars in thousands)</b>				
Balance at beginning of period	\$ 3,383	\$ 3,058	\$ 2,573	\$ 2,314	\$ 2,282
Charge-offs					
Real estate loans:					
Commercial					
Residential first mortgage					
Construction and land development					36
Home equity and second mortgage					21
Commercial loans		3	1	35	59
Consumer loans	8	2	3	2	15
Commercial equipment		4	14	24	
Total charge-offs	8	9	18	61	131
Recoveries					
Real estate loans:					
Commercial					
Residential first mortgage			33		
Construction and land development					
Home equity and second mortgage					
Commercial loans					
Consumer loans	3		9		3
Commercial equipment		5	8	2	
Total recoveries	3	5	50	2	3
Net (recoveries) charge-offs	5	4	(32)	58	128
Provision for loan losses	406	329	453	317	160
Balance at end of period	\$ 3,784	\$ 3,383	\$ 3,058	\$ 2,573	\$ 2,314
Ratio of net charge-offs (recoveries) to average loans outstanding during the year	0.00%	0.00%	(0.01)%	0.02%	0.06%

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The following table allocates the allowance for loan losses by loan category at the dates indicated. The allocation of the allowance to each category is not necessarily indicative of future losses and does not restrict the use of the allowance to absorb losses in any category.

	At December 31,									
	2006		2005		2004		2003		2002	
	(Dollars in thousands)									
	Percent of Loans in Each Category to Total		Percent of Loans in Each Category to Total		Percent of Loans in Each Category to Total		Percent of Loans in Each Category to Total		Percent of Loans in Each Category to Total	
	Amount	Loans	Amount	Loans	Amount	Loans	Amount	Loans	Amount	Loans
Real estate loans										
Commercial	\$ 1,479	41.69%	\$ 1,466	44.66%	\$ 1,909	46.51%	\$ 1,409	42.46%	\$ 1,077	37.07%
Residential first mortgage	97	18.93	73	19.71	59	20.16	64	19.45	118	24.44
Construction and land development	662	10.01	502	8.73	132	6.00	281	8.87	211	7.27
Home equity and second mortgage	104	5.76	109	6.93	120	8.16	244	8.85	276	9.48
Commercial loans	1,135	18.66	709	14.65	530	13.35	381	13.77	434	14.94
Consumer loans	126	0.66	124	0.84	138	1.18	63	1.85	68	2.31
Commercial equipment	181	4.29	400	4.48	170	4.64	131	4.71	130	4.49
Total allowance for loan losses	\$ 3,784	100.00%	\$ 3,383	100.00%	\$ 3,058	100.00%	\$ 2,573	100.00%	\$ 2,314	100.00%

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The Bank closely monitors the loan payment activity of all its loans. The Bank periodically reviews the adequacy of the allowance for loan losses based on an analysis of the loan portfolio, the Bank's historical loss experience, economic conditions in the Bank's market area, and a review of selected individual loans. Loan losses are charged off against the allowance when the uncollectibility is confirmed. Subsequent recoveries, if any, are credited to the allowance. The Bank believes it has established its existing allowance for loan losses in accordance with accounting principles generally accepted in the United States of America and is in compliance with appropriate regulatory guidelines. However, the establishment of the level of the allowance for loan losses is highly subjective and dependent on incomplete information as to the ultimate disposition of loans. Accordingly, there can be no assurance that actual losses may not vary from the amounts estimated or that the Bank's regulators will not require the Bank to significantly increase or decrease its allowance for loan losses, thereby affecting the Bank's financial condition and earnings. For a more complete discussion of the allowance for loan losses, see the section captioned *Management's Discussion and Analysis of Financial Condition and Results of Operations - Critical Accounting Policies* in the Company's 2006 Annual Report to Stockholders.

**Investment Activities**

The Bank maintains a portfolio of investment securities to provide liquidity as well as a source of earnings. The Bank's investment securities portfolio consists primarily of mortgage-backed and other securities issued by U.S. government-sponsored enterprises (GSEs) including Freddie Mac and Fannie Mae. The Bank also has smaller holdings of privately issued mortgage-backed securities, U.S. Treasury obligations, and other equity and debt securities. As a member of the Federal Reserve and FHLB systems, the Bank is also required to invest in the stock of the Federal Reserve Bank of Richmond and FHLB of Atlanta.

The following table sets forth the carrying value of the Company's investment securities portfolio and FHLB of Atlanta and Federal Reserve Bank stock at the dates indicated. At December 31, 2006, their estimated fair value was \$111.5 million.

	<b>At December 31,</b>		
	<b>2006</b>	<b>2005</b>	<b>2004</b>
	<b>(Dollars in thousands)</b>		
Asset-backed securities			
Freddie Mac and Fannie Mae	\$ 72,602	\$ 84,334	\$ 155,678
Other	29,956	37,383	16,535
<b>Total asset-backed securities</b>	<b>102,558</b>	<b>121,717</b>	<b>172,213</b>
Freddie Mac and Fannie Mae stock	342	719	766
Bond mutual funds	3,262	127	630
Treasury bills	800	499	300
Other investments	145	604	1,781
<b>Total investment securities</b>	<b>107,107</b>	<b>123,666</b>	<b>175,690</b>
FHLB and Federal Reserve Bank stock	6,100	7,190	6,144
<b>Total investment securities and FHLB and Federal Reserve Bank stock</b>	<b>\$ 113,207</b>	<b>\$ 130,856</b>	<b>\$ 181,834</b>

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The maturities and weighted average yields for investment securities available for sale and held to maturity at December 31, 2006 are shown below.

	One Year or Less		After One Through Five Years		After Five Through Ten Years		After Ten Years	
	Amortized Cost	Average Yield	Amortized Cost	Average Yield	Amortized Cost	Average Yield	Amortized Cost	Average Yield
(Dollars in thousands)								
Investment securities available for sale								
Corporate equity securities	\$ 255	4.70%	\$	0.00%	\$	0.00%	\$	0.00%
Asset-backed securities	143	7.23%	749	5.46%	3,987	4.90%	1,003	4.79%
Mutual Funds	3,246	4.30%		0.00%		0.00%		0.00%
<b>Total investment securities available for sale</b>	<b>\$ 3,644</b>	<b>4.45%</b>	<b>\$ 749</b>	<b>0.00%</b>	<b>\$ 3,987</b>	<b>4.90%</b>	<b>\$ 1,003</b>	<b>4.79%</b>
Investment securities held-to- maturity								
Asset-backed securities	\$ 7,240	4.94%	\$ 29,248	5.04%	\$ 29,881	5.36%	\$ 30,492	5.79%
Treasury bills	800	5.04%		0.00%		0.00%		0.00%
Other investments	11	4.68%	134	4.68%		0.00%		0.00%
<b>Total investment securities held-to-maturity</b>	<b>\$ 8,051</b>	<b>4.95%</b>	<b>\$ 29,382</b>	<b>5.03%</b>	<b>\$ 29,881</b>	<b>5.36%</b>	<b>\$ 30,492</b>	<b>5.79%</b>

The Bank's investment policy provides that securities that will be held for indefinite periods of time, including securities that will be used as part of the Bank's asset/liability management strategy and that may be sold in response to changes in interest rates, prepayments and similar factors, are classified as available for sale and accounted for at fair value. Management's intent is to hold securities reported at amortized cost to maturity. Certain of the Company's asset-backed securities are issued by private issuers (defined as an issuer that is not a government or a government-sponsored entity). Listed below are the Company's investments in certain of these issuers that aggregate to more than 10% of the Company's equity. For further information regarding the Company's investment securities, see Note 3 of Notes to Consolidated Financial Statements.

Issuer	Book Value	Rating
Wells Fargo	\$6,023,058	AAA
Morgan Stanley	\$5,012,318	AAA
Countrywide	\$4,036,168	AAA



**Table of Contents****Deposits and Other Sources of Funds**

**General.** The funds needed by the Bank to make loans are primarily generated by deposit accounts solicited from the communities surrounding its main office and eight branches in the southern Maryland area. Total deposits were \$418.0 million as of December 31, 2006. The Bank uses borrowings from the FHLB of Atlanta, reverse repurchase agreements, and other sources to supplement funding from deposits.

**Deposits.** The Bank's deposit products include savings, money market, demand deposit, IRA, SEP, Christmas clubs, and time deposit accounts. Variations in service charges, terms and interest rates are used to target specific markets. Ancillary products and services for deposit customers include safe deposit boxes, travelers checks, night depositories, automated clearinghouse transactions, wire transfers, ATMs, and online and telephone banking. The Bank is a member of JEANIE, Cirrus and STAR ATM networks. The Bank has occasionally used deposit brokers to obtain funds. At December 31, 2006, brokered deposits totaled \$24.3 million. At December 31, 2005, brokered deposits totaled \$24.7 million.

The following table sets forth for the periods indicated the average balances outstanding and average interest rates for each major category of deposits.

	2006		2005		2004	
	Average Balance	Average Rate	Average Balance	Average Rate	Average Balance	Average Rate
			(Dollars in thousands)			
Savings	\$ 34,570	1.18%	\$ 36,696	0.59%	\$ 37,776	0.47%
Interest-bearing demand and money market accounts	104,410	2.92	89,394	1.55	85,212	0.89
Certificates of deposit	204,675	4.21	146,512	3.32	93,267	2.46
Total interest-bearing deposits	343,655	3.51	272,602	2.37	216,255	1.49
Noninterest-bearing demand deposits	42,030		39,855		32,909	
Total	\$ 385,685	3.13	\$ 312,457	2.07	\$ 249,164	1.29

The following table indicates the amount of the Bank's certificates of deposit and other time deposits of more than \$100,000 by time remaining until maturity as of December 31, 2006.

Maturity Period	Certificates of Deposit (Dollars in thousands)
Three months or less	\$26,242
Three through six months	7,912
Six through twelve months	17,785
Over twelve months	11,057
Total	\$62,996

**Borrowings.** Deposits are the primary source of funds for the Bank's lending and investment activities and for its general business purposes. The Bank uses advances from the FHLB of Atlanta to supplement its supply of lendable funds and to meet deposit withdrawal requirements. Advances from the FHLB are secured by the Bank's stock in the FHLB, a portion of the Bank's residential mortgage loans, and its eligible investments. Generally the Bank's ability to

borrow from the FHLB of Atlanta is limited by its available collateral and also by an overall limitation of 40% of assets. In addition to advances the Bank uses reverse repurchase agreements to enhance its funding. Other short-term debt consists of notes payable to the U.S. Treasury on Treasury, tax and loan accounts. Long-term borrowings consist of adjustable-rate advances with rates based upon LIBOR, fixed-rate advances, and convertible advances. The table below sets forth information about borrowings for the years indicated.



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	<b>At or for the Year Ended December 31,</b>		
	<b>2006</b>	<b>2005</b>	<b>2004</b>
	<b>(Dollars in thousands)</b>		
Long-term debt outstanding at end of period	\$ 96,046	\$ 107,824	\$ 82,931
Weighted average rate on outstanding long-term debt	4.42%	4.25%	4.20%
Maximum outstanding long-term debt of any month end	\$ 108,078	\$ 107,826	\$ 82,931
Average outstanding long-term debt	\$ 101,520	\$ 93,409	\$ 73,830
Approximate average rate paid on long-term debt	4.42%	4.25%	4.44%
Short-term debt outstanding at end of period	\$ 6,568	\$ 20,075	\$ 115,304
Weighted average rate on outstanding short-term debt	5.08%	4.43%	2.53%
Maximum outstanding short-term debt at any month end	\$ 37,590	\$ 123,968	\$ 122,693
Average outstanding short-term debt	\$ 18,129	\$ 82,665	\$ 64,736
Approximate average rate paid on short-term debt	4.99%	3.10%	1.80%

For more information regarding the Bank's borrowings, see Note 9 of Notes to Consolidated Financial Statements.

**Subsidiary Activities**

Under the Maryland Financial Institutions Code, commercial banks may invest in service corporations and in other subsidiaries that offer the public a financial, fiduciary or insurance service. In April 1997, the Bank formed a wholly owned subsidiary, Community Mortgage Corporation of Tri-County, to offer mortgage banking, brokerage, and other services to the public. This corporation was inactive until 2001. At that time, the Bank transferred a property that was acquired by deed in lieu of foreclosure to this subsidiary in order to complete development of this parcel. In August 1999, the Bank formed a wholly-owned subsidiary, Tri-County Investment Corporation to hold and manage a portion of the Bank's investment portfolio.

The Company has two direct subsidiaries other than the Bank. In July 2004, Tri-County Capital Trust I was established as a statutory trust under Delaware law as a wholly-owned subsidiary of the Company for the purpose of issuing trust-preferred securities. Tri-County Capital Trust I issued \$7.0 million of trust-preferred securities on July 22, 2004. In June 2005, Tri-County Capital Trust II was also established as a statutory trust under Delaware law as a wholly-owned subsidiary of the Company for the purpose of issuing trust-preferred securities. Tri-County Capital Trust II issued \$5.0 million of trust preferred securities on June 15, 2005.

**SUPERVISION AND REGULATION****Regulation of the Company**

**General.** The Company is a public company registered with the Securities and Exchange Commission (the "SEC") and, as the sole stockholder of the Bank, it is a bank holding company and registered as such with the Board of Governors of the Federal Reserve System (the "FRB"). Bank holding companies are subject to comprehensive regulation by the FRB under the Bank Holding Company Act of 1956, as amended (the "BHCA"), and the regulations of the FRB. As a public company the Company is required to file annual, quarterly and current reports with the SEC, and as a bank holding company, the Company is required to file with the FRB annual reports and such additional information as the FRB may require, and is subject to regular examinations by the FRB. The FRB also has extensive enforcement authority over bank holding companies, including, among other things, the ability to assess civil money penalties, to issue cease and desist or removal orders, and to require that a holding company divest subsidiaries (including its bank subsidiaries). In general, enforcement actions may be initiated for violations of law and regulations and unsafe or unsound practices. The following discussion summarizes certain of the regulations applicable to the Company but does not purport to be a complete description of such regulations and is qualified in its entirety by reference to the actual laws and regulations involved.

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Under the BHCA, a bank holding company must obtain FRB approval before: (i) acquiring, directly or indirectly, ownership or control of any voting shares of another bank or bank holding company if, after such acquisition, it would own or control more than 5% of such shares (unless it already owns or controls the majority of such shares); (ii) acquiring all or substantially all of the assets of another bank or bank holding company; or (iii) merging or consolidating with another bank holding company. In evaluating such application, the FRB considers factors such as the financial condition and managerial resources of the companies involved, the convenience and needs of the communities to be served and competitive factors.

The Riegle-Neal Interstate Banking and Branching Efficiency of 1994 (the Riegle-Neal Act ) authorized the FRB to approve an application of a bank holding company meeting certain qualitative criteria to acquire control of, or acquire all or substantially all of the assets of, a bank located in a state other than such holding company's home state, without regard to whether the transaction is prohibited by the laws of any state. The FRB may not approve the acquisition of a bank that has not been in existence for the minimum time period (not exceeding five years) specified by the statutory law of the host state. The Riegle-Neal Act also prohibits the FRB from approving such an application if the applicant (and its depository institution affiliates) controls or would control more than 10% of the insured deposits in the United States or 30% or more of the deposits in the target bank's home state or in any state in which the target bank maintains a branch. The Riegle-Neal Act does not affect the authority of states to limit the percentage of total insured deposits in the state that may be held or controlled by a bank or bank holding company to the extent such limitation does not discriminate against out-of-state banks or bank holding companies. Individual states may also waive the 30% state-wide concentration limit contained in the Riegle-Neal Act. Under Maryland law, a bank holding company is prohibited from acquiring control of any bank if the bank holding company would control more than 30% of the total deposits of all depository institutions in the State of Maryland unless waived by the Commissioner of Financial Regulation.

Additionally, the federal banking agencies are authorized to approve interstate bank merger transactions without regard to whether such transaction is prohibited by the law of any state, unless the home state of one of the banks opted out of the Riegle-Neal Act by adopting a law after the date of enactment of the Riegle-Neal Act and prior to June 1, 1997, which applies equally to all out-of-state banks and expressly prohibits merger transactions involving out-of-state banks. The State of Maryland did not pass such a law during this period. Interstate acquisitions of branches will be permitted only if the law of the state in which the branch is located permits such acquisitions. Interstate mergers and branch acquisitions are also subject to the nationwide and statewide insured deposit concentration amounts described above.

The BHCA also prohibits a bank holding company, with certain exceptions, from acquiring direct or indirect ownership or control of more than 5% of the voting shares of any company that is not a bank or bank holding company, or from engaging directly or indirectly in activities other than those of banking, managing or controlling banks, or providing services for its subsidiaries. The principal exceptions to these prohibitions involve certain non-bank activities which, by statute or by FRB regulation or order, have been identified as activities closely related to the business of banking or managing or controlling banks. The list of activities permitted by the FRB includes, among other things, operating a savings institution, mortgage company, finance company, credit card company or factoring company; performing certain data processing operations; providing certain investment and financial advice; underwriting and acting as an insurance agent for certain types of credit-related insurance; leasing property on a full-payout, non-operating basis; selling money orders, travelers' checks and United States Savings Bonds; real estate and personal property appraising; providing tax planning and preparation services; and, subject to certain limitations, providing securities brokerage services for customers.

Effective with the enactment of the Gramm-Leach-Bliley Act (the G-L-B Act ), bank holding companies whose financial institution subsidiaries are well capitalized and well managed and have satisfactory Community Reinvestment Act records can elect to become financial holding companies, which are permitted to engage in a broader range of financial activities than are permitted to bank holding companies. Financial holding companies are authorized to engage in, directly or indirectly, financial activities. A financial activity is an activity that is: (i) financial in nature; (ii) incidental to an activity that is financial in nature; or (iii) complementary to a financial activity and that does not pose a safety and soundness risk. The G-L-B Act includes a list of activities that are deemed to be financial in

nature. Other activities also may be decided by the FRB to be financial in nature or incidental thereto if they meet specified criteria. A financial holding company that intends to engage in a new activity to acquire a company to engage in such an activity is required to give prior notice to the FRB. If the activity

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is not either specified in the G-L-B Act as being a financial activity or one that the FRB has determined by rule or regulation to be financial in nature, the prior approval of the FRB is required.

Federal law provides that no person (broadly defined to include business entities) directly or indirectly or acting in concert with one or more persons, or through one or more subsidiaries, or through one or more transactions, may acquire control of a bank holding company or insured bank without the approval of the appropriate federal regulator, which in the Company's (and Bank's) case will be the FRB. Control is defined to mean direct or indirect ownership, control of, or holding irrevocable proxies representing 25% or more of any class of voting stock, control in any manner of the election of a majority of the bank's directors or a determination by the FRB that the acquirer has or would have the power to direct, or directly or indirectly to exercise a controlling influence over, the management or policies of the institution. Acquisition of more than 10% of any class of a bank's stock creates a rebuttable presumption of control under certain circumstances that requires that a filing be made with the FRB unless the FRB determines that the presumption has been rebutted. Any company that seeks to acquire 25% or more of a class of a bank's voting stock, or otherwise acquire control, must first receive the prior approval of the FRB under the Bank Holding Company Act and no existing bank holding company may acquire more than 5% of any class of a nonsubsidiary bank's voting stock without prior FRB approval.

The Maryland Financial Institutions Code prohibits a bank holding company from acquiring more than 5% of any class of voting stock of a bank or bank holding company without the approval of the Commissioner of Financial Regulation, except as otherwise expressly permitted by federal law or in certain other limited situations. The Maryland Financial Institutions Code additionally prohibits any person from acquiring voting stock in a bank or bank holding company without 60 days prior notice to the Commissioner if such acquisition will give the person control of 25% or more of the voting stock of the bank or bank holding company or will affect the power to direct or to cause the direction of the policy or management of the bank or bank holding company. Any doubt whether the stock acquisition will affect the power to direct or cause the direction of policy or management shall be resolved in favor of reporting to the Commissioner. The Commissioner may deny approval of the acquisition if the Commissioner determines it to be anti-competitive or to threaten the safety or soundness of a banking institution. Voting stock acquired in violation of this statute may not be voted for five years.

**Dividends.** The FRB has issued a policy statement on the payment of cash dividends by bank holding companies, which expresses the FRB's view that a bank holding company should pay cash dividends only to the extent that the company's net income for the past year is sufficient to cover both the cash dividends and a rate of earnings retention that is consistent with the company's capital needs, asset quality and overall financial condition. The FRB also indicated that it would be inappropriate for a company experiencing serious financial problems to borrow funds to pay dividends. Furthermore, under the prompt corrective action regulations adopted by the FRB pursuant to Federal Deposit Insurance Corporation Improvement Act (FDICIA), the FRB may prohibit a bank holding company from paying any dividends if the holding company's bank subsidiary is classified as undercapitalized.

**Stock Repurchases.** Bank holding companies are required to give the FRB prior written notice of any purchase or redemption of its outstanding equity securities if the gross consideration for the purchase or redemption, when combined with the net consideration paid for all such purchases or redemptions during the preceding 12 months, is equal to 10% or more of their consolidated retained earnings. The FRB may disapprove such a purchase or redemption if it determines that the proposal would constitute an unsafe or unsound practice or would violate any law, regulation, FRB order, or any condition imposed by, or written agreement with, the FRB. There is an exception for this approval requirement for certain well-capitalized, well-managed bank holding companies.

**Capital Requirements.** The FRB has established capital requirements, similar to the capital requirements for state member banks, for bank holding companies with consolidated assets of \$500 million or more. As of December 31, 2006, the Company's levels of consolidated regulatory capital exceeded the FRB's minimum requirements.

**Regulation of the Bank**

**General.** The Bank is a Maryland commercial bank and its deposit accounts are insured by the Deposit Insurance Fund of the FDIC. The Bank is a member of the Federal Reserve and FHLB systems. The Bank is

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subject to supervision, examination and regulation by Commissioner of Financial Regulation of the State of Maryland (the Commissioner) and the FRB and to Maryland and federal statutory and regulatory provisions governing such matters as capital standards, mergers, and establishment of branch offices. The FDIC, as deposit insurer, has certain secondary examination and supervisory authority. The Bank is required to file reports with the Commissioner and the FRB concerning its activities and financial condition and is required to obtain regulatory approvals prior to entering into certain transactions, including mergers with, or acquisitions of, other depository institutions.

As an institution with federally insured deposits, the Bank is subject to various operational regulations promulgated by the FRB, including Regulation B (Equal Credit Opportunity), Regulation D (Reserve Requirements), Regulation E (Electronic Fund Transfers), Regulation P (Privacy), Regulation W (Transactions Between Member Banks and Their Affiliates), Regulation Z (Truth in Lending), Regulation CC (Availability of Funds and Collection of Checks) and Regulation DD (Truth in Savings).

The system of regulation and supervision applicable to the Bank establishes a comprehensive framework for the operations of the Bank and is intended primarily for the protection of the FDIC and the depositors of the Bank. The regulatory structure also gives the regulatory authorities extensive discretion in connection with their supervisory and enforcement activities, including with respect to the classification of assets and the establishment of loss reserves for regulatory purposes. Changes in the regulatory framework could have a material effect on the Bank and its respective operations that in turn, could have a material effect on the Company. The following discussion summarizes certain of the regulations applicable to the Bank but does not purport to be a complete description of such regulations and is qualified in its entirety by reference to the actual laws and regulations involved.

**Capital Adequacy.** The FRB has established guidelines with respect to the maintenance of appropriate levels of capital by bank holding companies and state member banks, respectively. The regulations impose two sets of capital adequacy requirements: minimum leverage rules, which require bank holding companies and member banks to maintain a specified minimum ratio of capital-to-total assets, and risk-based capital rules, which require the maintenance of specified minimum ratios of capital to risk-weighted assets.

The regulations of the FRB require bank holding companies and state member banks, respectively, to maintain a minimum leverage ratio of Tier 1 capital (as defined in the risk-based capital guidelines discussed in the following paragraphs) to total assets of 3.0%. Although setting a minimum 3.0% leverage ratio, the capital regulations state that only the strongest bank holding companies and banks, with composite examination ratings of 1 under the rating system used by the federal bank regulators, would be permitted to operate at or near such minimum level of capital. All other bank holding companies and banks are expected to maintain a leverage ratio of at least 4.0%. Any bank or bank holding company experiencing or anticipating significant growth would be expected to maintain capital well above the minimum levels. In addition, the FRB has indicated that whenever appropriate, and in particular when a bank holding company is undertaking expansion, seeking to engage in new activities, or otherwise facing unusual or abnormal risks, it will consider, on a case-by-case basis, the level of an organization's ratio of tangible Tier 1 capital (after deducting all intangibles) to total assets in making an overall assessment of capital.

The risk-based capital rules of the FRB require bank holding companies and state member banks, respectively, to maintain minimum regulatory capital levels based upon a weighting of their assets and off-balance sheet obligations according to risk. Risk-based capital is composed of two elements: Tier 1 capital and Tier 2 capital. Tier 1 capital consists primarily of common stockholders' equity, certain perpetual preferred stock (which must be noncumulative in the case of banks), and minority interests in the equity accounts of consolidated subsidiaries; less all intangible assets, except for certain servicing assets, purchased credit card relationships, deferred tax assets and credit enhancing interest-only strips. Tier 2 capital elements include, subject to certain limitations, the allowance for losses on loans and leases; perpetual preferred stock that does not qualify as Tier 1 capital and long-term preferred stock with an original maturity of at least 20 years from issuance; hybrid capital instruments, including perpetual debt and mandatory convertible securities, subordinated debt and intermediate-term preferred stock and up to 45% of unrealized gains on available for sale equity securities with readily determinable market values.

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The risk-based capital regulations assign balance sheet assets and credit equivalent amounts of off-balance sheet obligations to one of four broad risk categories based principally on the degree of credit risk associated with the obligor. The assets and off-balance sheet items in the four risk categories are weighted at 0%, 20%, 50% and 100%. These computations result in the total risk-weighted assets. The risk-based capital regulations require all banks and bank holding companies to maintain a minimum ratio of total capital (Tier 1 capital plus Tier 2 capital) to total risk-weighted assets of 8%, with at least 4% as Tier 1 capital. For the purpose of calculating these ratios: (i) Tier 2 capital is limited to no more than 100% of Tier 1 capital; and (ii) the aggregate amount of certain types of Tier 2 capital is limited. In addition, the risk-based capital regulations limit the allowance for loan losses includable as capital to 1.25% of total risk-weighted assets.

FRB regulations and guidelines additionally specify that state member banks with significant exposure to declines in the economic value of their capital due to changes in interest rates may be required to maintain higher risk-based capital ratios.

The FRB has issued regulations that classify state member banks by capital levels and which authorize the FRB to take various prompt corrective actions to resolve the problems of any bank that fails to satisfy the capital standards. Under such regulations, a well capitalized bank is one that is not subject to any regulatory order or directive to meet any specific capital level and that has or exceeds the following capital levels: a total risk-based capital ratio of 10%, a Tier 1 risk-based capital ratio of 6%, and a leverage ratio of 5%. An adequately capitalized bank is one that does not qualify as well capitalized but meets or exceeds the following capital requirements: a total risk-based capital ratio of 8%, a Tier 1 risk-based capital ratio of 4%, and a leverage ratio of either (i) 4% or (ii) 3% if the bank has the highest composite examination rating. A bank not meeting these criteria is treated as undercapitalized, significantly undercapitalized, or critically undercapitalized depending on the extent to which the bank's capital levels are below these standards. A state member bank that falls within any of the three undercapitalized categories established by the prompt corrective action regulation will be subject to regulatory sanctions. As of December 31, 2006, the Bank was well capitalized as defined by the FRB's regulations.

**Branching.** Maryland law provides that, with the approval of the Commissioner, Maryland banks may establish branches within the State of Maryland without geographic restriction and may establish branches in other states by any means permitted by the laws of such state or by federal law. The Riegle-Neal Act authorizes the FRB to approve interstate branching *de novo* by merger by state member banks in any state that did not opt out and only in states that specifically allow for such branching. The Riegle-Neal Act also required the appropriate federal banking agencies to prescribe regulations that prohibit any out-of-state bank from using the interstate branching authority primarily for the purpose of deposit production. These regulations include guidelines to ensure that interstate branches operated by an out-of-state bank in a host state are reasonably helping to meet the credit needs of the communities which they serve.

**Dividend Limitations.** Pursuant to the Maryland Financial Institutions Code, Maryland banks may only pay dividends from undivided profits or, with the prior approval of the Commissioner, their surplus in excess of 100% of required capital stock. The Maryland Financial Institutions Code further restricts the payment of dividends by prohibiting a Maryland bank from declaring a dividend on its shares of common stock until its surplus fund equals the amount of required capital stock or, if the surplus fund does not equal the amount of capital stock, in an amount in excess of 90% of net earnings.

Without the approval of the FRB, a state member bank may not declare or pay a dividend if the total of all dividends declared during the year exceeds its net income during the current calendar year and retained net income for the prior two years. The Bank is further prohibited from making a capital distribution if it would be thereafter undercapitalized within the meaning of the prompt corrective action regulations discussed above. In addition, the Bank may not make a capital distribution that would reduce its net worth below the amount required to maintain the liquidation account established for the benefit of its depositors at the time of its conversion to stock form.

**Insurance of Deposit Accounts.** The Bank's deposits are insured up to applicable limits by the Deposit Insurance Fund of the FDIC. The Deposit Insurance Fund is the successor to the Bank Insurance Fund and the Savings Association Insurance Fund, which were merged in 2006. The FDIC recently amended its risk-based assessment system for 2007 to implement authority granted by the Federal Deposit Insurance Reform Act of 2005 ( Reform Act ). Under the revised system, insured institutions are assigned to one of four risk categories based on



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supervisory evaluations, regulatory capital levels and certain other factors. An institution's assessment rate depends upon the category to which it is assigned. Risk category I, which contains the least risky depository institutions, is expected to include more than 90% of all institutions. Unlike the other categories, Risk Category I contains further risk differentiation based on the FDIC's analysis of financial ratios, examination component ratings and other information. Assessment rates are determined by the FDIC and currently range from five to seven basis points for the healthiest institutions (Risk Category I) to 43 basis points of assessable deposits for the riskiest (Risk Category IV). The FDIC may adjust rates uniformly from one quarter to the next, except that no single adjustment can exceed three basis points.

The Reform Act also provided for a one-time credit for eligible institutions based on their assessment base as of December 31, 1996. Subject to certain limitations with respect to institutions that are exhibiting weaknesses, credits can be used to offset assessments until exhausted. The Bank's one-time credit is expected to approximate \$195,719. The Reform Act also provided for the possibility that the FDIC may pay dividends to insured institutions once the Deposit Insurance fund reserve ratio equals or exceeds 1.35% of estimated insured deposits.

In addition to the assessment for deposit insurance, institutions are required to make payments on bonds issued in the late 1980s by the Financing Corporation to recapitalize a predecessor deposit insurance fund. This payment is established quarterly and during the calendar year ending December 31, 2006 averaged 1.28 basis points of assessable deposits.

The Reform Act provided the FDIC with authority to adjust the Deposit Insurance Fund ratio to insured deposits within a range of 1.15% and 1.50%, in contrast to the prior statutorily fixed ratio of 1.25%. The ratio, which is viewed by the FDIC as the level that the fund should achieve, was established by the agency at 1.25% for 2007.

The FDIC has authority to increase insurance assessments. A significant increase in insurance premiums would likely have an adverse effect on the operating expenses and results of operations of the Bank. Management cannot predict what insurance assessment rates will be in the future.

Insurance of deposits may be terminated by the FDIC upon a finding that the institution has engaged in unsafe or unsound practices, is in an unsafe or unsound condition to continue operations or has violated any applicable law, regulation, rule, order or condition imposed by the FDIC or the FRB. The management of the Bank does not know of any practice, condition or violation that might lead to termination of deposit insurance.

**Transactions with Affiliates.** A state member bank or its subsidiaries may not engage in covered transactions with any one affiliate in an amount greater than 10% of such bank's capital stock and surplus, and for all such transactions with all affiliates a state member bank is limited to an amount equal to 20% of capital stock and surplus. All such transactions must also be on terms substantially the same, or at least as favorable, to the bank or subsidiary as those provided to a non-affiliate. The term covered transaction includes the making of loans, purchase of assets, issuance of a guarantee and similar types of transactions. Certain covered transactions, such as loans to affiliates, must meet specified collateral requirements. An affiliate of a state member bank is any company or entity that controls or is under common control with the state member bank and, for purposes of the aggregate limit on transactions with affiliates, any subsidiary that would be deemed a financial subsidiary of a national bank. In a holding company context, the parent holding company of a state member bank (such as the Company) and any companies that are controlled by such parent holding company are affiliates of the state member bank. The BHCA further prohibits a depository institution from extending credit to or offering any other services, or fixing or varying the consideration for such extension of credit or service, on the condition that the customer obtain some additional service from the institution or certain of its affiliates or not obtain services of a competitor of the institution, subject to certain limited exceptions.

**Loans to Directors, Executive Officers and Principal Stockholders.** Loans to directors, executive officers and principal stockholders of a state member bank must be made on substantially the same terms as those prevailing for comparable transactions with persons who are not executive officers, directors, principal stockholders or employees of the bank unless the loan is made pursuant to a compensation or benefit plan that is widely available to employees and does not favor insiders. Loans to any executive officer, director and principal stockholder together with all other outstanding loans to such person and affiliated interests generally may not exceed 15% of the bank's unimpaired capital and surplus and all loans to such persons may not exceed the institution's unimpaired capital and





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unimpaired surplus. Loans to directors, executive officers and principal stockholders, and their respective affiliates, in excess of the greater of \$25,000 or 5% of capital and surplus, or any loans aggregating \$500,000 or more, must be approved in advance by a majority of the board of directors of the bank with any interested director not participating in the voting. State member banks are prohibited from paying the overdrafts of any of their executive officers or directors unless payment is made pursuant to a written, pre-authorized interest-bearing extension of credit plan that specifies a method of repayment or transfer of funds from another account at the bank. In addition, loans to executive officers may not be made on terms more favorable than those afforded other borrowers and are restricted as to type, amount and terms of credit.

**Enforcement.** The Commissioner has extensive enforcement authority over Maryland banks. Such authority includes the ability to issue cease and desist orders and civil money penalties and to remove directors or officers. The Commissioner may also take possession of a Maryland bank whose capital is impaired and seek to have a receiver appointed by a court.

The FRB has primary federal enforcement responsibility over state banks under its jurisdiction, including the authority to bring enforcement action against all institution-related parties, including stockholders, and any attorneys, appraisers and accountants who knowingly or recklessly participate in wrongful action likely to have an adverse effect on an institution. Formal enforcement action may range from the issuance of capital directive or cease and desist order to removal of officers and/or directors, receivership, conservatorship or termination of deposit insurance. Civil money penalties cover a wide range of violations and actions, and range up to \$25,000 per day or even up to \$1 million per day (in the most egregious cases). Criminal penalties for most financial institution crimes include fines of up to \$1 million and imprisonment for up to 30 years.

**Personnel**

As of December 31, 2006, the Bank had 103 full-time employees and 7 part-time employees. The employees are not represented by a collective bargaining agreement. The Bank believes its employee relations are good.

**Executive Officers of the Registrant**

The executive officers of the Company are as follows

**Michael L. Middleton** (59 years old) is President and Chief Executive Officer of the Company and the Bank. He joined the Bank in 1973 and served in various management positions until 1979 when he became president of the Bank. Mr. Middleton is a Certified Public Accountant and holds a Master of Business Administration. As President and Chief Executive Officer of the Bank, Mr. Middleton is responsible for the overall operation of the Bank pursuant to the policies and procedures established by the Board of Directors. From 1996 to 2004, Mr. Middleton served on the Board of Directors of the Federal Home Loan Bank of Atlanta, and served as Chairman from 2003 to 2004. Mr. Middleton also served as Federal Home Loan Bank of Atlanta representative to the Council of Federal Home Loan Banks. Mr. Middleton currently serves on the board of the Baltimore Branch of the Federal Reserve Bank of Richmond.

**C. Marie Brown** (64 years old) has been employed with the Bank since 1972 and has served as Chief Operating Officer since 1999. Before her appointment as Chief Operating Officer, Ms. Brown served as Senior Vice President of the Bank. She is a supporter of the Handicapped and Retarded Citizens of Charles County, a member of the Zonta Club of Charles County and serves on various administrative committees of the Hughesville Baptist Church.

**Gregory C. Cockerham** (52 years old) joined the Bank in November 1988 and has served as Chief Lending Officer since 1996. Before his appointment as Executive Vice President, Mr. Cockerham served as Vice President of the Bank. Mr. Cockerham has been in banking for 28 years. He is a Paul Harris Fellow with the Rotary Club of Charles County and serves on various civic boards in the County.

**William J. Pasenelli** (48 years old) joined the Bank as Chief Financial Officer in April 2000. Before joining the Bank, Mr. Pasenelli had been Chief Financial Officer of Acacia Federal Savings Bank, Annandale,

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Virginia since 1987. Mr. Pasenelli is a member of the American Institute of Certified Public Accountants, the DC Institute of Certified Public Accountants, and other civic groups.

**James M. Burke** (38 years old) joined the Bank in 2006. He serves as the Bank's Executive Vice President - Credit. Before his appointment as Executive Vice President - Credit, he served as the Bank's senior credit officer. Prior to joining the Bank, Mr. Burke served as Executive Vice President of Mercantile Southern Maryland Bank. Mr. Burke has 16 years of banking experience. Mr. Burke is member of the board of directors of Civista Medical Center and other civic groups.

**James F. DiMisa** (48 years old) joined the Bank in 2006. He serves as Executive Vice President- Bank Operations. Prior to joining the Bank, Mr. DiMisa served as Executive Vice President of Mercantile Southern Maryland Bank. Mr. DiMisa has 28 years of banking experience. Mr. DiMisa is a member of various civic and professional groups.

**Item 1A. Risk Factors**

*An investment in shares of our common stock involves various risks. Our business, financial condition and results of operations could be harmed by any of the following risks or by other risks that have not been identified or that we may believe are immaterial or unlikely. The value or market price of our common stock could decline due to any of these risks, and you may lose all or part of your investment. The risks discussed below also include forward-looking statements, and our actual results may differ substantially from those discussed in these forward-looking statements.*

**Our business strategy includes the continuation of significant growth plans, and our financial condition and results of operations could be negatively affected if we fail to grow or fail to manage our growth effectively.**

Our assets have increased \$293.4 million, or 104%, from \$282.1 million at December 31, 2002 to \$575.5 million at December 31, 2006, primarily due to increases in loans and investment securities. We expect to continue to experience growth in the amount of our assets, the level of our deposits and the scale of our operations. Achieving our growth targets requires us to attract customers that currently bank at other financial institutions in our market, thereby increasing our share of the market. Our ability to successfully grow will depend on a variety of factors, including our ability to attract and retain experienced bankers, the continued availability of desirable business opportunities, the competitive responses from other financial institutions in our market areas and our ability to manage our growth. While we believe we have the management resources and internal systems in place to successfully manage our future growth, there can be no assurance growth opportunities will be available or that we will successfully manage our growth. If we do not manage our growth effectively, we may not be able to achieve our business plan and our business and prospects could be harmed.

**Certain interest rate movements may hurt our earnings.**

Interest rates were at historically low levels. However, since June 30, 2004, the U.S. Federal Reserve has increased its target for the federal funds rate seventeen times, from 1.00% to 5.25%. While these short-term market interest rates (which we use as a guide to price our deposits) have increased, longer-term market interest rates (which we use as a guide to price our longer-term loans) have not. This flattening of the market yield curve has resulted in our interest rate spread declining from 3.21% at December 31, 2003 to 2.82% at December 31, 2006 and net interest margin declining from 3.44% at December 31, 2003 to 3.24% at December 31, 2006. If short-term interest rates continue to rise, and if rates on our deposits and borrowings reprice upwards faster than the rates on our long-term loans and investments, we would experience further compression of our interest rate spread and net interest margin, which would have a negative effect on our profitability.

**Our increased emphasis on commercial and construction lending may expose us to increased lending risks.**

At December 31, 2006, our loan portfolio consisted of \$177.9 million, or 41.7%, of commercial real estate loans, \$42.7 million, or 10.0%, of construction and land development loans, \$79.6 million, or 18.7%, of commercial business loans and \$18.3 million, or 4.3%, of commercial equipment loans. We intend to increase our emphasis on these types of loans. These types of loans generally expose a lender to greater risk of non-payment and loss than

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one- to four-family residential mortgage loans because repayment of the loans often depends on the successful operation of the property, the income stream of the borrowers and, for construction loans, the accuracy of the estimate of the property's value at completion of construction and the estimated cost of construction. Such loans typically involve larger loan balances to single borrowers or groups of related borrowers compared to one- to four-family residential mortgage loans. Commercial business loans expose us to additional risks since they typically are made on the basis of the borrower's ability to make repayments from the cash flow of the borrower's business and are secured by non-real estate collateral that may depreciate over time. In addition, since such loans generally entail greater risk than one- to four-family residential mortgage loans, we may need to increase our allowance for loan losses in the future to account for the likely increase in probable incurred credit losses associated with the growth of such loans. Also, many of our commercial and construction borrowers have more than one loan outstanding with us. Consequently, an adverse development with respect to one loan or one credit relationship can expose us to a significantly greater risk of loss compared to an adverse development with respect to a one- to four-family residential mortgage loan.

**Our recent results may not be indicative of our future operating results.**

We have achieved significant growth in earnings per share in recent years. For example, net earnings per share (diluted) grew from \$0.73 for the year ended December 31, 2002 to \$1.58 for the year ended December 31, 2006. Our strong performance during this time period was, in part, the result of an extremely favorable interest rate environment. In the future, we may not have the benefit of a favorable interest rate environment. Various factors, such as economic conditions, regulatory and legislative considerations and competition, may also impede or restrict our ability to increase earnings at this same rate.

**Strong competition within our market area could hurt our profits and slow growth.**

We face intense competition both in making loans and attracting deposits. This competition has made it more difficult for us to make new loans and has occasionally forced us to offer higher deposit rates. Price competition for loans and deposits might result in us earning less on our loans and paying more on our deposits, which reduces net interest income. According to the Federal Deposit Insurance Corporation, as of June 30, 2006, we held 11.2% of the deposits in Calvert, Charles and St. Mary's counties, Maryland, which was the third largest market share of deposits out of the 14 financial institutions which held deposits in these counties. Some of the institutions with which we compete have substantially greater resources and lending limits than we have and may offer services that we do not provide. We expect competition to increase in the future as a result of legislative, regulatory and technological changes and the continuing trend of consolidation in the financial services industry. Our profitability depends upon our continued ability to compete successfully in our market area.

**If we do not achieve profitability on our new branch, it may negatively impact our earnings.**

We opened our Prince Frederick branch office on May 19, 2005. Numerous factors contribute to the performance of a new branch, such as a suitable location, qualified personnel and an effective marketing strategy. Additionally, it takes time for a new branch to generate significant deposits and make sufficient loans to produce enough income to offset expenses, some of which, like salaries and occupancy expense, are relatively fixed costs. We expect that it may take a period of time before the new branch office can become profitable. During this period, operating this new branch office may negatively impact our net income.

**If the value of real estate in southern Maryland were to decline materially, a significant portion of our loan portfolio could become under-collateralized, which could have a material adverse effect on us.**

With most of our loans concentrated in southern Maryland, a decline in local economic conditions could adversely affect the value of the real estate collateral securing our loans. A decline in property values would diminish our ability to recover on defaulted loans by selling the real estate collateral, making it more likely that we would suffer losses on defaulted loans. Additionally, a decrease in asset quality could require additions to our allowance for loan losses through increased provisions for loan losses, which would hurt our profits. Also, 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 real estate loan portfolios are more geographically diverse. Real estate values

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are affected by various factors in addition to local economic conditions, including, among other things, changes in general or regional economic conditions, governmental rules or policies and natural disasters.

**Our business is subject to the success of the local economy in which we operate.**

Because the majority of our borrowers and depositors are individuals and businesses located and doing business in southern Maryland, our success depends to a significant extent upon economic conditions in southern Maryland. Adverse economic conditions in our market area could reduce our growth rate, affect the ability of our customers to repay their loans and generally affect our financial condition and results of operations. Conditions such as inflation, recession, unemployment, high interest rates, short money supply, scarce natural resources, international disorders, terrorism and other factors beyond our control may adversely affect our profitability. We are less able than a larger institution to spread the risks of unfavorable local economic conditions across a large number of diversified economies. Any sustained period of increased payment delinquencies, foreclosures or losses caused by adverse market or economic conditions in the State of Maryland could adversely affect the value of our assets, revenues, results of operations and financial condition. Moreover, we cannot give any assurance we will benefit from any market growth or favorable economic conditions in our primary market areas if they do occur.

**The trading history of our common stock is characterized by low trading volume. Our common stock may be subject to sudden decreases.**

Although our common stock trades on OTC Electronic Bulletin Board, it has not been regularly traded. We cannot predict the extent to which investor interest in us will lead to a more active trading market in our common stock or how liquid that market might become. A public trading market having the desired characteristics of depth, liquidity and orderliness depends upon the presence in the marketplace of willing buyers and sellers of our common stock at any given time, which presence is dependent upon the individual decisions of investors, over which we have no control.

The market price of our common stock may be highly volatile and subject to wide fluctuations in response to numerous factors, including, but not limited to, the factors discussed in other risk factors and the following:

- Ø actual or anticipated fluctuations in our operating results;
- Ø changes in interest rates;
- Ø changes in the legal or regulatory environment in which we operate;
- Ø press releases, announcements or publicity relating to us or our competitors or relating to trends in our industry;
- Ø changes in expectations as to our future financial performance, including financial estimates or recommendations by securities analysts and investors;
- Ø future sales of our common stock;
- Ø changes in economic conditions in our marketplace, general conditions in the U.S. economy, financial markets or the banking industry; and
- Ø other developments affecting our competitors or us.

These factors may adversely affect the trading price of our common stock, regardless of our actual operating performance, and could prevent you from selling your common stock at or above the price you desire. In addition, the stock markets, from time to time, experience extreme price and volume fluctuations that may be unrelated or disproportionate to the operating performance of companies. These broad fluctuations may adversely affect the market price of our common stock, regardless of our trading performance.

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**We operate in a highly regulated environment and we may be adversely affected by changes in laws and regulations.**

Community Bank of Tri-County is subject to extensive regulation, supervision and examination by the Commissioner of Financial Regulation of the State of Maryland, its chartering authority, the Federal Reserve Board, as its federal regulator, and by the Federal Deposit Insurance Corporation, as insurer of its deposits. Tri-County Financial Corporation is subject to regulation and supervision by the Federal Reserve Board. Such regulation and supervision govern the activities in which an institution and its holding company may engage and are intended primarily for the protection of the insurance fund and for the depositors and borrowers of Community Bank of Tri-County. The regulation and supervision by the Commissioner of Financial Regulation of the State of Maryland, the Federal Reserve Board and the Federal Deposit Insurance Corporation are not intended to protect the interests of investors in Tri-County Financial Corporation common stock. Regulatory authorities have extensive discretion in their supervisory and enforcement activities, including the imposition of restrictions on our operations, the classification of our assets and determination of the level of our allowance for loan losses. Any change in such regulation and oversight, whether in the form of regulatory policy, regulations, legislation or supervisory action, may have a material impact on our operations.

**Provisions of our articles of incorporation, bylaws and Maryland law, as well as state and federal banking regulations, could delay or prevent a takeover of us by a third party.**

Provisions in our articles of incorporation and bylaws and the corporate law of the State of Maryland could delay, defer or prevent a third party from acquiring us, despite the possible benefit to our stockholders, or otherwise adversely affect the price of our common stock. These provisions include: supermajority voting requirements for certain business combinations; the election of directors to staggered terms of three years; and advance notice requirements for nominations for election to our board of directors and for proposing matters that shareholders may act on at shareholder meetings. In addition, we are subject to Maryland laws, including one that prohibits us from engaging in a business combination with any interested shareholder for a period of five years from the date the person became an interested shareholder unless certain conditions are met. These provisions may discourage potential takeover attempts, discourage bids for our common stock at a premium over market price or adversely affect the market price of, and the voting and other rights of the holders of, our common stock. These provisions could also discourage proxy contests and make it more difficult for you and other shareholders to elect directors other than the candidates nominated by our Board.

**Item 1B. Unresolved Staff Comments**

Not applicable.

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The following table sets forth the location of the Bank's offices, as well as certain additional information relating to these offices as of December 31, 2006.

<b>Office Location</b>	<b>Year Facility Commenced Operation</b>	<b>Leased or Owned</b>	<b>Date of Lease Expiration</b>	<b>Approximate Square Footage</b>
<b>Main Office</b> 3035 Leonardtown Road Waldorf, Maryland	1974	Owned		16,500
<b>Branch Offices</b> 22730 Three Notch Road Lexington Park, Maryland	1992	Owned		2,500
25395 Point Lookout Road Leonardtown, Maryland	1961	Owned		1,700
101 Drury Drive La Plata, Maryland	2001	Owned		2,645
10321 Southern Maryland Boulevard Dunkirk, Maryland	1991	Leased	2009	2,500
8010 Matthews Road Bryans Road, Maryland	1996	Owned		2,500
20 St. Patrick's Drive Waldorf, Maryland	1998	Leased (Land) Owned (Building)		2,840
30165 Three Notch Road Charlotte Hall, Maryland	2001	Leased (Land) Owned (Building)	2026	2,800
200 Market Square Prince Frederick, Maryland	2005	Leased (Land) Owned (Building)	2028	2,800

**Item 3. Legal Proceedings**

Neither the Company, the Bank, nor any subsidiary is engaged in any legal proceedings of a material nature at the present time. From time to time the Bank is a party to legal proceedings in the ordinary course of business.

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

No matters were submitted to a vote of security holders during the quarter ended December 31, 2006.

**PART II****Item 5. Market for Registrant's Common Equity, Related Security Holder Matters and Issuer Purchases of Equity Securities****Market Price and Dividends on Registrant's and Related Stockholder Matters.**

The information contained under the section captioned "Market for the Registrant's Common Stock and Related Security Holder Matters" in the Company's Annual Report to Stockholders for the fiscal year ended December 31, 2006 (the "Annual Report") filed as Exhibit 13 hereto is incorporated herein by reference.

**Table of Contents****Stock Performance Graph.**

This information contained under the section captured Stock Performance Group of the Annual Report filed as Exhibit 13 hereto is incorporated by reference.

**Recent Sales of Unregistered Securities.**

On August 22, September 13, October 16 and October 18, 2006, the Company issued 5,000 shares of its common stock, par value \$0.01 per share, respectively, in a private placement exempt from registration under Section 4(2) of the Securities Act of 1933, as amended. An underwriter was not utilized in the transactions. Shares were sold to two persons, both of whom were newly appointed directors of the Company and Community Bank of Tri-County and each were accredited investors. The Company received an aggregate of \$177,500 in cash for the shares that were issued. There were no underwriting discounts or commissions. The net proceeds from the offering were used for general corporate purposes.

**Purchases of Equity Securities by the Issuer and Affiliated Purchasers for the Most Recent Fiscal Quarter.**

<b>Period</b>	<b>Total Number of Shares Purchased</b>	<b>Average Price Paid per Share</b>	<b>Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs</b>	<b>Maximum Number of Shares that May Yet Be Purchased Under the Plans or Programs</b>
October 2006 Beginning date: October 1 Ending date: October 31	10,089	\$ 23.33	10,089	64,900
November 2006 Beginning date: November 1 Ending date: November 30				64,900
December 2006 Beginning date: December 1 Ending date: December 31	1,163	23.94	1,163	63,737
Total	11,252	\$ 23.40	11,252	63,737

- (i) On October 25, 2004, Tri-County Financial Corp. announced a repurchase program under which it would repurchase



39,000 shares.  
The Board of  
Directors  
authorized  
three-for-two  
stock splits of  
Tri-County  
Financial's  
common stock in  
December 2004,  
December 2005  
and  
November 2006,  
increasing the  
shares under this  
program to  
131,625. The  
repurchase  
program will  
continue until it  
is completed or  
terminated by the  
Board of  
Directors.

**Item 6. Selected Financial Data**

The information contained under the section captioned "Selected Financial Data" of the Annual Report filed as Exhibit 13 hereto is incorporated herein by reference.

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

The information contained in the section captioned "Management's Discussion and Analysis of Financial Condition and Results of Operations" of the Annual Report filed as Exhibit 13 hereto is incorporated herein by reference.

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

The information contained in the section captioned Asset/Liability Risk Management of the Annual Report is incorporated herein by reference.

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

The Consolidated Financial Statements, Notes to Consolidated Financial Statements and Report of Independent Registered Public Accounting Firm included in the Annual Report filed as Exhibit 13 hereto are incorporated herein by reference.

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

None.

**Item 9A. Controls and Procedures**

As of the end of the period covered by this report, management of the Company carried out an evaluation, under the supervision and with the participation of the Company's principal executive officer and principal financial officer, of the effectiveness of the Company's disclosure controls and procedures. Based on this evaluation, the Company's principal executive officer and principal financial officer concluded that the Company's disclosure controls and procedures are effective in ensuring that information required to be disclosed by the Company in reports that it files or submits under the Securities Exchange Act of 1934, as amended, is (1) recorded, processed, summarized and reported, within the time periods specified in the Securities and Exchange Commission's rules and forms and (2) accumulated and communicated to the Company's management, including its principal executive and principal financial officers as appropriate to allow timely decisions regarding required disclosure. It should be noted that the design of the Company's disclosure controls and procedures is based in part upon certain reasonable assumptions about the likelihood of future events, and there can be no reasonable assurance that any design of disclosure controls and procedures will succeed in achieving its stated goals under all potential future conditions, regardless of how remote, but the Company's principal executive and financial officers have concluded that the Company's disclosure controls and procedures are, in fact, effective at a reasonable assurance level.

There have been no changes in the Company's internal control over financial reporting (to the extent that elements of internal control over financial reporting are subsumed within disclosure controls and procedures) identified in connection with the evaluation described in the above paragraph that occurred during the Company's last fiscal quarter, that has materially affected, or is likely to materially affect, the Company's internal control over financial reporting.

**Item 9B. Other Information**

Not applicable.

**PART III**

**Item 10. Directors and Executive Officers of the Registrant**

For information concerning the Company's directors, the information contained under the section captioned Proposal 1 Election of Directors in the Company's definitive proxy statement for the Company's 2007 Annual Meeting of Stockholders (the Proxy Statement) is incorporated herein by reference. For information concerning the executive officers of the Company, see Item 1 - Business Executive Officers under Part I of this Annual Report on Form 10-K.

For information regarding compliance with Section 16(a) of the Exchange Act, the cover page of this Annual Report on Form 10-K and the information contained under the section captioned Section 16(a) Beneficial Ownership Reporting Compliance in the Proxy Statement are incorporated herein by reference.

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For information concerning the Company's code of ethics, the information contained under the section captioned Corporate Governance Code of Ethics and Business Conduct in the Proxy Statement is incorporated by reference. A copy of the code of ethics and business conduct is filed as Exhibit 14 hereto.

For information regarding the audit committee and its composition and the audit committee financial expert, the section captioned Corporate Governance Committees of the Board of Directors Audit Committee in the Proxy Statement is incorporated by reference.

**Item 11. Executive Compensation**

For information regarding executive compensation, the information contained under the sections captioned Executive Compensation and Directors Compensation in the Proxy Statement is incorporated herein by reference.

For information regarding the compensation committee report, the section captioned Compensation Committee Report in the Proxy Statement is incorporated by reference.

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

**(a) Security Ownership of Certain Owners**

The information required by this item is incorporated herein by reference to the section captioned Principal Holders of Voting Securities in the Proxy Statement.

**(b) Security Ownership of Management**

Information required by this item is incorporated herein by reference to the section captioned Principal Holders of Voting Securities in the Proxy Statement.

**(c) Changes in Control**

Management of the Company knows of no arrangements, including any pledge by any person of securities of the Company, the operation of which may at a subsequent date result in a change in control of the registrant.

**(d) Equity Compensation Plan Information**

The Company has adopted a variety of compensation plans pursuant to which equity may be awarded to participants. In 2005, the 1995 Stock Option and Incentive Plan and the 1995 Stock Option Plan for Non-Employee Directors expired. In 2005, the stockholders approved the Tri-County Financial Corporation 2005 Equity Compensation Plan. This plan covers employees and non-employee directors. The following table sets forth certain information with respect to the Company's Equity Compensation Plans as of December 31, 2006.

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<b>Plan Category</b>	<b>(a) Number of securities to be issued  upon exercise of outstanding options, warrants, and rights</b>	<b>(b) Weighted average exercise price of outstanding options, warrants, and rights</b>	<b>(c) Number of securities remaining available for future issuance under equity compensation plans  (excluding securities reflected in column (a))</b>
Equity plans approved by security holders	356,897	\$14.00	158,999
Equity compensation plans not approved by security holders (1)	60,200	13.05	
<b>Total</b>	<b>417,097</b>	<b>\$13.86</b>	<b>158,999</b>

(1) Consists of the Company's 1995 Stock Option Plan for Non-Employee Directors, which expired in 2005 and which provided grants of non-incentive stock options to directors who are not employees of the Company or its subsidiaries. Options were granted under the plan at an exercise price equal to their fair market value at the date of grant and had a term of ten years. Options are generally exercisable

while an  
optionee serves  
as a director or  
within one year  
thereafter.

**Item 13. Certain Relationships and Related Transactions**

The information regarding certain relationships and related transactions, the section captioned Relationships and Transactions with the Company and the Bank in the Proxy Statement is incorporated herein by reference.

For information regarding director independence, the section captioned Proposal 1 Election of Directors in the Proxy Statement is incorporated by reference.

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

The information required by this item is incorporated herein by reference to the section captioned Proposal 2 Ratification of Appointment of Auditors in the Proxy Statement.

**PART IV**

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

**(a) List of Documents Filed as Part of this Report**

(1) *Financial Statements*. The following consolidated financial statements and notes related thereto are incorporated by reference from Item 7 hereof:

Report of Independent Registered Public Accounting Firm

Consolidated Balance Sheets as of December 31, 2006 and 2005

Consolidated Statements of Income for the Years Ended December 31, 2006, 2005 and 2004

Consolidated Statements of Changes in Stockholders Equity for the Years Ended December 31, 2006, 2005 and 2004

Consolidated Statements of Cash Flows for the Years Ended December 31, 2006, 2005 and 2004

Notes to Consolidated Financial Statements

(2) *Financial Statement Schedules*. All schedules for which provision is made in the applicable accounting regulations of the Securities and Exchange Commission are omitted because of the absence of conditions under which they are required or because the required information is included in the consolidated financial statements and related notes thereto.

(3) *Exhibits*. The following is a list of exhibits filed as part of this Annual Report on Form 10-K and is also the Exhibit Index.

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<b>No.</b>	<b>Description</b>
3.1	Articles of Incorporation of Tri-County Financial Corporation (1)
3.2	Amended and Restated Bylaws of Tri-County Financial Corporation (2)
10.1*	Tri-County Financial Corporation 1995 Stock Option and Incentive Plan, as amended (3)
10.2*	Tri-County Financial Corporation 1995 Stock Option Plan for Non-Employee Directors, as amended (4)
10.3*	Employment Agreements with C. Marie Brown, as amended, and Gregory C. Cockerham (5)
10.4*	Employment Agreement with Michael L. Middleton (6)
10.5*	Guaranty Agreements with Michael L. Middleton, C. Marie Brown and Gregory C. Cockerham (3)
10.6*	Executive Incentive Compensation Plan (3)
10.7*	Executive Compensation Plan 2003 Amendment (7)
10.8*	Employment Agreement with William J. Pasenelli (3)
10.9*	Retirement Plan for Directors
10.10*	Split Dollar Agreements with Michael L. Middleton and C. Marie Brown (3)
10.11*	Guaranty Agreement with William J. Pasenelli (5)
10.12*	Split Dollar Agreement with William J. Pasenelli (5)
10.13*	Salary Continuation Agreement with Michael L. Middleton (7)
10.14*	Salary Continuation Agreement with C. Marie Brown (7)
10.15*	Salary Continuation Agreement with Gregory C. Cockerham (6)
10.16*	Salary Continuation Agreement with William J. Pasenelli (6)
10.17*	Amendment to the Community Bank of Tri-County Employment Agreement with C. Marie Brown (7)
10.18*	Amendment to the Community Bank of Tri-County Employment Agreement with Gregory C. Cockerham (8)
10.19*	Amendment to the Community Bank of Tri-County Employment Agreement with William J. Pasenelli (8)
10.20*	Tri-County Financial Corporation 2005 Equity Compensation Plan (9)

10.21*	Community Bank of Tri-County Deferred Compensation Plan
13	Annual Report to Stockholders for the year ended December 31, 2006
14	Code of Ethics (10)
21	Subsidiaries of the Registrant
23	Consent of Stegman & Company
31.1	Rule 13a-14a Certification of Chief Executive Officer
31.2	Rule 13a-14a Certification of Chief Financial Officer
32	Certification pursuant to 18 U.S.C. Section 1350

\* Management contract or compensatory arrangement.

(1) Incorporated by reference to the Registrant's Registration Statement on Form S-4 (No. 33-31287).

(2) Incorporated by reference to the Registrant's Quarterly Report on Form 10-Q for the quarter ended June 30, 2006.

(3) Incorporated by reference to the Registrant's Annual Report on Form 10-K for the fiscal year ended December 31, 2000.

(4) Incorporated by reference to the

Registrant's  
Registration  
Statement on  
Form S-8 (File  
No. 333-70800).

- (5) Incorporated by reference to the Registrant's Annual Report on Form 10-K for the fiscal year ended December 31, 1998.
- (6) Incorporated by reference to the Registrant's Quarterly Report on Form 10-Q for the quarter ended September 30, 2006.
- (7) Incorporated by reference to the Registrant's Annual Report on Form 10-K for the fiscal year ended December 31, 2001.
- (8) Incorporated by reference to the Registrant's Quarterly Report on Form 10-Q for the quarter ended September 30, 2005.
- (9) Incorporated by reference to Appendix A in the definitive proxy statement



(File  
No. 000-18279)  
filed with the  
Securities and  
Exchange  
Commission on  
April 11, 2005.

- (10) Incorporated by  
reference to the  
Registrant's  
Annual Report  
on Form 10-K  
for the year  
ended  
December 31,  
2005.

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- (b) **Exhibits.** The exhibits required by Item 601 of Regulation S-K are either filed as part of this Annual Report on Form 10-K or incorporated by reference herein.
- (c) **Financial Statements and Schedules Excluded From Annual Report.** There are no other financial statements and financial statement schedules which were excluded from this Annual Report pursuant to Rule 14a-3(b)(1) which are required to be included herein.

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**SIGNATURES**

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

TRI-COUNTY FINANCIAL  
CORPORATION

Date: March 26, 2007

By: /s/ Michael L. Middleton  
Michael L. Middleton  
President and Chief Executive Officer  
(Duly Authorized Representative)

Pursuant to the requirement 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.

By: /s/ Michael L. Middleton

Michael L. Middleton  
Director, President and Chief Executive  
Officer  
(Principal Executive Officer)

By: /s/ William J. Pasenelli

William J. Pasenelli  
Chief Financial Officer  
  
(Principal Financial and Accounting  
Officer)

Date: March 26, 2007

By: /s/ C. Marie Brown

C. Marie Brown  
Director and Chief Operating Officer

Date: March 26, 2007

By: /s/ Herbert N. Redmond, Jr.

Herbert N. Redmond, Jr.  
Director

Date: March 26, 2007

By: /s/ H. Beaman Smith

H. Beaman Smith  
Director

Date: March 26, 2007

By: /s/ A. Joseph Slater, Jr.

A. Joseph Slater, Jr.  
Director

Date: March 26, 2007

By: /s/ Louis P. Jenkins, Jr.

Louis P. Jenkins, Jr.  
Director

Date: March 26, 2007

By: /s/ James R. Shepherd

James R. Shepherd  
Director

Date: March 26, 2007

By: /s/ Philip T. Goldstein

Date: March 26, 2007

By: /s/ Joseph V. Stone, Jr.

Philip T. Goldstein  
Director

Joseph V. Stone, Jr.  
Director

Date: March 26, 2007

Date: March 26, 2007