



2020
ANNUAL REPORT

SELECTED FINANCIAL DATA

(Dollars in thousands, except per share data)

Years Ended December 31,

RESULTS OF CONTINUING OPERATIONS:

	2020	2019
Interest income	\$ 59,677	\$ 59,767
Interest expense	<u>7,080</u>	<u>9,636</u>
Net interest income	52,597	50,131
Provision for credit losses	<u>3,900</u>	<u>700</u>
Net interest income after provision for credit losses	48,697	49,431
Noninterest income	10,749	10,020
Noninterest expense	<u>38,399</u>	<u>37,557</u>
Income before income taxes	21,047	21,894
Income tax expense	<u>5,317</u>	<u>5,610</u>
Income from continuing operations	<u>\$ 15,730</u>	<u>\$ 16,284</u>

RESULTS OF DISCONTINUED OPERATIONS:

Noninterest income	\$ -	\$ 15
Noninterest expense	<u>-</u>	<u>128</u>
(Loss) income before income taxes	-	(113)
Income tax expense (benefit)	<u>-</u>	<u>(27)</u>
(Loss) income from discontinued operations	<u>\$ -</u>	<u>\$ (86)</u>

PER COMMON SHARE DATA:

Income from continuing operations - basic	\$ 1.27	\$ 1.28
Income (loss) from discontinued operations - basic	<u>-</u>	<u>(0.01)</u>
Net income	<u>\$ 1.27</u>	<u>\$ 1.27</u>
Income from continuing operations - diluted	\$ 1.27	\$ 1.28
Income (loss) from discontinued operations - diluted	<u>-</u>	<u>(0.01)</u>
Net income	<u>\$ 1.27</u>	<u>\$ 1.27</u>
Dividends paid	0.48	0.42
Book value (at year end)	16.55	15.42
Tangible book value (at year end) ¹	14.92	13.84

FINANCIAL CONDITION (at year end):

Loans	\$ 1,454,256	\$ 1,248,654
Assets	1,933,315	1,559,235
Deposits	1,700,705	1,341,334
Stockholders' equity	195,019	192,802

PERFORMANCE RATIOS (for the year)²:

Return on average total assets	0.92 %	1.08 %
Return on average stockholders' equity	7.95	8.52
Net interest margin	3.27	3.54
Efficiency ratio ³	60.62	62.64
Dividend payout ratio	37.80	33.07
Average stockholders' equity to average total assets	11.58	12.69

ASSET QUALITY RATIOS (for the year):

Nonperforming assets to total assets	0.32 %	0.77 %
Nonperforming assets and accruing TDRs to total assets	0.68	1.25
Allowance for credit losses to loans ⁴	0.95	0.84
Allowance for credit losses to nonaccrual loans	254.59	99.22
Allowance for credit losses to nonaccrual loans and TDRs	104.77	58.08

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

²Reflect the results of both continuing and discontinued operations.

³Noninterest expense as a percentage of total revenue (net interest income plus total noninterest income). Lower ratios indicate improved productivity.

⁴This ratio includes PPP loans of \$122.8 million. Without PPP loans, the ratio is 1.04%.

Dear Shareholders:

Fiscal year 2020 will be forever remembered as the year of COVID-19. As the Company faced many challenges in relation to the global pandemic, it was a surprising year for the Company from a financial perspective. The Company grew \$374.1 million in total assets to nearly \$2 billion by the end of 2020. Asset growth was significantly impacted by an increase in deposits of approximately \$359.4 million, or 26.8%, while organic loan growth, excluding the U.S. Small Business Administration Paycheck Protection Program (PPP) loans, increased \$82.8 million, or 6.6%, much higher than many of our peers. These significant financial highlights, amid a global health crisis, are a true testament to the strength of our markets and dedication of our team. We are proud that our team of nearly 300 employees continues to not only reaffirm our commitment to customers, communities and shareholders, they made a significant impact on the reputation of our Company.

Our ability to adapt and alter our delivery systems was key to our success during the pandemic. For approximately 2 ½ months, we completed customer transactions primarily through our branch drive-thru network and promoted the use of online and mobile banking. Without much persuasion or coaching, customers who normally banked in-person, began to adopt our digital banking services, creating convenience for them and efficiencies for us.

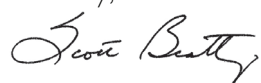
For our customers who experienced financial hardships due to the pandemic, we provided fee waivers and loan payment deferral programs. This assistance also included the participation in the PPP lending program, in which we were able to assist 1,525 small business customers totaling \$130.1 million. Our loan deferral program had a balance of \$34.9 million, or 2.4% of the total loan portfolio, at December 31, 2020 and primarily consisted of hospitality borrowers, who were hardest hit by state and local government shut downs and travel restrictions. The Company's assistance programs along with government stimulus, resulted in no losses during 2020 related to the pandemic and we continue to see significant improvements in credit quality metrics.

Our capital and credit quality ratios are better than they have been in recent memory. Total nonperforming assets are down \$5.7 million, or 47.8% when compared to 2019. We were able to raise \$25 million in additional capital through a subordinated debt offering in August of 2020 which proved to be an inexpensive way to bolster our already strong capital position in the event of an unexpected downturn in the economy. Later in the year, the excess capital gave us the opportunity to buy back approximately 747 thousand shares or approximately 6% of our outstanding common stock. These buybacks were viewed favorably by our investors and committed shareholders and may resume once we are able to do so.

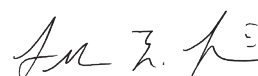
Looking forward, we feel strongly that our recent announcement of the purchase of Severn Bancorp enhances our overall franchise value. This acquisition will allow for expansion and growth into a very attractive market, connect our operations in and throughout Maryland and offer alternative revenue streams that replace those lost due to the sale of our insurance business operations in 2018. After the close of this transaction, the Company will be \$2.9 billion in total assets and the third largest bank headquartered in Maryland.

As our customers' preferences change, we will continue to make prudent decisions in the way we operate and conduct business. We want to thank our board of directors, shareholders, employees and customers for your loyalty, support, and investment in Shore Bancshares.

Sincerely,



Lloyd L. "Scott" Beatty, Jr.
President & CEO, Shore United Bank & Shore Bancshares, Inc.



Frank E. Mason, III
Board Chairman

COMMUNITY



SUPPORT THROUGHOUT 2020

During the pandemic as more people became unemployed and had limited resources, the demand for food assistance reached critical levels. As a local community bank, we responded to the needs of our communities by donating \$20,000 in response to the growing food assistance demands of Maryland, Delaware and Virginia Food Banks who worked tirelessly to purchase and distribute food to those in need.



With the absence of in-person social gatherings and events, aid and assistant programs were moved to virtual platforms. Our employees rallied to find safe solutions to support the community through food pantry drives, collection boxes for 'Toys for Tots', tote bags for virtual school supplies, and much needed items for homeless shelters and animal shelters.

\$245,000 donated to support local community organizations over and above branch collection drives.





FOCUS TO HELP LOCAL BUSINESSES SECURE FUNDING

During the COVID-19 Pandemic

When COVID-19 brought unprecedented change to our economy in early March, small business owners were immediately worried about what it could mean for the financial stability and future of their business. As an approved Small Business Administration (SBA) lender, we immediately developed a process to make Paycheck Protection Program (PPP) loans available to small businesses in our communities.

When the Small Business Administration (SBA) Paycheck Protection Program (PPP) expired on August 8, 2020, we had approved 1,525 loans for a total of \$130.1 million.

1,525 APPROVED PPP LOANS

\$130.1 MILLION DOLLARS



Community Banking Success Stories

“

Thank you to you and your team. On Friday, we were able to guarantee 35 hours of work and no layoffs to our employees through June. Also for those with healthcare, we are picking up the employee portion for at least the next few weeks. We are making some hires as well that never would have happened so a few more families lives will be helped too. Many have anxiety about virus issues but we were able to at least relieve them of the economic concerns for now. Hopefully by June, this will be in the rear view mirror.

Bruce, Local Business Owner

”

“

Anyone who owns a business and has explored the federal grant/loan from SBA knows how confusing the process can be. I just wanted to thank my local bank, Shore United Bank, who I've been banking with for 20 years for handling my PPP loan completely pain free and making it happen.

Eric, Local Business Owner

”

“

On the news I hear about other small businesses struggling through the SBA PPP loan process. However, that was not the case for us. I want to thank you for going above and beyond working with us and working with the Small Business Administration to help us secure the loan. Initially there was a lot of uncertainty from the SBA with their forms and the required documentation, however, you worked through the weekend and were on top of the changing requirements and worked closely with us to meet their requirements. Thanks for your help it is greatly appreciated.”

*Finance Director
Mid-Shore Non-Profit Organization*

”



WYE FINANCIAL PARTNERS

Name Change

In March, our investment services division, Wye Financial & Trust changed its name to Wye Financial Partners and Wye Trust.

Due to the SEC Reg B-1 (Regulation Best Interest) guidelines, the Company now uses separate and distinct names for each type of business it conducts. The trust business is offered through the bank's trust powers and the brokerage business is offered through LPL Financial, the Company's broker/dealer. The regulation seeks to make clear to clients what is a bank offering and what is not.

This change has not had a significant impact on clients as the team, processes, and service offerings have not changed. After a tumultuous first quarter due to the pandemic, Wye ended the year strong, profitable and with assets under management up 7%.

NEW WEST OCEAN CITY

Branch Opened

*12905 Ocean Gateway
Ocean City, Maryland*



In March 2020 we opened our West Ocean City Branch. Unfortunately, three days later we had to close all branch lobbies and service customers through the drive-thru window. Despite the pandemic, the branch remained open and serviced customer by appointment and via the drive-thru. Our lobbies re-opened in June with appropriate safety protocols in place. The branch continues to welcome new and visiting customers.

TRED AVON BRANCH REMODEL

212 Marlboro Avenue, Easton, Maryland

In July 2020, we began construction to completely renovate our Tred Avon Square branch location. We forged ahead with the project keeping the health and safety of our employees and customers our top priority. Although renovation projects can often be disruptive, we provided continual service to our customers. We appreciate the patience, cooperation and consideration from our customers, contractors, and staff.

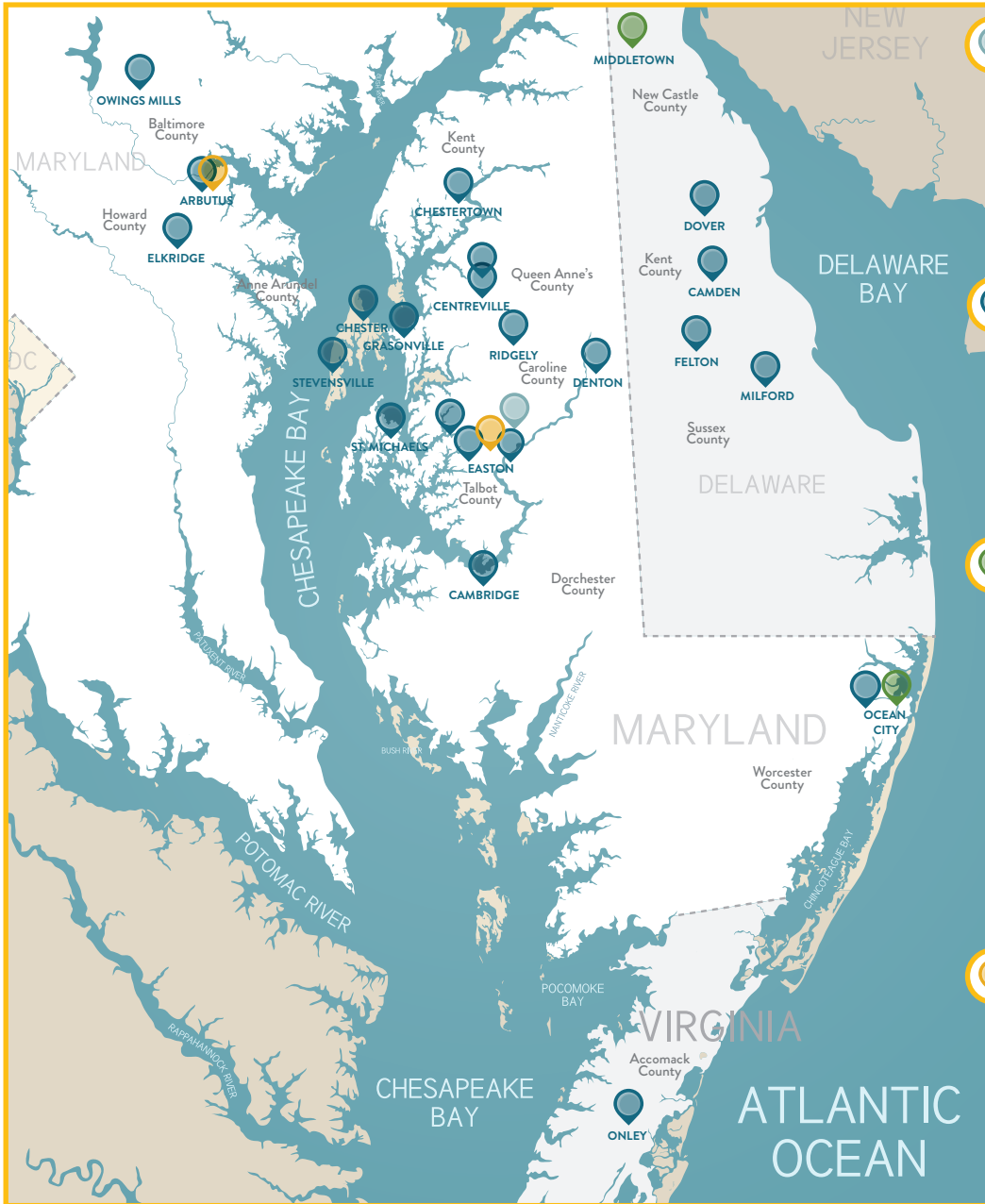
The newly renovated branch offers a refreshed, open floor plan for employees to engage with customers. Cash recyclers provide safe and quick automation for receiving and disbursing cash giving employees more time to provide exceptional customer service. Customer convenience was enhanced with the addition of a drive-up ATM.

THEN



NOW





SHORE BANCSHARES

HEADQUARTERS
 18 E. Dover Street
 Easton, MD 21601
 410.763.7800
 ShoreBancshares.com
 NASDAQ: SHBI

BANKING

SHORE UNITED BANK
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 Easton, MD 21601
 410.822.1400
 877.758.1600
 ShoreUnitedBank.com

LOAN PRODUCTION OFFICES

SHORE UNITED BANK
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 Ocean City, MD 21842
 443.856.2100
 ShoreUnitedBank.com

102 Sleepy Hollow Drive, Suite 204
 Middletown, DE 19709
 302.449.6320
 ShoreUnitedBank.com

INVESTMENTS

WYE FINANCIAL PARTNERS
 16 N. Washington Street
 Easton, MD 21601
 410.763.8543
 800.309.8124
 WyeFinancialPartners.com

1101 Maiden Choice Lane
 Baltimore, MD 21229
 800.309.8124
 WyeFinancialPartners.com

INVESTOR RELATIONS CONTACT:
 Edward C. Allen
 Edward.Allen@shbi.com
 443.262.9319

TRANSFER AGENT:
 Broadridge Corporate Issuer Solutions
 51 Mercedes Way
 Edgewood, NY 11717
 866.232.0392
 720.358.3588

BOARD OF DIRECTORS

SHORE BANCSHARES & SHORE UNITED BANK

CHAIRMAN OF THE BOARD

Frank E. Mason, III
President & Chief Executive Officer, JASCO

PRESIDENT & CHIEF EXECUTIVE OFFICER

Lloyd L. "Scott" Beatty, Jr.

Blenda W. Armistead
Investor

David J. Bates
Investor

R. Michael Clemmer, Jr.
President, Salisbury, Inc.

William E. Esham, III
Partner, Ayres, Jenkins, Gordy & Almand, PA

James A. Judge
Certified Public Accountant, Anthony Judge & Ware, LLC

Clyde V. Kelly, III
President & General Manager, Kelly Distributors

David W. Moore
President & Chief Executive Officer
Milford Housing Development Corporation

Jeffrey E. Thompson
Managing Partner, Thompson & Richard, LLP

Dawn M. Willey
Investor

OFFICERS | SHORE BANCSHARES

PRESIDENT & CHIEF EXECUTIVE OFFICER

Lloyd L. "Scott" Beatty, Jr.

EXECUTIVE VICE PRESIDENT & CHIEF FINANCIAL OFFICER

Edward C. Allen

EXECUTIVE VICE PRESIDENT & CHIEF OPERATING OFFICER

Donna J. Stevens

EXECUTIVE VICE PRESIDENT & GENERAL COUNSEL

W. David Morse

OFFICERS | SHORE UNITED BANK

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Donna J. Stevens

EXECUTIVE VICE PRESIDENT/LEGAL COUNSEL CORPORATE SECRETARY

W. David Morse

EXECUTIVE VICE PRESIDENT & CHIEF CREDIT OFFICER

Charles E. Ruch, Jr.

EXECUTIVE VICE PRESIDENT & CHIEF LENDING OFFICER

Michael T. Cavey

EXECUTIVE VICE PRESIDENT & CHIEF RETAIL BANKING OFFICER

Jennifer M. Joseph

SENIOR VICE PRESIDENT & CHIEF INFORMATION OFFICER

Charles F. "Fritz" Kade, III

SENIOR VICE PRESIDENT & CHIEF MARKETING & PROJECT OFFICER

Debra H. Rich

SENIOR VICE PRESIDENT & CHIEF HUMAN RESOURCES OFFICER

Marie P. DiDaniels

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

FORM 10-K

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

For the Year Ended December 31, 2020

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

Commission File No. 0-22345

SHORE BANCSHARES, INC.

(Exact name of registrant as specified in its charter)

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

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

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

<u>Title of Each Class:</u>	<u>Trading Symbol(s)</u>	<u>Name of Each Exchange on Which Registered:</u>
Common stock, par value \$.01 per share	SHBI	Nasdaq Global Select Market

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

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 16(d) of the Act. Yes 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 whether the registrant has submitted electronically every Interactive Data File required to be submitted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit files). Yes No

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

Large accelerated filer	<input type="checkbox"/>	Accelerated filer	<input type="checkbox"/>
Non-accelerated filer	<input checked="" type="checkbox"/>	Smaller reporting company	<input checked="" type="checkbox"/>
		Emerging growth company	<input type="checkbox"/>

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act.

Indicate by check mark whether the registrant has filed a report on and attestation to its management's assessment of the effectiveness of its internal control over financial reporting under Section 404(b) of the Sarbanes-Oxley Act (15 U.S.C. 7262(b)) by the registered public accounting firm that prepared or issued its audit report.

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

State the aggregate market value of the voting and non-voting common equity held by non-affiliates computed by reference to the price at which the common equity was last sold, or the average bid and asked price of such common equity, as of the last business day of the registrant's most recently completed second fiscal quarter: \$ 138,909,647.

The number of shares outstanding of the registrant's common stock as of the latest practicable date: 11,751,859 as of March 15, 2021.

Documents Incorporated by Reference

Certain information required by Part III of this annual report is incorporated therein by reference to the definitive proxy statement for the 2021 Annual Meeting of Stockholders.

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Cautionary note regarding forward-looking statements

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

In addition to the foregoing, the COVID-19 pandemic is adversely affecting us, our customers, counterparties, employees and third party service providers, and the ultimate extent of the impact on our business, financial position, results of operations, liquidity, and prospects is uncertain. Continued deterioration in general business and economic conditions, including further increases in unemployment rates, or turbulence in domestic or global financial markets could adversely affect our revenues and the values of our assets and liabilities, reduce the availability of funding, lead to a tightening of credit, and further increase stock price volatility, which could result in impairment to our goodwill in future periods. Changes to statutes, regulations, or regulatory policies or practices as a result of, or in response to COVID-19, could affect us in substantial and unpredictable ways, including the potential adverse impact of loan modifications and payment deferrals implemented consistent with recent regulatory guidance. The following factors, among others, could cause our financial performance to differ materially from that expressed in such forward-looking statements:

COVID-19 Pandemic

- responsive actions related to the COVID-19 pandemic may adversely affect our business, financial condition, results of operations, liquidity, and cash flow. It is impossible to predict, with reliability, the extent of any such impact;
- public health officials have recommended and mandated precautions to mitigate the spread of COVID-19, including prohibitions on congregating in heavily populated areas and shelter-in-place orders or similar measures. As a result, we have temporarily closed certain branches and other locations. Our results could be adversely impacted by these closures and other actions taken to contain the impact of COVID-19, and the extent of such impact will depend on future developments, which are highly uncertain and cannot be reliably predicted;
- asset quality within the Company’s loan portfolio and the value of collateral securing our loans may deteriorate and be adversely impacted by the effects and duration of the COVID-19 pandemic and other circumstances;
- our allowance for loan losses may increase if borrowers experience financial difficulties and the net worth and liquidity of loan guarantors may decline, impairing their ability to honor their commitments to us, either or both of which will adversely affect our results of operations;
- if the economy is unable to substantially reopen, and high levels of unemployment continue for an extended period of time, loan delinquencies, problem assets, and foreclosures may increase, resulting in increased charges and reduced income; collateral for loans, especially real estate, may decline in value, which could cause loan losses to increase;

- liquidity risks associated with our business could be adversely affected by the COVID-19 pandemic and other circumstances;
- our ability to maintain important deposit customer relationships and our reputation could be impacted by the COVID-19 pandemic and other circumstances;
- the sufficiency of our capital, including sources of capital and the extent to which we may be required to raise additional capital to meet our goals may be impacted by the COVID-19 pandemic and other circumstances;
- potential exposure to fraud, negligence, computer theft and cyber-crime as an effect of the COVID-19 pandemic and other circumstances could increase;
- the adequacy of our risk management framework may be impacted by the COVID-19 pandemic as our cyber security risks are increased as the result of an increase in the number of employees working remotely;

General Economic Conditions

- general economic conditions, whether national or regional, and conditions in the lending markets in which we participate that may have an adverse effect on the demand for our loans and other products, our credit quality and related levels of nonperforming assets and loan losses, and the value and salability of the real estate that we own or that is the collateral for our loans;
- results of examinations of us by our regulators, including the possibility that our regulators may, among other things, require us to increase our reserve for loan losses or to write-down assets;
- our ability to prudently manage our growth and execute our strategy;
- the effect of acquisitions we have made or may make, including, without limitation, the failure to achieve the expected revenue growth and/or expense savings from such acquisitions, and/or the failure to effectively integrate an acquisition target into our operations;
- impairment of our goodwill and intangible assets;
- changing bank regulatory conditions, policies or programs, whether arising as new legislation or regulatory initiatives, that could lead to restrictions on activities of banks generally, or our subsidiary bank in particular, more restrictive regulatory capital requirements, increased costs, including deposit insurance premiums, regulation or prohibition of certain income producing activities or changes in the secondary market for loans and other products;
- changes in market rates and prices may adversely impact the value of securities, loans, deposits and other financial instruments and the interest rate sensitivity of our balance sheet;
- our liquidity requirements could be adversely affected by changes in our assets and liabilities;
- the effect of legislative or regulatory developments, including changes in laws concerning taxes, banking, securities, insurance and other aspects of the financial services industry;

- competitive factors among financial services organizations, including product and pricing pressures and our ability to attract, develop and retain qualified banking professionals;
- the expected discontinuation of the London Interbank Offering Rate (“LIBOR”) after 2021 and uncertainty regarding potential alternative reference rates, including Secured Overnight Financing Rate (“SOFR”);
- the growth and profitability of non-interest or fee income being less than expected;
- the effect of changes in accounting policies and practices, as may be adopted by the Financial Accounting Standards Board, the Securities and Exchange Commission (the “SEC”), the Public Company Accounting Oversight Board and other regulatory agencies; and
- the effect of fiscal and governmental policies of the United States federal government.

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

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

PART I

Item 1. Business.

BUSINESS

General

The Company was incorporated under the laws of Maryland on March 15, 1996 and is a financial holding company registered under the Bank Holding Company Act of 1956, as amended (the “BHC Act”). The Company is the largest independent financial holding company located on the Eastern Shore of Maryland. The Company, through its wholly owned banking subsidiary, Shore United Bank (the “Bank”) provides commercial banking products and services, including trust, wealth management and financial planning services. The Company and the Bank are Affirmative Action/Equal Opportunity Employers.

Pending Transaction

On March 3, 2021, the Company and Severn Bancorp, Inc. (“Severn”) entered into a definitive agreement for the Company to acquire the Maryland-based Severn.

This transaction will create the third largest community bank headquartered in Maryland. This transaction will, among others, (i) permit the Company to expand its Maryland market area by entering the greater Annapolis market area, (ii) provide increased opportunities for current Severn products and services and (iii) enhance the Company’s scale to drive efficiency and profitability. Additionally, this transaction is intended to create a competitive position in the Columbia/Baltimore/Towson MSA, while filling in the Company’s current market footprint.

Under the terms of the agreement, Severn shareholders will have the right to receive 0.6207 shares of Shore common stock and \$1.59 in cash for each share of Severn common stock. Upon closing, Shore shareholders will own approximately 59.6% of the combined Company and Severn will own approximately 40.4% of the combined Company. The transaction is subject to satisfaction of customary closing conditions, including regulatory approvals and shareholder approval from Shore and Severn shareholders. The transaction is expected to close in the third quarter of 2021.

As of December 31, 2020, Severn had more than \$950 million in assets and operated 7 full-service community banking offices throughout Anne Arundel County, Maryland.

Banking Products and Services

The Bank is a Maryland chartered commercial bank with trust powers that can trace its origin to 1876. The Bank currently operates 22 full service branches, 24 ATMs, 2 loan production offices, and provides a full range of commercial and consumer banking products and services to individuals, businesses, and other organizations in Baltimore City, Baltimore County, Howard County, Kent County, Queen Anne’s County, Caroline County, Talbot County, Dorchester County and Worcester County in Maryland, Kent County, Delaware and in Accomack County, Virginia. The Bank’s deposits are insured up to applicable legal limits by the Federal Deposit Insurance Corporation (the “FDIC”).

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

Services to individuals include checking accounts, various savings programs, mortgage loans, home improvement loans, installment and other personal loans, credit cards, personal lines of credit, automobile and other consumer financing, safe deposit boxes, debit cards, 24-hour telephone banking, internet banking, mobile banking, and 24-hour automatic teller

machine services. The Bank also offers non-deposit products, such as mutual funds and annuities, and discount brokerage services to their customers. Additionally, the Bank has Saturday hours and extended hours on certain evenings during the week for added customer convenience.

Lending Activities

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

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

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

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

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

Deposit Activities

The Bank offers a full array of deposit products including checking, savings and money market accounts, and regular and IRA certificates of deposit. The Bank also offers the CDARS program, providing up to \$50 million of FDIC insurance to our customers. Another program offered by the Bank is the ICS program, which is an insured cash sweep program allowing customers the ability to insure deposits over \$250 thousand among other Banks that participate in the ICS network while providing competitive rates and easy access to funds. In addition, we offer our commercial customers packages which include cash management services and various checking opportunities and other cash sweep products.

Trust Services

The Bank has a trust department through which it offers trust, asset management and financial planning services to customers within our market areas using the trade name Wye Financial Partners.

Seasonality

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

Employees and Human Capital Resources

At March 15, 2021, we employed 295 persons, of which 286 were employed on a full-time basis. None of our employees are represented by any collective bargaining unit or are a party to a collective bargaining agreement. We believe the relationship with our employees to be excellent and were recently named a Best Bank to Work for by American Banker. Our ability to attract and retain employees is a key to our success. We offer a competitive total rewards program to our employees and monitor the competitiveness of our compensation and benefits programs in our various market areas.

The Company prides itself on being a values-driven organization, where employees are empowered to share Ideas that keep the organization connected. Our company core values guide each team member to:

- Act as an Owner
- Practice Balanced Risk Management
- Leverage the Team
- Create a positive impact

We believe that these values enable our success with our customers and have helped us build an inspiring, vibrant and accountability driven culture. In addition, we are committed to developing our staff through internal/external training programs, availability of online training resources, and continuing to implement leadership development programs to all levels of leadership within the organization. This includes identifying future leaders and preparing them for leadership opportunities

The safety, health and wellness for our employees is a top priority and consists of policies, procedures, guidelines, and mandates all tasks be conducted in a safe and efficient manner complying with all local, state and federal safety and health regulations. At the onset of the COVID-19 pandemic, we successfully moved to a virtual-workplace and had 85% of our people working remotely. As of today, most employees have returned to the workplace. Employees are subject to policies and procedures put in place to protect them including a full stock of PPE. The organization has continually provided guidelines to employees to promote healthy habits and ways to stay connected while working remotely.

COMPETITION

Shore Bancshares, Inc. and the Bank operate in a highly competitive environment. Our competitors include community banks, commercial banks, credit unions, thrifts, mortgage banking companies, credit card issuers, investment advisory firms, brokerage firms, mutual fund companies and e-commerce and other internet-based companies. We compete on a local and regional basis for banking and investment products and services.

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

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

SUPERVISION AND REGULATION

General

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

The Bank is a Maryland chartered commercial bank subject to the banking laws of Maryland and to regulation by the Commissioner of Financial Regulation of Maryland. The primary federal regulator of the Bank is the FRB. The deposits of the Bank are insured by the FDIC, so certain laws and regulations administered by the FDIC also govern its deposit taking operations. In addition to the foregoing, the Bank is subject to numerous state and federal statutes and regulations that affect the business of banking generally.

Nonbank affiliates of the Company are subject to examination by the FRB, and, as affiliates of the Bank, may be subject to examination by the Bank’s regulators from time to time.

To the extent that the following information describes statutory and regulatory provisions, it is qualified in its entirety by reference to the text of applicable statutory and regulatory provisions. Legislative and regulatory initiatives, which necessarily impact the regulation of the financial services industry, are introduced from time-to-time. We cannot predict whether or when potential legislation or new regulations will be enacted, and if enacted, the effect that new legislation or any implemented regulations and supervisory policies would have on our financial condition and results of operations. The Dodd-Frank Wall Street Reform and Consumer Protection Act (the “Dodd-Frank Act”), by way of example, contains a comprehensive set of provisions designed to govern the practices and oversight of financial institutions and other participants in the financial markets. The Dodd-Frank Act made extensive changes in the regulation of financial institutions and their holding companies. Some of the changes brought about by the Dodd-Frank Act have been modified by the Economic Growth, Regulatory Relief, and Consumer Protection Act of 2018 (the “Regulatory Relief Act”), signed into law on May 24, 2018. The Dodd-Frank Act has increased the regulatory burden and compliance costs of the Company. Moreover, bank regulatory agencies can be more aggressive in responding to concerns and trends identified in examinations, which could result in an increased issuance of enforcement actions to financial institutions requiring action to address credit quality, liquidity and risk management, and capital adequacy, as well as other safety and soundness concerns.

Regulation of Financial Holding Companies

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

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

The Dodd-Frank Act, enacted in 2010, made sweeping changes to the financial regulatory landscape that impacts all financial institutions, including the Company and the Bank. The Dodd-Frank Act directs federal bank regulators to require that all companies that directly or indirectly control an insured depository institution serve as sources of financial strength for the institution. The term “source of financial strength” is defined under the Dodd-Frank Act as the ability of a company to provide financial assistance to its insured depository institution subsidiaries in the event of financial distress. The appropriate federal banking agency for such a depository institution may require reports from companies that control the insured depository institution to assess their abilities to serve as sources of strength and to enforce compliance with the source-of-strength requirements. The appropriate federal banking agency may also require a holding company to provide financial assistance to a bank with impaired capital. Under this requirement, the Company could be required to provide financial assistance to the Bank should it experience financial distress.

Federal Regulation of Banks

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

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

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

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

Increase in Small Bank Holding Company Policy Threshold. The Regulatory Relief Act directed the FRB to increase the asset threshold for qualifying for the FRB’s “Small Bank Holding Company Policy Statement” (the “Policy”), from \$1 billion to \$3 billion. The FRB’s revisions to the Policy took effect on August 30, 2018. Small BHCs or savings and loan holding companies (“SLHCs”) are excluded from the Policy if they are engaged in significant nonbanking activities, engaged in significant off-balance sheet activities, or have a material amount of debt or equity registered with the SEC. The FRB also retains the authority to exclude any BHC or SLHC from the Policy if such action is warranted for supervisory purposes. The Policy allows covered BHCs to operate with higher levels of debt than would normally be permitted, subject to certain restrictions on dividends and the expectation that the BHC will reduce its reliance on debt over time. Also, BHCs that are subject to the Policy are exempt from the FRB’s consolidated risk-based and leverage capital rules implementing Basel III. BHCs subject to the Policy also have less extensive regulatory reporting requirements than larger organizations filing reports on a semi-annual rather than quarterly basis. The Company meets the conditions of the FRB’s Policy and is

therefore currently excluded from consolidated capital requirements. However, the Bank remains subject to regulatory capital requirements administered by the federal banking agencies.

Deposit Insurance

Our deposits are insured up to applicable limits by the DIF of the FDIC. Deposit insurance is mandatory. We are required to pay assessments to the FDIC on a quarterly basis. The assessment amount is the product of multiplying the assessment base by the assessment amount.

The assessment base against which the assessment rate is applied to determine the total assessment due for a given period is the depository institution's average total consolidated assets during the assessment period less average tangible equity during that assessment period. Tangible equity is defined in the assessment rule as Tier 1 Capital and is calculated monthly, unless the insured depository institution has less than \$1 billion in assets, in which case the insured depository institution calculates Tier 1 Capital on an end-of-quarter basis. Parents or holding companies of other insured depository institutions are required to report separately from their subsidiary depository institutions.

The FDIC's methodology for setting assessments for individual banks has changed over time, although the broad policy is that lower-risk institutions should pay lower assessments than higher-risk institutions. The FDIC now uses a methodology, known as the "financial ratios method," that began to apply on July 1, 2016, in order to meet requirements of the Dodd-Frank Act. The statute established a minimum designated reserve ratio (the "DFR"), for the DIF of 1.35% of the estimated insured deposits and required the FDIC to adopt a restoration plan should the reserve ratio fall below 1.35%. The financial ratios took effect when the DRR exceeded 1.15%. The FDIC declared that the DIF reserve ratio exceeded 1.15% by the end of the second quarter of 2016. Accordingly, beginning July 1, 2016, the FDIC began to use the financial ratios method. This methodology assigns a specific assessment rate to each institution based on the institution's leverage capital, supervisory ratings, and information from the institution's call report. Under this methodology, the assessment rate schedules used to determine assessments due from insured depository institutions become progressively lower when the reserve ratio in the DIF exceeds 2% and 2.5%.

The Dodd-Frank Act also raised the limit for federal deposit insurance to \$250,000 for most deposit accounts and increased the cash limit of Securities Investor Protection Corporation protection from \$100,000 to \$250,000.

The FDIC has authority to increase insurance assessments. A significant increase in insurance assessments would likely have an adverse effect on our operating expenses and results of operations. We cannot predict what insurance assessment rates will be in the future. Furthermore, deposit insurance may be terminated by the FDIC upon a finding that an insured depository 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.

Capital Adequacy Guidelines

Bank holding companies and banks are subject to various regulatory capital requirements administered by state and federal agencies. These agencies may establish higher minimum requirements if, for example, a banking organization previously has received special attention or has a high susceptibility to interest rate risk. Risk-based capital requirements determine the adequacy of capital based on the risk inherent in various classes of assets and off-balance sheet items. Under the Dodd-Frank Act, the FRB must apply consolidated capital requirements to depository institution holding companies that are no less stringent than those currently applied to depository institutions. The Dodd-Frank Act additionally requires capital requirements to be countercyclical so that the required amount of capital increases in times of economic expansion and decreases in times of economic contraction, consistent with safety and soundness.

Under federal regulations, bank holding companies and banks must meet certain risk-based capital requirements. Effective as of January 1, 2015, the Basel III final capital framework, among other things, (i) introduces as a new capital measure "Common Equity Tier 1" ("CET1"), (ii) specifies that Tier 1 capital consists of CET1 and "Additional Tier 1 capital" instruments meeting specified requirements, (iii) defines CET1 narrowly by requiring that most adjustments to regulatory capital measures be made to CET1 and not to the other components of capital, and (iv) expands the scope of the adjustments as compared to existing regulations. Beginning January 1, 2016, financial institutions are required to

maintain a minimum “capital conservation buffer” to avoid restrictions on capital distributions such as dividends and equity repurchases and other payments such as discretionary bonuses to executive officers. The minimum capital conservation buffer has been phased-in over a four year transition period with minimum buffers of 0.625%, 1.25%, 1.875%, and 2.50% during 2016, 2017, 2018, and 2019, respectively.

As fully phased-in on January 1, 2019, Basel III subjects banks to the following risk-based capital requirements:

- a minimum ratio of CET1 to risk-weighted assets of at least 4.5%, plus a 2.5% capital conservation buffer, or 7%;
- a minimum ratio of Tier 1 capital to risk-weighted assets of at least 6.0%, plus the capital conservation buffer, or 8.5%;
- a minimum ratio of Total (Tier 1 plus Tier 2) capital to risk-weighted assets of at least 8.0%, plus the capital conservation buffer, or 10.5%; and
- a minimum leverage ratio of 4%, calculated as the ratio of Tier 1 capital to balance sheet exposures plus certain off-balance sheet exposures.

The Basel III final framework provides for a number of deductions from and adjustments to CET1. These include, for example, the requirement that mortgage servicing rights, deferred tax assets dependent upon future taxable income and significant investments in non-consolidated financial entities be deducted from CET1 to the extent that any one such category exceeds 10% of CET1 or all such categories in the aggregate exceed 15% of CET1. Basel III also includes, as part of the definition of CET1 capital, a requirement that banking institutions include the amount of Additional Other Comprehensive Income (“AOCI”), which primarily consists of unrealized gains and losses on available-for-sale securities, which are not required to be treated as other-than-temporary impairment, net of tax) in calculating regulatory capital. Banking institutions had the option to opt out of including AOCI in CET1 capital if they elected to do so in their first regulatory report following January 1, 2015. As permitted by Basel III, the Company and the Bank have elected to exclude AOCI from CET1.

In addition, goodwill and most intangible assets are deducted from Tier 1 capital. For purposes of applicable total risk-based capital regulatory guidelines, Tier 2 capital (sometimes referred to as “supplementary capital”) is defined to include, subject to limitations: perpetual preferred stock not included in Tier 1 capital, intermediate-term preferred stock and any related surplus, certain hybrid capital instruments, perpetual debt and mandatory convertible debt securities, allowances for loan and lease losses, and intermediate-term subordinated debt instruments. The maximum amount of qualifying Tier 2 capital is 100% of qualifying Tier 1 capital. For purposes of determining total capital under federal guidelines, total capital equals Tier 1 capital, plus qualifying Tier 2 capital, minus investments in unconsolidated subsidiaries, reciprocal holdings of bank holding company capital securities, and deferred tax assets and other deductions.

Basel III changed the manner of calculating risk-weighted assets. New methodologies for determining risk-weighted assets in the general capital rules are included, including revisions to recognition of credit risk mitigation, including a greater recognition of financial collateral and a wider range of eligible guarantors. They also include risk weighting of equity exposures and past due loans; and higher (greater than 100%) risk weighting for certain commercial real estate exposures that have higher credit risk profiles, including higher loan to value and equity components. In particular, loans categorized as “high-volatility commercial real estate” loans (“HVCRE loans”), as defined pursuant to applicable federal regulations, are required to be assigned a 150% risk weighting, and require additional capital support.

In addition to the uniform risk-based capital guidelines and regulatory capital ratios that apply across the industry, the regulators have the discretion to set individual minimum capital requirements for specific institutions at rates significantly above the minimum guidelines and ratios. Future changes in regulations or practices could further reduce the amount of capital recognized for purposes of capital adequacy. Such a change could affect our ability to grow and could restrict the amount of profits, if any, available for the payment of dividends.

In addition, the Dodd-Frank Act requires the federal banking agencies to adopt capital requirements that address the risks that the activities of an institution poses to the institution and the public and private stakeholders, including risks arising from certain enumerated activities.

Basel III became applicable to the Bank on January 1, 2015. The Company meets the conditions of the FRB's "Small Bank Holding Company Policy Statement" and is therefore currently excluded from consolidated capital requirements. Overall, the Corporation believes that implementation of the Basel III Rule has not had and will not have a material adverse effect on the Corporation's or the Bank's capital ratios, earnings, shareholder's equity, or its ability to pay dividends, effect stock repurchases or pay discretionary bonuses to executive officers.

In December 2017, the Basel Committee published standards that it described as the finalization of the Basel III post-crisis regulatory reforms (the standards are commonly referred to as "Basel IV"). Among other things, these standards revise the Basel Committee's standardized approach for credit risk (including recalibrating risk weights and introducing new capital requirements for certain "unconditionally cancellable commitments," such as unused credit card lines of credit) and provides a new standardized approach for operational risk capital. Under the Basel framework, these standards will generally be effective on January 1, 2022, with an aggregate output floor phasing in through January 1, 2027. Under the current U.S. capital rules, operational risk capital requirements and a capital floor apply only to advanced approaches institutions, and not to the Company or the Bank. The impact of Basel IV on us will depend on the manner in which it is implemented by the federal bank regulators.

In 2018, the federal bank regulatory agencies issued a variety of proposals and made statements concerning regulatory capital standards. These proposals touched on such areas as commercial real estate exposure, credit loss allowances under generally accepted accounting principles and capital requirements for covered swap entities, among others. Public statements by key agency officials have also suggested a revisiting of capital policy and supervisory approaches on a going-forward basis. In July 2019, the federal bank regulators adopted a final rule that simplifies the capital treatment for certain deferred tax assets, mortgage servicing assets, investments in non-consolidated financial entities and minority interests for banking organizations, such as the Company and the Bank, that are not subject to the advanced approaches requirements. We will be assessing the impact on us of these new regulations and supervisory approaches as they are proposed and implemented.

In February 2019, the U.S. federal bank regulatory agencies approved a final rule modifying their regulatory capital rules and providing an option to phase-in over a three-year period the Day 1 adverse regulatory capital effects of CECL accounting standard. Additionally, in March 2020, the U.S. Federal bank regulatory agencies issued an interim final rule that provides banking organizations an option to delay the estimated CECL impact on regulatory capital for an additional two years for a total transition period of up to five years to provide regulatory relief to banking organizations to better focus on supporting lending to creditworthy households and businesses in light of recent strains on the U.S. economy as a result of the COVID-19 pandemic. The capital relief in the interim is calibrated to approximate the difference in allowances under CECL relative to the incurred loss methodology for the first two years of the transition period using a 25% scaling factor. The cumulative difference at the end of the second year of the transition period is then phased in to regulatory capital at 25% per year over a three-year transition period. The final rule was adopted and became effective in September 2020. As a result, entities may gradually phase in the full effect of CECL on regulatory capital over a five-year transition period. The Company is not required to implement the CECL model until January 1, 2023.

Prompt Corrective Action

The federal banking regulators are required to take "prompt corrective action" with respect to capital-deficient institutions. Federal banking regulations define, for each capital category, the levels at which institutions are "well capitalized," "adequately capitalized," "undercapitalized," "significantly undercapitalized," and "critically undercapitalized." Under applicable regulations, the Bank was "well capitalized," which means it had a common equity Tier 1 capital ratio of 6.5% or higher; a Tier I risk-based capital ratio of 8.0% or higher; a total risk-based capital ratio of 10.0% or higher; a leverage ratio of 5.0% or higher; and was not subject to any written agreement, order or directive requiring it to maintain a specific capital level for any capital measure.

As noted above, Basel III integrates the capital requirements into the prompt corrective action category definitions. The following capital requirements have applied to the Bank since January 1, 2015.

Capital Category	Total Risk-Based Capital Ratio	Tier 1 Risk-Based Capital Ratio	Common Equity Tier 1 (CET1) Capital Ratio	Leverage Ratio	Tangible Equity to Assets	Supplemental Leverage Ratio
Well Capitalized	10% or greater	8% or greater	6.5% or greater	5% or greater	n/a	n/a
Adequately Capitalized	8% or greater	6% or greater	4.5% or greater	4% or greater	n/a	3% or greater
Undercapitalized	Less than 8%	Less than 6%	Less than 4.5%	Less than 4%	n/a	Less than 3%
Significantly Undercapitalized	Less than 6%	Less than 4%	Less than 3%	Less than 3%	n/a	n/a
Critically Undercapitalized	n/a	n/a	n/a	n/a	Less than 2%	n/a

As of December 31, 2020, the Bank was “well capitalized” according to the guidelines as generally discussed above.

An institution may be downgraded to, or deemed to be in, a capital category that is lower than indicated by its capital ratios if it is determined to be in an unsafe or unsound condition or if it receives an unsatisfactory examination rating with respect to certain matters. An institution’s capital category is determined solely for the purpose of applying prompt corrective action regulations, and the capital category may not constitute an accurate representation of the institution’s overall financial condition or prospects for other purposes.

In the event an institution becomes “undercapitalized,” it must submit a capital restoration plan. The capital restoration plan will not be accepted by the regulators unless each company having control of the undercapitalized institution guarantees the subsidiary’s compliance with the capital restoration plan up to a certain specified amount. Any such guarantee from a depository institution’s holding company is entitled to a priority of payment in bankruptcy. The aggregate liability of the holding company of an undercapitalized bank is limited to the lesser of 5% of the institution’s assets at the time it became undercapitalized or the amount necessary to cause the institution to be “adequately capitalized.” The bank regulators have greater power in situations where an institution becomes “significantly” or “critically” undercapitalized or fails to submit a capital restoration plan. In addition to requiring undercapitalized institutions to submit a capital restoration plan, bank regulations contain broad restrictions on certain activities of undercapitalized institutions including asset growth, acquisitions, branch establishment and expansion into new lines of business. With certain exceptions, an insured depository institution is prohibited from making capital distributions, including dividends, and is prohibited from paying management fees to control persons if the institution would be undercapitalized after any such distribution or payment.

As an institution’s capital decreases, the regulators’ enforcement powers become more severe. A significantly undercapitalized institution is subject to mandated capital raising activities, restrictions on interest rates paid and transactions with affiliates, removal of management, and other restrictions. A regulator has limited discretion in dealing with a critically undercapitalized institution and is virtually required to appoint a receiver or conservator.

Banks with risk-based capital and leverage ratios below the required minimums may also be subject to certain administrative actions, including the termination of deposit insurance upon notice and hearing, or a temporary suspension of insurance without a hearing in the event the institution has no tangible capital.

Safety and Soundness Standards

The federal banking agencies have adopted guidelines designed to assist the federal banking agencies in identifying and addressing potential safety and soundness concerns before capital becomes impaired. The guidelines set forth operational and managerial standards relating to: (i) internal controls, information systems and internal audit systems; (ii) loan documentation; (iii) credit underwriting; (iv) asset growth; (v) earnings; and (vi) compensation, fees and benefits.

In addition, the federal banking agencies have also adopted safety and soundness guidelines with respect to asset quality and for evaluating and monitoring earnings to ensure that earnings are sufficient for the maintenance of adequate capital and reserves. These guidelines provide six standards for establishing and maintaining a system to identify problem assets and prevent those assets from deteriorating. Under these standards, an insured depository institution should: (i) conduct periodic asset quality reviews to identify problem assets; (ii) estimate the inherent losses in problem assets and establish reserves that are sufficient to absorb estimated losses; (iii) compare problem asset totals to capital; (iv) take appropriate corrective action to resolve problem assets; (v) consider the size and potential risks of material asset concentrations; and (vi) provide periodic asset quality reports with adequate information for management and the board of directors to assess the level of asset risk.

Community Reinvestment Act

The Community Reinvestment Act (“CRA”) requires the federal banking regulatory agencies to assess all financial institutions that they regulate to determine whether these institutions are meeting the credit needs of the communities they serve, including their assessment area(s) (as established for these purposes in accordance with applicable regulations based principally on the location of branch offices). In addition to substantial penalties and corrective measures that may be required for a violation of certain fair lending laws, the federal banking agencies may take compliance with such laws and CRA into account when regulating and supervising other activities. Under the CRA, institutions are assigned a rating of “outstanding,” “satisfactory,” “needs to improve,” or “unsatisfactory.” An institution’s record in meeting the requirements of the CRA is based on a performance-based evaluation system, and is made publicly available and is taken into consideration in evaluating any applications it files with federal regulators to engage in certain activities, including approval of a branch or other deposit facility, mergers and acquisitions, office relocations, or expansions into nonbanking activities. Our Bank received a “satisfactory” rating in its most recent CRA evaluation.

In April 2018, the U.S. Department of Treasury issued a memorandum to the federal banking regulators recommending changes to the CRA’s regulations to reduce their complexity and associated burden on banks, and in December 2019, the FDIC and the Office of the Comptroller of the Currency (the “OCC”) proposed for public comment rules to modernize the agencies’ regulations under the CRA. The OCC adopted its final rules in May 2020, and, to date, the FDIC has not adopted revised rules. In September 2020, the FRB released for public comment its proposed rules to modernize CRA regulations. We will continue to evaluate the impact of any changes to the CRA regulations.

Anti-Terrorism, Money Laundering Legislation and OFAC

The Bank is subject to the Bank Secrecy Act (“BSA”) and the Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism Act of 2001 (the “USA Patriot Act”). These statutes and related rules and regulations impose requirements and limitations on specified financial transactions and accounts and other relationships intended to guard against money laundering and terrorism financing. The principal requirements for an insured depository institution include (i) establishment of an anti-money laundering program that includes training and audit components, (ii) establishment of a “know your customer” program involving due diligence to confirm the identities of persons seeking to open accounts and to deny accounts to those persons unable to demonstrate their identities, (iii) the filing of currency transaction reports for deposits and withdrawals of large amounts of cash and suspicious activities reports for activity that might signify money laundering, tax evasion, or other criminal activities, (iv) additional precautions for accounts sought and managed for non-U.S. persons and (v) verification and certification of money laundering risk with respect to private banking and foreign correspondent banking relationships. For many of these tasks a bank must keep records to be made available to its primary federal regulator. Anti-money laundering rules and policies are developed by a bureau within FinCEN, but compliance by individual institutions is overseen by its primary federal regulator.

The Bank has established appropriate anti-money laundering and customer identification programs. The Bank also maintains records of cash purchases of negotiable instruments, files reports of certain cash transactions exceeding \$10,000 (daily aggregate amount), and reports suspicious activity that might signify money laundering, tax evasion, or other criminal activities pursuant to the BSA. The Bank otherwise has implemented policies and procedures to comply with the foregoing requirements.

The Treasury Department's Office of Foreign Assets Control ("OFAC"), administers and enforces economic and trade sanctions against targeted foreign countries and persons, as defined by various Executive Orders and Acts of Congress. OFAC publishes lists of persons that are the target of sanctions, including the List of Specially Designated Nationals and Blocked Persons. Financial institutions are responsible for, among other things, blocking accounts of and transactions with sanctioned persons and countries, prohibiting unlicensed trade and financial transactions with them and reporting blocked and rejected transactions after their occurrence. If the Company or the Bank finds a name or other information on any transaction, account or wire transfer that is on an OFAC list or that otherwise indicates that the transaction involves a target of sanctions, the Company or the Bank generally must freeze or block such account or transaction, file a suspicious activity report, and notify the appropriate authorities. Banking regulators examine banks for compliance with the economic sanctions regulations administered by OFAC.

The Bank has implemented policies and procedures to comply with the foregoing requirements.

Data Privacy and Cybersecurity

The GLB Act and the implementing regulations issued by federal regulatory agencies require financial institutions (including banks, insurance agencies, and broker/dealers) to adopt policies and procedures regarding the disclosure of nonpublic personal information about their customers to non-affiliated third parties. In general, financial institutions are required to explain to customers their policies and procedures regarding the disclosure of such nonpublic personal information and, unless otherwise required or permitted by law, financial institutions are prohibited from disclosing such information except as provided in their policies and procedures. Specifically, the GLB Act established certain information security guidelines that require each financial institution, under the supervision and ongoing oversight of its board of directors or an appropriate committee thereof, to develop, implement, and maintain a comprehensive written information security program designed to ensure the security and confidentiality of customer information, to protect against anticipated threats or hazards to the security or integrity of such information, and to protect against unauthorized access to or use of such information that could result in substantial harm or inconvenience to any customer.

Recent cyber-attacks against banks and other financial institutions that resulted in unauthorized access to confidential customer information have prompted the federal banking regulators to issue extensive guidance on cybersecurity. Among other things, financial institutions are expected to design multiple layers of security controls to establish lines of defense and ensure that their risk management processes address the risks posed by compromised customer credentials, including security measures to authenticate customers accessing internet-based services. A financial institution also should have a robust business continuity program to recover from a cyberattack and procedures for monitoring the security of third-party service providers that may have access to nonpublic data at the institution.

The Consumer Financial Protection Bureau

The Dodd-Frank Act created the Consumer Financial Protection Bureau ("CFPB"), which is an independent bureau with broad authority to regulate the consumer finance industry, including regulated financial institutions, nonbanks and others involved in extending credit to consumers. The CFPB has authority through rulemaking, orders, policy statements, guidance, and enforcement actions to administer and enforce federal consumer financial laws, to oversee several entities and market segments not previously under the supervision of a federal regulator, and to impose its own regulations and pursue enforcement actions when it determines that a practice is unfair, deceptive, or abusive. The federal consumer financial laws and all the functions and responsibilities associated with them, many of which were previously enforced by other federal regulatory agencies, were transferred to the CFPB on July 21, 2011. While the CFPB has the power to interpret, administer, and enforce federal consumer financial laws, the Dodd-Frank Act provides that the federal banking regulatory agencies continue to have examination and enforcement powers over the financial institutions that they

supervise relating to the matters within the jurisdiction of the CFPB if such institutions have less than \$10 billion in assets. The Dodd-Frank Act also gives state attorneys general the ability to enforce federal consumer protection laws.

Mortgage Loan Origination

The Dodd-Frank Act authorizes the CFPB to establish certain minimum standards for the origination of residential mortgages, including a determination of the borrower's ability to repay. Under the Dodd-Frank Act and the implementing final rule adopted by the CFPB, or the ATR/QM Rule, a financial institution may not make a residential mortgage loan to a consumer unless it first makes a "reasonable and good faith determination" that the consumer has a "reasonable ability" to repay the loan. In addition, the ATR/QM Rule limits prepayment penalties and permits borrowers to raise certain defenses to foreclosure if they receive any loan other than a "qualified mortgage," as defined by the CFPB. For this purpose, the ATR/QM Rule defines a "qualified mortgage" to include a loan with a borrower debt-to-income ratio of less than or equal to 43% or, alternatively, a loan eligible for purchase by Fannie Mae or Freddie Mac while they operate under federal conservatorship or receivership, and loans eligible for insurance or guarantee by the Federal Housing Administration, Veterans Administration, or United States Department of Agriculture. Additionally, a qualified mortgage may not: (i) contain excess upfront points and fees; (ii) have a term greater than 30 years; or (iii) include interest only or negative amortization payments. The ATR/QM Rule specifies the types of income and assets that may be considered in the ability-to-repay determination, the permissible sources for verification, and the required methods of calculating the loan's monthly payments. The ATR/QM Rule became effective in January 2014.

The Regulatory Relief Act provides that for certain insured depository institutions and insured credit unions with less than \$10 billion in total consolidated assets, mortgage loans that are originated and retained in portfolio will automatically be deemed to satisfy the "ability to repay" requirement. To qualify for this, the insured depository institutions and credit unions must meet conditions relating to prepayment penalties, points and fees, negative amortization, interest-only features and documentation.

The Regulatory Relief Act directs Federal banking agencies to issue regulations exempting certain insured depository institutions and insured credit unions with assets of \$10 billion or less from the requirement to establish escrow accounts for certain residential mortgage loans.

Insured depository institutions and insured credit unions that originated fewer than 500 closed-end mortgage loans or 500 open-end lines of credit in each of the two preceding years are exempt from a subset of disclosure requirements (recently imposed by the CFPB) under the Home Mortgage Disclosure Act ("HMDA"), provided they have received certain minimum CRA ratings in their most recent examinations.

The Regulatory Relief Act also directs the Comptroller of the Currency to conduct a study assessing the effect of the exemption described above on the amount of HMDA data available at the national and local level.

In addition, Section 941 of the Dodd-Frank Act amended the Securities Exchange Act of 1934, as amended (the "Exchange Act") to require sponsors of asset-backed securities ("ABS") to retain at least 5% of the credit risk of the assets underlying the securities and generally prohibits sponsors from transferring or hedging that credit risk. In October 2014, the federal banking regulatory agencies adopted a final rule to implement this requirement (the "Risk Retention Rule"). Among other things, the Risk Retention Rule requires a securitizer to retain not less than 5% of the credit risk of any asset that the securitizer, through the issuance of an ABS, transfers, sells, or conveys to a third party; and prohibits a securitizer from directly or indirectly hedging or otherwise transferring the credit risk that the securitizer is required to retain. In certain situations, the final rule allows securitizers to allocate a portion of the risk retention requirement to the originator(s) of the securitized assets, if an originator contributes at least 20% of the assets in the securitization. The Risk Retention Rule also provides an exemption to the risk retention requirements for an ABS collateralized exclusively by Qualified Residential Mortgages ("QRMs"), and ties the definition of a QRM to the definition of a "qualified mortgage" established by the CFPB for purposes of evaluating a consumer's ability to repay a mortgage loan. The federal banking agencies have agreed to review the definition of QRMs in 2019, following the CFPB's own review of its "qualified mortgage" regulation. For purposes of residential mortgage securitizations, the Risk Retention Rule took effect on December 24, 2015. For all other securitizations, the rule took effect on December 24, 2016.

Other Provisions of the Dodd-Frank Act

The Dodd-Frank Act implements far-reaching changes across the financial regulatory landscape. In addition to the reforms previously mentioned, the Dodd-Frank Act also:

- requires BHCs and banks to be both well capitalized and well managed in order to acquire banks located outside their home state and requires any BHC electing to be treated as a financial holding company to be both well managed and well capitalized;
- eliminates all remaining restrictions on interstate banking by authorizing national and state banks to establish de novo branches in any state that would permit a bank chartered in that state to open a branch at that location; and
- repeals Regulation Q, the federal prohibition on the payment of interest on demand deposits, thereby permitting depository institutions to pay interest on business transaction and other accounts.

Although a significant number of the rules and regulations mandated by the Dodd-Frank Act have been finalized, many of the requirements called for have yet to be implemented and will likely be subject to implementing regulations over the course of several years. Given the uncertainty associated with the manner in which the provisions of the Dodd-Frank Act will be implemented by the various agencies, the full extent of the impact such requirements will have on financial institutions' operations is unclear.

Other Laws and Regulations

Our operations are subject to several additional laws, some of which are specific to banking and others of which are applicable to commercial operations generally. For example, with respect to our lending practices, we are subject to the following laws and regulations, among several others:

- Truth-In-Lending Act, governing disclosures of credit terms to consumer borrowers;
- HMDA, requiring financial institutions to provide information to enable the public and public officials to determine whether a financial institution is fulfilling its obligation to help meet the housing needs of the community it serves;
- Equal Credit Opportunity Act, prohibiting discrimination on the basis of race, creed, or other prohibited factors in extending credit;
- Fair Credit Reporting Act of 1978, as amended by the Fair and Accurate Credit Transactions Act, governing the use and provision of information to credit reporting agencies, certain identity theft protections, and certain credit and other disclosures;
- Fair Debt Collection Practices Act, governing how consumer debts may be collected by collection agencies;
- Real Estate Settlement Procedures Act, requiring certain disclosures concerning loan closing costs and escrows, and governing transfers of loan servicing and the amounts of escrows for loans secured by one-to-four family residential properties;
- Rules and regulations established by the National Flood Insurance Program;
- Rules and regulations of the various federal agencies charged with the responsibility of implementing these federal laws.

Our deposit operations are subject to federal laws applicable to depository accounts, including:

- Right to Financial Privacy Act, which imposes a duty to maintain confidentiality of consumer financial records and prescribes procedures for complying with administrative subpoenas of financial records;
- Truth-In-Savings Act, requiring certain disclosures for consumer deposit accounts;
- Electronic Funds Transfer Act and Regulation E of the FRB, which govern automatic deposits to and withdrawals from deposit accounts and customers' rights and liabilities arising from the use of automated teller machines and other electronic banking services; and
- Rules and regulations of the various federal agencies charged with the responsibility of implementing these federal laws.

We are also subject to a variety of laws and regulations that are not limited to banking organizations. For example, in lending to commercial and consumer borrowers, and in owning and operating our own property, we are subject to regulations and potential liabilities under state and federal environmental laws. In addition, we must comply with privacy and data security laws and regulations at both the federal and state level.

We are heavily regulated by regulatory agencies at the federal and state levels. Like most of our competitors, we have faced and expect to continue to face increased regulation and regulatory and political scrutiny, which creates significant uncertainty for us, as well as for the financial services industry in general.

Enforcement Powers

The federal regulatory agencies have substantial penalties available to use against depository institutions and certain "institution-affiliated parties." Institution-affiliated parties primarily include management, employees, and agents of a financial institution, as well as independent contractors and consultants, such as attorneys, accountants, and others who participate in the conduct of the financial institution's affairs. An institution can be subject to an enforcement action due to the failure to timely file required reports, the filing of false or misleading information, or the submission of inaccurate reports, or engaging in other unsafe or unsound banking practices. Civil penalties may be as high as \$1,924,589 per day for violations.

The Financial Institution Reform Recovery and Enforcement Act provided regulators with greater flexibility to commence enforcement actions against institutions and institution-affiliated parties and to terminate an institution's deposit insurance. It also expanded the power of banking regulatory agencies to issue regulatory orders. Such orders may, among other things, require affirmative action to correct any harm resulting from a violation or practice, including restitution, reimbursement, indemnification, or guarantees against loss. A financial institution may also be ordered to restrict its growth, dispose of certain assets, rescind agreements or contracts, or take other actions as determined by the ordering agency to be appropriate. The Dodd-Frank Act increases regulatory oversight, supervision and examination of banks, BHCs, and their respective subsidiaries by the appropriate regulatory agency.

Federal Securities Laws

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

Governmental Monetary and Credit Policies and Economic Controls

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

AVAILABLE INFORMATION

The Company maintains an Internet site at www.shorebancshares.com on which it makes available, free of charge, its Annual Report on Form 10-K, Quarterly Reports on Form 10-Q, Current Reports on Form 8-K, and all amendments to the foregoing as soon as reasonably practicable after these reports are electronically filed with, or furnished to, the SEC. In addition, stockholders may access these reports and documents on the SEC's website at www.sec.gov. The information on, or accessible through, our website or any other website cited in this Annual Report on Form 10-K is not part of, or incorporated by reference into, this Annual Report on Form 10-K and should not be relied upon in determining whether to make an investment decision.

Item 1A. RISK FACTORS.

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

Risks Relating to Our Business

Changes in U.S. or regional economic conditions could have an adverse effect on our business, financial condition or results of operations.

Our business and operations, which primarily consist of lending money to clients in the form of loans, borrowing money from clients in the form of deposits and investing in securities, are sensitive to general business and economic conditions in the United States. The effect of COVID-19 has already impacted our results and it is entirely uncertain how the crisis will be resolved. If the U.S. economy further weakens, our growth and the profitability from our lending, deposit and investment operations could be constrained. Uncertainty about the federal fiscal policymaking process, the medium- and long-term fiscal outlook of the federal government and future tax rates is a concern for businesses, consumers and investors in the United States. The COVID-19 pandemic has further complicated the economic picture and drove unemployment to multi decade highs while raising the fear of inflation.

Weak economic conditions are characterized by numerous factors, including deflation, fluctuations in debt and equity capital markets, a lack of liquidity and depressed prices in the secondary market for mortgage loans, increased delinquencies on mortgage, consumer and commercial loans, residential and commercial real estate price declines and lower home sales and commercial activity. The current economic environment is characterized by interest rates at near historically low levels, which may impact our ability to attract deposits and to generate attractive earnings through our loan and investment portfolios.

All of these factors can individually or in the aggregate be detrimental to our business, and the interplay between these factors can be complex and unpredictable. Adverse economic conditions could have a material adverse effect on our business, financial condition and results of operations.

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

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

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

The FRB and the FDIC, along with the other federal banking regulators, issued guidance in December 2006 entitled “Concentrations in Commercial Real Estate Lending, Sound Risk Management Practices” directed at institutions that have particularly high concentrations of commercial real estate loans within their lending portfolios. This guidance suggests that these institutions face a heightened risk of financial difficulties in the event of adverse changes in the economy and commercial real estate markets. Accordingly, the guidance suggests that institutions whose concentrations exceed certain percentages of capital should implement heightened risk management practices appropriate to their concentration risk. Federal bank regulatory guidelines identify institutions potentially exposed to commercial real estate concentration risk as those that have (i) experienced rapid growth in commercial real estate lending, (ii) notable exposure to a specific type of commercial real estate, (iii) total reported loans for construction, land development and other land loans representing 100% or more of the institution’s capital, or (iv) total commercial real estate loans representing 300% or more of the institution’s capital if the outstanding balance of the institution’s commercial real estate loan portfolio has increased 50% or more during the prior 36 months. The guidance provides that banking regulators may require such institutions to reduce their concentrations and/or maintain higher capital ratios than institutions with lower concentrations in commercial real estate. Due to our emphasis on commercial real estate and construction lending, as of December 31, 2020, non-owner-occupied commercial real estate loans (including construction, land and land development loans) represented 307.3% of total risk-based capital. Construction, land and land development loans represent 54.8% of total risk-based capital. The commercial real estate portfolio has increased 53.5% during the prior 36 months. We may be subject to heightened supervisory scrutiny during future examinations and/or be required to maintain higher levels of capital as a result of our commercial real estate concentrations, which could require us to obtain additional capital, and may adversely affect shareholder returns. Management cannot predict the extent to which this guidance will impact our operations or capital requirements. Further, we cannot guarantee that any risk management practices we implement will be effective in preventing losses resulting from concentrations in our commercial real estate portfolio.

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

Our results of operations may be materially and adversely affected by changes in prevailing economic conditions, including declines in real estate values, rapid changes in interest rates and the monetary and fiscal policies of the federal government. Our results of operations are significantly impacted by the spread between the interest rates earned on assets and the interest rates paid on deposits and other interest-bearing liabilities (i.e., net interest income), including advances from the Federal Home Loan Bank (the “FHLB”) of Atlanta. Interest rate risk arises from mismatches (i.e., the interest sensitivity gap) between the dollar amount of repricing or maturing assets and liabilities. If more assets reprice or mature than liabilities during a falling interest rate environment, then our earnings could be negatively impacted. Conversely, if more liabilities reprice or mature than assets during a rising interest rate environment, then our earnings could be negatively impacted. Changes in market interest rates are affected by many factors beyond our control, including inflation, unemployment, money supply, international events, and events in world financial markets. Changes in interest rates, particularly by the FRB, which implements national monetary policy in order to mitigate recessionary and inflationary pressures, also affect the value of our loans. In setting its policy, the FRB may utilize techniques such as: (i) engaging in open market transactions in United States government securities; (ii) setting the discount rate on member bank borrowings; and (iii) determining reserve requirements. These techniques may have an adverse effect on our deposit levels, net interest margin, loan demand or our business and operations. In addition, an increase in interest rates could adversely affect borrowers’ ability to pay the principal or interest on existing loans or reduce their desire to borrow more money. This may lead to an increase in our nonperforming assets, a decrease in loan originations, or a reduction in the value of and income from our loans, any of which could have a material and negative effect on our results of operations.

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

The risk of credit losses on loans varies with, among other things, general economic conditions, the type of loan being made, the creditworthiness of the borrower over the term of the loan and, in the case of a collateralized loan, the value and marketability of the collateral for the loan. Management at the Bank bases the allowance for credit losses upon, among other things, historical experience, an evaluation of economic conditions and regular reviews of delinquencies and loan portfolio quality. If management’s assumptions and judgments prove to be incorrect and the allowance for credit losses is inadequate to absorb future losses, or if the bank regulatory authorities, as a part of their examination process, require the Bank to increase its allowance for credit losses, our earnings and capital could be significantly and adversely affected. We estimate losses inherent in our loan portfolio, the adequacy of our allowance for credit losses and the values of certain assets by using estimates based on difficult, subjective, and complex judgments, including estimates as to the effects of economic conditions and how those economic conditions might affect the ability of our borrowers to repay their loans or the value of assets. Material additions to the allowance for credit losses at the Bank would result in a decrease in the Bank’s net income and capital and could have a material adverse effect on our financial condition.

Our investment securities portfolio is subject to credit risk, market risk and liquidity risk.

As of December 31, 2020, we had classified 68.0% of our debt securities as available-for-sale pursuant to the Accounting Standards Codification (“ASC”) Topic 320 (“ASC 320”) of the Financial Accounting Standards Board (“FASB”) relating to accounting for investments. ASC 320 requires that unrealized gains and losses in the estimated value of the available-for-sale portfolio be “marked to market” and reflected as a separate item in stockholders’ equity (net of tax) as accumulated other comprehensive income (loss). The remaining debt securities are classified as held-to-maturity in accordance with ASC 320 and are stated at amortized cost. Equity securities with readily determinable fair values are recorded at fair value with changes in fair value recorded in earnings. Stockholders’ equity will continue to reflect the unrealized gains and losses (net of tax) of these investments. There can be no assurance that the market value of our investment portfolio will not decline, causing a corresponding decline in stockholders’ equity.

The Bank is a member of the FHLB of Atlanta and our investments include stock issued by the FHLB of Atlanta. These investments could be subject to future impairment charges and there can be no guaranty of future dividends.

Management believes that several factors will affect the market values of our investment portfolio. These risk factors include, but are not limited to, rating agency downgrades of the securities, defaults of the issuers of the securities, lack of

market pricing of the securities, and instability in the credit markets. Lack of market activity with respect to some securities has, in certain circumstances, required us to base our fair market valuation on unobservable inputs. Any changes in these risk factors, in current accounting principles or interpretations of these principles could impact our assessment of fair value and thus the determination of other-than-temporary impairment of the securities in the investment securities portfolio. Write-downs of investment securities would negatively affect our earnings and regulatory capital ratios.

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

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

Under current accounting standards, goodwill is not amortized but, instead, is subject to impairment tests on at least an annual basis or more frequently if an event occurs or circumstances change that reduce the fair value of a reporting unit below its carrying amount. Intangible assets other than goodwill are also subject to impairment tests at least annually. A decline in the price of the Company's common stock or occurrence of a triggering event following any of our quarterly earnings releases and prior to the filing of the periodic report for that period could, under certain circumstances, cause us to perform goodwill and other intangible assets impairment tests and result in an impairment charge being recorded for that period which was not reflected in such earnings release. In the event that we conclude that all or a portion of our goodwill or other intangible assets may be impaired, a non-cash charge for the amount of such impairment would be recorded to earnings. At December 31, 2020, we had recorded goodwill of \$17.5 million and other intangible assets of \$1.7 million, representing approximately 9.0% and 0.9% of stockholders' equity, respectively.

In assessing the realizability of deferred tax assets, management considers whether it is more likely than not that some portion or all of the deferred tax assets will not be realized. Assessing the need for, or the sufficiency of, a valuation allowance requires management to evaluate all available evidence, both negative and positive, including the recent trend of quarterly earnings. Positive evidence necessary to overcome the negative evidence includes whether future taxable income in sufficient amounts and character within the carryback and carryforward periods is available under the tax law, including the use of tax planning strategies. When negative evidence (e.g., cumulative losses in recent years, history of operating loss or tax credit carry forwards expiring unused) exists, more positive evidence than negative evidence will be necessary. At December 31, 2020, our deferred tax assets were approximately \$6.1 million. There was a valuation allowance for deferred taxes of \$169 thousand recorded at December 31, 2020 on the parent company as management believes it is more likely than not that the losses in the current year will not be realized for state income tax purposes.

Changes in accounting standards or interpretation of new or existing standards may affect how we report our financial condition and results of operations.

From time to time the FASB and the SEC change accounting regulations and reporting standards that govern the preparation of the Company's financial statements. In addition, the FASB, SEC, bank regulators and the outside independent auditors may revise their previous interpretations regarding existing accounting regulations and the application of these accounting standards. These changes can be hard to predict and can materially impact how to record and report our financial condition and results of operations. In some cases, there could be a requirement to apply a new or revised accounting standard retroactively, resulting in the restatement of prior period financial statements.

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

We face substantial competition in all phases of our operations from a variety of different competitors. We compete with commercial banks, credit unions, savings and loan associations, mortgage banking firms, consumer finance companies, securities brokerage firms, money market funds and other mutual funds, as well as other local and community, super-regional, national and international financial institutions that operate offices in our primary market areas and elsewhere.

Our future growth and success will depend on our ability to compete effectively in this highly competitive financial services environment. Failure to compete effectively to attract new or to retain existing, clients may reduce or limit our net income and our market share and may adversely affect our results of operations, financial condition and growth.

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

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

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

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

The cost savings that we estimate for mergers and acquisitions may not be realized.

The success of our mergers and acquisitions may depend, in part, on the ability to realize the estimated cost savings from combining the acquired businesses with our existing operations. It is possible that the potential cost savings could turn out to be more difficult to achieve than anticipated. The cost savings estimates also depend on the ability to combine the businesses in a manner that permits those cost savings to be realized. If the estimates turn out to be incorrect or there is an inability to combine successfully, the anticipated cost savings may not be realized fully or at all or may take longer to realize than expected.

Combining acquired businesses with the Bank may be more difficult, costly, or time-consuming than expected, or could result in the loss of customers.

It is possible that the process of merger integration of acquired companies could result in the loss of key employees, the disruption of ongoing business or inconsistencies in standards, controls, procedures and policies that adversely affect the ability to maintain relationships with clients and employees or to achieve the anticipated benefits of the merger or acquisition. There also may be disruptions that cause the Bank to lose customers or cause customers to withdraw their deposits. Customers may not readily accept changes to their banking arrangements or other customer relationships after the merger or acquisition.

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

A significant portion of our loan portfolio is secured by real property. During the ordinary course of business, we may foreclose on and take title to properties securing certain loans. In doing so, there is a risk that hazardous or toxic substances could be found on these properties. If hazardous or toxic substances are found, we may be liable for remediation costs, as well as for personal injury and property damage.

Environmental laws may require us to incur substantial expenses and may materially reduce the affected property's value or limit our ability to use or sell the affected property. In addition, future laws or more stringent interpretations of enforcement policies with respect to existing laws may increase our exposure to environmental liability. Although we have policies and procedures to perform an environmental review before initiating any foreclosure action on real property, these

reviews may not be sufficient to detect all potential environmental hazards. The remediation costs and any other financial liabilities associated with an environmental hazard could have a material adverse effect on our financial condition and results of operations.

We may be subject to other adverse claims.

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

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

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

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

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

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

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

We rely heavily on communications and information systems to conduct our business. We, our customers, and other financial institutions with which we interact, are subject to ongoing, continuous attempts to penetrate key systems by individual hackers, organized criminals, and in some cases, state-sponsored organizations. Any failure, interruption or breach in security of these systems could result in failures or disruptions in our customer relationship management, general ledger, deposit, loan and other systems, misappropriation of funds, and theft of proprietary Company or customer data. The occurrence of any failure, interruption or security breach of our information systems could damage our reputation, result in a loss of customer business, subject us to additional regulatory scrutiny, or expose us to civil litigation and possible financial liability.

Security breaches and other disruptions could compromise our information and expose us to liability, which would cause our business and reputation to suffer.

In the ordinary course of our business, we collect and store sensitive data, including intellectual property, our proprietary business information and that of our customers, suppliers and business partners, and personally identifiable information of our customers and employees, in our data centers and on our networks. The secure processing, maintenance and transmission of this information is critical to our operations and business strategy. Despite our security measures, our information technology and infrastructure may be vulnerable to attacks by hackers or breached due to employee error, malfeasance or other disruptions. Any such breach could compromise our networks and the information stored there could be accessed, publicly disclosed, lost or stolen. Any such access, disclosure or other loss of information could result in legal claims or proceedings, liability under laws that protect the privacy of personal information, and regulatory penalties, disrupt our operations and the services we provide to customers, damage our reputation, and cause a loss of confidence in our products and services, which could adversely affect our business, revenues and competitive position.

Our reliance on third party vendors could expose us to additional cyber risk and liability.

The operation of our business involves outsourcing of certain business functions and reliance on third-party providers, which may result in transmission and maintenance of personal, confidential, and proprietary information to and by such vendors. Although we require third-party providers to maintain certain levels of information security, such providers remain vulnerable to breaches, unauthorized access, misuse, computer viruses, or other malicious attacks that could ultimately compromise sensitive information possessed by our company. Although we contract to limit our liability in connection with attacks against third-party providers, we remain exposed to risk of loss associated with such vendors.

We outsource certain aspects of our data processing to certain third-party providers which may expose us to additional risk.

We outsource certain key aspects of our data processing to certain third-party providers. While we have selected these third-party providers carefully, we cannot control their actions. If our third-party providers encounter difficulties, including those which result from their failure to provide services for any reason or their poor performance of services, or if we have difficulty in communicating with them, our ability to adequately process and account for customer transactions could be affected, and our business operations could be adversely impacted. Replacing these third-party providers could also entail significant delay and expense.

Our third-party providers may be vulnerable to unauthorized access, computer viruses, phishing schemes and other security breaches. Threats to information security also exist in the processing of customer information through various other third-party providers and their personnel. We may be required to expend significant additional resources to protect against the threat of such security breaches and computer viruses, or to alleviate problems caused by such security breaches or viruses. To the extent that the activities of our third-party providers or the activities of our customers involve the storage and transmission of confidential information, security breaches and viruses could expose us to claims, regulatory scrutiny, litigation and other possible liabilities.

We are dependent on our information technology and telecommunications systems and third-party servicers, and systems failures, interruptions or breaches of security could have an adverse effect on our financial condition and results of operations.

Our business is highly dependent on the successful and uninterrupted functioning of our information technology and telecommunications systems and third-party servicers. We outsource many of our major systems, such as data processing and deposit processing systems. The failure of these systems, or the termination of a third-party software license or service agreement on which any of these systems is based, could interrupt our operations. Because our information technology and telecommunications systems interface with and depend on third-party systems, we could experience service denials if demand for such services exceeds capacity or such third-party systems fail or experience interruptions. If sustained or repeated, a system failure or service denial could result in a deterioration of our ability to provide customer service, compromise our ability to operate effectively, damage our reputation, result in a loss of customer business and/or subject

us to additional regulatory scrutiny and possible financial liability, any of which could have a material adverse effect on our financial condition and results of operations.

In addition, we provide our customers the ability to bank remotely, including online over the Internet. The secure transmission of confidential information is a critical element of remote banking. Our network could be vulnerable to unauthorized access, computer viruses, phishing schemes, spam attacks, human error, natural disasters, power loss and other security breaches. We may be required to spend significant capital and other resources to protect against the threat of security breaches and computer viruses, or to alleviate problems caused by security breaches or viruses. Further, we outsource some of the data processing functions used for remote banking, and accordingly we are dependent on the expertise and performance of our third-party providers. To the extent that our activities, the activities of our customers, or the activities of our third-party service providers involve the storage and transmission of confidential information, security breaches and viruses could expose us to claims, litigation and other possible liabilities. Any inability to prevent security breaches or computer viruses could also cause existing customers to lose confidence in our systems and could adversely affect our reputation, results of operations and ability to attract and maintain customers and businesses. In addition, a security breach could also subject us to additional regulatory scrutiny, expose us to civil litigation and possible financial liability and cause reputational damage.

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

Our future success will depend, in part, upon our ability to use technology to provide products and services that provide convenience to customers and to create additional efficiencies in operations. We may need to make significant additional capital investments in technology in the future, and we may not be able to effectively implement new technology-driven products and services.

Increased regulatory oversight and uncertainty relating to the LIBOR calculation process and potential phasing out of LIBOR after 2021 may adversely affect the results of our operations.

On July 27, 2017, the United Kingdom's Financial Conduct Authority, which regulates the LIBOR, announced that it intends to stop persuading or compelling banks to submit rates for the calculation of LIBOR after 2021. The announcement indicates that the continuation of LIBOR on the current basis cannot and will not be guaranteed after 2021. Uncertainty as to the nature of alternative reference rates and as to potential changes in other reforms to LIBOR may adversely affect LIBOR rates and the value of LIBOR-based loans, and to a lesser extent securities in our portfolio, and may impact the availability and cost of hedging instruments and borrowings, including the rates we pay on our subordinated debentures and trust preferred securities. If LIBOR rates are no longer available or do not remain an acceptable market benchmark, any successor or replacement interest rates may perform differently, which may adversely affect our revenue or our expenses. We may incur significant costs to transition both our borrowing arrangements and the loan agreements with our customers from LIBOR, which may have an adverse effect on our results of operations. Further, we may face exposure to litigation over the nature and performance of any replacement index. The impact of alternatives to LIBOR on the valuations, pricing and operation of our financial instruments is not yet known.

The ongoing COVID-19 pandemic has led to periods of significant volatility in financial, commodities and other markets and could harm our business and results of operations.

In December 2019, COVID-19 was first reported in Wuhan, Hubei Province, China. Since then, COVID-19 infections have spread to additional countries including the United States. In March 2020, the World Health Organization declared COVID-19 to be a pandemic. Given the ongoing and dynamic nature of the circumstances, it is difficult to predict the impact of the coronavirus pandemic on our business, and there is no guarantee that our efforts to address or mitigate the adverse impacts of the coronavirus will be effective. The impact to date has included periods of significant volatility in financial, commodities and other markets. This volatility has had and, if it continues, could continue to have an adverse impact on our customers and on our business, financial condition and results of operations as well as our growth strategy.

Our business is dependent upon the willingness and ability of our customers to conduct banking and other financial transactions. The spread of COVID-19 has caused and could continue to cause severe disruptions in the U.S. economy at

large, and has resulted and may continue to result in disruptions to our customers' businesses, and a decrease in consumer confidence and business generally. In addition, recent actions by US federal, state and local governments to address the pandemic, including travel bans, stay-at-home orders and school, business and entertainment venue closures, have had and may continue to have a significant adverse effect on our customers and the markets in which we conduct our business. The extent of impacts resulting from the coronavirus pandemic and other events beyond our control will depend on future developments, which are highly uncertain and cannot be predicted, including new information which may emerge concerning the severity of the coronavirus pandemic and actions taken to contain the coronavirus or its impact, among others.

Disruptions to our customers could result in increased risk of delinquencies, defaults, foreclosures and losses on our loans. The escalation of the pandemic may also negatively impact regional economic conditions for a period of time, resulting in declines in local loan demand, liquidity of loan guarantors, loan collateral (particularly in real estate), loan originations and deposit availability. If the global response to contain COVID-19 escalates or is unsuccessful, we could experience a material adverse effect on our business, financial condition, results of operations and cash flows.

The spread of the COVID-19 outbreak and the governmental responses may disrupt banking and other financial activity in the areas in which we operate and could potentially create widespread business continuity issues for us.

The outbreak of COVID-19 and the U.S. federal, state and local governmental responses may result in a disruption in the services we provide. We rely on our third-party vendors to conduct business and to process, record, and monitor transactions. If any of these vendors are unable to continue to provide us with these services or experience interruptions in their ability to provide us with these services, it could negatively impact our ability to serve our customers. Furthermore, the coronavirus pandemic could negatively impact the ability of our employees and customers to engage in banking and other financial transactions in the geographic areas in which we operate and could create widespread business continuity issues for us. We also could be adversely affected if key personnel or a significant number of employees were to become unavailable due to infection, quarantine or other effects and restrictions of a COVID-19 outbreak in our market areas. Although we have business continuity plans and other safeguards in place, there is no assurance that such plans and safeguards will be effective. If we are unable to promptly recover from such business disruptions, our business and financial conditions and results of operations would be adversely affected. We also may incur additional costs to remedy damages caused by such disruptions, which could adversely affect our financial condition and results of operations.

Our participation in the SBA Paycheck Protection Program ("PPP") exposes us to risks related to noncompliance with the PPP, as well as litigation risk related to our administration of the PPP, which could have a material adverse impact on our business, financial condition and results of operations.

The Company is a participating lender in the PPP, a loan program administered through the SBA, that was created to help eligible businesses, organizations and self-employed persons fund their operational costs during the COVID-19 pandemic. Under this program, the SBA guarantees 100% of the amounts loaned under the PPP. The PPP opened on April 3, 2020; however, because of the short window between the passing of the CARES Act and the opening of the PPP, there is some ambiguity in the laws, rules and guidance regarding the operation of the PPP, which exposes the Company to risks relating to noncompliance with the PPP. For instance, other financial institutions have experienced litigation related to their process and procedures used in processing applications for the PPP. Any financial liability, litigation costs or reputational damage caused by PPP related litigation could have a material adverse impact on our business, financial condition and results of operations. In addition, the Company may be exposed to credit risk on PPP loans if a determination is made by the SBA that there is a deficiency in the manner in which the loan was originated, funded, or serviced. If a deficiency is identified, the SBA may deny its liability under the guaranty, reduce the amount of the guaranty, or, if it has already paid under the guaranty, seek recovery of any loss related to the deficiency from the Company.

We are subject to increasing credit risk as a result of the COVID-19 pandemic, which could adversely impact our profitability.

Our business depends on our ability to successfully measure and manage credit risk. As a commercial lender, we are exposed to the risk that the principal of, or interest on, a loan will not be paid timely or at all or that the value of any collateral supporting a loan will be insufficient to cover our outstanding exposure. In addition, we are exposed to risks

with respect to the risks resulting from changes in economic and industry conditions and risks inherent in dealing with individual loans and borrowers. As the overall economic climate in the U.S., generally, and in our market areas specifically, experiences material disruption due to the COVID-19 pandemic, our borrowers may experience difficulties in repaying their loans and governmental actions may provide payment relief to borrowers affected by COVID-19 and preclude our ability to initiate foreclosure proceedings in certain circumstances and, as a result, the collateral we hold may decrease in value or become illiquid, and the level of our nonperforming loans, charge-offs and delinquencies could rise and require significant additional provisions for credit losses. Additional factors related to the credit quality of certain commercial real estate and multifamily residential loans include the duration of state and local moratoriums on evictions for non-payment of rent or other fees. The payment on these loans that are secured by income producing properties are typically dependent on the successful operation of the related real estate property and may subject us to risks from adverse conditions in the real estate market or the general economy.

We are actively working to support our borrowers to mitigate the impact of the COVID-19 pandemic on them and on our loan portfolio, including through loan modifications that defer payments for those who experienced a hardship as a result of the COVID-19 pandemic. Although recent regulatory guidance provides that such loan modifications are exempt from the calculation and reporting of TDRs and loan delinquencies, we cannot predict whether such loan modifications may ultimately have an adverse impact on our profitability in future periods. Our inability to successfully manage the increased credit risk caused by the COVID-19 pandemic could have a material adverse effect on our business, financial condition and results of operations.

Unpredictable future developments related to or resulting from the COVID-19 pandemic could materially and adversely affect our business and results of operations.

Because there have been no comparable recent global pandemics that resulted in a similar global impact, we do not yet know the full extent of the COVID-19 pandemic's effects on our business, operations, or the global economy as a whole. Any future development will be highly uncertain and cannot be predicted, including the scope and duration of the pandemic, the effectiveness of our work from home arrangements, third party providers' ability to support our operation, and any actions taken by governmental authorities and other third parties in response to the pandemic. We are continuing to monitor the COVID-19 pandemic and related risks, although the rapid development and fluidity of the situation precludes any specific prediction as to its ultimate impact on us.

Risks Relating to the Regulation of our Industry

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

Banking is highly regulated under federal and state law. As such, we are subject to extensive regulation, supervision and legal requirements that govern almost all aspects of our operations. Compliance with laws and regulations can be difficult and costly, and changes to laws and regulations often impose additional operating costs. Our failure to comply with these laws and regulations, even if the failure follows good faith effort or reflects a difference in interpretation, could subject us to restrictions on our business activities, enforcement actions and fines and other penalties, any of which could adversely affect our results of operations, regulatory capital levels and the price of our securities. Further, any new laws, rules and regulations, such as the Dodd-Frank Act, could make compliance more difficult or expensive or otherwise adversely affect our business, financial condition and results of operations.

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

The FRB and the Commissioner periodically examine our business, including our compliance with laws and regulations. If, as a result of an examination, the FRB or the Commissioner were to determine that our financial condition, capital resource, asset quality, earnings prospects, management, liquidity or other aspects of any of our operations had become unsatisfactory, or that we were in violation of any law or regulation, it may take a number of different remedial actions as it deems appropriate. Any regulatory action against us could have a material adverse effect on our business, financial condition and results of operations.

Our FDIC deposit insurance premiums and assessments may increase.

The deposits of the Bank are insured by the FDIC up to legal limits and, accordingly, subject to the payment of FDIC deposit insurance assessments. The Bank's regular assessments are determined by its risk classifications, which are based on its regulatory capital levels and the level of supervisory concern that it poses. Further increase in assessment rates or special assessments may occur in the future, especially if there are significant additional financial institution failures. Any future special assessments, increases in assessment rates or required prepayments in FDIC insurance premiums could reduce our profitability or limit our ability to pursue certain business opportunities, which could have a material adverse effect on our business, financial condition and results of operations.

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

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

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

We are subject to extensive regulation as a financial institution and are also required to follow the corporate governance and financial reporting practices and policies required of a company whose stock is registered under the Exchange Act and listed on the NASDAQ Global Select Market. Compliance with these requirements means we incur significant legal, accounting and other expenses. Compliance also requires a significant diversion of management time and attention, particularly with regard to disclosure controls and procedures and internal control over financial reporting. Although we have reviewed, and will continue to review, our disclosure controls and procedures in order to determine whether they are effective, our controls and procedures may not be able to prevent errors or frauds in the future.

Faulty judgments, simple errors or mistakes, or the failure of our personnel to adhere to established controls and procedures may make it difficult for us to ensure that the objectives of the control system will be met. A failure of our controls and procedures to detect other than inconsequential errors or fraud could seriously harm our business and results of operations.

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

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

Risks Relating to the Company's Securities

Our common stock is not insured by any governmental entity.

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

Our ability to pay dividends is limited by law and contract.

The continued ability to pay dividends to shareholders depends in part on dividends from the Bank. The amount of dividends that the Bank may pay to the Company is limited by federal laws and regulations. The ability of the Bank to pay dividends is also subject to its profitability, financial condition and cash flow requirements. There is no assurance that the Bank will be able to pay dividends to the Company in the future. The decision may be made to limit the payment of dividends even when the legal ability to pay them exists, in order to retain earnings for other uses.

The shares of our common stock are not heavily traded.

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

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

Future sales of our common stock or other securities may dilute the value and adversely affect the market price of our common stock.

In many situations, the board of directors has the authority, without any vote of our shareholders, to issue shares of authorized but unissued stock, including shares authorized and unissued under our equity incentive plans. In the future, additional securities may be issued, through public or private offerings, in order to raise additional capital. Any such issuance would dilute the percentage of ownership interest of existing shareholders and may dilute the per share book value of our common stock. In addition, option holders may exercise their options at a time when we would otherwise be able to obtain additional equity capital on more favorable terms.

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

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

class or series, to issue securities having terms favorable to management to persons affiliated with or otherwise friendly to management.

Maryland law also contains anti-takeover provisions that apply to us. The Maryland Business Combination Act generally prohibits, subject to certain limited exceptions, corporations from being involved in any “business combination” (defined as a variety of transactions, including a merger, consolidation, share exchange, asset transfer or issuance or reclassification of equity securities) with any “interested shareholder” for a period of five years following the most recent date on which the interested shareholder became an interested shareholder. An interested shareholder is defined generally as a person who is the beneficial owner of 10% or more of the voting power of the outstanding voting stock of the corporation after the date on which the corporation had 100 or more beneficial owners of its stock or who is an affiliate or associate of the corporation and was the beneficial owner, directly or indirectly, of 10% or more of the voting power of the then outstanding stock of the corporation at any time within the two-year period immediately prior to the date in question and after the date on which the corporation had 100 or more beneficial owners of its stock.

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

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

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

Item 1B. Unresolved Staff Comments.

None.

Item 2. Properties.

Our offices are listed in the tables below. The address of the Company and Bank's main office is 18 East Dover Street in Easton, Maryland. The Company owns the real property at 28969 Information Lane in Easton, Maryland, which also houses the Operations, Information Technology, and Human Resources departments of the Company and its subsidiary.

Shore United Bank

Branches		
Main Office 18 East Dover Street Easton, Maryland 21601	Elliott Road Branch 8275 Elliott Road Easton, Maryland 21601	Tred Avon Square Branch 212 Marlboro Road Easton, Maryland 21601
St. Michaels Branch 1013 South Talbot Street St. Michaels, Maryland 21663	Sunburst Branch 424 Dorchester Avenue Cambridge, Maryland 21613	Centreville Branch 109 North Commerce Street Centreville, Maryland 21617
Route 213 South Branch 2609 Centreville Road Centreville, Maryland 21617	Chester Branch 300 Castle Marina Road Chester, Maryland 21619	Denton Branch 850 South 5 th Avenue Denton, Maryland 21629
Grasonville Branch 202 Pullman Crossing Grasonville, Maryland 21638	Stevensville Branch 408 Thompson Creek Road Stevensville, Maryland 21666	Tuckahoe Branch 22151 WES Street Ridgely, Maryland 21660
Washington Square Branch 899 Washington Avenue Chestertown, Maryland 21620	Felton Branch 120 West Main Street Felton, Delaware 19943	Milford Branch 698-A North Dupont Boulevard Milford, Delaware 19963
Camden Branch 4580 South DuPont Highway Camden, Delaware 19934	Dover Branch 800 S. Governors Avenue Dover, Delaware 19904	Arbutus Branch 1101 Maiden Choice Lane Baltimore, MD 21229
Elkridge Branch 6050 Marshalee Drive Elkridge, MD 21075	Owings Mills Branch 9612 Reisterstown Road Owings Mills, MD 21117	Onley Branch 25306 Lankford Highway Onley, VA 23418
Ocean City Branch 12905B Ocean Gateway Ocean City, MD 21842		

ATMs

Memorial Hospital at Easton 219 South Washington Street Easton, Maryland 21601	Talbottown 218 North Washington Street Easton, Maryland 21601
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Offices

Division Office - Wye Financial Partners 16 North Washington Street, Suite 1 Easton, Maryland 21601	Loan Production Office – Middletown 102 Sleepy Hollow Unit 204 Middletown, Delaware 19709	Loan Production Office – Ocean City 9748 Stephen Decatur Highway Unit 104 Ocean City, Maryland 21842
Administrative Office – 28969 Information Lane Easton, Maryland 21601	Administrative Office – 23 South Harrison Street Easton, Maryland 21601	

The Bank owns the real property on which all of its Maryland offices are located, except that it operates under leases at its St. Michaels branch, loan production office and Bank branch in Ocean City and the office of Wye Financial Partners in Easton. The Bank leases the real property on which all of its Delaware offices are located, except that it owns the real property on which the Camden and Dover Branches are located. The Bank operates under a lease at its Onley branch in Virginia. For information about rent expense for all leased premises, see Note 4 to the Consolidated Financial Statements appearing in Item 8 of Part II of this annual report.

Item 3. Legal Proceedings.

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

Item 4. Mine Safety Disclosures.

This item is not applicable.

PART II

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

MARKET INFORMATION, HOLDERS AND CASH DIVIDENDS

The shares of the Company’s common stock are listed on the NASDAQ Global Select Market under the symbol “SHBI”. As of March 15, 2021, the Company had approximately 1,201 registered holders of record.

Shareholders received quarterly cash dividends on shares of common stock totaling \$6.0 million in 2020 and \$5.3 million in 2019. Dividends increased from 2019 due to the Company’s operating results from continuing operations and excess capital. As a general matter, the payment of dividends is at the discretion of the Company’s Board of Directors, based on such factors as operating results, financial condition, capital adequacy, regulatory requirements, and stockholder return. The Company anticipates continuing a regular quarterly cash dividend. However, we have no obligation to pay dividends and we may change our dividend policy at any time without notice to shareholders. Any future determination to pay dividends to holders of our common stock will depend on our results of operations, financial condition, capital requirements, banking regulations, contractual restrictions and any other factors that our board of directors may deem relevant.

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

Broadridge
51 Mercedes Way
Edgewood, NY 11717
Investor Relations: 1-800-353-0103
E-mail for investor inquiries: shareholder@broadridge.com .
www.broadridge.com

EQUITY COMPENSATION PLAN INFORMATION

The following table contains information about these equity compensation plans as of December 31, 2020.

<u>Plan Category</u>	<u>Number of securities to be issued upon exercise of outstanding options, warrants and rights (a)</u>	<u>Weighted-average exercise price of outstanding options, warrants, and rights (b)</u>	<u>Number of securities remaining available for future issuance under equity compensation plans [excluding securities reflected in column (a)] (c)</u>
Equity compensation plans approved by security holders	2,709	6.64	608,414
Equity compensation plans not approved by security holders	—	—	—
Total	2,709	6.64	608,414

All other information required by this item is incorporated herein by reference to the section of the Company’s definitive proxy statement to be filed in connection with the 2021 Annual Meeting of Stockholders entitled “Beneficial Ownership of Common Stock”.

UNREGISTERED SALES OF EQUITY SECURITIES AND ISSUER PURCHASES OF EQUITY SECURITIES

There were no unregistered sales of the Company's stock during the fourth quarter of 2020.

The Company completed its original stock repurchase program that was approved in April of 2019 on October 26, 2020 which authorized the repurchase of up to \$10.0 million of the Company's common stock. Subsequently, on November 24, 2020 the Company announced an additional stock repurchase program which was approved by the Board and authorized management to repurchase up to \$5.0 million of the Company's common stock. During the fourth quarter of 2020, the Company repurchased 183,471 shares of its common stock under the "original" repurchase plan and repurchased 253,900 shares of its common stock under the "new" repurchase plan.

The following tables provide information with respect to purchases made by or on behalf of us or any "affiliated purchaser" (as defined in Rule 10b-18(a)(3) under the Exchange Act) of our common stock during the fourth quarter of 2020.

Original Stock Repurchase Plan \$10.0 million (2019-2020)

Period	Total Number Of Shares Purchased	Average Price Paid Per Share	Total Number of Shares Purchased as Part of the Publicly Announced Plans or Programs	Maximum Dollar Value Of Shares that May Yet Be Purchased Under the Plans or Programs
October 1, 2020 to October 31, 2020	183,471	\$ 11.63	183,471	\$ —
November 1, 2020 to November 30, 2020	—	—	—	—
December 1, 2020 to December 31, 2020	—	—	—	—
Total	<u>183,471</u>	\$ 11.63	<u>183,471</u>	

New Stock Repurchase Plan \$5.0 million (2020-2021)

Period	Total Number Of Shares Purchased	Average Price Paid Per Share	Total Number of Shares Purchased as Part of the Publicly Announced Plans or Programs	Maximum Dollar Value Of Shares that May Yet Be Purchased Under the Plans or Programs
October 1, 2020 to October 31, 2020	—	\$ —	—	\$ 5,000,000
November 1, 2020 to November 30, 2020	5,100	13.93	5,100	4,928,957
December 1, 2020 to December 31, 2020	248,800	14.32	248,800	1,366,141
Total	<u>253,900</u>	\$ 14.31	<u>253,900</u>	

Item 6. Selected Financial Data

Not required.

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

The following discussion compares the Company’s financial condition at December 31, 2020 to its financial condition at December 31, 2019 and the results of operations for the years ended December 31, 2020 and 2019. This discussion should be read in conjunction with the Consolidated Financial Statements and the Notes thereto appearing in Item 8 of Part II of this annual report.

PERFORMANCE OVERVIEW

The Company recorded net income of \$15.73 million for 2020 and net income of \$16.20 million for 2019. The basic and diluted income per share was \$1.27 and \$1.28 from continuing operations for fiscal year 2020 and 2019, respectively. When comparing net income from continuing operations for 2020 to 2019, earnings decreased due to a higher provision for credit losses and higher noninterest expenses, almost entirely offset by an increase in net interest income and noninterest income.

Total assets were \$1.933 billion at December 31, 2020, a \$374.1 million, or 24.0%, increase when compared to the \$1.559 billion at December 31, 2019. The primary factors contributing to the increase were increases in gross loans of \$205.6 million, which included PPP loans of \$122.9 million, interest-bearing deposits with other banks of \$93.7 million and \$73.2 million in securities.

Total deposits increased \$359.4 million, or 26.8%, to \$1.701 billion at December 31, 2020. The overall increase in deposits can be attributed to a combination of factors which include, direct stimulus payments to customers, customers improving their liquidity position by participating in our deferred loan program and the result of new business and municipal relationships developed during 2020. Total stockholders’ equity increased \$2.2 million, or 1.1%, to \$195.0 million, or 10.09% of total assets at December 31, 2020. The increase in total stockholders’ equity was primarily due to current year earnings and other comprehensive income, partially offset by repurchases of the Company’s common stock throughout the year totaling \$9.1 million.

COVID-19 Pandemic

The outbreak of COVID-19 has led to adverse impacts on economic conditions and created uncertainty in financial markets. Correspondingly, in early March 2020, the Company began preparing for potential disruptions and government limitations of activity in the markets in which we serve. Our team activated our Business Continuity Program and was able to quickly execute on multiple initiatives to adjust our operations to protect the health and safety of our employees and clients. Since the beginning of the crisis, we have been in close contact with our clients, assessing the level of impact on their businesses, and providing relief programs according to each client’s specific situation and qualifications. We have also enhanced awareness of digital banking offerings, expanded services at our drive through locations, and allowed customers to make appointments in the branch for critical services. The Company’s branches remain open and have taken steps to comply with various government directives regarding “social distancing,” as well as, enhanced cleaning and disinfecting of all surface areas to protect its clients and employees.

Small Business Administration’s Paycheck Protection Program

We established our process for participating in the Small Business Administration’s Paycheck Protection Program (“PPP”) that enabled our clients to utilize this valuable resource beginning in April 2020. Loans under the PPP are designed to provide assistance for small businesses during the COVID-19 pandemic to help meet the costs associated with payroll, mortgage interest, rent and utilities. These loans are guaranteed by the SBA and forgiveness of the loans, by the SBA, is granted to the borrower if the borrower uses at least 60% of the funds to cover payroll costs and benefits. Forgiveness is also based on the small business maintaining or quickly rehiring their employees and maintaining salary levels for their employees. Loans under the PPP do not require any collateral or personal guarantees, as such, these loans are included in the Company’s commercial loans segment. Through August 8, 2020, our team was able to process 1,488 PPP loans for approximately \$126.7 million in the first and second rounds of the program, which has allowed us to further strengthen and deepen our client relationships, while positively impacting thousands of individuals. We are also closely monitoring

the credit quality of the loan portfolio and monitor lines of credit draws for deviation from normal activity to improve loan performance and reduce credit risk.

Short-term Modifications for Borrowers

In keeping with regulatory guidance to work with borrowers during this unprecedented situation and as outlined in Section 4013 of the Coronavirus Aid, Relief, and Economic Security Act (“CARES Act”), the Company is providing modifications where appropriate, including interest only payments or payment deferrals for clients that could be adversely affected by the COVID-19 pandemic. Section 4013 of the CARES Act also addressed COVID-19 related modifications and specified that such modifications made on loans that were current as of December 31, 2019 are not TDRs. In accordance with interagency guidance issued in April 2020, these short-term modifications made to a borrower affected by the COVID-19 pandemic and governmental shutdown orders, such as payment deferrals, fee waivers and extensions of repayment terms, do not need to be identified as TDRs if the loans were current at the time a modification plan was implemented. For the year ended December 31, 2020, the Company had executed principal and/or interest deferrals on outstanding loan balances of \$221.1 million, of which only \$34.9 million, or 2.40% of the total portfolio remained on deferral as of December 31, 2020.

(Dollars in thousands)	Total Loan Balance as of December 31, 2020	Total Loans Modified as of December 31, 2020	Loans Modified to Interest Only Payments (6 months or less)	Loans Modified to Payment Deferral (3 months)	Percentage of Loans Modified
Hospitality Industry	\$ 114,592	\$ 32,260	\$ 32,260	\$ -	28.15 %
Non-owner occupied Retail Stores	133,992	-	-	-	—
Non-owner occupied Restaurants	11,644	-	-	-	—
Owner-occupied Retail Stores	14,376	-	-	-	—
Owner-occupied Restaurants	9,226	-	-	-	—
Oil & Gas Industry	-	-	-	-	—
Other Commercial Loans	774,867	2,269	2,269	-	0.29
Total Commercial Loans	1,058,697	34,529	34,529	-	3.26
Residential 1-4 family Personal	228,752	-	-	-	—
Residential 1-4 family Rentals	90,982	300	300	-	0.33
Home Equity Loans	45,488	-	-	-	—
Total Residential Real Estate Loans	365,222	300	300	-	0.08
Consumer Loans	30,282	79	-	79	0.26
Mortgage Warehouse Loans	-	-	-	-	—
Credit Card, Overdrafts and Other	55	-	-	-	—
TOTAL LOANS	\$ 1,454,256	\$ 34,908	\$ 34,829	\$ 79	2.40 %

CRITICAL ACCOUNTING POLICIES

The Company’s consolidated financial statements are prepared in accordance with GAAP and follow general practices within the industries in which it operates. Application of these principles requires management to make estimates, assumptions, and judgments that affect the amounts reported in the financial statements and accompanying notes. These estimates, assumptions, and judgments are based on information available as of the date of the financial statements; accordingly, as this information changes, the financial statements could reflect different estimates, assumptions, and judgments. Certain policies inherently have a greater reliance on the use of estimates, assumptions, and judgments and as such have a greater possibility of producing results that could be materially different than originally reported.

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

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

Goodwill represents the excess of the cost of an acquisition over the fair value of the net assets acquired. Determining fair value is subjective, requiring the use of estimates, assumptions and management judgment. Goodwill is tested at least annually for impairment, usually during the fourth quarter, or on an interim basis if circumstances dictate. Impairment testing requires a qualitative assessment or that the fair value of each of the Company's reporting units be compared to the carrying amount of its net assets, including goodwill. If the fair value of a reporting unit is less than book value, an expense may be required to write down the related goodwill to record an impairment loss. As of December 31, 2020, the Company had only one banking reporting unit.

RECENT ACCOUNTING PRONOUNCEMENTS AND DEVELOPMENTS

The Notes to the Consolidated Financial Statements discuss new accounting policies that the Company adopted during 2020 and the expected impact of accounting policies recently issued or proposed but not yet required to be adopted. To the extent the adoption of new accounting standards materially affects our financial condition, results of operations or liquidity, the impacts are discussed in the applicable section(s) of this discussion and Notes to the Consolidated Financial Statements.

RESULTS OF OPERATIONS

Net Interest Income and Net Interest Margin

Net interest income remains the most significant factor affecting our results of operations. Net interest income represents the excess of interest and fees earned on total average earning assets (loans, investment securities, federal funds sold and interest-bearing deposits with other banks) over interest owed on average interest-bearing liabilities (deposits and borrowings). Tax-equivalent net interest income is net interest income adjusted for the tax-favored status of income from certain loans and investments. As shown in the table below, tax-equivalent net interest income for 2020 was \$52.7 million. This represented a \$2.4 million, or 4.9%, increase from 2019. The increase in net interest income when comparing 2020 to 2019 was primarily the result of higher average balances on loans and lower average rates paid on interest-bearing deposits, partially offset by lower average yields on taxable investment securities and interest-bearing deposits with other banks. In addition, the issuance of subordinated debt in the third quarter of 2020, contributed to the offset in the increase in net interest income when comparing the periods.

Our net interest margin (i.e., tax-equivalent net interest income divided by average earning assets) represents the net yield on earning assets minus the cost of average interest liabilities. The net interest margin is managed through loan and deposit pricing and asset/liability strategies. The net interest margin was 3.27% for 2020 and 3.54% for 2019. The net interest margin decreased when comparing 2020 to 2019 primarily due to a decline in the average yields on total earning assets of 50bps, which was compounded by the significant increase in deposits, resulting in excess liquidity being invested in lower yielding assets. Partially offsetting the decrease in average yields on earnings assets was a decline in the average rates paid on interest-bearing deposits of 34bps and the decrease in the average balance on long-term advances from the FHLB. The net interest spread, which is the difference between the average yield on earning assets and the average rate paid for interest-bearing liabilities was 3.05% for 2020 and 3.20% for 2019.

The following table sets forth the major components of net interest income, on a tax-equivalent basis, for the years ended December 31, 2020 and 2019.

(Dollars in thousands)	2020			2019		
	Average Balance	Interest (1)	Yield/Rate	Average Balance	Interest (1)	Yield/Rate
Earning assets						
Loans (2), (3)	\$ 1,368,887	\$ 56,561	4.13 %	\$ 1,226,361	\$ 55,553	4.53 %
Investment securities:						
Taxable	138,391	2,997	2.16	156,383	3,582	2.29
Interest-bearing deposits	103,726	260	0.25	39,944	794	1.99
Total earning assets	1,611,004	59,818	3.71 %	1,422,688	59,929	4.21 %
Cash and due from banks	18,042			18,241		
Other assets	92,575			68,399		
Allowance for credit losses	(11,624)			(10,425)		
Total assets	\$ 1,709,997			\$ 1,498,903		
Interest-bearing liabilities						
Demand deposits	\$ 343,848	903	0.26 %	\$ 252,907	1,735	0.69 %
Money market and savings deposits	434,781	1,172	0.27	389,000	2,782	0.72
Brokered Deposits	—	—	—	16,369	388	2.37
Certificates of deposit \$100,000 or more	129,150	2,191	1.70	113,017	1,839	1.63
Other time deposits	148,823	2,174	1.46	146,344	1,982	1.35
Interest-bearing deposits	1,056,602	6,440	0.61	917,637	8,726	0.95
Securities sold under retail repurchase agreements and short-term FHLB advances	1,484	5	0.34	18,453	481	2.61
Advances from FHLB - long-term	3,934	113	2.87	15,000	429	2.86
Subordinated debt	8,617	522	6.06	—	—	—
Total interest-bearing liabilities	1,070,637	7,080	0.66 %	951,090	9,636	1.01 %
Noninterest-bearing deposits	431,319			348,665		
Other liabilities	10,072			9,009		
Stockholders' equity	197,969			190,139		
Total liabilities and stockholders' equity	\$ 1,709,997			\$ 1,498,903		
Net interest spread		\$ 52,738	3.05 %		\$ 50,293	3.20 %
Net interest margin			3.27 %			3.54 %
Tax-equivalent adjustment						
Loans						
Total						

- (1) All amounts are reported on a tax-equivalent basis computed using the statutory federal income tax rate of 21% for 2020 and 2019, exclusive of nondeductible interest expense. The tax-equivalent adjustment amounts used in the above table to compute yields aggregated \$141 thousand in 2020 and \$162 thousand in 2019.
- (2) Average loan balances include nonaccrual loans.
- (3) Interest income on loans includes amortized loan fees, net of costs, and all are included in the yield calculations.

On a tax-equivalent basis, total interest income was \$59.8 million for 2020 compared to \$59.9 million for 2019. The decrease in interest income for 2020 compared to 2019 was primarily due to the decrease in the average yields of loans, offset by the increase in the average balance on loans and the addition of fees, net of costs, on PPP loans during 2020. The average balance of loans in 2020 increased \$142.5 million and the yield earned on these loans declined to 4.13% from 4.53%. This was primarily the result of the origination of PPP loans which had an average balance at the end of 2020 of \$58.6 million and an average yield of 2.18%, well below the average yield on the Bank's traditional loans. The decrease in interest income on interest-bearing deposits and taxable investment securities was impacted by Federal Reserve rate cuts during the first quarter of 2020, as seen in the Rate/Volume Variance Analysis below. As a percentage of total average earning assets, loans, investment securities, and interest-bearing deposits were 85.0%, 8.6%, and 6.4%, respectively, for 2020. The comparable percentages for 2019 were 86.2%, 11.0%, and 2.8%, respectively.

Interest expense was \$7.1 million for 2020 compared to \$9.6 million for 2019. The decrease in interest expense for 2020 was primarily due to decreases in the average rates paid on interest-bearing deposits, partially offset by the addition of interest on subordinated debt in the third quarter of 2020. During 2020, demand deposits, money market/savings deposits and certificates of deposit over \$100 thousand experienced the most significant growth with increases in the average balances of \$90.9 million, \$45.8 million and \$16.1 million, respectively, while the average rates paid on these deposits (decreased)/increased (43), (45) and 7bps, respectively. In addition, the elimination of brokered deposits resulted in a decrease in the average balance of \$16.4 million for 2020.

During 2020, the lower average rates on interest-bearing liabilities, specifically short-term and long-term advances from the FHLB produced \$229 thousand less in interest expense and decreased volume produced \$563 thousand less in interest expense, as shown in the table below. Partially offsetting these decreases was the addition of subordinated debt during 2020 resulting in an average balance of \$8.6 million with a rate of 6.06%.

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

(Dollars in thousands)	2020 over (under) 2019		
	Total Variance	Caused By	
		Rate	Volume
Interest income from earning assets:			
Loans	\$ 1,008	\$ (5,140)	\$ 6,148
Taxable investment securities	(585)	(193)	(392)
Interest-bearing deposits	(534)	(1,087)	553
Total interest income	(111)	(6,420)	6,309
Interest expense on deposits and borrowed funds:			
Interest-bearing demand deposits	(832)	(1,324)	492
Money market and savings deposits	(1,610)	(1,910)	300
Brokered deposits	(388)	—	(388)
Time deposits	544	240	304
Securities sold under repurchase agreements and short-term FHLB advances	(476)	(231)	(245)
Advances from FHLB - Long-term	(316)	2	(318)
Subordinated debt	522	—	522
Total interest expense	(2,556)	(3,223)	667
Net interest income	\$ 2,445	\$ (3,197)	\$ 5,642

Noninterest Income

Noninterest income from continuing operations increased \$729 thousand, or 7.3%, in 2020 when compared to 2019. The increase in noninterest income in 2020 when compared to 2019 was primarily due to increases in other noninterest income of \$1.4 million which was the result of increases in BOLI and COLI income of \$656 thousand, swap fee income of \$495 thousand and other fees on bank services of \$264 thousand, partially offset by a decrease in service charges on deposit accounts of \$1.1 million. In addition, the Bank had gains on sales of securities during 2020 of \$347 thousand and an increase in trust and investment fee income of \$36 thousand. The significant decrease in bank service fees was due to the Bank providing fee waivers during 2020 for customers who were impacted by the pandemic. The increase in BOLI income was attributed to a full year of earnings from \$25.6 million in insurance contracts purchased in 2019 used to offset future employee benefit costs.

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

(Dollars in thousands)	Years Ended		Change from Prior Year	
	2020	2019	2020/ 19	
			Amount	Percent
Service charges on deposit accounts	\$ 2,839	\$ 3,910	\$ (1,071)	(27.4)%
Trust and investment fee income	1,558	1,522	36	2.4
Gains on sales and calls of investment securities	347	—	347	100.0
Other noninterest income	6,005	4,588	1,417	30.9
Total	\$ 10,749	\$ 10,020	\$ 729	7.3

Noninterest Expense

Noninterest expense from continuing operations increased \$842 thousand, or 2.2%, in 2020 when compared to 2019. The increase in noninterest expenses was primarily due to increases in employee benefits of \$1.2 million, due to an increase in medical claims from the Company's self-funded insurance program and a full year of expense for the supplemental executive retirement plans ("SERPs") in 2020, data processing of \$498 thousand, the result of utilizing additional services from our core processor, occupancy expense of \$161 thousand due to the addition of a new branch in 2020 and FDIC insurance premium expense due to the absence of a credit received in 2019, partially offset by decreases in salaries and wages of \$478 thousand, OREO expenses, net of \$369 thousand and other noninterest expenses of \$432 thousand. The decrease in salaries and wages resulted from the deferral of direct origination costs related to the origination of PPP loans in 2020. The decrease in other noninterest expense was primarily due to decreases in advertising, marketing, travel and entertainment expenses due to the pandemic, coupled with a decrease in other loan expenses.

The Company had 287 full-time equivalent employees at December 31, 2020, and 294 full-time equivalent employees at December 31, 2019.

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

(Dollars in thousands)	Years Ended		Change from Prior Year	
	2020	2019	2020/ 19	
			Amount	Percent
Salaries and wages	\$ 14,935	\$ 15,413	\$ (478)	(3.1)%
Employee benefits	6,461	5,283	1,178	22.3
Occupancy expense	2,919	2,758	161	5.8
Furniture and equipment expense	1,224	1,107	117	10.6
Data processing	4,288	3,790	498	13.1
Directors' fees	504	479	25	5.2
Amortization of intangible assets	533	605	(72)	(11.9)
FDIC insurance premium expense	485	344	141	41.0
Other real estate owned expenses, net	56	425	(369)	(86.8)
Legal and professional fees	2,296	2,223	73	3.3
Other noninterest expenses	4,698	5,130	(432)	(8.4)
Total	\$ 38,399	\$ 37,557	\$ 842	2.2

Income Taxes

The Company reported an income tax expense for continuing operations of \$5.3 million for 2020, compared to an income tax expense for continuing operations of \$5.6 million for 2019. The effective tax rate for continuing operations was 25.3% for 2020 and 25.6% for 2019. The Company's effective tax rate remained relatively unchanged for 2020 compared to 2019. Please refer to Note 16 of the Notes to Consolidated Financial Statements included in Part II of this Annual Report on Form 10-K for further information.

REVIEW OF FINANCIAL CONDITION

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

Assets

Interest-Bearing Deposits with Other Banks and Federal Funds Sold

The Company invests excess cash balances (i.e., the excess cash remaining after funding loans and investing in securities with deposits and borrowings) in interest-bearing accounts and federal funds sold offered by our correspondent banks. These liquid investments are maintained at a level that management believes is necessary to meet current liquidity needs. Total interest-bearing deposits with other banks increased \$93.7 million from \$76.5 million at December 31, 2019 to \$170.3 million at December 31, 2020. This significant increase was the result of deposit growth of \$359.4 million, or 26.8%. Average interest-bearing deposits with other banks increased \$63.8 million in 2020 when compared to 2019. The increase in 2020 was due to higher average balances on interest and noninterest-bearing deposits of \$139.0 million and \$82.7 million, respectively.

Investment Securities

The investment portfolio is structured to provide us with liquidity and also plays an important role in the overall management of interest rate risk. Investment securities available for sale are stated at estimated fair value based on quoted prices and may be sold as part of the asset/liability management strategy or which may be sold in response to changing interest rates. Net unrealized holding gains and losses on available for sale debt securities are reported net of related income taxes as accumulated other comprehensive income, a separate component of stockholders' equity. Investment securities in the held to maturity category are stated at cost adjusted for amortization of premiums and accretion of discounts. We have the intent and current ability to hold such securities until maturity. At December 31, 2020, 68% of the portfolio was classified as available for sale and 32% as held to maturity. At December 31, 2019, 94% of the portfolio was classified as available for sale and 6% as held to maturity. Total investment securities increased \$73.2 million from \$137.1 million at December 31, 2019 to \$210.3 million at December 31, 2020. The Bank purchased \$130.7 million in securities in 2020, of which \$73.5 million was classified as available for sale and \$57.2 million as held to maturity. The significant change in investment strategy when comparing 2020 to 2019 was due to excess liquidity experienced in 2020, which was partially utilized to purchase securities with a higher yield than the then current overnight Fed funds rate. The larger percentage of securities designated as held to maturity reflects the amount that management believes is not needed to support our anticipated growth and liquidity needs. We do not typically invest in derivative securities and held no such investments at December 31, 2020 or December 31, 2019.

Investment securities available for sale were \$139.6 million at the end of 2020 and \$122.8 million at the end of 2019. The Bank purchased \$73.5 million in available for sale securities in 2020 and \$0 for 2019. During 2020, the Bank purchased thirteen mortgage-backed securities and four government agency bonds of \$55.4 million and \$18.0 million, respectively. At year-end 2020, 16.9% of the available for sale securities in the portfolio were U.S. Government agencies and 83.1% of the securities were mortgage-backed securities, compared to 19.4% and 80.6%, respectively, at year-end 2019. Our investments in mortgage-backed securities are issued or guaranteed by U.S. Government agencies or government-sponsored agencies.

Investment securities held to maturity were \$65.7 million at the end of 2020 and \$8.8 million at the end of 2019. The Bank purchased \$57.2 million in held to maturity securities in 2020 and \$4 million for 2019. During 2020, the Bank purchased six mortgage-backed securities of \$27.4 million, five government agency bonds of \$17.7 million and seven subordinated debt instruments from other banks of \$12.1 million. In 2019, the Company purchased one corporate bond of \$4.0 million. At year-end 2020, 28.7% of the held to maturity securities in the portfolio were U.S. Government agencies, 41.5% of the securities were mortgage-backed securities, 29.2% were subordinated debt instruments and less than 1% were community reinvestment bonds. At year-end 2019, 16.0% of the held to maturity securities in the portfolio were U.S. Government agencies, 79.4% of the securities were subordinated debt instruments and 4.6% were community reinvestment bonds.

The following tables set forth the weighted average yields by maturity category of the bond investment portfolio as of December 31, 2020 and 2019.

(Dollars in thousands)	1 Year or Less Average Yield	1-5 Years Average Yield	5-10 Years Average Yield	Over 10 Years Average Yield
2020				
Available for sale:				
U.S. Government agencies	1.50 %	— %	1.20 %	— %
Mortgage-backed	—	1.57	2.11	1.61
Total available for sale	1.50	1.57	1.82	1.61
Held to maturity:				
U.S. Government agencies	— %	— %	0.91 %	1.84 %
Mortgage-backed	—	—	—	1.34
States and political subdivisions ¹	—	3.02	—	—
Other Debt Securities	—	2.68	4.51	—
Total held to maturity	—	3.02	3.06	1.45

¹ Yields have been adjusted to reflect a tax equivalent basis using the statutory federal tax rate of 21%.

(Dollars in thousands)	1 Year or Less Average Yield	1-5 Years Average Yield	5-10 Years Average Yield	Over 10 Years Average Yield
2019				
Available for sale:				
U.S. Government agencies	1.74 %	1.54 %	— %	4.16 %
Mortgage-backed	—	1.45	2.20	2.19
Total available for sale	1.74	1.53	2.20	2.23
Held to maturity:				
U.S. Government agencies	— %	— %	— %	2.08 %
States and political subdivisions ²	—	5.20	—	—
Other Debt Securities	—	—	4.21	—
Total held to maturity	—	5.20	4.21	2.08

² Yields have been adjusted to reflect a tax equivalent basis using the statutory federal tax rate of 21%.

Loans

The loan portfolio is the primary source of our income. Loans totaled \$1.5 billion at December 31, 2020, an increase of \$205.6 million, or 16.5%, from 2019. At December 31, 2020, PPP loans accounted for \$122.9 million of total loans. Most of our loans, excluding PPP loans, are secured by real estate and are classified as construction, residential or commercial real estate loans. The increase in loans, excluding PPP loans, was comprised of increases in commercial real estate loans of \$74.7 million, or 12.7%, consumer loans of \$13.7 million, or 77.4%, construction loans of \$6.9 million, or 6.9% and residential loans of \$1.0 million, or less than 1%, at December 31, 2020 compared to December 31, 2019. These increases

were partially offset by a decrease of \$13.6 million, or 13.4%, in commercial loans, excluding PPP loans. At December 31, 2020, excluding PPP loans, the loan portfolio was comprised of 49.7% commercial real estate, 33.3% residential real estate, 8.0% construction, 6.6% commercial and 2.4% consumer. That compares to 47.0%, 35.4%, 8.0%, 8.2% and 1.4, respectively, at December 31, 2019. At December 31, 2020, 78.8% of the loan portfolio had fixed interest rates and 21.2% had adjustable interest rates, compared to 75.5% and 24.5%, respectively, at December 31, 2019. See the discussion below under the caption “Asset Quality - Provision for Credit Losses and Risk Management” and Note 3, “Loans and Allowance for Credit Losses”, in the Notes to Consolidated Financial Statements for additional information. At December 31, 2020 and 2019, the Company did not have any loans held for sale. We do not engage in foreign or subprime lending activities.

The table below sets forth the maturities and interest rate sensitivity of the loan portfolio at December 31, 2020.

(Dollars in thousands)	Maturing within one year	Maturing after one but within five years	Maturing after five but within fifteen years	Maturing after fifteen years	Total
Construction	\$ 55,128	\$ 38,831	\$ 10,275	\$ 2,526	\$ 106,760
Residential real estate	32,342	58,293	110,251	242,656	443,542
Commercial real estate	90,636	184,450	263,492	122,654	661,232
Commercial	10,587	150,048	23,775	26,846	211,256
Consumer	966	26,989	2,325	1,186	31,466
Total	<u>\$ 189,659</u>	<u>\$ 458,611</u>	<u>\$ 410,118</u>	<u>\$ 395,868</u>	<u>\$ 1,454,256</u>
Rate terms:					
Fixed-interest rate loans	\$ 160,844	\$ 430,157	\$ 384,335	\$ 171,053	\$ 1,146,389
Adjustable-interest rate loans	28,815	28,454	25,783	224,815	307,867
Total	<u>\$ 189,659</u>	<u>\$ 458,611</u>	<u>\$ 410,118</u>	<u>\$ 395,868</u>	<u>\$ 1,454,256</u>

Liabilities

Deposits

The Bank uses deposits primarily to fund loans and to purchase investment securities. Total deposits increased from \$1.34 billion at December 31, 2019 to \$1.70 billion at December 31, 2020 due to increases in every deposit product, with the exception of a decrease in time deposits of \$2.2 million. The increases in deposit products consisted of the following: noninterest-bearing deposits of \$152.5 million, interest-bearing checking deposits of \$144.0 million, and savings and money market accounts of \$65.1 million. Average interest-bearing deposits increased \$139.0 million, or 15.1%, in 2020, compared to an increase of \$64.0 million, or 7.5% in 2019. Average certificates of deposit and other time deposits increased \$18.6 million, or 7.2% in 2020, compared to an increase of \$14.5 million, or 5.9% in 2019. Average noninterest-bearing deposits increased \$82.7 million, or 23.7%, in 2020, compared to an increase of \$22.0 million, or 6.7% in 2019. The elimination of brokered deposits in late 2019 decreased the average balance in these deposits in 2020 by \$16.4 million. Deposits provided funding for approximately 92.4% and 89.0% of average earning assets for 2020 and 2019, respectively.

The following table sets forth the average balances of deposits and the percentage of each category to total average deposits for the years ended December 31, 2020 and 2019.

(Dollars in thousands)	Average Balances			
	2020		2019	
Noninterest-bearing demand	\$ 431,319	29.0 %	\$ 348,665	27.5 %
Interest-bearing deposits				
Demand	343,848	23.1	252,907	20.0
Money market and savings	434,781	29.2	389,000	30.7
Brokered deposits	—	—	16,369	1.3
Certificates of deposit, \$100,000 to \$249,999	88,934	6.0	81,696	6.5
Certificates of deposit, \$250,000 or more	40,216	2.7	31,321	2.5
Other time deposits	148,823	10.0	146,344	11.5
Total	<u>\$ 1,487,921</u>	<u>100.0 %</u>	<u>\$ 1,266,302</u>	<u>100.0 %</u>

The following table sets forth the maturity ranges of certificates of deposit with balances of \$250,000 or more as of December 31, 2020.

(Dollars in thousands)	Uninsured	
Three months or less	\$ 4,370	\$ 1,370
Over three through 6 months	13,335	4,335
Over 6 through 12 months	14,366	3,616
Over 12 months	11,087	2,190
Total	<u>\$ 43,158</u>	<u>\$ 11,511</u>

Securities Sold Under Retail Repurchase Agreements

Securities sold under agreements to repurchase are issued in conjunction with cash management services for commercial depositors. At December 31, 2020 and December 31, 2019, the Company had \$1.1 million and \$1.2 million, respectively, in securities sold under retail repurchase agreements

Long-Term Advances from FHLB

The Company occasionally borrows from Federal Home Loan Bank to meet longer term liquidity needs, specifically to fund loan growth when liquidity from deposit growth is not sufficient. The Company had no long-term FHLB borrowings outstanding at the end of 2020 and \$15.0 million outstanding at the end of 2019. The amount of outstanding long-term borrowings at December 31, 2019 consisted of a long-term advance from the FHLB of \$15.0 million, which carried an interest rate of 2.82%. This advance was paid off in April of 2020.

Subordinated Debt

On August 25, 2020, the Company entered into Subordinated Note Purchase Agreements with certain accredited purchasers pursuant to which the Company issued and sold \$25.0 million in aggregate principal amount with an initial interest rate of 5.375% Fixed-to-Floating Rate Subordinated Notes due September 1, 2030.

The Company plans to use the net proceeds of the offering for general corporate purposes, organic growth and to support the Bank's regulatory capital ratios. The Notes were structured to qualify as Tier 2 capital of the Company for regulatory capital purposes and bear an initial interest rate of 5.375% until September 1, 2025, with interest during this period payable semi-annually in arrears. From and including September 1, 2025, to but excluding the maturity date or early redemption date, the interest rate will reset quarterly to an annual floating rate equal to three-month SOFR, plus 526.5 basis points, with interest during this period payable quarterly in arrears. The Notes are redeemable by the Company at its option, in whole or in part, on or after September 1, 2025. Initial debt issuance costs were \$611 thousand. The debt balance of \$24.4 million is presented net of unamortized issuance costs of \$571 thousand at December 31, 2020.

Capital Resources Management

Total stockholders' equity for the Company was \$195.0 million at December 31, 2020, compared to \$192.8 million at December 31, 2019. The increase in stockholders' equity in 2020 was primarily due to 2020 earnings and accumulated other comprehensive income, which primarily consisted of unrealized gains in available-for-sale securities, which was partially offset by dividends paid to common stockholders and stock repurchases. The ratio of period-end equity to total assets was 10.09% for 2020, as compared to 12.37% for 2019.

We record unrealized holding gains (losses), net of tax, on investment securities available for sale as accumulated other comprehensive income (loss), a separate component of stockholders' equity. At December 31, 2020, the portion of the investment portfolio designated as "available for sale" had a net unrealized holding gain, net of tax, of \$1.5 million compared to net unrealized holding gain, net of tax, of \$218 thousand at December 31, 2019.

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

Quantitative measures established by regulation to ensure capital adequacy require the Bank to maintain minimum ratios of common equity Tier 1, Tier 1, and total capital as a percentage of assets and off-balance sheet exposures, adjusted for risk weights ranging from 0% to 1,250%. The Bank is also required to maintain capital at a minimum level based on quarterly average assets, which is known as the leverage ratio.

In July 2013, federal bank regulatory agencies issued a final rule that revised their risk-based capital requirements and the method for calculating risk-weighted assets to make them consistent with certain standards that were developed by Basel III and certain provisions of the Dodd-Frank Act. The final rule currently applies to all depository institutions and bank holding companies and savings and loan holding companies with total consolidated assets of more than \$3 billion. The Company has total consolidated assets of less than \$3 billion and is currently exempt from the consolidated capital requirements.

As of December 31, 2020, the Bank was in compliance with all applicable regulatory capital requirements to which it was subject, and was classified as "well capitalized" for purposes of the prompt corrective action regulations.

The following table compares the Bank's capital ratios to the minimum regulatory requirements as of December 31, 2020 and 2019.

(Dollars in thousands)	2020	2019	Minimum Regulatory Requirements for 2020
Common equity Tier 1 capital	\$ 180,696	\$ 163,206	
Tier 1 capital	180,696	163,206	
Tier 2 capital	14,189	10,808	
Total risk-based capital	194,885	174,014	
Net risk-weighted assets	1,367,544	1,254,980	
Adjusted average total assets	1,857,802	1,533,919	
Risk-based capital ratios:			
Common equity Tier 1	13.21 %	13.00 %	7.00*
Tier 1	13.21	13.00	8.50*
Total capital	14.25	13.87	10.50*
Tier 1 leverage ratio	9.73	10.64	4.00

* includes phased in capital conservation buffer of 2.50%

See Note 18 to the Consolidated Financial Statements for further information about the regulatory capital positions of the Bank (December 31, 2020 and 2019).

Asset Quality - Provision for Credit Losses and Risk Management

Originating loans involves a degree of risk that credit losses will occur in varying amounts according to, among other factors, the types of loans being made, the credit-worthiness of the borrowers over the terms of the loans, the quality of the collateral for the loans, if any, as well as general economic conditions. Through the Company's and the Bank's Asset/Liability Management Committees, the Company's Audit Committee and the Company's Board actively reviews critical risk positions, including credit, market, liquidity and operational risk. The Company's goal in managing risk is to reduce earnings volatility, control exposure to unnecessary risk, and ensure appropriate returns for risk assumed. Senior

members of management actively manage risk at the product level, supplemented with corporate level oversight through the Asset/Liability Management Committee and internal audit function. The risk management structure is designed to identify risk through a systematic process, enabling timely and appropriate action to avoid and mitigate risk.

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

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

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

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

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

The historical formula allowance is used to estimate the loss on internally risk-rated loans, exclusive of those identified as impaired. Loans are grouped by type (construction, residential real estate, commercial real estate, commercial or consumer). Each loan type is assigned allowance factors based on management's estimate of the risk, complexity and size of individual loans within a particular category using average historical charge-offs by segment over the last 16 quarters.

The qualitative formula allowance is used to estimate the losses on loans stemming from more global factors such as delinquencies, loss history, effects of changes in lending policy, the experience and depth of management, national and local economic trends, concentrations of credit, the quality of the loan review system and the effect of external factors as deemed appropriate. Loans that are identified as pass-watch, special mention, substandard and doubtful are considered to have elevated credit risk. These loans are assigned higher allowance factors than favorably rated loans due to

management's concerns regarding collectability or management's knowledge of particular elements regarding the borrower.

As seen in the table below, the provision for credit losses was \$3.9 million for 2020 and \$700 thousand for 2019. The increase in the provision for credit losses was the result of new and elevated qualitative factors within the allowance model related to economic conditions and the COVID-19 pandemic. Net loan charge-offs totaled \$519 thousand in 2020 and \$536 thousand in 2019.

The allowance for credit losses was \$13.9 million, or 1.04% of period end loans, excluding PPP loans, at December 31, 2020, compared to an allowance of \$10.5 million, or 0.84% of period end loans at December 31, 2019. The higher allowance percentage at the end of 2020 when compared to the end of 2019 was the result of higher qualitative factors in the analysis of the allowance for loan losses as it related to current economic conditions and the COVID-19 pandemic. While the majority of our credit quality metrics have shown improvement or stability from the prior year end, our allowance and related provision is reflective of our evaluation of risks related to the pandemic's impact on our borrowers and the overall lending environment. The ratio of net charge-offs to average loans was 0.04% for both 2020 and 2019.

The overall credit quality improved in 2020 compared to 2019 primarily due to a reduction in nonaccrual loans of \$5.1 million, loans 90 days and still accruing of \$522 thousand and OREO of \$74 thousand. In addition, accruing TDRs declined \$504 thousand when comparing 2020 to 2019 which reflects continued workout efforts on outstanding problem loans. When comparing 2020 to 2019 loan risk categories, substandard and special mention loans decreased \$2.5 million and \$2.1 million, respectively. The decrease in substandard and special mention loans was primarily due to property sales, payoffs and credit risk rating upgrades during 2020. Pass/Watch loans increased \$41.3 million during 2020 when compared to 2019 due to specific industry loans being added due to the impact of the pandemic. These loans consisted of hospitality, restaurants, retail stores and other commercial loans. Management will continue to monitor and charge off nonperforming assets as rapidly as possible, and focus on the generation of healthy loan growth and new business development opportunities.

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

	2020		2019	
	Net (charge-offs) recoveries	Percentage of net charge-offs (annualized) to average loans outstanding during the year	Net (charge-offs) recoveries	Percentage of net charge-offs (annualized) to average loans outstanding during the year
(Dollars in thousands)				
Construction	\$ 17	(0.02)%	\$ 15	(0.01)%
Residential real estate	10	-	(619)	0.14
Commercial real estate	(600)	0.10	206	(0.04)
Commercial	36	(0.02)	(106)	0.10
Consumer	18	(0.07)	(32)	0.29
Total	\$ (519)	0.04 %	\$ (536)	0.04 %
Average loans outstanding during the period	\$ 1,368,887		\$ 1,226,361	
Allowance for credit losses at period end as a percentage of total period end loans ⁽¹⁾		0.95 %		0.84 %
Allowance for credit losses at period end as a percentage of average loans ⁽²⁾		1.01 %		0.86 %
Allowance for credit losses at period end as a percentage of period end nonaccrual loans		254.59 %		99.22 %

(1) As of December 31, 2020, this ratio includes PPP loans of \$122.9 million. Excluding these loans, the ratio is 1.04% for December 31, 2020.

(2) As of December 31, 2020, this ratio includes average PPP loans of \$85.6 million. Excluding these loans, the ratio is 1.08% for December 31, 2020.

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

(Dollars in thousands)	2020		2019	
	Amount	% of Loans	Amount	% of Loans
Construction	\$ 1,937	7.3 %	\$ 1,576	8.0 %
Residential real estate	3,338	30.5	2,501	35.4
Commercial real estate	5,872	45.5	4,032	47.0
Commercial	2,089	14.5	1,929	8.2
Consumer	652	2.2	469	1.4
Total	<u>\$ 13,888</u>	<u>100.0 %</u>	<u>\$ 10,507</u>	<u>100.0 %</u>

At December 31, 2020, nonperforming assets were \$6.3 million, a decrease of \$5.7 million, or 47.8%, when compared to December 31, 2019. The decrease in nonperforming assets was due to diligent workout efforts by the Company to reduce nonaccrual loans and other real estate owned properties. Accruing TDRs were \$7.0 million at December 31, 2020, a decrease of \$504 thousand, or 6.7%, when compared to December 31, 2019. At December 31, 2020, the ratio of nonaccrual loans to total assets was 0.28%, a decrease from 0.68% at December 31, 2019. The ratio of accruing TDRs to total assets at December 31, 2020 was 0.36% improving from 0.48% at December 31, 2019.

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

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

(Dollars in thousands)	2020	2019
Nonperforming assets		
Nonaccrual loans	\$ 5,455	\$ 10,590
Total loans 90 days or more past due and still accruing	804	1,326
Other real estate owned	—	74
Total nonperforming assets	<u>\$ 6,259</u>	<u>\$ 11,990</u>
Total accruing TDRs		
	<u>\$ 6,997</u>	<u>\$ 7,501</u>
As a percent of total loans:		
Nonaccrual loans	0.38 %	0.85 %
Accruing TDRs	0.48 %	0.60 %
Nonaccrual loans and accruing TDRs	0.86 %	1.45 %
As a percent of total loans and other real estate owned:		
Nonperforming assets	0.43 %	0.96 %
Nonperforming assets and accruing TDRs	0.91 %	1.56 %
As a percent of total assets:		
Nonaccrual loans	0.28 %	0.68 %
Nonperforming assets	0.32 %	0.77 %
Accruing TDRs	0.36 %	0.48 %
Nonperforming assets and accruing TDRs	0.69 %	1.25 %

Market Risk Management and Interest Sensitivity

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

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

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

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

The statement of condition is subject to quarterly testing for six alternative interest rate shock possibilities to indicate the inherent interest rate risk. Average interest rates are shocked by +/- 100, 200, 300 and 400 basis points ("bp"), although the Company may elect not to use particular scenarios that it determines are impractical in a current rate environment. It is management's goal to structure the balance sheet so that net interest earnings at risk over a twelve-month period and the economic value of equity at risk do not exceed policy guidelines at the various interest rate shock levels.

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

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

The following tables present the projected change in the Bank's net interest income and EVE at December 31, 2020 and 2019 that would occur upon an immediate change in interest rates based on independent analysis, but without giving effect to any steps that management might take to counteract that change:

Estimated Changes in Net Interest Income

Change in Interest Rates:	+400 bp	+300 bp	+200 bp	+100 bp	-100 bp	-200 bp
Policy Limit	40 %	30 %	20 %	10 %	(10)%	(20)%
December 31, 2020	23.5 %	18.1 %	12.6 %	6.9 %	(3.9)%	(4.8)%
December 31, 2019	8.1 %	6.3 %	4.5 %	2.4 %	(7.7)%	(13.2)%

Estimated Changes in Economic Value of Equity

Change in Interest Rates:	+400 bp	+300 bp	+200 bp	+100 bp	-100 bp	-200 bp
Policy Limit	25 %	20 %	15 %	10 %	(20)%	(35)%
December 31, 2020	13.9 %	12.0 %	10.0 %	6.9 %	(16.7)%	(18.5)%
December 31, 2019	(3.6)%	(1.2)%	1.3 %	1.4 %	(7.7)%	(20.9)%

As with any method of measuring interest rate risk, certain shortcomings are inherent in the method of analysis presented in the foregoing tables. For example, although certain assets and liabilities may have similar maturities or periods to repricing, they may react in different degrees to changes in market interest rates. Also, the interest rates on certain types of assets and liabilities may fluctuate in advance of changes in market interest rates, while interest rates on other types may lag behind changes in market rates. Additionally, certain assets, such as adjustable rate mortgage loans, have features which restrict changes in interest rates on a short-term basis and over the life of the asset. Further, if interest rates change, expected rates of prepayments on loans and early withdrawals from certificates of deposit could deviate significantly from those assumed in calculating the tables.

Off-Balance Sheet Arrangements

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

Commitments to extend credit are agreements to lend to a customer as long as there is no violation of any condition established in the contract. Letters of credit are conditional commitments issued by the Bank to guarantee the performance of a customer to a third party. Letters of credit and other commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. Because many of the letters of credit and commitments are expected to expire without being drawn upon, the total commitment amount does not necessarily represent future cash requirements. Further information about these arrangements is provided in Note 21 to the Consolidated Financial Statements.

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

Liquidity Management

Liquidity describes our ability to meet financial obligations that arise during the normal course of business. Liquidity is primarily needed to meet the borrowing and deposit withdrawal requirements of customers and to fund current and planned expenditures. Liquidity is derived through increased customer deposits, maturities in the investment portfolio, loan repayments and income from earning assets. To the extent that deposits are not adequate to fund customer loan demand, liquidity needs can be met in the short-term funds markets. We have arrangements with correspondent banks whereby we

have \$15 million available in federal funds lines of credit and a reverse repurchase agreement available to meet any short-term needs which may not otherwise be funded by the Bank's portfolio of readily marketable investments that can be converted to cash. The Bank is also a member of the FHLB, which provides another source of liquidity, and had credit availability of approximately \$316.7 million from the FHLB as of December 31, 2020.

At December 31, 2020, our loan to deposit ratio was approximately 85.5%, lower than the 93.1% at year-end 2019. This decrease is the result of our excess liquidity position due to our deposits increasing \$359.4 million, or 26.8% since year end 2019. Investment securities available for sale totaling \$139.6 million at the end of 2020 were available for the management of liquidity and interest rate risk. The comparable amount was \$122.8 million at December 31, 2019. Cash and cash equivalents were \$186.9 million at December 31, 2020, an increase of \$91.9 million, or 96.8%, compared to the \$95.0 million at year-end 2019, which reflects the increase in deposits during 2020. Management is not aware of any demands, commitments, events or uncertainties that will materially affect our ability to maintain liquidity at satisfactory levels.

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

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

Item 8. Financial Statements and Supplementary Data.

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MANAGEMENT'S REPORT ON INTERNAL CONTROL OVER FINANCIAL REPORTING

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

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

Management assessed the effectiveness of the Company's internal control over financial reporting as of December 31, 2020 based upon criteria set forth in Internal Control – Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (2013 COSO Framework).

Based on this assessment and on the foregoing criteria, management has concluded that, as of December 31, 2020, the Company's internal control over financial reporting is effective. This annual report does not include an attestation report of the Company's independent registered public accounting firm, regarding internal control over financial reporting. Management's report was not subject to attestation by the Company's registered public accounting firm pursuant to rules of the Securities and Exchange Commission that permit the Company to provide only management's report in its annual report.

March 26, 2021

/s/ Lloyd L. Beatty, Jr.

Lloyd L. Beatty, Jr.
President and Chief Executive Officer
(Principal Executive Officer)

/s/ Edward C. Allen

Edward C. Allen
Executive Vice President and Chief Financial Officer
(Principal Financial Officer)



Report of Independent Registered Public Accounting Firm

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

Opinion on the Financial Statements

We have audited the accompanying consolidated balance sheets of Shore Bancshares, Inc. and its subsidiary (the Company) as of December 31, 2020 and 2019, the related consolidated statements of income, comprehensive income, changes in stockholders' equity, and cash flows for the years then ended, and the related notes to the consolidated financial statements (collectively, the financial statements). In our opinion, the financial statements present fairly, in all material respects, the financial position of the Company as of December 31, 2020 and 2019, and the results of its operations and its cash flows for the years then ended, in conformity with accounting principles generally accepted in the United States of America.

Basis for Opinion

These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on the Company's financial statements based on our audits. We are a public accounting firm registered with the Public Company Accounting Oversight Board (United States) (PCAOB) and are required to be independent with respect to the Company in accordance with U.S. federal securities laws and the applicable rules and regulations of the Securities and Exchange Commission and the PCAOB.

We conducted our audits in accordance with the standards of the PCAOB. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether due to error or fraud. The Company is not required to have, nor were we engaged to perform, an audit of its internal control over financial reporting. As part of our audits we are required to obtain an understanding of internal control over financial reporting but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control over financial reporting. Accordingly, we express no such opinion.

Our audits included performing procedures to assess the risks of material misstatement of the financial statements, whether due to error or fraud, and performing procedures that respond to those risks. Such procedures included examining, on a test basis, evidence regarding the amounts and disclosures in the financial statements. Our audits also included evaluating the accounting principles used and significant estimates made by management, as well as evaluating the overall presentation of the financial statements. We believe that our audits provide a reasonable basis for our opinion.

Critical Audit Matter

The critical audit matter communicated below is a matter arising from the current period audit of the financial statements that was communicated or required to be communicated to the audit committee and that: (1) relates to accounts or disclosures that are material to the financial statements and (2) involved our especially challenging, subjective, or complex judgments. The communication of critical audit matters does not alter in any way our opinion on the financial statements, taken as a whole, and we are not, by communicating the critical audit matter below, providing a separate opinion on the critical audit matter or on the accounts or disclosures to which it relates.

Allowance for Loan Losses – Qualitative Formula Allowance

As described in Note 1 (Summary of Significant Accounting Policies) and Note 3 (Loans and Allowance for Credit Losses) to the consolidated financial statements, the Company maintains an allowance for credit losses to provide for probable losses inherent in the loan portfolio, which totaled \$13,888,000 at December 31, 2020. The Company's allowance for credit losses consists of three components: (i) the specific allowance; (ii) the historical formula allowance; and (iii) the qualitative formula allowance. For loans that are not individually evaluated for impairment, the qualitative formula allowance uses various qualitative factors to develop loss percentages which are applied to the loan portfolio, by loan pool, based on management's assessment of shared risk characteristics within groups of similar loans. The qualitative formula allowance is determined based on management's continuing evaluation of internal and external factors (described in Note 1), which may impact the underlying quality of the loan portfolio.

Management exercised significant judgment when assessing the factors which serve as the basis for the qualitative formula allowance component of the allowance for credit losses estimate. We identified the assessment of those qualitative factors and the determination of the qualitative formula allowance as a critical audit matter as auditing the qualitative factors and the resultant qualitative formula allowance involved especially complex and subjective auditor judgment in evaluating management's assessment of the inherently subjective estimates.

How We Addressed the Matter in Our Audit

The primary audit procedures we performed to address this critical audit matter included:

- Substantively testing management's process, including evaluating their judgments and assumptions for developing the qualitative formula allowance, which included:
 - Evaluating the completeness and accuracy of data inputs used as a basis for the qualitative factors.
 - Evaluating the reasonableness of management's judgments related to the determination of qualitative factors.
 - Evaluating the qualitative factors for directional consistency and for reasonableness.
 - Testing the mathematical accuracy of the allowance calculation, including the application of the qualitative factors.

/s/ Yount, Hyde & Barbour, P.C.

We have served as the Company's auditor since 2017.

Winchester, Virginia
March 26, 2021

SHORE BANCSHARES, INC.
CONSOLIDATED BALANCE SHEETS
December 31,

(In thousands, except share and per share data)	2020	2019
ASSETS		
Cash and due from banks	\$ 16,666	\$ 18,465
Interest-bearing deposits with other banks	170,251	76,506
Cash and cash equivalents	186,917	94,971
Investment securities:		
Available-for-sale, at fair value	139,568	122,791
Held to maturity, at amortized cost - fair value of \$65,828 (2020) and \$8,654 (2019)	65,706	8,786
Equity securities, at fair value	1,395	1,342
Restricted securities	3,626	4,190
Loans	1,454,256	1,248,654
Less: allowance for credit losses	(13,888)	(10,507)
Loans, net	1,440,368	1,238,147
Premises and equipment, net	24,924	23,821
Goodwill	17,518	17,518
Other intangible assets, net	1,719	2,252
Other real estate owned, net	—	74
Right-of-use assets	4,795	4,771
Other assets	46,779	40,572
TOTAL ASSETS	\$ 1,933,315	\$ 1,559,235
LIABILITIES		
Deposits:		
Noninterest-bearing	\$ 509,091	\$ 356,618
Interest-bearing	1,191,614	984,716
Total deposits	1,700,705	1,341,334
Securities sold under retail repurchase agreements	1,050	1,226
Advances from FHLB - long-term	—	15,000
Subordinated debt	24,429	—
Total borrowings	25,479	16,226
Lease liabilities	4,874	4,792
Other liabilities	7,238	4,081
TOTAL LIABILITIES	1,738,296	1,366,433
COMMITMENTS AND CONTINGENCIES		
STOCKHOLDERS' EQUITY		
Common stock, par value \$.01 per share; shares authorized - 35,000,000; shares issued and outstanding - 11,783,380 (2020) and 12,500,372 (2019)	118	125
Additional paid in capital	52,167	61,045
Retained earnings	141,205	131,425
Accumulated other comprehensive income	1,529	207
TOTAL STOCKHOLDERS' EQUITY	195,019	192,802
TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY	\$ 1,933,315	\$ 1,559,235

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

SHORE BANCSHARES, INC.
CONSOLIDATED STATEMENTS OF INCOME
For the Years Ended December 31,

(In thousands, except per share data)	2020	2019
INTEREST INCOME		
Interest and fees on loans	\$ 56,420	\$ 55,391
Interest and dividends on investment securities:		
Taxable	2,997	3,582
Interest on deposits with other banks	260	794
Total interest income	<u>59,677</u>	<u>59,767</u>
INTEREST EXPENSE		
Interest on deposits	6,440	8,726
Interest on short-term borrowings	5	481
Interest on long-term borrowings	635	429
Total interest expense	<u>7,080</u>	<u>9,636</u>
NET INTEREST INCOME	<u>52,597</u>	<u>50,131</u>
Provision for credit losses	3,900	700
NET INTEREST INCOME AFTER PROVISION FOR CREDIT LOSSES	<u>48,697</u>	<u>49,431</u>
NONINTEREST INCOME		
Service charges on deposit accounts	2,839	3,910
Trust and investment fee income	1,558	1,522
Gains on sales and calls of investment securities	347	—
Other noninterest income	6,005	4,588
Total noninterest income	<u>10,749</u>	<u>10,020</u>
NONINTEREST EXPENSE		
Salaries and wages	14,935	15,413
Employee benefits	6,461	5,283
Occupancy expense	2,919	2,758
Furniture and equipment expense	1,224	1,107
Data processing	4,288	3,790
Directors' fees	504	479
Amortization of other intangible assets	533	605
FDIC insurance premium expense	485	344
Other real estate owned expenses, net	56	425
Legal and professional fees	2,296	2,223
Other noninterest expenses	4,698	5,130
Total noninterest expense	<u>38,399</u>	<u>37,557</u>
Income from continuing operations before income taxes	21,047	21,894
Income tax expense	5,317	5,610
Income from continuing operations	<u>15,730</u>	<u>16,284</u>
Loss from discontinued operations before income taxes	—	(113)
Income tax benefit	—	(27)
Loss from discontinued operations	<u>—</u>	<u>(86)</u>
NET INCOME	<u>\$ 15,730</u>	<u>\$ 16,198</u>
Earnings per common share - Basic and diluted		
Income from continuing operations	\$ 1.27	\$ 1.28
Loss from discontinued operations	—	(0.01)
Net income	<u>\$ 1.27</u>	<u>\$ 1.27</u>
Dividends paid per common share	<u>\$ 0.48</u>	<u>\$ 0.42</u>

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

SHORE BANCSHARES, INC.
CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME
For the Years Ended December 31,

(In thousands)	2020	2019
Net income	<u>\$ 15,730</u>	<u>\$ 16,198</u>
Other comprehensive income:		
Investment securities:		
Unrealized holding gains on available-for-sale-securities	2,151	4,314
Tax effect	(581)	(1,178)
Reclassification of (gains) recognized in net income	(347)	—
Tax effect	88	—
Amortization of unrealized loss on securities transferred from available-for-sale to held-to-maturity	15	29
Tax effect	(4)	(8)
Total other comprehensive income	<u>1,322</u>	<u>3,157</u>
Comprehensive income	<u>\$ 17,052</u>	<u>\$ 19,355</u>

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

SHORE BANCSHARES, INC.
CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY
For the Years Ended December 31, 2020 and 2019

(In thousands)	Common Stock	Additional Paid in Capital	Retained Earnings	Accumulated Other Comprehensive Income	Total Stockholders' Equity
Balances, January 1, 2020	\$ 125	\$ 61,045	\$ 131,425	\$ 207	\$ 192,802
Net income	—	—	3,118	—	3,118
Other comprehensive income	—	—	—	1,251	1,251
Stock-based compensation	—	61	—	—	61
Vesting of restricted stock, net of shares surrendered	—	(39)	—	—	(39)
Cash dividends declared	—	—	(1,499)	—	(1,499)
Balances, March 31, 2020	<u>\$ 125</u>	<u>\$ 61,067</u>	<u>\$ 133,044</u>	<u>\$ 1,458</u>	<u>\$ 195,694</u>
Net Income	—	—	5,335	—	5,335
Other comprehensive income	—	—	—	546	546
Stock-based compensation	—	62	—	—	62
Cash dividends declared	—	—	(1,503)	—	(1,503)
Balances, June 30, 2020	<u>\$ 125</u>	<u>\$ 61,129</u>	<u>\$ 136,876</u>	<u>\$ 2,004</u>	<u>\$ 200,134</u>
Net Income	—	—	3,391	—	3,391
Other comprehensive (loss)	—	—	—	(100)	(100)
Retirement of common stock	(3)	(3,106)	—	—	(3,109)
Stock-based compensation	—	67	—	—	67
Cash dividends declared	—	—	(1,502)	—	(1,502)
Balances, September 30, 2020	<u>\$ 122</u>	<u>\$ 58,090</u>	<u>\$ 138,765</u>	<u>\$ 1,904</u>	<u>\$ 198,881</u>
Net Income	—	—	3,886	—	3,886
Other comprehensive (loss)	—	—	—	(375)	(375)
Retirement of common stock	(4)	(5,999)	—	—	(6,003)
Stock-based compensation	—	73	—	—	73
Cash dividends declared	—	—	(1,446)	—	(1,446)
Exercise of options	—	3	—	—	3
Balances, December 31, 2020	<u>\$ 118</u>	<u>\$ 52,167</u>	<u>\$ 141,205</u>	<u>\$ 1,529</u>	<u>\$ 195,019</u>

(In thousands)	Common Stock	Additional Paid in Capital	Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Total Stockholders' Equity
Balances, January 1, 2019	\$ 127	\$ 65,434	\$ 120,574	\$ (2,950)	\$ 183,185
Net Income	—	—	3,754	—	3,754
Other comprehensive income	—	—	—	1,446	1,446
Stock-based compensation	—	63	—	—	63
Exercise of options and vesting of restricted stock, net of shares surrendered	1	(89)	—	—	(88)
Cash dividends declared	—	—	(1,278)	—	(1,278)
Balances, March 31, 2019	<u>\$ 128</u>	<u>\$ 65,408</u>	<u>\$ 123,050</u>	<u>\$ (1,504)</u>	<u>\$ 187,082</u>
Net Income	—	—	4,224	—	4,224
Other comprehensive income	—	—	—	1,311	1,311
Stock-based compensation	—	(32)	—	—	(32)
Cash dividends declared	—	—	(1,278)	—	(1,278)
Balances, June 30, 2019	<u>\$ 128</u>	<u>\$ 65,376</u>	<u>\$ 125,996</u>	<u>\$ (193)</u>	<u>\$ 191,307</u>
Net Income	—	—	4,206	—	4,206
Other comprehensive income	—	—	—	226	226
Retirement of common stock	(1)	(558)	—	—	(559)
Stock-based compensation	—	61	—	—	61
Cash dividends declared	—	—	(1,278)	—	(1,278)
Balances, September 30, 2019	<u>\$ 127</u>	<u>\$ 64,879</u>	<u>\$ 128,924</u>	<u>\$ 33</u>	<u>\$ 193,963</u>
Net Income	—	—	4,014	—	4,014
Other comprehensive income	—	—	—	174	174
Retirement of common stock	(2)	(3,891)	—	—	(3,893)
Stock-based compensation	—	57	—	—	57
Cash dividends declared	—	—	(1,513)	—	(1,513)
Balances, December 31, 2019	<u>\$ 125</u>	<u>\$ 61,045</u>	<u>\$ 131,425</u>	<u>\$ 207</u>	<u>\$ 192,802</u>

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

SHORE BANCSHARES, INC.
CONSOLIDATED STATEMENTS OF CASH FLOWS
For the Years Ended December 31,

(In thousands)	2020	2019
CASH FLOWS FROM OPERATING ACTIVITIES:	\$ 15,730	\$ 16,198
Net Income		
Adjustments to reconcile net income to net cash provided by operating activities:		
Net accretion of acquisition accounting estimates	(330)	(468)
Provision for credit losses	3,900	700
Depreciation and amortization	2,476	2,393
Net amortization of securities	513	512
Amortization of debt issuance costs	40	—
Stock-based compensation expense	263	149
Deferred income (benefit) tax expense	(2,185)	241
(Gains) on sales and calls of securities	(347)	—
Losses on sales and disposals of premises and equipment	41	—
Losses on sales and valuation adjustments on other real estate owned	56	417
Fair value adjustment on equity securities	(28)	(42)
Net changes in:		
Accrued interest receivable	(3,161)	(110)
Cash surrender values on compensation plans	(917)	(443)
Other assets	(255)	2,304
Accrued interest payable	317	(274)
Other liabilities	2,317	(7,834)
Net cash provided by operating activities	<u>18,430</u>	<u>13,743</u>
CASH FLOWS FROM INVESTING ACTIVITIES:		
Proceeds from maturities and principal payments of investment securities available for sale	45,329	35,447
Proceeds from sales and calls of investment securities available for sale	13,019	—
Purchases of investment securities available for sale	(73,450)	—
Proceeds from maturities and principal payments of investment securities held to maturity	244	1,282
Purchases of securities held to maturity	(57,186)	(4,000)
Purchases of equity securities	(25)	(31)
Net change in loans	(205,901)	(53,528)
Purchases of premises and equipment	(2,375)	(2,244)
Proceeds from sales of premises and equipment	2	—
Proceeds from sales of other real estate owned	18	731
Net redemption of restricted securities	564	2,286
Purchases of bank owned life insurance	(319)	(25,621)
Net cash (used in) investing activities	<u>(280,080)</u>	<u>(45,678)</u>
CASH FLOWS FROM FINANCING ACTIVITIES:		
Net changes in:		
Noninterest-bearing deposits	152,473	26,152
Interest-bearing deposits	207,008	103,002
Short-term borrowings	(176)	(59,586)
Long-term borrowings	(15,000)	—
Proceeds from the issuance of subordinated debt, net of issuance costs	24,389	—
Common stock dividends paid	(5,950)	(5,347)
Retirement of common stock	(9,112)	(4,452)
Repurchase of shares for tax withholding on exercised options and vested restricted stock	(39)	(88)
Stock options exercised	3	—
Net cash provided by financing activities	<u>353,596</u>	<u>59,681</u>
Net increase in cash and cash equivalents	<u>91,946</u>	<u>27,746</u>
Cash and cash equivalents at beginning of period	<u>94,971</u>	<u>67,225</u>
Cash and cash equivalents at end of period	<u>\$ 186,917</u>	<u>\$ 94,971</u>
Supplemental cash flows information:		
Interest paid	<u>\$ 6,833</u>	<u>\$ 10,071</u>
Income taxes paid	<u>\$ 7,935</u>	<u>\$ 11,920</u>
Lease liabilities arising from right-of-use assets	<u>\$ 605</u>	<u>\$ 5,243</u>
Unrealized gain on securities available for sale	<u>\$ 1,804</u>	<u>\$ 4,314</u>
Amortization of unrealized loss on securities transferred from available for sale to held to maturity	<u>\$ 15</u>	<u>\$ 29</u>

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

NOTE 1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

The consolidated financial statements include the accounts of Shore Bancshares, Inc. and its subsidiary (collectively referred to in these Notes as the “Company”), with all significant intercompany transactions eliminated. The investment in subsidiary is recorded on the Company’s books (Parent only) on the basis of its equity in the net assets of the subsidiary. The accounting and reporting policies of the Company conform to accounting principles generally accepted in the United States of America (“GAAP”). For purposes of comparability, certain reclassifications have been made to amounts previously reported to conform with the current period presentation. Reclassifications had no effect on prior year net income or stockholders’ equity.

Nature of Operations

The Company engages in the banking business through Shore United Bank, a Maryland commercial bank with trust powers. The Company’s primary source of revenue is interest earned on commercial, real estate and consumer loans made to customers located in Maryland, Delaware and the Eastern Shore of Virginia. The Company engages in the trust services business through the trust department at Shore United Bank under the trade name Wye Financial Partners.

Use of Estimates

The preparation of financial statements requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities as of the date of the financial statements, and affect the reported amounts of revenues earned and expenses incurred during the reporting period. Actual results could differ from those estimates. Estimates that could change significantly relate to the determination of the allowance for loan losses, and the subsequent evaluation of goodwill for impairment.

Investment Securities Available for Sale

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

Investment Securities Held to Maturity

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

Equity Securities

Equity securities with readily determinable fair values are carried at fair value, with changes in fair value reported in net income. Any equity securities without readily determinable fair values are carried at cost, minus impairment, if any, plus or minus changes resulting from observable price changes in orderly transactions for identical or similar investments. Restricted equity securities are carried at cost and are periodically evaluated for impairment based on the ultimate recovery of par value. The entirety of any impairment on equity securities is recognized in earnings.

Loans

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

A loan is considered impaired if it is probable that the Company will not collect all principal and interest payments according to the loan's contractual terms when due. An impaired loan may show deficiencies in the borrower's overall financial condition, payment history, support available from financial guarantors and/or the fair market value of collateral. The impairment of a loan is measured at the present value of expected future cash flows using the loan's effective interest rate, or at the loan's observable market price or the fair value of the collateral if the loan is collateral dependent. Generally, the Company measures impairment on such loans by reference to the fair value of the collateral or the present value of expected future cash flows. Once the amount of impairment has been determined, the uncollectible portion is charged off. Income on nonaccrual impaired loans is recognized on a cash basis, and payments are first applied against the principal balance outstanding (i.e., placing impaired loans on nonaccrual status). Generally, interest income is not recognized on impaired loans unless the likelihood of further loss is remote or the impairment analysis yielded no impairment for the loan. The allowance for credit losses may include specific reserves related to impaired loans. Specific reserves remain until charge offs are made. Reserves for probable credit losses related to these loans are based on historical loss ratios and an analysis of qualitative factors and are included in the formula portion of the allowance for credit losses. See additional discussion below under the section, "Allowance for Credit Losses".

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

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

in any specific government or Company sponsored loan modification programs. All TDR loan agreements are contracts negotiated with each of the borrowers.

Allowance for Credit Losses

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

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

Three basic components comprise our allowance for credit losses: (i) the specific allowance; (ii) the historical formula allowance; and (iii) the qualitative formula allowance. Each component is determined based on estimates that can and do change when the actual events occur. The specific allowance is established against impaired loans based on our assessment of the losses that may be associated with the individual loans. The specific allowance remains until charge-offs are made or the metrics underlying the impairment calculation change. An impaired loan may show deficiencies in the borrower's overall financial condition, payment history, support available from financial guarantors and/or the fair market value of collateral.

The historical formula allowance is used to estimate the loss on internally risk-rated loans, exclusive of those identified as impaired. Loans are grouped by type (construction, residential real estate, commercial real estate, commercial or consumer) and similar risk characteristics. Each loan pool is assigned allowance factors based on management's estimate of the risk, complexity and size of individual loans within a particular category using average historical charge-offs by segment over the last 16 quarters. Loans identified as pass-watch, special mention, substandard, and doubtful are considered to have elevated credit risk. These loans are assigned higher allowance factors than favorably rated loans due to management's concerns regarding collectability or management's knowledge of particular elements regarding the borrower. The qualitative formula allowance captures losses that have impacted the portfolio but have yet to be recognized in either the specific or historical formula allowance. A pass-watch loan has adequate risk and may include loans which may have been upgraded from another higher risk category. A special mention loan has potential weaknesses that could result in a future loss to the Company if the weaknesses are realized. A substandard loan has certain deficiencies that could result in a future loss to the Company if these deficiencies are not corrected. A doubtful loan has enough risk that there is a high probability that the Company will sustain a loss.

The qualitative formula allowance is used to adjust the historical formula allowance to an amount that is reflective of the probable losses inherent in the loan portfolio. The qualitative formula allowance is established through the evaluation of various qualitative factors which are used to develop loss percentages that are applied to the identified pools of loans that are not individually evaluated for impairment. Management has significant discretion in making the adjustments inherent in the determination of the provision and allowance for credit losses, including the establishment of the allowance factors in the qualitative formula allowance component of the allowance. The establishment of the qualitative factors used in the qualitative formula allowance is a continuing exercise, based on management's ongoing assessment of the totality of all factors, including, but not limited to, delinquencies, loss history, effects of changes in lending policy, the experience and depth of management, national and local economic trends, concentrations of credit, the quality of the loan review system and the effect of other factors as deemed appropriate, and their impact on the portfolio. Allowance factors may change from period to period, resulting in an increase or decrease in the amount of the provision or allowance, based on the same volume and classification of loans. Changes in allowance factors will have a direct impact on the amount of the provision, and a corresponding effect on net income. Errors in management's perception and assessment of these factors and their impact on the portfolio could result in the allowance not being adequate to cover losses in the portfolio, and may result in additional provisions or charge-offs.

Premises and Equipment

Land is carried at cost and premises and equipment are stated at cost less accumulated depreciation and amortization. Depreciation and amortization are calculated using the straight-line method over the estimated useful lives of the assets. Useful lives range from three to 10 years for furniture, fixtures and equipment; three to five years for computer hardware and data handling equipment; and 10 to 40 years for buildings and building improvements. Land improvements are amortized over a period of 15 years and leasehold improvements are amortized over the term of the respective lease. Maintenance and repairs are charged to expense as incurred, while improvements which extend the useful life of an asset are capitalized and depreciated over the estimated remaining life of the asset.

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

Goodwill and Other Intangible Assets

Goodwill represents the excess of the cost of an acquisition over the fair value of the net assets acquired. Other intangible assets represent purchased assets that also lack physical substance but can be distinguished from goodwill because of contractual or other legal rights or because the asset is capable of being sold or exchanged either on its own or in combination with a related contract, asset or liability. Goodwill and other intangible assets are initially required to be recorded at fair value. Determining fair value is subjective, requiring the use of estimates, assumptions and management judgment.

Goodwill is tested at least annually for impairment, usually during the fourth quarter, or on an interim basis if circumstances dictate. Intangible assets that have finite lives are amortized over their estimated useful lives and also are subject to impairment testing.

Goodwill impairment testing requires a qualitative assessment or that the fair value of each of the Company's reporting units be compared to the carrying amount of its net assets, including goodwill. If the fair value of a reporting unit is less than book value, an expense may be required to write down the related goodwill to record an impairment loss. As of December 31, 2020, the Company had one reporting unit and operating segment (i.e., the Bank).

During 2020 and 2019, goodwill and other intangible assets were subjected to assessments for impairment. No impairment charges were recognized in either year. Our assessment of goodwill concluded it was not more likely that not that the fair value of the Company's reporting unit was less than its carrying amount.

Other Real Estate Owned

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

Borrowings

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

Subordinated Debt

Subordinated debt is carried at its outstanding principal balance, net of any unamortized issuance costs. For additional information on the Company's subordinated debt, refer to Note 11 of the Consolidated Financial Statements.

Income Taxes

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

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

The Company recognizes accrued interest and penalties as a component of tax expense.

The provision for income taxes includes the impact of reserve provisions and changes in the reserves that are considered appropriate as well as the related net interest and penalties. In addition, the Company is subject to the continuous examination of its income tax returns by the IRS and other tax authorities which may assert assessments against the Company. The Company regularly assesses the likelihood of adverse outcomes resulting from these examinations and assessments to determine the adequacy of its provision for income taxes. The Company remains subject to examination for tax years ending on or after December 31, 2017.

Basic and Diluted Earnings Per Common Share

Basic earnings per share is calculated by dividing net income available to common stockholders by the weighted-average number of common shares outstanding and does not include the effect of any potentially dilutive common stock equivalents. Included in this calculation due to dividend participation rights are restricted stock awards which have been

granted. Diluted earnings per share is calculated by dividing net income by the weighted-average number of shares outstanding, adjusted for the effect of any potentially dilutive common stock equivalents.

Transfers of Financial Assets

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

Cash and Cash Equivalents

Cash and due from banks, interest-bearing deposits with other banks and federal funds sold are considered “cash and cash equivalents” for financial reporting purposes. Certain interest-bearing deposits with banks may exceed balances that are recoverable under Federal Deposit Insurance (“FDIC”) insurance. Balances in excess of FDIC insurance at December 31, 2020 were approximately \$6.7 million.

Share-Based Compensation

The Company may grant share-based compensation to employees and non-employee directors in the form of restricted stock, restricted stock units and stock options. The fair value of restricted stock is determined based on the closing price of the Parent’s common stock on the date of grant. The Company recognizes compensation expense related to restricted stock on a straight-line basis over the vesting period for service-based awards. The fair value of RSUs is initially valued based on the closing price of the Parent’s common stock on the date of grant and is amortized in the statement of income over the vesting period. The RSUs are subsequently remeasured in each reporting period until settlement based on the quantity of awards for which it is probable that the performance conditions will be achieved. The fair value of stock options is estimated at the date of grant using the Black-Scholes option pricing model and related assumptions. The Company uses historical data to predict option exercise and employee termination behavior. Expected volatilities are based on the historical volatility of the Parent’s common stock. The expected term of options granted is derived from actual historical exercise activity and represents the period of time that options granted are expected to be outstanding. The risk-free rate is derived from the U.S. Treasury yield curve in effect at the time of grant based on the expected life of the option. The dividend yield is equal to the dividend yield of the Parent’s common stock at the time of grant. Expense related to stock options is recorded in the statements of income as a component of salaries and benefits for employees and as a component of other noninterest expense for non-employee directors, with a corresponding increase to capital surplus in shareholders’ equity.

Fair Value

The Company measures certain financial assets and liabilities at fair value, with the measurements made on a recurring or nonrecurring basis. Financial instruments measured at fair value on a recurring basis are investment securities available for sale and equity securities with readily determinable fair values. Impaired loans and other real estate owned are financial instruments measured at fair value on a nonrecurring basis. Fair value is defined as the exchange price that would be received for an asset or paid to transfer a liability (an exit price) in the principal or most advantageous market for the asset or liability in an orderly transaction between market participants on the measurement date. In determining fair value, the Company is required to maximize the use of observable inputs and minimize the use of unobservable inputs, reducing subjectivity. See Note 20 for a further discussion of fair value.

Advertising Costs

Advertising costs are generally expensed as incurred. The Company incurred advertising costs for continuing operations of approximately \$331 thousand for the year ended December 31, 2020 and \$425 thousand for the year ended December 31, 2019.

Comprehensive Income

Comprehensive income consists of net income and other comprehensive income. Other comprehensive income consists of unrealized gains and losses on available-for-sale securities net of any gains recognized from the sale of available-for-sale securities and the amortization of unrealized losses on securities transferred from AFS to HTM. In 2020, the amount reclassified out of accumulated comprehensive income was a gain on available-for-sale securities of \$347 thousand. The related tax effect for the reclassification was \$88 thousand. There were no reclassifications from accumulated other comprehensive income in 2019.

Recent Accounting Standards and Other Authoritative Guidance

ASU No. 2016-13 – In June 2016, the FASB issued ASU No. 2016-13, “Financial Instruments – Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments.” The amendments in this ASU, among other things, require the measurement of all expected credit losses for financial assets held at the reporting date based on historical experience, current conditions, and reasonable and supportable forecasts. Financial institutions and other organizations will now use forward-looking information to better inform their credit loss estimates. Many of the loss estimation techniques applied today will still be permitted, although the inputs to those techniques will change to reflect the full amount of expected credit losses. In addition, the ASU amends the accounting for credit losses on available-for-sale debt securities and purchased financial assets with credit deterioration. At the FASB’s October 16, 2019 meeting, the Board affirmed its decision to amend the effective date of this ASU for many companies. Public business entities that are SEC filers, excluding those meeting the smaller reporting company definition, will retain the initial required implementation date of fiscal years, and interim periods within those fiscal years, beginning after December 15, 2019. All other entities will be required to apply the guidance for fiscal years, and interim periods within those years, beginning after December 15, 2022. At this time, the Company has established a project management team which meets periodically to discuss and assign roles and responsibilities, key tasks to complete, and a general timeline to be followed for implementation. The team has been working with an advisory consultant and has purchased a vendor model for implementation. Historical data has been collected and uploaded to the new model and the team is in the process of finalizing the methodologies that will be utilized. The team is currently running a parallel simulation to its current incurred loss impairment model. The Company is continuing to evaluate the extent of the potential impact of this standard and continues to keep current on evolving interpretations and industry practices via webcasts, publications, conferences, and peer bank meetings.

Effective November 25, 2019, the SEC adopted Staff Accounting Bulletin (SAB) 119. SAB 119 updated portions of SEC interpretative guidance to align with FASB ASC 326, “Financial Instruments – Credit Losses.” It covers topics including (1) measuring current expected credit losses; (2) development, governance, and documentation of a systematic methodology; (3) documenting the results of a systematic methodology; and (4) validating a systematic methodology.

ASU No. 2019-12 – In December 2019, the FASB issued ASU 2019-12, “Income Taxes (Topic 740) – Simplifying the Accounting for Income Taxes.” The ASU is expected to reduce cost and complexity related to the accounting for income taxes by removing specific exceptions to general principles in Topic 740 (eliminating the need for an organization to analyze whether certain exceptions apply in a given period) and improving financial statement preparers’ application of certain income tax-related guidance. This ASU is part of the FASB’s simplification initiative to make narrow-scope simplifications and improvements to accounting standards through a series of short-term projects. For public business entities, the amendments are effective for fiscal years beginning after December 15, 2020, and interim periods within those fiscal years. Early adoption is permitted. The Company is currently assessing the impact that ASU 2019-12 will have on its consolidated financial statements.

ASU No. 2020-01 – In January 2020, the FASB issued ASU 2020-01, “Investments – Equity Securities (Topic 321), Investments – Equity Method and Joint Ventures (Topic 323), and Derivatives and Hedging (Topic 815) – Clarifying the Interactions between Topic 321, Topic 323, and Topic 815.” The ASU is based on a consensus of the Emerging Issues Task Force and is expected to increase comparability in accounting for these transactions. ASU 2016-01 made targeted improvements to accounting for financial instruments, including providing an entity the ability to measure certain equity securities without a readily determinable fair value at cost, less any impairment, plus or minus changes resulting from observable price changes in orderly transactions for the identical or a similar investment of the same issuer. Among other topics, the amendments clarify that an entity should consider observable transactions that require it to either apply or

discontinue the equity method of accounting. For public business entities, the amendments in the ASU are effective for fiscal years beginning after December 31, 2020, and interim periods within those fiscal years. Early adoption is permitted. The Company does not expect the adoption of ASU 2020-01 to have a material impact on its consolidated financial statements.

ASU No. 2020-04 – In March 2020, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) No. 2020-04 “Reference Rate Reform (Topic 848): Facilitation of the Effects of Reference Rate Reform on Financial Reporting.” These amendments provide temporary optional guidance to ease the potential burden in accounting for reference rate reform. The ASU provides optional expedients and exceptions for applying generally accepted accounting principles to contract modifications and hedging relationships, subject to meeting certain criteria, that reference the London Inter-bank Offered Rate (“LIBOR”) or another reference rate expected to be discontinued. It is intended to help stakeholders during the global market-wide reference rate transition period. The guidance is effective for all entities as of March 12, 2020 through December 31, 2022. At present, the Bank has limited exposure to LIBOR based pricing. LIBOR based loans only comprise 27 loans or 7.8% of the loan portfolio. The Bank is confident it can successfully negotiate a migration to the Secured Overnight Financing Rate (“SOFR”) between now and the implementation date. The Bank will notify customers within 120 days prior to migration to SOFR. The Bank acknowledges the replacement rate will be more volatile based on different countries migrating to different indexes and limited liquidity to support the rate. The Bank further acknowledges the volatility will be greatly influenced by the support provided by the Federal Reserve.

On March 12, 2020, the SEC finalized amendments to its “accelerated filer” and “large accelerated filer” definitions. The amendments increase the threshold criteria for meeting these filer classifications and were effective on April 27, 2020. Any changes in filer status are to be applied beginning with the filer’s first annual report filed with the SEC subsequent to the effective date. Prior to these changes, the Company was required to comply with section 404(b) of the Sarbanes Oxley Act concerning auditor attestation over internal control over financial reporting as an “accelerated filer” as it had more than \$75 million in public float but less than \$700 million at the end of the Company’s most recent second quarter. The rule change expands the category of “smaller reporting companies” to include entities with public float of less than \$700 million and less than \$100 million in annual revenues. The Company is now classified as a “smaller reporting company” and “nonaccelerated filer”. If the Company’s annual revenues exceed \$100 million, its category will change back to “accelerated filer”. The classifications of “accelerated filer” and “large accelerated filer” require a public company to obtain an auditor attestation concerning the effectiveness of internal control over financial reporting (“ICFR”) and include the opinion on ICFR in its annual report on Form 10-K. Smaller reporting companies also have additional time to file quarterly and annual financial statements. All public companies are required to obtain and file annual financial statement audits, as well as provide management’s assertion on effectiveness of internal control over financial reporting, but the external auditor attestation of internal control over financial reporting is not required for smaller reporting companies. As the Bank has total assets exceeding \$1.0 billion, it remains subject to FDICIA, which requires an auditor attestation concerning internal controls over financial reporting. As such, other than the additional time provided to file quarterly and annual financial statements, this change does not significantly change the Company’s annual reporting and audit requirements.

In October 2020, the FASB issued ASU 2020-08, “Codification Improvements to Subtopic 310-20, Receivables – Nonrefundable fees and Other Costs.” This ASU clarifies that an entity should reevaluate whether a callable debt security is within the scope of ASC paragraph 310-20-35-33 for each reporting period. For public business entities, the ASU is effective for fiscal years beginning after December 15, 2021, and interim periods within those fiscal years. Early adoption is not permitted. All entities should apply ASU No. 2020-08 on a prospective basis as of the beginning of the period of adoption for existing or newly purchased callable debt securities. The Company does not expect the adoption of ASU 2020-08 to have a material impact on its consolidated financial statements.

Recently Adopted Accounting Developments

In January 2017, the FASB issued ASU 2017-04, “Intangibles - Goodwill and Other (Topic 350) - Simplifying the Test for Goodwill Impairment” (“ASU 2017-04”). ASU 2017-04 simplifies the accounting for goodwill impairment for all entities by requiring impairment charges to be based on the first step in the previous two-step impairment test. Under the new guidance, if a reporting unit’s carrying amount exceeds its fair value, an entity will record an impairment charge based

on that difference. The impairment charge will be limited to the amount of goodwill allocated to that reporting unit. The standard eliminates the prior requirement to calculate a goodwill impairment charge using Step 2, which requires an entity to calculate any impairment charge by comparing the implied fair value of goodwill with its carrying amount. ASU 2017-04 was effective for the Company on January 1, 2020. There was no material impact on the Company's consolidated financial statements.

In March 2020, (Revised in April 2020) various regulatory agencies, including the Board of Governors of the CFPB System and the Federal Deposit Insurance Corporation, ("the agencies") issued an interagency statement on loan modifications and reporting for financial institutions working with customers affected by COVID-19. The interagency statement was effective immediately and impacted accounting for loan modifications. Under Accounting Standards Codification 310-40, "Receivables – Troubled Debt Restructurings by Creditors," ("ASC 310-40"), a restructuring of debt constitutes a troubled debt restructuring ("TDR") if the creditor, for economic or legal reasons related to the debtor's financial difficulties, grants a concession to the debtor that it would not otherwise consider. The agencies confirmed with the staff of the FASB that short-term modifications made on a good faith basis in response to COVID-19 to borrowers who were current prior to any relief, are not to be considered TDRs. This includes short-term (e.g., six months) modifications such as payment deferrals, fee waivers, extensions of repayment terms, or other delays in payment that are insignificant. Borrowers considered current are those that are less than 30 days past due on their contractual payments at the time a modification program is implemented. During 2020, the Company has offered payment deferrals for commercial and consumer customers for up to six months. The loan modifications offered to specific loan types are as follows:

- Full payment-balloon or full amortization loans – Once the deferral period has ended, the Company will go back to billing principal and interest. As payments are made, all funds will go towards interest until all accrued interest has been caught up. Once the accrued interest is satisfied, future payments will be broken out for both principal and interest. The amount of principal that had been deferred will be re-amortized when the balloon maturity/payoff date occurs.
- Full payment ARM loans – Once the deferral period has ended, the Company will go back to billing principal and interest. As payments are made, all funds will go towards interest until all accrued interest has been caught up. Once the accrued interest is satisfied, future payments will be broken out for both principal and interest. The amount of principal that had been deferred will be re-amortized when the ARM repricing occurs.
- Full Payment Rate Reset Loans - Once the deferral period has ended, the Company will go back to billing principal and interest. As payments are made, all funds will go towards interest until all accrued interest has been caught up. Once the accrued interest is satisfied, future payments will be broken out for both principal and interest. The amount of principal that had been deferred will be re-amortized when the rate reset occurs.
- Principal deferral only loans (any type) - Once the deferral period has ended, the Company will go back to billing principal and interest. The principal amount that has been deferred will be re-amortized when either the maturity, ARM repricing or rate reset occurs.
- Consumer loans – Borrowers are required to sign an amendment to the initial loan agreement at the time of deferral, which re-amortizes the loan and extends the maturity date based on the number of months deferred.

The interagency guidance along with the provisions of the CARES Act as further discussed in Note 3 to the Consolidated Financial Statements, impacted the Company's assessment of loan modifications in 2020.

NOTE 2. INVESTMENT SECURITIES

The following table provides information on the amortized cost and estimated fair values of investment securities at December 31, 2020 and 2019.

(Dollars in thousands)	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
Available-for-sale securities:				
2020				
U.S. Government agencies	\$ 23,600	\$ 20	\$ 83	\$ 23,537
Mortgage-backed	113,865	2,234	68	116,031
Total	<u>\$ 137,465</u>	<u>\$ 2,254</u>	<u>\$ 151</u>	<u>\$ 139,568</u>
2019				
U.S. Government agencies	\$ 23,854	\$ 3	\$ 31	\$ 23,826
Mortgage-backed	98,638	574	247	98,965
Total	<u>\$ 122,492</u>	<u>\$ 577</u>	<u>\$ 278</u>	<u>\$ 122,791</u>

During 2020, the Company sold available for sale securities for proceeds of \$13.0 million and recognized gross gains of \$347 thousand in the second quarter of 2020. No available for sale securities were sold during 2019.

(Dollars in thousands)	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
Held-to-maturity securities:				
2020				
U.S. Government agencies	\$ 18,893	\$ 38	\$ 43	\$ 18,888
Mortgage-backed	27,347	7	18	27,336
States and political subdivisions	400	1	—	401
Other debt securities	19,066	139	2	19,203
Total	<u>\$ 65,706</u>	<u>\$ 185</u>	<u>\$ 63</u>	<u>\$ 65,828</u>
2019				
U.S. Government agencies	\$ 1,386	\$ —	\$ 5	\$ 1,381
States and political subdivisions	400	1	—	401
Other debt securities	7,000	—	128	6,872
Total	<u>\$ 8,786</u>	<u>\$ 1</u>	<u>\$ 133</u>	<u>\$ 8,654</u>

Equity securities with an aggregate fair value of \$1.4 million at December 31, 2020 and \$1.3 million at December 31, 2019 are presented separately on the balance sheet. The fair value adjustment recorded through earnings totaled \$28 thousand for 2020 and \$42 thousand for 2019, respectively.

The following table provides information about gross unrealized losses and fair value by length of time that the individual securities have been in a continuous unrealized loss position at December 31, 2020 and 2019.

(Dollars in thousands)	Less than 12 Months		More than 12 Months		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
2020						
Available-for-sale securities:						
U.S. Government agencies	\$ 14,919	\$ 82	\$ 236	\$ 1	\$ 15,155	\$ 83
Mortgage-backed	11,869	68	—	—	11,869	68
Total	<u>\$ 26,788</u>	<u>\$ 150</u>	<u>\$ 236</u>	<u>\$ 1</u>	<u>\$ 27,024</u>	<u>\$ 151</u>
Held-to-maturity securities:						
U.S. Government agencies	\$ 6,646	\$ 43	\$ —	\$ —	\$ 6,646	\$ 43
Mortgage-backed	5,093	18	—	—	5,093	18
Other debt securities	498	2	—	—	498	2
Total	<u>\$ 12,237</u>	<u>\$ 63</u>	<u>\$ —</u>	<u>\$ —</u>	<u>\$ 12,237</u>	<u>\$ 63</u>
2019						
Available-for-sale securities:						
U.S. Government agencies	\$ 4,995	\$ 5	\$ 18,516	\$ 26	\$ 23,511	\$ 31
Mortgage-backed	12,180	27	22,282	220	34,462	247
Total	<u>\$ 17,175</u>	<u>\$ 32</u>	<u>\$ 40,798</u>	<u>\$ 246</u>	<u>\$ 57,973</u>	<u>\$ 278</u>
Held-to-maturity securities:						
U.S. Government agencies	\$ 1,381	\$ 5	\$ —	\$ —	\$ 1,381	\$ 5
Other debt securities	3,905	95	2,967	33	6,872	128
Total	<u>\$ 5,286</u>	<u>\$ 100</u>	<u>\$ 2,967</u>	<u>\$ 33</u>	<u>\$ 8,253</u>	<u>\$ 133</u>

All of the securities with unrealized losses in the portfolio have modest duration risk, low credit risk, and minimal losses when compared to total amortized cost. The unrealized losses on debt securities that exist are the result of market changes in interest rates since original purchase and are not related to credit concerns. Because the Company does not intend to sell these securities and it is not more likely than not that the Company will be required to sell these securities before recovery of their amortized cost bases, which may be at maturity for debt securities, the Company considers the unrealized losses to be temporary. There were seven available-for-sale securities in an unrealized loss position at December 31, 2020, of which four were mortgage-backed and three were U.S. Government agencies.

There were four held-to-maturity securities in an unrealized loss position at December 31, 2020, of which two were U.S. Government agency bonds, one corporate bond and one mortgage-backed security.

The following table provides information on the amortized cost and estimated fair values of investment securities by maturity date at December 31, 2020.

(Dollars in thousands)	Available for sale		Held to maturity	
	Amortized Cost	Fair Value	Amortized Cost	Fair Value
Due in one year or less	\$ 4,999	\$ 5,015	\$ —	\$ —
Due after one year through five years	1,393	1,431	2,944	2,957
Due after five years through ten years	57,061	58,419	27,728	27,818
Due after ten years	74,012	74,703	35,034	35,053
Total	<u>\$ 137,465</u>	<u>\$ 139,568</u>	<u>\$ 65,706</u>	<u>\$ 65,828</u>

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

The following table sets forth the amortized cost and estimated fair values of securities which have been pledged as collateral for obligations to federal, state and local government agencies, and other purposes as required or permitted by law, or sold under agreements to repurchase at December 31, 2020 and 2019. All pledged securities are in the available-for-sale investment portfolio.

(Dollars in thousands)	2020		2019	
	Amortized Cost	Fair Value	Amortized Cost	Fair Value
Pledged available-for-sale securities	<u>\$ 60,600</u>	<u>\$ 61,094</u>	\$ 66,904	\$ 67,142

There were no obligations of states or political subdivisions with carrying values, as to any issuer, exceeding 10% of stockholders' equity at December 31, 2020 or 2019.

NOTE 3. LOANS AND ALLOWANCE FOR CREDIT LOSSES

The Company makes residential mortgage, commercial and consumer loans to customers primarily in Baltimore City, Baltimore County, Howard County, Kent County, Queen Anne's County, Caroline County, Talbot County, Dorchester County and Worcester County in Maryland, Kent County, Delaware and in Accomack County, Virginia. The following table provides information about the principal classes of the loan portfolio at December 31, 2020 and 2019.

(Dollars in thousands)	2020	2019
Construction	<u>\$ 106,760</u>	\$ 99,829
Residential real estate	443,542	442,506
Commercial real estate	661,232	586,562
Commercial	211,256	102,020
Consumer	31,466	17,737
Total loans	<u>1,454,256</u>	1,248,654
Allowance for credit losses	<u>(13,888)</u>	(10,507)
Total loans, net	<u>\$ 1,440,368</u>	<u>\$ 1,238,147</u>

In the normal course of banking business, loans are made to officers and directors and their affiliated interests. These loans are made on substantially the same terms and conditions as those prevailing at the time for comparable transactions with persons who are not related to the Company and are not considered to involve more than the normal risk of collectability. As of December 31, 2020 and 2019, such loans outstanding, both direct and indirect (including guarantees), to directors, their associates and policy-making officers, totaled approximately \$3.7 million and \$18.8 million, respectively. During 2020 and 2019, loan additions were approximately \$701 thousand and \$15.7 million, respectively, and loan repayments were approximately \$776 thousand and \$8.6 million, respectively. Due to changes in the composition of related parties, \$15.0 million of loans included in the total for the prior year end were no longer reported as related party loans at December 31, 2020. Net loan origination costs, included in balances above, totaled \$622 thousand and \$1.8 million as of December 31, 2020 and 2019, respectively. At December 31, 2020 and December 31, 2019 included in total loans were

\$52.3 million and \$79.2 million in loans, respectively, acquired as part of the 2017 NWBI branch acquisition. These balances are presented net of the related discount which totaled \$754 thousand at December 31, 2020 and \$1.1 million at December 31, 2019.

In 2020, the Company participated in the Paycheck Protection Program (PPP). The PPP commenced subsequent to the passage of the Coronavirus Aid, Relief and Economic Security (“CARES”) Act in March 2020, and was later expanded by the Paycheck Protection Program and Health Care Enhancement Act of April 2020. The PPP was designed to provide U.S. small businesses with cash-flow assistance during the COVID-19 pandemic through loans that are fully guaranteed by the Small Business Administration (SBA) which may be forgiven upon satisfaction of certain criteria. As of December 31, 2020, the Company held PPP loans with a total outstanding balance of \$122.9 million, which is included in the commercial loan segment in the table above. As compensation for originating the loans, the Company received lender processing fees from the SBA, which were deferred, along with the related loan origination costs. These net fees are being accreted to interest income over the remaining contractual lives of the loans. Upon forgiveness of a PPP loan and repayment by the SBA, which may be prior to the loan’s maturity, the remainder of any unrecognized net fees are recognized as interest income. The Company has continued to participate in the newest round of the PPP during the first quarter of 2021.

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

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

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

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

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

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

The following tables include impairment information relating to loans and the allowance for credit losses as of December 31, 2020 and 2019.

(Dollars in thousands)	Construction	Residential real estate	Commercial real estate	Commercial	Consumer	Total
2020						
Loans individually evaluated for impairment	\$ 331	\$ 5,722	\$ 6,917	\$ 258	\$ 28	\$ 13,256
Loans collectively evaluated for impairment	<u>106,429</u>	<u>437,820</u>	<u>654,315</u>	<u>210,998</u>	<u>31,438</u>	<u>1,441,000</u>
Total loans	<u>\$ 106,760</u>	<u>\$ 443,542</u>	<u>\$ 661,232</u>	<u>\$ 211,256</u>	<u>\$ 31,466</u>	<u>\$ 1,454,256</u>

Allowance for credit losses allocated to:

Loans individually evaluated for impairment	\$ —	\$ 135	\$ 78	\$ —	\$ —	\$ 213
Loans collectively evaluated for impairment	<u>2,022</u>	<u>3,564</u>	<u>5,348</u>	<u>2,089</u>	<u>652</u>	<u>13,675</u>
Total allowance	<u>\$ 2,022</u>	<u>\$ 3,699</u>	<u>\$ 5,426</u>	<u>\$ 2,089</u>	<u>\$ 652</u>	<u>\$ 13,888</u>

(Dollars in thousands)	Construction	Residential real estate	Commercial real estate	Commercial	Consumer	Total
2019						
Loans individually evaluated for impairment	\$ 41	\$ 7,072	\$ 12,006	\$ 298	\$ —	\$ 19,417
Loans collectively evaluated for impairment	<u>99,788</u>	<u>435,434</u>	<u>574,556</u>	<u>101,722</u>	<u>17,737</u>	<u>1,229,237</u>
Total loans	<u>\$ 99,829</u>	<u>\$ 442,506</u>	<u>\$ 586,562</u>	<u>\$ 102,020</u>	<u>\$ 17,737</u>	<u>\$ 1,248,654</u>

Allowance for credit losses allocated to:

Loans individually evaluated for impairment	\$ —	\$ 395	\$ 580	\$ —	\$ —	\$ 975
Loans collectively evaluated for impairment	<u>1,576</u>	<u>2,106</u>	<u>3,452</u>	<u>1,929</u>	<u>469</u>	<u>9,532</u>
Total allowance	<u>\$ 1,576</u>	<u>\$ 2,501</u>	<u>\$ 4,032</u>	<u>\$ 1,929</u>	<u>\$ 469</u>	<u>\$ 10,507</u>

The allowance for loan losses was 0.95% of total loans and 1.04% when excluding PPP loans, at December 31, 2020 compared to 0.84% at December 31, 2019.

In the first quarter of 2020, the Company transitioned from its in-house allowance model to an external vendor's allowance model software for the calculation of the allowance for loan losses. Prior to the adoption of the new model, the Company ran both models parallel for multiple periods to confirm the reasonableness of the new model's output as compared to the old. The primary motivation for the change was to increase efficiencies in the calculation of the allowance estimate under the current incurred loss standard and also allow for a more seamless transition for the Company's eventual adoption of the Current Expected Credit Loss standard in 2023. The Company's processes for loan segmentation, assessing qualitative factors, and determining specific reserves for impaired loans remained substantially unchanged when comparing the models. As part of the new model, more precise averages are utilized in the calculation of the net charge-off ratios used in the historical loss analysis and the historical loss rates are applied to all pools of loans accounted for under ASC 450. Additionally, the historical look-back periods for retail loan pools were adjusted to four years in the new model as compared to two years under the prior in-house model. While there were some variances between loan pools when comparing the two models, the Company's ending recorded allowance and provision for loan losses during 2020 were not materially impacted as a result of the transition.

The following tables provide information on impaired loans and any related allowance by loan class as of December 31, 2020 and 2019. The difference between the unpaid principal balance and the recorded investment is the amount of partial charge-offs that have been taken and interest paid on nonaccrual loans that has been applied to principal.

(Dollars in thousands)	Unpaid principal balance	Recorded investment with no allowance	Recorded investment with an allowance	Related allowance	Quarter-to-date average recorded investment	Year-to-date average recorded investment	Interest recorded investment
2020							
Impaired nonaccrual loans:							
Construction	\$ 297	\$ 297	\$ —	\$ —	\$ 297	\$ 247	\$ —
Residential real estate	1,665	1,585	—	—	1,861	2,648	—
Commercial real estate	4,288	3,220	67	67	3,971	5,669	—
Commercial	401	258	—	—	272	390	—
Consumer	28	28	—	—	28	9	—
Total	<u>\$ 6,679</u>	<u>\$ 5,388</u>	<u>\$ 67</u>	<u>\$ 67</u>	<u>\$ 6,429</u>	<u>\$ 8,963</u>	<u>\$ —</u>
Impaired accruing TDRs:							
Construction	\$ 34	\$ 34	\$ —	\$ —	\$ 34	\$ 37	\$ 3
Residential real estate	3,845	2,617	1,228	135	3,857	3,920	160
Commercial real estate	3,118	2,479	639	11	3,261	3,349	104
Commercial	—	—	—	—	—	—	—
Consumer	—	—	—	—	—	—	—
Total	<u>\$ 6,997</u>	<u>\$ 5,130</u>	<u>\$ 1,867</u>	<u>\$ 146</u>	<u>\$ 7,152</u>	<u>\$ 7,306</u>	<u>\$ 267</u>
Other impaired accruing loans:							
Construction	\$ —	\$ —	\$ —	\$ —	\$ —	\$ 25	\$ —
Residential real estate	292	292	—	—	269	362	2
Commercial real estate	512	512	—	—	532	774	5
Commercial	—	—	—	—	—	13	—
Consumer	—	—	—	—	—	9	—
Total	<u>\$ 804</u>	<u>\$ 804</u>	<u>\$ —</u>	<u>\$ —</u>	<u>\$ 801</u>	<u>\$ 1,183</u>	<u>\$ 7</u>
Total impaired loans:							
Construction	\$ 331	\$ 331	\$ —	\$ —	\$ 331	\$ 309	\$ 3
Residential real estate	5,802	4,494	1,228	135	5,987	6,930	162
Commercial real estate	7,918	6,211	706	78	7,764	9,792	109
Commercial	401	258	—	—	272	403	—
Consumer	28	28	—	—	28	18	—
Total	<u>\$ 14,480</u>	<u>\$ 11,322</u>	<u>\$ 1,934</u>	<u>\$ 213</u>	<u>\$ 14,382</u>	<u>\$ 17,452</u>	<u>\$ 274</u>

(Dollars in thousands)	Unpaid principal balance	Recorded investment with no allowance	Recorded investment with an allowance	Related allowance	Quarter-to-date average recorded investment	Year-to-date average recorded investment	Interest income recognized
2019							
Impaired nonaccrual loans:							
Construction	\$ —	\$ —	\$ —	\$ —	\$ —	\$ 1,076	\$ —
Residential real estate	2,660	678	1,797	215	2,052	2,691	—
Commercial real estate	8,242	5,680	2,137	561	8,533	9,421	—
Commercial	421	298	—	—	301	313	—
Consumer	—	—	—	—	—	—	—
Total	\$ 11,323	\$ 6,656	\$ 3,934	\$ 776	\$ 10,886	\$ 13,501	\$ —
Impaired accruing TDRs:							
Construction	\$ 41	\$ 41	\$ —	\$ —	\$ 41	\$ 46	\$ 10
Residential real estate	4,041	2,583	1,458	180	4,052	4,157	171
Commercial real estate	3,419	2,748	671	19	3,438	3,496	125
Commercial	—	—	—	—	—	—	—
Consumer	—	—	—	—	—	—	—
Total	\$ 7,501	\$ 5,372	\$ 2,129	\$ 199	\$ 7,531	\$ 7,699	\$ 306
Other impaired accruing loans:							
Construction	\$ —	\$ —	\$ —	\$ —	\$ —	\$ 18	\$ —
Residential real estate	556	556	—	—	786	337	5
Commercial real estate	770	770	—	—	297	336	4
Commercial	—	—	—	—	89	38	1
Consumer	—	—	—	—	—	3	—
Total	\$ 1,326	\$ 1,326	\$ —	\$ —	\$ 1,172	\$ 732	\$ 10
Total impaired loans:							
Construction	\$ 41	\$ 41	\$ —	\$ —	\$ 41	\$ 1,140	\$ 10
Residential real estate	7,257	3,817	3,255	395	6,890	7,185	176
Commercial real estate	12,431	9,198	2,808	580	12,268	13,253	129
Commercial	421	298	—	—	390	351	1
Consumer	—	—	—	—	—	3	—
Total	\$ 20,150	\$ 13,354	\$ 6,063	\$ 975	\$ 19,589	\$ 21,932	\$ 316

The following tables provide a roll-forward for troubled debt restructurings as of and for the years ended December 31, 2020 and December 31, 2019.

(Dollars in thousands)	1/1/2020 TDR Balance	New TDRs	Disbursements (Payments)	Charge- offs	Reclassifications/ Transfer In/(Out)	Payoffs	12/31/2020 TDR Balance	Related Allowance
2020								
Accruing TDRs								
Construction	\$ 41	\$ —	\$ (7)	\$ —	\$ —	\$ —	\$ 34	\$ —
Residential real estate	4,041	—	(113)	—	—	(83)	3,845	135
Commercial real estate	3,419	—	(97)	—	—	(204)	3,118	11
Commercial	—	—	—	—	—	—	—	—
Consumer	—	—	—	—	—	—	—	—
Total	\$ 7,501	\$ —	\$ (217)	\$ —	\$ —	\$ (287)	\$ 6,997	\$ 146
Nonaccrual TDRs								
Construction	\$ —	\$ —	\$ —	\$ —	\$ —	\$ —	\$ —	\$ —
Residential real estate	1,393	—	(51)	—	—	(1,342)	—	—
Commercial real estate	—	1,506	(401)	—	—	(1,105)	—	—
Commercial	299	—	(41)	—	—	—	258	—
Consumer	—	—	—	—	—	—	—	—
Total	\$ 1,692	\$ 1,506	\$ (493)	\$ —	\$ —	\$ (2,447)	\$ 258	\$ —
Total	\$ 9,193	\$ 1,506	\$ (710)	\$ —	\$ —	\$ (2,734)	\$ 7,255	\$ 146

(Dollars in thousands)	1/1/2019 TDR Balance	New TDRs	Disbursements (Payments)	Charge- offs	Reclassifications/ Transfer In/(Out)	Payoffs	12/31/2019 TDR Balance	Related Allowance
2019								
Accruing TDRs								
Construction	\$ 51	\$ —	\$ (10)	\$ —	\$ —	\$ —	\$ 41	\$ —
Residential real estate	4,454	41	(101)	—	—	(353)	4,041	180
Commercial real estate	4,158	—	(739)	—	—	—	3,419	19
Commercial	—	—	—	—	—	—	—	—
Consumer	—	—	—	—	—	—	—	—
Total	\$ 8,663	\$ 41	\$ (850)	\$ —	\$ —	\$ (353)	\$ 7,501	\$ 199
Nonaccrual TDRs								
Construction	\$ 2,798	\$ —	\$ (1,402)	\$ (3)	\$ (1,393)	\$ —	\$ —	\$ —
Residential real estate	—	—	—	—	1,393	—	1,393	113
Commercial real estate	—	—	—	—	—	—	—	—
Commercial	320	—	(21)	—	—	—	299	—
Consumer	—	—	—	—	—	—	—	—
Total	\$ 3,118	\$ —	\$ (1,423)	\$ (3)	\$ —	\$ —	\$ 1,692	\$ 113
Total	\$ 11,781	\$ 41	\$ (2,273)	\$ (3)	\$ —	\$ (353)	\$ 9,193	\$ 312

The following table provides information on loans that were modified and considered TDRs during 2020 and 2019.

(Dollars in thousands)	Number of contracts	Premodification outstanding recorded investment	Postmodification outstanding recorded investment	Related allowance
TDRs:				
2020				
Construction	—	\$ —	\$ —	\$ —
Residential real estate	—	—	—	—
Commercial real estate	1	1,535	1,506	—
Commercial	—	—	—	—
Consumer	—	—	—	—
Total	1	\$ 1,535	\$ 1,506	\$ —
2019				
Construction	—	\$ —	\$ —	\$ —
Residential real estate	3	2,310	2,119	—
Commercial real estate	1	2,152	1,531	—
Commercial	—	—	—	—
Consumer	—	—	—	—
Total	4	\$ 4,462	\$ 3,650	\$ —

During the year ended December 31, 2020 there was one new TDR that was modified to extend the term of the loan.

For the year ended December 31, 2020, the Company had executed principal and/or interest deferrals on outstanding loan balances of \$221.1 million, of which only \$34.9 million remained on deferral as of December 31, 2020. These deferrals were no more than six months in duration and were for loans not more than 30 days past due as of December 31, 2019. As such, they were not considered TDRs based on the relief provisions of the CARES Act and recent interagency regulatory guidance.

There were no TDRs which subsequently defaulted within 12 months of modification for the year ended December 31, 2020 and 2019. Generally, a loan is considered in default when principal or interest is past due 90 days or more, the loan is placed on nonaccrual, the loan is charged off, or there is a transfer to OREO or repossessed assets.

Management uses risk ratings as part of its monitoring of the credit quality in the Company's loan portfolio. Loans that are identified as special mention, substandard or doubtful are adversely rated. These loans and the pass/watch loans are assigned higher qualitative factors than favorably rated loans in the calculation of the formula portion of the allowance for credit losses. At December 31, 2020, there were no nonaccrual loans classified as special mention or doubtful and \$5.5 million of nonaccrual loans were classified as substandard. Similarly, at December 31, 2019, there were no nonaccrual loans classified as special mention or doubtful and \$10.6 million of nonaccrual loans were classified as substandard.

The following tables provide information on loan risk ratings as of December 31, 2020 and 2019.

(Dollars in thousands)	Pass/Performing	Pass/Watch	Special Mention	Substandard	Doubtful	Total
2020						
Construction	\$ 81,926	\$ 22,547	\$ 1,990	\$ 297	\$ —	\$ 106,760
Residential real estate	401,494	36,759	2,946	2,343	—	443,542
Commercial real estate	514,524	133,892	3,504	9,312	—	661,232
Commercial	182,166	25,870	2,948	272	—	211,256
Consumer	31,221	215	—	30	—	31,466
Total	<u>\$ 1,211,331</u>	<u>\$ 219,283</u>	<u>\$ 11,388</u>	<u>\$ 12,254</u>	<u>\$ —</u>	<u>\$ 1,454,256</u>

(Dollars in thousands)	Pass/Performing	Pass/Watch	Special Mention	Substandard	Doubtful	Total
2019						
Construction	\$ 84,357	\$ 13,068	\$ 2,404	\$ —	\$ —	\$ 99,829
Residential real estate	404,500	29,223	5,549	3,234	—	442,506
Commercial real estate	455,388	115,190	4,822	11,162	—	586,562
Commercial	80,816	20,130	746	328	—	102,020
Consumer	17,347	383	2	5	—	17,737
Total	<u>\$ 1,042,408</u>	<u>\$ 177,994</u>	<u>\$ 13,523</u>	<u>\$ 14,729</u>	<u>\$ —</u>	<u>\$ 1,248,654</u>

The following tables provide information on the aging of the loan portfolio as of December 31, 2020 and 2019.

(Dollars in thousands)	Accruing					Nonaccrual	Total
	Current	30-59 days past due	60-89 days past due	Greater than 90 days	Total past due		
2020							
Construction	\$ 106,463	\$ —	\$ —	\$ —	\$ —	\$ 297	\$ 106,760
Residential real estate	440,210	517	938	292	1,747	1,585	443,542
Commercial real estate	657,066	367	—	512	879	3,287	661,232
Commercial	210,704	226	68	—	294	258	211,256
Consumer	31,318	119	1	—	120	28	31,466
Total	<u>\$ 1,445,761</u>	<u>\$ 1,229</u>	<u>\$ 1,007</u>	<u>\$ 804</u>	<u>\$ 3,040</u>	<u>\$ 5,455</u>	<u>\$ 1,454,256</u>
Percent of total loans	99.3 %	0.1 %	0.1 %	0.1 %	0.3 %	0.4 %	100.0 %

(Dollars in thousands)	Accruing					Nonaccrual	Total
	Current	30-59 days past due	60-89 days past due	Greater than 90 days	Total past due		
2019							
Construction	\$ 99,234	\$ 595	\$ —	\$ —	\$ 595	\$ —	\$ 99,829
Residential real estate	435,671	3,021	783	556	4,360	2,475	442,506
Commercial real estate	577,015	743	217	770	1,730	7,817	586,562
Commercial	101,476	246	—	—	246	298	102,020
Consumer	17,680	57	—	—	57	—	17,737
Total	<u>\$ 1,231,076</u>	<u>\$ 4,662</u>	<u>\$ 1,000</u>	<u>\$ 1,326</u>	<u>\$ 6,988</u>	<u>\$ 10,590</u>	<u>\$ 1,248,654</u>
Percent of total loans	98.6 %	0.4 %	0.1 %	0.1 %	0.6 %	0.8 %	100.0 %

The following tables provide a summary of the activity in the allowance for credit losses allocated by loan class for 2020 and 2019. Allocation of a portion of the allowance to one loan class does not preclude its availability to absorb losses in other loan classes.

(Dollars in thousands)	Construction	Residential real estate	Commercial real estate	Commercial	Consumer	Total
2020						
Allowance for credit losses:						
Beginning Balance	\$ 1,576	\$ 2,501	\$ 4,032	\$ 1,929	\$ 469	\$ 10,507
Charge-offs	—	(201)	(601)	(286)	(9)	(1,097)
Recoveries	17	211	1	322	27	578
Net (charge-offs) recoveries	17	10	(600)	36	18	(519)
Provision	429	1,188	1,994	124	165	3,900
Ending Balance	\$ 2,022	\$ 3,699	\$ 5,426	\$ 2,089	\$ 652	\$ 13,888

(Dollars in thousands)	Construction	Residential real estate	Commercial real estate	Commercial	Consumer	Total
2019						
Allowance for credit losses:						
Beginning Balance	\$ 2,662	\$ 2,353	\$ 3,077	\$ 1,949	\$ 302	\$ 10,343
Charge-offs	(3)	(646)	—	(411)	(37)	(1,097)
Recoveries	18	27	206	306	4	561
Net (charge-offs) recoveries	15	(619)	206	(105)	(33)	(536)
Provision	(1,101)	767	749	85	200	700
Ending Balance	\$ 1,576	\$ 2,501	\$ 4,032	\$ 1,929	\$ 469	\$ 10,507

Foreclosure Proceedings

Consumer mortgage loans collateralized by residential real estate property that are in the process of foreclosure totaled \$0 and \$23 thousand as of December 31, 2020 and 2019. There were no residential real estate properties included in the balance of other real estate owned at December 31, 2020 and December 31, 2019.

All accruing TDRs were in compliance with their modified terms. Both performing and non-performing TDRs had no further commitments associated with them as of December 31, 2020 and December 31, 2019.

NOTE 4. LEASES

On January 1, 2019, the Company adopted ASU No. 2016-02 “Leases (Topic 842)” and all subsequent ASUs that modified Topic 842. The Company elected the prospective application approach provided by ASU 2018-11 and did not adjust prior periods for ASC 842. The Company also elected certain practical expedients within the standard and consistent with such elections did not reassess whether any expired or existing contracts are or contain leases, did not reassess the lease classification for any expired or existing leases, and did not reassess any initial direct costs for existing leases. As stated in the Company’s 2019 Form 10-K, the implementation of the new standard resulted in recognition of right-of-use assets and lease liabilities totaling \$3.8 million at the date of adoption, which are primarily related to the Company’s lease of premises used in operations. During the course of 2019, the Company recognized additional right-of-use assets and lease liabilities of \$1.4 million, primarily related to the lease of additional premises used in operations. During 2020, the Company recognized new right-of-use assets and lease liabilities for one location, one equipment lease, and two renewals on existing assets totaling \$637 thousand.

Lease liabilities represent the Company's obligation to make lease payments and are presented at each reporting date as the net present value of the remaining contractual cash flows. Cash flows are discounted at the Company's incremental borrowing rate in effect at the commencement date of the lease. Right-of-use assets represent the Company's right to use the underlying asset for the lease term and are calculated as the sum of the lease liability and if applicable, prepaid rent, initial direct costs and any incentives received from the lessor.

The Company's long-term lease agreements are classified as operating leases. Certain of these leases offer the option to extend the lease term and the Company has included such extensions in its calculation of the lease liabilities to the extent the options are reasonably certain of being exercised. The lease agreements do not provide for residual value guarantees and have no restrictions or covenants that would impact dividends or require incurring additional financial obligations.

The following tables present information about the Company's leases:

(Dollars in thousands)	December 31, 2020	December 31, 2019
Lease liabilities	\$ 4,874	\$ 4,792
Right-of-use assets	\$ 4,795	\$ 4,771
Weighted average remaining lease term	10.49 years	11.76 years
Weighted average discount rate	2.89 %	3.13 %

Lease cost (in thousands)	For the year ended December 31, 2020	For the year ended December 31, 2019
Operating lease cost	\$ 712	\$ 620
Short-term lease cost	—	—
Total lease cost	\$ 712	\$ 620

Cash paid for amounts included in the measurement of lease liabilities	\$ 666	\$ 587
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A maturity analysis of operating lease liabilities and reconciliation of the undiscounted cash flows to the total of operating lease liabilities is as follows:

Lease payments due (in thousands)	As of December 31,
Twelve months ending December 31, 2021	\$ 652
Twelve months ending December 31, 2022	651
Twelve months ending December 31, 2023	610
Twelve months ending December 31, 2024	569
Twelve months ending December 31, 2025	423
Thereafter	2,816
Total undiscounted cash flows	\$ 5,721
Discount	847
Lease liabilities	\$ 4,874

NOTE 5. PREMISES AND EQUIPMENT

The following table provides information on premises and equipment from continuing operations at December 31, 2020 and 2019.

(Dollars in thousands)	2020	2019
Land	\$ 8,509	\$ 8,509
Buildings and land improvements	22,101	21,250
Furniture and equipment	8,283	7,354
	<u>38,893</u>	<u>37,113</u>
Accumulated depreciation	<u>(13,969)</u>	<u>(13,292)</u>
Total	<u>\$ 24,924</u>	<u>\$ 23,821</u>

Depreciation expense of continuing operations totaled \$1.2 million for 2020 and \$1.1 million for 2019.

NOTE 6. GOODWILL AND OTHER INTANGIBLE ASSETS

Due to the COVID-19 pandemic and its impact on market conditions, the Company performed a full annual qualitative assessment of goodwill as of December 31, 2020. As a result of management's qualitative evaluation of relevant events and circumstances as of December 31, 2020, the Company concluded that it was not more likely than not that fair value was less than carrying value. Changes in the economic environment, operations, or other adverse events could result in future impairment charges which could have a material adverse impact on the Company's operating results.

The following table provides information on the significant components of goodwill and other acquired intangible assets at December 31, 2020 and 2019.

2020

(Dollars in thousands)	Gross Carrying Amount	Accumulated Impairment Charges	Accumulated Amortization	Net Carrying Amount	Weighted Average Remaining Life (in years)
Goodwill	<u>\$ 19,728</u>	<u>\$ (1,543)</u>	<u>\$ (667)</u>	<u>\$ 17,518</u>	—
Other intangible assets					
Amortizable					
Core deposit intangible	<u>\$ 3,954</u>	<u>\$ —</u>	<u>\$ (2,235)</u>	<u>\$ 1,719</u>	4.7
Total other intangible assets	<u>\$ 3,954</u>	<u>\$ —</u>	<u>\$ (2,235)</u>	<u>\$ 1,719</u>	

2019

(Dollars in thousands)	Gross Carrying Amount	Accumulated Impairment Charges	Accumulated Amortization	Net Carrying Amount	Weighted Average Remaining Life (in years)
Goodwill	<u>\$ 19,728</u>	<u>\$ (1,543)</u>	<u>\$ (667)</u>	<u>\$ 17,518</u>	—
Other intangible assets					
Amortizable					
Core deposit intangible	<u>\$ 3,954</u>	<u>\$ —</u>	<u>\$ (1,702)</u>	<u>\$ 2,252</u>	5.7
Total other intangible assets	<u>\$ 3,954</u>	<u>\$ —</u>	<u>\$ (1,702)</u>	<u>\$ 2,252</u>	

The aggregate amortization expense was \$533 thousand and \$605 thousand for the years ended December 31, 2020 and 2019, respectively.

At December 31, 2020, estimated future remaining amortization for amortizing intangibles within the years ending December 31, is as follows:

(Dollars in thousands)	Amortization Expense
2021	\$ 461
2022	389
2023	317
2024	246
2025	174
Thereafter	132
Total amortizing intangible assets	<u>\$ 1,719</u>

NOTE 7. OTHER ASSETS

The Company had the following other assets from continuing operations at December 31, 2020 and 2019.

(Dollars in thousands)	2020	2019
Accrued interest receivable	\$ 6,616	\$ 3,455
Deferred income taxes	4,442	2,754
Prepaid expenses	1,472	1,157
Cash surrender value on life insurance	31,018	29,782
Income taxes receivable	156	175
Other assets	3,075	3,249
Total	<u>\$ 46,779</u>	<u>\$ 40,572</u>

NOTE 8. OTHER LIABILITIES

The Company had the following other liabilities from continuing operations at December 31, 2020 and 2019.

(Dollars in thousands)	2020	2019
Accrued interest payable	\$ 647	\$ 330
Deferred compensation liability	2,905	1,401
Other liabilities	3,686	2,350
Total	<u>\$ 7,238</u>	<u>\$ 4,081</u>

NOTE 9. DEPOSITS

The approximate amount of certificates of deposit of \$250,000 or more was \$43.2 million and \$38.9 million at December 31, 2020 and 2019, respectively.

The following table provides information on the approximate maturities of total time deposits at December 31, 2020 and 2019.

(Dollars in thousands)	2020	2019
Due in one year or less	\$ 179,073	\$ 126,055
Due in one to three years	71,327	116,979
Due in three to five years	24,473	34,084
Total	<u>\$ 274,873</u>	<u>\$ 277,118</u>

As of December 31, 2020 and 2019, deposits, both direct and indirect, from directors, their associates and policy-making officers, totaled approximately \$4.8 million and \$5.5 million, respectively.

At December 31, 2020 and December 31, 2019, we had no brokered deposits.

NOTE 10. BORROWINGS

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

The following table summarizes certain information on short-term borrowings for the years ended December 31, 2020 and 2019.

(Dollars in thousands)	2020		2019	
	Amount	Rate	Amount	Rate
Average for the Year				
Repurchase agreements	\$ 1,484	0.32 %	\$ 1,061	1.39 %
FHLB Advances	—	—	17,378	2.68
Overnight Fed Funds purchased	1	0.61	14	2.86
At Year End				
Repurchase agreements	\$ 1,050	0.03 %	\$ 1,226	0.81 %
FHLB Advances	—	—	—	—
Overnight Fed Funds purchased	—	—	—	—

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

The Bank had \$15.0 million in federal funds lines of credit and a reverse repurchase agreement available on a short-term basis from correspondent banks at December 31, 2020 and 2019. In addition, the Bank had secured credit availability of approximately \$316.7 million and \$270.1 million from the Federal Home Loan Bank at December 31, 2020 and 2019, respectively. The Bank has pledged as collateral, under a blanket lien, all qualifying residential loans under borrowing agreements with the Federal Home Loan Bank. The Bank had no short-term borrowings from the Federal Home Loan Bank at December 31, 2020 and December 31, 2019. At December 31, 2019, the Bank had \$15.0 million of fixed rate long-term borrowings from the Federal Home Loan Bank, which carried an interest rate of 2.82%. These advances were paid off in April of 2020.

NOTE 11. SUBORDINATED DEBT

On August 25, 2020, the Company entered into Subordinated Note Purchase Agreements with certain Purchasers pursuant to which the Company issued and sold \$25.0 million in aggregate principal amount with an initial interest rate of 5.375% Fixed-to-Floating Rate Subordinated Notes due September 1, 2030.

The Company plans to use the net proceeds of this offering for general corporate purposes, organic growth and to support the Bank's regulatory capital ratios. The Notes were structured to qualify as Tier 2 capital for regulatory capital purposes and bear an initial interest rate of 5.375% until September 1, 2025, with interest during this period payable semi-annually in arrears. From and including September 1, 2025, to but excluding the maturity date or early redemption date, the interest rate will reset quarterly to an annual floating rate equal to three-month SOFR, plus 526.5 basis points, with interest during this period payable quarterly in arrears. The Notes are redeemable by the Company at its option, in whole or in part, on or after September 1, 2025. Initial debt issuance costs were \$611 thousand. The debt balance of \$24.4 million is presented net of unamortized issuance costs of \$571 thousand at December 31, 2020.

NOTE 12. BENEFIT PLANS

401(k) and Profit Sharing Plan

The Company has a 401(k) and profit sharing plan covering substantially all full-time employees. The plan calls for matching contributions by the Company, and the Company makes discretionary contributions based on profits. Company contributions to this plan excluding discontinued operations and included in noninterest expense totaled \$601 thousand and \$580 thousand for 2020 and 2019, respectively.

NOTE 13. STOCK-BASED COMPENSATION

At the 2016 annual meeting, stockholders approved the Shore Bancshares, Inc. 2016 Stock and Incentive Plan (“2016 Equity Plan”), replacing the Shore Bancshares, Inc. 2006 Stock and Incentive Plan (“2006 Equity Plan”), which expired on that date. The Company may issue shares of common stock or grant other equity-based awards pursuant to the 2016 Equity Plan. Stock-based awards granted to date generally are time-based, vest in equal installments on each anniversary of the grant date and range over a one- to three-year period of time, and, in the case of stock options, expire 10 years from the grant date. As part of the 2016 Equity Plan, a performance equity incentive award program, known as the “Long-term incentive plan” allows participating officers of the Company to earn incentive awards of performance share/restricted stock units if certain pre-determined targets are achieved at the end of a three-year performance cycle. Stock-based compensation expense based on the grant date fair value is recognized ratably over the requisite service period for all awards and reflects forfeitures as they occur. The 2016 Equity Plan originally reserved 750,000 shares of common stock for grant, and 608,414 shares remained available for grant at December 31, 2020.

The following tables provide information on stock-based compensation expense for 2020 and 2019.

(Dollars in thousands)	December 31,	
	2020	2019
Stock-based compensation expense	\$ 263	\$ 149
Excess tax benefits related to stock-based compensation	11	7

(Dollars in thousands)	December 31,	
	2020	2019
Unrecognized stock-based compensation expense	\$ 97	\$ 35
Weighted average period unrecognized expense is expected to be recognized	0.3 years	0.1 years

The following table summarizes restricted stock award activity for the Company under the 2016 Equity Plan for the two years ended December 31.

	2020		2019	
	Number of Shares	Weighted Average Grant Date Fair Value	Number of Shares	Weighted Average Grant Date Fair Value
Nonvested at beginning of period	15,702	\$ 15.36	—	\$ —
Granted	25,507	13.78	15,702	15.36
Vested	(15,065)	15.35	—	—
Forfeited	(1,639)	15.85	—	—
Nonvested at end of period	24,505	\$ 13.78	15,702	\$ 15.36

The total fair value of restricted stock awards that vested was \$243 thousand in 2020.

Restricted stock units (RSUs) are similar to restricted stock, except the recipient does not receive the stock immediately, but instead receives it upon the terms and conditions of the Company’s long-term incentive plans which are subject to performance milestones achieved at the end of a three-year period. Each RSU cliff vests at the end of the three-year period

and entitles the recipient to receive one share of common stock on a specified issuance date. The recipient does not have any stockholder rights, including voting rights, with respect to the shares underlying awarded RSUs until the recipient becomes the holder of those shares.

During 2017, the Company entered into a long-term incentive plan agreement with officers of the Company and its subsidiaries to award RSUs based on a performance metric to be achieved as of December 31, 2019. Based on the results for the year ended December 31, 2019, 6,451 shares were vested.

The following table summarizes restricted stock units activity at the end of the performance cycle for the Company under the 2016 Equity Plan for the two years ended December 31.

	2020		2019	
	Number of Shares	Weighted Average Grant Date Fair Value	Number of Shares	Weighted Average Grant Date Fair Value
Outstanding at beginning of period	6,451	\$ 16.57	38,562	\$ 14.69
Granted	—	—	—	—
Vested	(6,451)	16.57	(15,577)	11.68
Forfeited	—	—	(16,534)	16.78
Outstanding at end of period	—	\$ —	6,451	\$ 16.57

The fair value of restricted stock units that vested during 2020 and 2019 was \$107 thousand and \$241 thousand, respectively.

The following table summarizes stock option activity for the Company under the 2016 Equity Plan for the two years ended December 31, 2020.

	2020		2019	
	Number of Shares	Weighted Average Grant Date Exercise Price	Number of Shares	Weighted Average Exercise Prices
Outstanding at beginning of period	11,671	\$ 9.25	27,249	\$ 9.68
Granted	—	—	—	—
Exercised	(7,760)	9.01	(15,578)	10.01
Expired/Cancelled	(1,202)	16.65	—	—
Outstanding at end of period	2,709	\$ 6.64	11,671	\$ 9.25
Exercisable at end of period	2,709	\$ 6.64	11,671	\$ 9.25

There were no stock options granted during 2020 and 2019, respectively.

At December 31, 2020, the aggregate intrinsic value of the options outstanding and exercisable under the 2016 Equity Plan was \$22 thousand based on the \$14.60 market value per share of Shore Bancshares, Inc.'s common stock at December 31, 2020. Similarly, the aggregate intrinsic value of the options outstanding and exercisable was \$95 thousand at December 31, 2019. The intrinsic value of options exercised during 2020 was \$10 thousand based on the \$12.33 average market value per share of the Company's common stock. The intrinsic value of options exercised in 2019 was \$72 thousand based on the \$14.66 market value per share of the Company's common stock at January 15, 2019. At December 31, 2020, the weighted average remaining contract life of options outstanding and exercisable was 1.3 years.

NOTE 14. DEFERRED COMPENSATION

The Company has multiple deferred compensation agreements with current and former employees. The Executive Deferred Compensation Plan (the "Plan") is reserved for members of management and highly compensated employees of the Company and the Bank. During 2019, the Plan was expanded to include additional officers who had not previously participated. The Plan permits a participant to elect, each year, to defer receipt of up to 100% of his or her salary and bonus

to be earned in the following year. The Plan also permits the participant to defer the receipt of performance-based compensation not later than six months before the end of the period for which it is to be earned. The deferred amounts are credited to an account maintained on behalf of the participant and are invested at the discretion of each participant in certain deemed investment options selected by the Compensation Committee of the Board of the Company. The actual investments purchased are owned by the Company and held in a Rabbi Trust. The accounts of the Rabbi Trust are consolidated and the investments are included in other assets on the Consolidated Balance Sheets. The Company and the Bank may also make matching, mandatory and discretionary contributions for certain participants. A participant is fully vested at all times in the amounts that he or she elects to defer. Any contributions by the Company will vest over a five-year period.

The following table provides information on Shore Bancshares, Inc.'s contributions and participant deferrals to the Plan for 2020 and 2019 and the related deferred compensation liability at December 31, 2020 and 2019.

(Dollars in thousands)	2020	2019
Deferred compensation contribution	\$ —	\$ —
Elective deferrals	319	133
Deferred compensation liability	614	363

During 2019, the Company introduced a new SERP plan for executive officers of the Company and the Bank. The related liability is unfunded; however, BOLI was purchased in order to offset the benefit costs. The following table provides information on the expense recognized during the years ended December 31, 2020 and 2019, as well as the balance of the unfunded SERP liability and the cash surrender value of policies purchased to offset the SERP benefit costs as of December 31, 2020 and 2019. The unfunded SERP liability and cash surrender value were included in other liabilities and other assets, respectively.

(Dollars in thousands)	2020	2019
Cash surrender value	\$ 27,501	\$ 26,721
Deferred compensation liability - SERP	1,659	347
SERP Expense	1,422	347

Lastly, in 2016, the Bank assumed agreements held by the former CNB Bank under which its former directors had elected to defer part of their fees and compensation while serving on the former Board of CNB. The amounts deferred were invested in insurance policies on the lives of the respective individuals. Amounts available under the policies are to be paid to the individuals as retirement benefits over future years.

The following table includes information on the deferred compensation liability and cash surrender value at December 31, 2020 and 2019.

(Dollars in thousands)	2020	2019
Deferred compensation liability	\$ 631	\$ 691
Cash surrender value	2,979	2,919

NOTE 15. OTHER EXPENSES

The following table summarizes the Company's other noninterest expenses for the years ended December 31, excluding discontinued operations:

(Dollars in thousands)	2020	2019
Advertising and marketing	\$ 331	\$ 425
Other customer expense	538	400
Other expense	1,919	2,220
Other loan expense	361	277
Software expense	908	1,001
Travel and entertainment expense	180	322
Trust professional fees	461	485
Total other noninterest expense	<u>\$ 4,698</u>	<u>\$ 5,130</u>

NOTE 16. INCOME TAXES

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

(Dollars in thousands)	2020	2019
Current tax expense:		
Federal	\$ 5,477	\$ 3,974
State	2,025	1,395
	<u>7,502</u>	<u>5,369</u>
Deferred income tax (benefit) expense:		
Federal	(1,650)	122
State	(535)	119
	<u>(2,185)</u>	<u>241</u>
Total income tax expense	<u>\$ 5,317</u>	<u>\$ 5,610</u>

The following table provides a reconciliation of tax computed at the statutory federal tax rate to the actual tax expense for continuing operations for each of the two years ended December 31.

	2020	2019
Tax at federal statutory rate	21 %	21 %
Tax effect of:		
Tax-exempt income	(1.6)	(1.0)
State income taxes, net of federal benefit	5.6	5.5
Other	0.3	0.1
Actual income tax expense rate	<u>25.3 %</u>	<u>25.6 %</u>

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

(Dollars in thousands)	2020	2019
Deferred tax assets:		
Allowance for credit losses	\$ 3,721	\$ 2,850
Write-downs of other real estate owned	12	9
Nonaccrual loan interest	367	353
Unrealized losses on available-for-sale securities transferred to held to maturity	—	4
Other	2,152	735
Total deferred tax assets	6,252	3,951
Less valuation allowance	(169)	(63)
Deferred tax assets net of valuation allowance	6,083	3,888
Deferred tax liabilities:		
Depreciation	177	198
Acquisition accounting adjustments	580	508
Deferred capital gain on branch sale	187	194
Unrealized gains on available-for-sale securities	567	74
Other	130	160
Total deferred tax liabilities	1,641	1,134
Net deferred tax assets	\$ 4,442	\$ 2,754

NOTE 17. EARNINGS PER COMMON SHARE

Basic earnings per common share is calculated by dividing net income available to common stockholders by the weighted average number of common shares outstanding during the period. Diluted earnings per common share is calculated by dividing net income available to common stockholders by the weighted average number of common shares outstanding during the period, adjusted for the dilutive effect of common stock equivalents (stock-based awards). The following table provides information relating to the calculation of earnings per common share for the years ended December 31, 2020 and 2019.

(In thousands, except per share data)	2020	2019
Net income from continuing operations	\$ 15,730	\$ 16,284
Net loss from discontinued operations	-	(86)
Net Income	\$ 15,730	\$ 16,198
Weighted average shares outstanding - Basic	12,380	12,725
Dilutive effect of common stock equivalents-options	1	5
Weighted average shares outstanding - Diluted	12,381	12,730
Basic and diluted earnings per common share		
Income from continuing operations	\$ 1.27	\$ 1.28
Loss from discontinued operations	—	(0.01)
Net income	\$ 1.27	\$ 1.27

There were no weighted average common stock equivalents excluded from the calculation of diluted earnings per share for the years ended December 31, 2020 and 2019.

NOTE 18. REGULATORY CAPITAL REQUIREMENTS

Banks and bank holding companies are subject to various regulatory capital requirements administered by the federal banking agencies. Failure to meet minimum capital requirements can initiate certain mandatory - and possibly additional discretionary - actions by regulators that, if undertaken, could have a direct material effect on the financial statements. Under capital adequacy guidelines and the regulatory framework for prompt corrective action, the Bank must meet specific

capital guidelines that involve quantitative measures of the Banks' assets, liabilities, and certain off-balance sheet items as calculated under regulatory accounting practices. The Banks' capital amounts and classification are also subject to qualitative judgments by the regulators about components, risk weightings, and other factors.

Basel III

The FRB and the FDIC approved the final rules implementing the Basel Committee on Banking Supervision's ("BCBS") capital guidelines for U.S. banks. Under the final rules, minimum requirements increased for both the quantity and quality of capital held by the Company. The rules include a new common equity Tier 1 capital to risk-weighted assets minimum ratio of 4.5%, raise the minimum ratio of Tier 1 capital to risk-weighted assets to 6.0%, require a minimum ratio of Total Capital to risk-weighted assets of 8.0%, and require a minimum Tier 1 leverage ratio of 4.0%. A capital conservation buffer, comprised of common equity Tier 1 capital, is also established above the regulatory minimum capital requirements. This capital conservation buffer was phased in beginning January 1, 2016 at 0.625% of risk-weighted assets and increased each subsequent year by an additional 0.625% until reaching its final level of 2.5% on January 1, 2019. Strict eligibility criteria for regulatory capital instruments were also implemented under the final rules. The final rules also revise the definition and calculation of Tier 1 capital, Total Capital, and risk-weighted assets. At December 31, 2020 the capital conservation buffer was 2.50% and the Bank's specific capital buffer was 6.25%.

The phase-in period for the final rules began on January 1, 2015, with full compliance with all of the final rules' requirements phased in over a multi-year schedule, ending on January 1, 2019.

Quantitative measures established by regulation to ensure capital adequacy require the Bank to maintain amounts and ratios (set forth in the table below) of Common Equity Tier 1, Tier 1 and total capital (as defined in the regulations) to risk-weighted assets (as defined), and of Tier 1 capital (as defined) to average assets (leverage ratio). As of December 31, 2020, management believes that Shore United Bank met all capital adequacy requirements to which it was subject.

As of December 31, 2020, the most recent notification from the Federal Reserve Bank categorized Shore United Bank, as well capitalized under the regulatory framework for prompt corrective action. There are no conditions or events since that notification that management believes would change the Bank's classification. To be categorized as well capitalized, the Bank must maintain minimum common equity Tier 1, Tier 1 risk-based and total risk-based capital ratios, and Tier 1 leverage ratios, which are described below.

The minimum ratios for capital adequacy purposes are 7.00%, 8.50%, 10.50% and 4.00% for the common equity Tier 1, Tier 1 risk-based capital, total risk-based capital and leverage ratios, respectively which include a capital conservation buffer of 2.50% respectively. To be categorized as well capitalized, a bank must maintain minimum ratios of 6.50%, 8.00%, 10.00% and 5.00% for its common equity Tier 1, Tier 1 risk-based capital, total risk-based capital and leverage ratios, respectively.

The following tables present the capital amounts and ratios as of December 31, 2020 and 2019.

(Dollars in thousands)	Common Equity/ Tier 1 Capital	Total Risk- Based Capital	Net Risk- Weighted Assets	Adjusted Average Total Assets	Common Equity Tier 1 ratio	Tier 1 Risk-Based Capital Ratio	Total Risk-Based Capital Ratio	Tier 1 Leverage Ratio
2020								
Shore United Bank	\$ 180,696	\$ 194,885	\$ 1,367,544	\$ 1,857,802	13.21 %	13.21 %	14.25 %	9.73 %
(Dollars in thousands)	Common Equity/ Tier 1 Capital	Total Risk- Based Capital	Net Risk- Weighted Assets	Adjusted Average Total Assets	Common Equity Tier 1 ratio	Tier 1 Risk-Based Capital Ratio	Total Risk-Based Capital Ratio	Tier 1 Leverage Ratio
2019								
Shore United Bank	\$ 163,206	\$ 174,014	\$ 1,254,980	\$ 1,533,919	13.00 %	13.00 %	13.87 %	10.64 %

In August of 2018 the Economic Growth, Regulatory Relief, and Consumer Protection Act ("EGRRCPA") directed the Federal Reserve Board ("FRB") to revise the Small Bank Holding Company Policy Statement to raise the total consolidated asset limit in the Policy Statement from \$1 billion to \$3 billion. The Company was previously required to

comply with the minimum capital requirements on a consolidated basis; however, the Company continues to meet the conditions of the revised policy statement and was, therefore, exempt from the consolidated capital requirements at December 31, 2020 and 2019.

Bank and holding company regulations, as well as Maryland law, impose certain restrictions on dividend payments by the Bank, as well as restricting extensions of credit and transfers of assets between the Bank and the Company.

At December 31, 2020, the Bank could pay dividends to the parent to the extent of its earnings so long as it maintained required capital ratios. There were no dividends paid by the Bank to Shore Bancshares, Inc. for the years ended December 31, 2020 and 2019, respectively. Shore Bancshares, Inc. had no outstanding receivables from its subsidiary at December 31, 2020 or 2019.

NOTE 19. ACCUMULATED OTHER COMPREHENSIVE INCOME

The Company records unrealized holding gains (losses), net of tax, on investment securities available for sale as accumulated other comprehensive income (loss), a separate component of stockholders' equity. The following table provides information on the changes in the components of accumulated other comprehensive income (loss) for 2020 and 2019.

(Dollars in thousands)	Unrealized gains (losses) on available for sale securities	Unrealized gains (losses) on securities transferred from Available-for-sale to Held-to-maturity	Accumulated other comprehensive income (loss)
Balance, December 31, 2019	\$ 218	\$ (11)	\$ 207
Other comprehensive income before reclassifications	1,570	11	1,581
Reclassification of gains recognized	(259)	—	(259)
Balance, December 31, 2020	<u>\$ 1,529</u>	<u>\$ —</u>	<u>\$ 1,529</u>
Balance, December 31, 2018	\$ (2,918)	\$ (32)	\$ (2,950)
Other comprehensive income	3,136	21	3,157
Balances, December 31, 2019	<u>\$ 218</u>	<u>\$ (11)</u>	<u>\$ 207</u>

NOTE 20. FAIR VALUE MEASUREMENTS

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

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

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

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

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

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

Assets Measured at Fair Value on a Recurring Basis

Investment Securities Available for Sale

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

Equity Securities

Fair value measurement for equity securities is based on quoted market prices retrieved by the Company via on-line resources. Although these securities have readily available fair market values, the Company deems that they be classified as level 2 investments in the fair value hierarchy due to not being considered traded in a highly active market.

The tables below present the recorded amount of assets measured at fair value on a recurring basis at December 31, 2020 and 2019. No assets were transferred from one hierarchy level to another during 2020 or 2019.

(Dollars in thousands)	Fair Value	Quoted Prices (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
2020				
Securities available for sale:				
U.S. Government agencies	\$ 23,537	\$ —	\$ 23,537	\$ —
Mortgage-backed	116,031	—	116,031	—
	<u>139,568</u>	<u>—</u>	<u>139,568</u>	<u>—</u>
Equity	1,395	—	1,395	—
Total	<u>\$ 140,963</u>	<u>\$ —</u>	<u>\$ 140,963</u>	<u>\$ —</u>

(Dollars in thousands)	Fair Value	Quoted Prices (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
2019				
Securities available for sale:				
U.S. Government agencies	\$ 23,826	\$ —	\$ 23,826	\$ —
Mortgage-backed	98,965	—	98,965	—
	<u>122,791</u>	<u>—</u>	<u>122,791</u>	<u>—</u>
Equity	1,342	—	1,342	—
Total	<u>\$ 124,133</u>	<u>\$ —</u>	<u>\$ 124,133</u>	<u>\$ —</u>

Assets Measured at Fair Value on a Nonrecurring Basis

Impaired Loans

Loans are considered impaired when, based on current information and events, it is probable that the Company will be unable to collect all amounts due according to the contractual terms of the loan agreement. Loan impairment is measured using the present value of expected cash flows, the loan's observable market price or the fair value of the collateral (less selling costs) if the loans are collateral dependent and these are considered Level 3 in the fair value hierarchy. Collateral may be real estate and/or business assets including equipment, inventory and/or accounts receivable. The value of business equipment, inventory and accounts receivable, discounted on management's review and analysis. Appraised and reported values may be discounted based on management's historical knowledge, changes in market conditions from the time of valuation, and/or management's expertise and knowledge of the client and the client's business.

Impaired loans are reviewed and evaluated on at least a quarterly basis for additional impairment and adjusted accordingly, based on the factors identified above. Valuation techniques are consistent with those techniques applied in prior periods.

Other Real Estate Owned (Foreclosed Assets)

Foreclosed assets are adjusted for fair value upon transfer of loans to foreclosed assets establishing a new cost basis. Subsequently, foreclosed assets are carried at the lower of carrying value or fair value. The estimated fair value for foreclosed assets included in Level 3 are determined by independent market based appraisals and other available market information, less costs to sell, that may be reduced further based on market expectations or an executed sales agreement. If the fair value of the collateral deteriorates subsequent to the initial recognition, the Company records the foreclosed asset as a non-recurring Level 3 adjustment. Valuation techniques are consistent with those techniques applied in prior periods.

The following tables set forth the Company's financial assets subject to fair value adjustments (impairment) on a nonrecurring basis at December 31, 2020 and 2019, that are valued at the lower of cost or market. Assets are classified in their entirety based on the lowest level of input that is significant to the fair value measurement.

Quantitative Information about Level 3 Fair Value Measurements					
(Dollars in thousands)	Fair Value	Valuation Technique	Unobservable Input	Range	Weighted Average (3)
2020					
Nonrecurring measurements:					
Impaired loans	\$ 610	Appraisal of collateral	(1)Liquidation expense (2)	10%	(10%)
Impaired loans	\$ 1,110	Discounted cash flow analysis (1)	Discount rate	6% - 7.25%	(6%)

Quantitative Information about Level 3 Fair Value Measurements					
(Dollars in thousands)	Fair Value	Valuation Technique	Unobservable Input	Range	
2019					
Nonrecurring measurements:					
Impaired loans	\$ 2,489	Appraisal of collateral	(1)Liquidation expense (2)	10%	
Impaired loans	\$ 2,599	Discounted cash flow analysis (1)	Discount rate	4% - 7.25%	
Other real estate owned	\$ 74	Appraisal of collateral	(1)Appraisal adjustments (2) Liquidation expense (2)	0% - 31% 10%	

- (1) Fair value is generally determined through independent appraisals of the underlying collateral (impaired loans and OREO) or discounted cash flow analyses (impaired loans), which generally include various level III inputs which are not identifiable.
- (2) Appraisals may be adjusted by management for qualitative factors such as economic conditions and estimated liquidation expenses. The range of liquidation expenses and other appraisal adjustments are presented as a percent of the appraisal.
- (3) Unobservable inputs were weighted by the relative fair value of the instruments.

Fair Value of Financial Assets and Financial Liabilities

The carrying amounts and estimated fair values of the Company's financial instruments are presented in the following table. Fair values for December 31, 2020 and 2019 were estimated using an exit price notion.

(Dollars in thousands)	2020		2019	
	Carrying Amount	Estimated Fair Value	Carrying Amount	Estimated Fair Value
Financial assets				
Level 1 inputs				
Cash and cash equivalents	\$ 186,917	\$ 186,917	\$ 94,971	\$ 94,971
Level 2 inputs				
Investment securities held to maturity	\$ 65,706	\$ 65,828	\$ 8,786	\$ 8,654
Restricted securities	3,626	3,626	4,190	4,190
Cash surrender value on life insurance	31,018	31,018	29,782	29,782
Level 3 inputs				
Loans, net	\$ 1,440,368	\$ 1,436,292	\$ 1,238,147	\$ 1,242,867
Financial liabilities				
Level 2 inputs				
Deposits:				
Noninterest-bearing demand	\$ 509,091	\$ 509,091	\$ 356,618	\$ 356,618
Checking plus interest	446,243	446,243	302,227	302,227
Money market	292,974	292,974	262,050	262,050
Savings	177,524	177,524	143,322	143,322
Club	392	392	387	387
Certificates of deposit, \$100,000 or more	129,623	131,271	127,600	128,167
Other time	144,858	146,137	149,130	149,209
Securities sold under retail repurchase agreement	1,050	1,050	1,226	1,226
Advances from FHLB - long-term	—	—	15,000	15,040
Subordinated debt	24,429	25,745	—	—

NOTE 21. FINANCIAL INSTRUMENTS WITH OFF-BALANCE SHEET RISK

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

The following table provides information on commitments outstanding as of December 31, 2020 and 2019.

(Dollars in thousands)	2020	2019
Commitments to extend credit	\$ 248,607	\$ 211,652
Letters of credit	7,944	7,691
Total	\$ 256,551	\$ 219,343

The Bank has established an reserve for off balance sheet credit exposures. The reserve is established as losses are estimated to have occurred through a loss for off balance sheet credit exposures charged to earnings. Losses are charged against the allowance when management believes the required funding of these exposures is uncollectible. While this

evaluation is completed on a regular basis, it is inherently subjective as it requires estimates that are susceptible to significant revision as more information becomes available.

NOTE 22. CONTINGENCIES

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

NOTE 23. PARENT COMPANY FINANCIAL INFORMATION

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

Condensed Balance Sheets December 31,

(Dollars in thousands)	2020	2019
Assets		
Cash	\$ 16,653	\$ 7,522
Investment in subsidiaries	201,462	183,183
Other assets	3,204	2,483
Total assets	<u>\$ 221,319</u>	<u>\$ 193,188</u>
Liabilities		
Accrued interest payable	\$ 482	\$ —
Other liabilities	1,389	386
Long-term debt	24,429	—
Total liabilities	<u>26,300</u>	<u>386</u>
Stockholders' equity		
Common stock	118	125
Additional paid in capital	52,167	61,045
Retained earnings	141,205	131,425
Accumulated other comprehensive income	1,529	207
Total stockholders' equity	<u>195,019</u>	<u>192,802</u>
Total liabilities and stockholders' equity	<u>\$ 221,319</u>	<u>\$ 193,188</u>

Condensed Statements of Income
For the Years Ended December 31,

(Dollars in thousands)	2020	2019
Income		
Management and other fees from subsidiaries	\$ —	\$ 498
Gain on company owned life insurance	152	4
Other operating income	—	62
Total income	152	564
Expenses		
Interest expense	522	22
Salaries and employee benefits	349	111
Legal and professional fees	600	658
Other operating expenses	251	274
Total expenses	1,722	1,065
(Loss) before income tax (benefit) and equity in undistributed net income of subsidiaries	(1,570)	(501)
Income tax (benefit)	(343)	(131)
(Loss) before equity in undistributed net income of subsidiaries	(1,227)	(370)
Equity in undistributed net income of subsidiaries	16,957	16,568
Net income	\$ 15,730	\$ 16,198

Condensed Statements of Cash Flows
For the Years Ended December 31,

(Dollars in thousands)	2020	2019
Cash flows from operating activities:		
Net income	\$ 15,730	\$ 16,198
Adjustments to reconcile net income to cash provided by (used in) operating activities:		
Equity in undistributed net income of subsidiaries	(16,957)	(16,568)
Amortization of debt issuance costs	40	—
Stock-based compensation expense	263	149
Company owned life insurance income	(152)	—
Net (increase) in other assets	(250)	(1,093)
Net increase (decrease) in other liabilities	1,485	(6,109)
Net cash provided by (used in) operating activities	<u>159</u>	<u>(7,423)</u>
Cash flows from investing activities:		
Purchase of company owned life insurance	(319)	(139)
Transfer to subsidiary	—	(571)
Net cash (used in) investing activities	<u>(319)</u>	<u>(710)</u>
Cash flows from financing activities:		
Increase in short-term borrowings	—	(1,041)
Proceeds from the issuance of subordinated debt, net of issuance costs	24,389	—
Common stock dividends paid	(5,950)	(5,347)
Retirement of common stock	(9,112)	(4,452)
Exercise of stock options	3	—
Repurchase of shares for tax withholding on exercised options and vested restricted stock	(39)	(88)
Net cash provided by (used in) financing activities	<u>9,291</u>	<u>(10,928)</u>
Net increase (decrease) in cash and cash equivalents	9,131	(19,061)
Cash and cash equivalents at beginning of year	7,522	26,583
Cash and cash equivalents at end of year	<u>\$ 16,653</u>	<u>\$ 7,522</u>
Supplemental cash flow information:		
Transfer of building, available for sale securities and other assets to banking subsidiary	<u>\$ —</u>	<u>\$ 5,032</u>

NOTE 24. REVENUE RECOGNITION

Topic 606 does not apply to revenue associated with financial instruments, including revenue from loans and securities. Topic 606 is applicable to noninterest revenue streams such as trust and asset management income, deposit related fees, interchange fees and merchant income. Noninterest revenue streams in-scope of Topic 606 are discussed below.

Service Charges on Deposit Accounts

Service charges on deposit accounts consist of account analysis fees (i.e., net fees earned on analyzed business and public checking accounts), monthly service fees, check orders, and other deposit account related fees. The Company's performance obligation for account analysis fees and monthly service fees is generally satisfied, and the related revenue recognized, over the period in which the service is provided.

Check orders and other deposit account related fees are largely transactional based, and therefore, the Company's performance obligation is satisfied, and related revenue recognized, at a point in time. Payment for service charges on

deposit accounts is primarily received immediately or at the end of the month through a direct charge to customers' accounts.

Trust and Investment Fee Income

Trust and investment fee income are primarily comprised of fees earned from the management and administration of trusts and other customer assets. The Company's performance obligation is generally satisfied over time and the resulting fees are recognized monthly, based upon the month-end market value of the assets under management and the applicable fee rate. Payment is generally received a few days after month end through a direct charge to customers' accounts. The Company does not earn performance-based incentives.

Optional services such as real estate sales and tax return preparation services are also available to existing trust and asset management customers. The Company's performance obligation for these transactional-based services is generally satisfied, and related revenue recognized, at a point in time (i.e., as incurred). Payment is received shortly after services are rendered.

Other Noninterest Income

Other noninterest income consists of: fees, exchange, other service charges, safety deposit box rental fees, and other miscellaneous revenue streams. Fees and other service charges are primarily comprised of debit and credit card income, ATM fees, merchant services income, and other service charges. Debit and credit card income is primarily comprised of interchange fees earned whenever the Company's debit and credit cards are processed through card payment networks such as Visa. ATM fees are primarily generated when a Company cardholder uses a non-Company ATM or a non-Company cardholder uses a Company ATM. Merchant services income mainly represents fees charged to merchants to process their debit and credit card transactions, in addition to account management fees. Other service charges include revenue from processing wire transfers, bill pay service, cashier's checks, and other services. The Company's performance obligation for fees, exchange, and other service charges are largely satisfied, and related revenue recognized, when the services are rendered or upon completion. Payment is typically received immediately or in the following month. Safe deposit box rental fees are charged to the customer on an annual basis and recognized upon receipt of payment. The Company determined that rentals and renewals of safe deposit boxes will be recognized on a monthly basis consistent with the duration of the performance obligation.

The following presents noninterest income from continued operations, segregated by revenue streams in-scope and out-of-scope of Topic 606, for December 31, 2020 and 2019.

(Dollars in thousands)	2020	2019
Noninterest Income		
<i>In-scope of Topic 606:</i>		
Service charges on deposit accounts	\$ 2,839	\$ 3,910
Trust and investment fee income	1,558	1,522
Interchange income	3,006	2,678
Other noninterest income	1,803	1,354
Noninterest Income (in-scope of Topic 606)	9,206	9,464
Noninterest Income (out-of-scope of Topic 606)	1,543	556
Total Noninterest Income	\$ 10,749	\$ 10,020

Contract Balances

A contract asset balance occurs when an entity performs a service for a customer before the customer pays consideration (resulting in a contract receivable) or before payment is due (resulting in a contract asset). A contract liability balance is an entity's obligation to transfer a service to a customer for which the entity has already received payment (or payment is due) from the customer. The Company's noninterest revenue streams are largely based on transactional activity, or standard month-end revenue accruals such as asset management fees based on month-end market values. Consideration is often received immediately or shortly after the Company satisfies its performance obligation and revenue is recognized.

The Company does not typically enter into long-term revenue contracts with customers, and therefore, does not experience significant contract balances. As of December 31, 2020 and 2019, the Company did not have any significant contract balances.

NOTE 25. SUBSEQUENT EVENTS

Pending Acquisition

On March 3, 2021, the Company and Severn Bancorp, Inc. (“Severn”) entered into a definitive agreement for the Company to acquire the Maryland-based Severn.

This transaction will create the third largest community bank headquartered in Maryland. The primary reasons for the Company to acquire Severn was to access and deploy excess capital and deposits into a high growth market, while also enhancing scale to drive efficiency and profitability. Additionally, this transaction will create a competitive position in the Columbia/Baltimore/Towson MSA, while filling in our current market footprint.

Under the terms of the agreement, Severn shareholders will receive 0.6207 shares of Shore common stock and \$1.59 in cash for each share of Severn common stock. Upon closing, Shore shareholders will own approximately 59.6% of the combined Company and Severn will own approximately 40.4% of the combined Company. The transaction is still subject to satisfaction of customary closing conditions, including regulatory approvals and shareholder approval from Shore and Severn shareholders. The transaction is expected to close in the third quarter of 2021.

As of December 31, 2020, Severn had more than \$950 million in assets and operated 7 full-service community banking offices throughout Anne Arundel County, Maryland.

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

None.

Item 9A. Controls and Procedures.

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

An evaluation of the effectiveness of these disclosure controls as of December 31, 2020 was carried out under the supervision and with the participation of the Company's management, including the PEO and the PFO. Based on that evaluation, the Company's management, including the PEO and the PFO, has concluded that the Company's disclosure controls and procedures are, in fact, effective at the reasonable assurance level.

During the fourth quarter of 2020, there was no change in the Company's internal control over financial reporting that has materially affected, or is reasonably likely to materially affect, the Company's internal control over financial reporting.

As required by Section 404 of the Sarbanes-Oxley Act of 2002, management has performed an evaluation and testing of the Company's internal control over financial reporting as of December 31, 2020. Management's report on the Company's internal control over financial reporting is included in Item 8 of Part II of this annual report.

Item 9B. Other Information.

None.

PART III

Item 10. Directors, Executive Officers and Corporate Governance.

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

All other information required by this item is incorporated herein by reference to the following sections of the Company's definitive proxy statement to be filed in connection with the 2021 Annual Meeting of Stockholders:

- Election of Directors (Proposal 1);
- Continuing Directors;
- Executive Officers;
- Qualifications of Director Nominees and Continuing Directors;
- Delinquent Section 16(a) Reports;
- Corporate Governance Matters (under the heading, "Board Committees"); and
- New Employee Stock Purchase Plan (Proposal 4).

Item 11. Executive Compensation.

The information required by this item is incorporated herein by reference to the following sections of the Company's definitive proxy statement to be filed in connection with the 2021 Annual Meeting of Stockholders:

- Executive Compensation
- Director Compensation

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

The information required by this item regarding security ownership of certain beneficial owners and management is incorporated by reference to the sections of the Company's definitive proxy statement to be filed in connection with the 2021 Annual Meeting of the Stockholders entitled "Beneficial Ownership of Common Stock." Information relating to securities authorized for issuance under the Company's equity compensation plans is included in Part II of this Annual Report on Form 10-K under "Item 5. Market for Registrant's Common Equity, Related Shareholder Matters and Issuer Purchases of Equity Securities."

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

The information required by this item is incorporated herein by reference to the sections of the Company's definitive proxy statement to be filed in connection with the 2021 Annual Meeting of Stockholders entitled "Certain Relationships and Related Transactions" and "Corporate Governance Matters" (under the heading, "Director Independence").

Item 14. Principal Accounting Fees and Services.

The information required by this item is incorporated herein by reference to the section of the Company's definitive proxy statement to be filed in connection with the 2021 Annual Meeting of Stockholders entitled "Audit Fees and Services".

PART IV

Item 15. Exhibits, Financial Statement Schedules.

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

Report of Independent Registered Public Accounting Firm
Consolidated Balance Sheets at December 31, 2020 and 2019
Consolidated Statements of Income — Years Ended December 31, 2020 and 2019
Consolidated Statements of Comprehensive Income — Years Ended December 31, 2020 and 2019
Consolidated Statements of Changes in Stockholders' Equity — Years Ended December 31, 2020 and 2019
Consolidated Statements of Cash Flows — Years Ended December 31, 2020 and 2019
Notes to Consolidated Financial Statements for the years ended December 31, 2020 and 2019

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

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

Item 16. Form 10-K Summary.

None.

EXHIBIT LIST

<u>Exhibit No.</u>	<u>Description</u>
3.1(i)	Amended and Restated Articles of Incorporation (incorporated by reference to Exhibit 3.1 of the Company's Form 8-K filed on December 14, 2000)
3.1(ii)	Articles Supplementary relating to the Fixed Rate Cumulative Perpetual Preferred Stock, Series A (incorporated by reference Exhibit 4.1 of the Company's Form 8-K filed on January 13, 2009)
3.1(iii)	Articles Supplementary relating to the reclassification of Fixed Rate Cumulative Perpetual Preferred Stock, Series A, as common stock (incorporated by reference Exhibit 3.1(i) of the Company's Form 8-K filed on June 17, 2009)
3.2	Amended and Restated By-Laws (filed herewith)
4.1	Description of Registrant's Securities (incorporated by reference to Exhibit 4.1 to the Company's Form 10-K filed on March 13, 2020).
4.2	Form of Common Stock Certificate (incorporated by reference to Exhibit 4.1 of the Company's Form S-3 filed on June 25, 2010)
10.1	Shore Bancshares, Inc. Management Incentive Plan (incorporated by reference to Exhibit 10.1 of the Company's Form 8-K filed on April 21, 2010)
10.2	Shore Bancshares, Inc. Amended and Restated Executive Deferred Compensation Plan (incorporated by reference to Exhibit 10.2 of the Company's Form 8-K filed on February 14, 2007)
10.3	Shore Bancshares, Inc. 2006 Stock and Incentive Compensation Plan (incorporated by reference to Appendix A of the Company's 2006 definitive proxy statement filed on March 24, 2006)
10.4	Form of Restricted Stock Award Agreement under the 2006 Stock and Incentive Compensation Plan (incorporated by reference to Exhibit 10.1 to the Company's Form 8-K filed on April 11, 2007)
10.5	Form of Performance Share/Restricted Stock Unit Award Agreement (incorporated by reference to Exhibit 10.1 to the Company's Form 8-K filed on July 8, 2015).
10.6	Shore Bancshares, Inc. 2016 Stock and Incentive Compensation Plan (incorporated by reference to Appendix A of the Company's 2016 definitive proxy statement filed on March 15, 2016)
10.7	Form of Restricted Stock Award Agreement under the 2016 Stock and Incentive Compensation Plan (incorporated by reference to Exhibit 10.7 to the Company's Form 10-K filed on March 13, 2020).
10.8	Form of Restricted Stock Units Award under the 2016 Stock and Incentive Compensation Plan (incorporated by reference to Exhibit 10.8 to the Company's Form 10-K filed on March 13, 2020).
10.9	Change in Control Agreement, dated October 31, 2017, between Shore United Bank and Edward C. Allen (incorporated by reference to Exhibit 10.4 to the Company's Form 8-K filed on November 1, 2017)
10.10	Change in Control Agreement, dated November 2, 2018 between Shore United Bank and Lloyd L. Beatty, Jr. (incorporated by reference to Exhibit 10.1 to the Company's Form 8-K filed on November 2, 2018)
10.11	Change in Control Agreement, dated November 2, 2018 between Shore United Bank and Donna J. Stevens (incorporated by reference to Exhibit 10.2 to the Company's Form 8-K filed on November 2, 2018)

- 10.12 Shore Bancshares Announces Stock Repurchase Plan (Incorporated by reference to Exhibit 99.1 to the Company’s Form 8-K filed on April 24, 2019).
- 10.13 Supplemental Executive Retirement Plan for Lloyd L. Beatty, Jr. (Incorporated by reference to Exhibit 10.1 to the Company’s Form 8-K filed on July 25, 2019).
- 10.14 Supplemental Executive Retirement Plan for Edward C. Allen (Incorporated by reference to Exhibit 10.2 to the Company’s Form 8-K filed on July 25, 2019).
- 10.15 Supplemental Executive Retirement Plan for Donna J. Stevens (Incorporated by reference to Exhibit 10.3 to the Company’s Form 8-K filed on July 25, 2019).
- 10.16 2019 Deferred Compensation Plan (incorporated by reference to Exhibit 10.16 to the Company’s Form 10-K filed on March 13, 2020).
- 21 Subsidiaries of the Company (included in the “BUSINESS—General” section of Item 1 of Part I of this Annual Report on Form 10-K)
- 23.1 Consent of Yount, Hyde & Barbour, P.C. (filed herewith)
- 31.1 Certifications of the PEO pursuant to Section 302 of the Sarbanes-Oxley Act (filed herewith)
- 31.2 Certifications of the PFO pursuant to Section 302 of the Sarbanes-Oxley Act (filed herewith)
- 32 Certification pursuant to Section 906 of the Sarbanes-Oxley Act (furnished herewith)
- 101.INS XBRL Instance Document (filed herewith)
- 101.SCH XBRL Taxonomy Extension Schema (filed herewith)
- 101.CAL XBRL Taxonomy Extension Calculation Linkbase (filed herewith)
- 101.DEF XBRL Taxonomy Extension Definition Linkbase (filed herewith)
- 101.LAB XBRL Taxonomy Extension Label Linkbase (filed herewith)
- 101.PRE XBRL Taxonomy Extension Presentation Linkbase (filed herewith)
- 104 The cover page of Shore Bancshares, Inc.’s Annual Report on Form 10-K for the year ended December 31, 2020, formatted in Inline XBRL (contained in Exhibit 101).

SIGNATURES

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

Shore Bancshares, Inc.

Date: March 26, 2021

By: /s/ Lloyd L. Beatty, Jr.

Lloyd L. Beatty, Jr.

President and Chief Executive Officer

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

/s/ Blenda W. Armistead
Blenda W. Armistead, Director
March 26, 2021

/s/ Frank E. Mason, III
Frank E. Mason, III, Director
March 26, 2021

/s/ Clyde V. Kelly, III
Clyde V. Kelly, III, Director
March 26, 2021

/s/ James A. Judge
James A. Judge, Director
March 26, 2021

/s/ William E. Esham, III
William E. Esham, III, Director
March 26, 2021

/s/ Jeffery E. Thompson
Jeffery E. Thompson, Director
March 26, 2021

/s/ David J. Bates
David J. Bates, Director
March 26, 2021

/s/ Lloyd L. Beatty, Jr.
Lloyd L. Beatty, Jr.
Director, President, and Chief Executive Officer
(Principal Executive Officer)
March 26, 2021

/s/ David W. Moore
David W. Moore, Director
March 26, 2021

/s/ R. Michael Clemmer, Jr.
R. Michael Clemmer, Jr., Director
March 26, 2021

/s/ Dawn M. Willey
Dawn M. Willey, Director
March 26, 2021

/s/ Edward C. Allen
Edward C. Allen
Executive Vice President and Chief Financial Officer
(Principal Financial Officer)
March 26, 2021



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