

FIRST MARINER BANCORP  
Form 10-Q  
August 09, 2006

**UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION**

WASHINGTON, D.C. 20549

**FORM 10-Q**

(Mark One)

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

**For the quarterly period ended June 30, 2006.**

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

**For the transition period from                      to**

**Commission file number: 0-21815**

**FIRST MARINER BANCORP**

(Exact name of registrant as specified in its charter)

**Maryland**

(State of Incorporation)

**52-1834860**

(I.R.S. Employer Identification Number)

**3301 Boston Street, Baltimore, MD**  
(Address of principal executive offices)

**21224**  
(Zip Code)

**410-342-2600**  
(Telephone Number)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act during the preceding 12 months (or for such shorter period that the registrant was required to file such report, and (2) has been subject to such filing requirements for the past 90 days.

Yes  No

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

Large accelerated filer

Accelerated filer

Non-accelerated filer

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Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act)

Yes  No

The number of shares of common stock outstanding as of August 4, 2006 is 6,286,084 shares.

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	<b>June 30, 2006 (unaudited)</b>	<b>December 31, 2005</b>
<b>ASSETS</b>		
Cash and due from banks	\$ 30,484	\$ 40,157
Federal funds sold and interest-bearing deposits	16,455	5,678
Securities available for sale, at fair value	266,639	276,939
Loans held for sale	119,405	92,351
Loans receivable	860,748	851,586
Allowance for loan losses	(12,112)	(11,743)
Loans, net	848,636	839,843
Other real estate owned	1,065	931
Restricted stock investments	13,446	13,647
Premises and equipment, net	44,215	40,402
Accrued interest receivable	8,750	8,037
Deferred income taxes	7,118	5,940
Bank-owned life insurance	27,882	27,375
Prepaid expenses and other assets	12,537	11,178
<b>Total assets</b>	<b>\$ 1,396,632</b>	<b>\$ 1,362,478</b>
<b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>		
<b>Liabilities:</b>		
<b>Deposits:</b>		
Noninterest-bearing	\$ 187,218	\$ 182,049
Interest-bearing	695,550	693,961
Total deposits	882,768	876,010
Short-term borrowings	221,342	199,376
Long-term borrowings	129,829	131,000
Junior subordinated deferrable interest debentures	73,724	73,724
Accrued expenses and other liabilities	14,198	9,993
<b>Total liabilities</b>	<b>1,321,861</b>	<b>1,290,103</b>
<b>Stockholders' equity:</b>		
Common stock, \$.05 par value; 20,000,000 shares authorized; 6,286,084 and 6,262,442 shares issued and outstanding, respectively	314	313
Additional paid-in capital	55,590	55,193
Retained earnings	24,045	20,185
Accumulated other comprehensive loss	(5,178)	(3,316)
<b>Total stockholders' equity</b>	<b>74,771</b>	<b>72,375</b>
<b>Total liabilities and stockholders' equity</b>	<b>\$ 1,396,632</b>	<b>\$ 1,362,478</b>

*See accompanying notes to the consolidated financial statements*



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

	Three Months Ended		Six Months Ended	
	June 30, 2006 <i>(unaudited)</i>	2005	June 30, 2006 <i>(unaudited)</i>	2005
<b>Interest income:</b>				
Loans	\$ 20,668	\$ 16,514	\$ 39,696	\$ 31,186
Investments and other earning assets	3,520	3,519	6,807	7,006
Total interest income	24,188	20,033	46,503	38,192
<b>Interest expense:</b>				
Deposits	5,585	4,004	10,632	7,512
Short-term borrowings	2,697	897	4,694	2,347
Long-term borrowings	3,264	3,192	6,293	5,149
Total interest expense	11,546	8,093	21,619	15,008
Net interest income	12,642	11,940	24,884	23,184
Provision for loan losses	623	981	1,045	1,395
Net interest income after provision for loan losses	12,019	10,959	23,839	21,789
<b>Noninterest income:</b>				
Gain on sale of mortgage loans	2,263	979	3,706	1,739
Other mortgage-banking revenue	799	646	1,424	1,004
ATM fees	824	800	1,609	1,519
Service fees on deposits	1,769	1,801	3,448	3,472
Commissions on sales of nondeposit investment products	122	167	216	292
Income from bank-owned life insurance	256	252	508	509
Commissions on sales of other insurance products	753	569	1,318	982
Other	601	393	1,154	616
Total noninterest income	7,387	5,607	13,383	10,133
<b>Noninterest expense:</b>				
Salaries and employee benefits	9,006	7,818	17,438	14,963
Occupancy	1,932	1,412	3,635	3,057
Furniture, fixtures and equipment	750	761	1,550	1,517
Professional services	257	310	459	643
Advertising	397	340	863	790
Data processing	468	518	917	1,039
ATM servicing expenses	242	277	525	559
Service & maintenance	528	428	1,066	838
Other	2,706	2,254	5,349	4,200
Total noninterest expense	16,286	14,118	31,802	27,606
Net income before income taxes	3,120	2,448	5,420	4,316
Income tax expense	919	721	1,559	1,214
Net income	\$ 2,201	\$ 1,727	\$ 3,861	\$ 3,102
<b>Net income per common share:</b>				
Basic	\$ 0.35	\$ 0.28	\$ 0.62	\$ 0.52
Diluted	\$ 0.33	\$ 0.27	\$ 0.58	\$ 0.48

*See accompanying notes to the consolidated financial statements.*

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

	<b>Six Months Ended June 30,</b>	
	<b>2006</b>	<b>2005</b>
	<i>(unaudited)</i>	
<b>Cash flows from operating activities:</b>		
Net income	\$ 3,861	\$ 3,102
<b>Adjustments to reconcile net income to net cash from operating activities:</b>		
Stock-based compensation	51	
Depreciation and amortization	2,200	1,847
Amortization of unearned loan fees and costs, net	(612 )	(477 )
Amortization of premiums and discounts on loans, net	(368 )	(370 )
Amortization of premiums and discounts on mortgage-backed securities, net	115	144
Gain on sale of mortgage loans	(3,706 )	(1,739 )
Increase in accrued interest receivable	(713 )	(459 )
Provision for loan losses	1,045	1,395
Gain on sale of other real estate owned	(9 )	
Loss (gain) on disposal of premises and equipment	2	(2 )
Increase in cash surrender value of bank-owned life insurance	(508 )	(514 )
Originations of mortgage loans held for sale	(615,874 )	(554,556 )
Proceeds from mortgage loans held for sale	592,526	490,828
Net increase in accrued expenses and other liabilities	4,191	1,215
Net increase in prepaids and other assets	(1,360 )	(222 )
Net cash used in operating activities	(19,159 )	(59,808 )
<b>Cash flows from investing activities:</b>		
Loan disbursements, net of principal repayments	(9,858 )	(67,546 )
Purchases of premises and equipment	(6,030 )	(22,783 )
Proceeds from disposals of premises and equipment	15	
Redemptions (purchases) of restricted stock investments	201	(3,606 )
<b>Activity in securities available for sale:</b>		
Maturities/calls/repayments of securities available for sale	12,402	26,468
Purchase of securities available for sale	(5,250 )	(10,367 )
Proceeds from sales of other real estate owned	875	
Net cash used in investing activities	(7,645 )	(77,834 )
<b>Cash flows from financing activities:</b>		
Net increase in deposits	6,759	58,709
Net increase in other borrowed funds	20,795	94,619
Repayment of repurchase agreements		(10,000 )
Excess tax benefit on share-based compensation	7	
Proceeds from stock issuance	347	4,285
Repurchase of common stock, net of costs		(1,578 )
Net cash provided by financing activities	27,908	146,035
Increase in cash and cash equivalents	1,104	8,393
Cash and cash equivalents at beginning of period	45,835	35,447
Cash and cash equivalents at end of period	\$ 46,939	\$ 43,840
<b>Supplemental information:</b>		
Interest paid on deposits and borrowed funds	\$ 21,308	\$ 14,565
Income taxes paid	\$ 1,616	\$ 1,107
Real estate acquired in satisfaction of loans	\$ 1,000	\$ 866

*See accompanying notes to the consolidated financial statements.*





**First Mariner Bancorp and Subsidiaries**  
**Notes to Consolidated Financial Statements**

(Information as of and for the three and six months ended June 30, 2006 and 2005 is unaudited)

NOTE 1 SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

*Basis Of Presentation*

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

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

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

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

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

*Derivative Loan Commitments Hedging Activities*

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

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

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

Beginning in January 2006, we expanded our secondary marketing and hedging operations, and began to hedge a portion of

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

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

### Counterparty Credit Risk

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

### NOTE 2 COMPREHENSIVE INCOME

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

<i>(dollars in thousands)</i>	Three Months Ended		Six Months Ended	
	June 30, 2006	2005	June 30, 2006	2005
Net income	\$ 2,201	\$ 1,727	\$ 3,861	\$ 3,102
Other comprehensive income items:				
Unrealized holding gains (losses) arising during the period (net of tax expense (benefit) of \$(426), \$1,080, \$(1,172), and \$(438), respectively)	(677 )	1,717	(1,862 )	(701 )
Total other comprehensive income (loss)	(677 )	1,717	(1,862 )	(701 )
Total comprehensive income	\$ 1,524	\$ 3,444	\$ 1,999	\$ 2,401

### NOTE 3 PER SHARE DATA

Basic earnings per share is computed by dividing income available to common stockholders by the weighted-average number of common shares outstanding. Diluted earnings per share is computed after adjusting the denominator of the basic earnings per share computation for the effects of all dilutive potential common shares outstanding during the period. The dilutive effects of options, warrants and their equivalents are computed using the treasury stock method. For the three month period ended June 30, 2006 and 2005, there were 8,600 and 271,000 shares, respectively, which were antidilutive and excluded from the computation and for the six month period ended June 30, 2006 and 2005, there were 4,324 and 149,290 shares, respectively, which were antidilutive and excluded from the computation.

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

<i>(dollars in thousands, except for per share data)</i>	Three Months Ended		Six Months Ended	
	June 30, 2006	2005	June 30, 2006	2005
Net income - basic and diluted	\$ 2,201	\$ 1,727	\$ 3,861	\$ 3,102
Weighted-average share outstanding - basic	6,276,362	6,090,962	6,270,629	5,960,496
Dilutive securities - options and warrants	352,783	368,961	342,364	465,040
Adjusted weighted-average shares outstanding - dilutive	6,629,145	6,459,923	6,612,993	6,425,536
Earnings per share - basic	\$ 0.35	\$ 0.28	\$ 0.62	\$ 0.52
Earnings per share - diluted	\$ 0.33	\$ 0.27	\$ 0.58	\$ 0.48

## NOTE 4 STOCK BASED COMPENSATION

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

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

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

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

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	Number of Shares	Weighted-Average Exercise Price	Weighted-Average Remaining Contractual Term (in years)	Aggregate Intrinsic Value (in thousands)
Outstanding at beginning of period	981,934	\$ 12.16		
Granted	9,600	18.62		
Exercised	(13,020)	12.57		
Forfeited/Cancelled	(10,233)	15.54		
Outstanding at end of period	968,281	\$ 12.18	5.6	\$ 6,893,753
Exercisable at end of period	968,281	\$ 12.18	5.6	\$ 6,893,753

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

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

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

(dollars in thousands, except per share data)	Three Months Ended June 30, 2005	Six Months Ended June 30, 2005
Net income, as reported	\$ 1,727	\$ 3,102
Deduct: Total stock-based employee compensation expense determined using the fair value based method for all awards, net of related tax effects	(141)	(598)
Pro forma net income	\$ 1,586	\$ 2,504
Earnings per share:		
Basic - as reported	\$ 0.28	\$ 0.52
Basic - pro forma	\$ 0.26	\$ 0.42
Diluted - as reported	\$ 0.27	\$ 0.48
Diluted - pro forma	\$ 0.25	\$ 0.39

The total intrinsic value of options exercised and the related tax benefit during the six months ended June 30, 2006 amounted to \$81,288 and \$31,393, respectively, and proceeds from exercises of stock options amounted to \$163,692 for the six months ended June 30, 2006.

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



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NOTE 5 COMMITMENTS AND CONTINGENT LIABILITIES

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

<i>(dollars in thousands)</i>	<b>June 30, 2006</b>	<b>December 31, 2005</b>
Commitments to extend credit (includes unused lines of credit)	\$330,759	\$374,944
Standby letters of credit	4,095	4,825

NOTE 6 SEGMENT INFORMATION

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

The following table presents certain information regarding the our business segments:

**For the six month period ended June 30, 2006:**

<i>(dollars in thousands)</i>	<b>Commercial and Consumer Banking</b>	<b>Consumer Finance</b>	<b>Mortgage- Banking</b>	<b>Total</b>
Interest income	\$ 36,272	\$ 6,569	\$ 3,662	\$ 46,503
Interest expense	17,687	1,461	2,471	21,619
Net interest income	18,585	5,108	1,191	24,884
Provision for loan losses	100	945		1,045
Net interest income after provision for loan losses	18,485	4,163	1,191	23,839
Noninterest income	6,868	1,575	4,940	13,383
Noninterest expense	21,623	4,665	5,514	31,802
Net intersegment income	(119	)	119	
Net income before income taxes	\$ 3,611	\$ 1,073	\$ 736	\$ 5,420
Total assets	\$ 1,219,742	\$ 57,485	\$ 119,405	\$ 1,396,632

**For the six month period ended June 30, 2005:**

<i>(dollars in thousands)</i>	<b>Commercial and Consumer Banking</b>	<b>Consumer Finance</b>	<b>Mortgage- Banking</b>	<b>Total</b>
Interest income	\$ 31,046	\$ 4,893	\$ 2,253	\$ 38,192
Interest expense	12,961	834	1,213	15,008
Net interest income	18,085	4,059	1,040	23,184

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Provision for loan losses	675	720		1,395
Net interest income after provision for loan losses	17,410	3,339	1,040	21,789
Noninterest income	6,528	1,016	2,589	10,133
Noninterest expense	19,555	3,724	4,327	27,606
Net intersegment income	(406	)	406	
Net income before income taxes	\$ 3,977	\$ 631	\$ (292	) \$ 4,316
Total assets	\$ 1,212,924	\$ 41,833	\$ 145,422	\$ 1,400,179

NOTE 7 FINANCIAL INSTRUMENTS

We utilize various derivative instruments to economically hedge the price risk associated with our outstanding derivative loan commitments, and loans which have settled with the borrower which have not been contracted for sale to investors. Management

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expects these derivatives will experience changes in fair value opposite to changes in fair value of the derivative loan commitments and warehouse loans, thereby reducing earnings volatility related to the recognition in earnings of changes in the values of the commitments. The instruments used to economically hedge the fair value of the derivative loan commitments include forward loan sales of mortgage-backed securities or Eurodollars under mandatory contracts and forward sales commitments under best efforts contracts. A forward loan sales commitment protects us from losses on sales of the loans arising from exercise of the loan commitments by securing the ultimate sales price and delivery date of the loans. A forward contract to sell mortgage-backed securities or Eurodollars hedges and protects price, volume and other interest rate lock commitment risks. We take into account various factors and strategies in determining the portion of the mortgage pipeline (derivative loan commitments) we want to hedge economically. Estimates of fair value take into consideration the probability of funding the loan.

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

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

<i>(dollars in thousands)</i>	<b>Notional Amount</b>	<b>Estimated Fair Value</b>
Interest rate lock commitments	\$ 37,807	\$ 37,535
<b>Open hedge positions:</b>		
Forward sales commitments on loan pipeline and funded loans	\$ 87,382	\$ 87,563
Forward contracts to sell mortgage-backed securities and Eurodollars	\$ 87,250	\$ 87,294

#### NOTE 8 RECENT ACCOUNTING PRONOUNCEMENTS

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

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

In March 2006, the FASB issued SFAS No. 156, Accounting for Servicing of Financial Assets an amendment of FASB Statement No. 140. This statement amends Statement No. 140 with respect to the accounting for separately recognized servicing assets and servicing liabilities. It requires an entity to recognize a servicing asset or servicing liability each time an obligation is undertaken to service a financial asset by entering into a servicing contract in certain situations and requires all separately recognized servicing assets and liabilities to be initially measured at fair value, if practicable. The statement permits the choice between the amortization method and the fair value measurement method for the

subsequent measurement of the servicing assets or liabilities and allows for a one-time reclassification of available-for-sale securities to trading securities at initial adoption. The statement also requires separate presentation of servicing assets and servicing liabilities subsequently measured at fair value in the statement of

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financial position and additional disclosures for all separately recognized servicing assets and servicing liabilities. The statement is effective for fiscal years beginning after September 15, 2006. The adoption of this standard is not anticipated to have a material impact on our financial condition, results of operations or liquidity.

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

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

### Forward-Looking Statements

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

### The Company

The Company is a financial holding company incorporated under the laws of Maryland and registered under the federal Bank Holding Company Act of 1956, as amended. First Mariner Bancorp is presently the fourth largest publicly held bank holding company headquartered in the state of Maryland. The Company was organized in 1994 and changed its name to First Mariner Bancorp in May 1995. Since 1995, the Company's strategy has involved building a network of banking branches, ATMs and other financial services outlets to capture market share and build a community franchise for stockholders, customers and employees. The Company is currently focused on growing assets and earnings by capitalizing on the broad network of bank branches, mortgage offices, consumer finance offices, and ATMs established during its infrastructure expansion phase.

The Company's business is conducted primarily through its wholly owned subsidiaries, First Mariner Bank (the Bank), Finance Maryland LLC (Finance Maryland), and FM Appraisals, LLC (FM Appraisals). The Bank is the largest operating subsidiary of the Company with assets exceeding \$1.3 billion as of June 30, 2006. The Bank was formed in 1995 through the merger of several small financial institutions. The Bank's primary market area for its core banking operations, which consist of traditional commercial and consumer lending, as well as retail and commercial deposit operations, is central Maryland as well as portions of Maryland's eastern shore. The Bank currently has an application pending to open a branch in Pennsylvania. The Bank is an independent community bank, and its deposits are insured by the Federal Deposit Insurance Corporation (FDIC).

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

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

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Finance Maryland was formed in July 2002, and engages in traditional consumer finance activities, making small direct cash loans to individuals, the purchase of installment loan sales contracts from local merchants and retail dealers of consumer goods, and

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loans to individuals via direct mail solicitations. Finance Maryland currently operates 17 branches, including a central approval office, in the State of Maryland and four branches in the state of Delaware, which operate under the trade name Finance Delaware. Finance Maryland had total assets of \$57.5 million as of June 30, 2006.

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

#### Critical Accounting Policies

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

#### *Allowance for loan losses*

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

The allowance is established and maintained at a level that management believes is adequate to cover losses resulting from the inability of borrowers to make required payments on loans. Estimates for loan losses are arrived at by analyzing risks associated with specific loans and the loan portfolio. Current trends in delinquencies and charge-offs, the views of Bank regulators, changes in the size and composition of the loan portfolio and peer comparisons are also factors. The analysis also requires consideration of the economic climate and direction and change in the interest rate environment, which may impact a borrower's ability to pay, legislation impacting the banking industry and environmental and economic conditions specific to the Bank's service areas. Because the calculation of the allowance for loan losses relies on estimates and judgments relating to inherently uncertain events, results may differ from our estimates.

#### *Investment securities*

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

#### *Deferred income taxes*

Under the liability method, deferred tax assets and liabilities are determined based on the difference between the financial statement and tax bases of assets and liabilities. Deferred tax assets are subject to management's judgment based upon available evidence that future realization is more likely than not. For financial reporting purposes, a valuation allowance of 100% of the deferred tax asset has been recognized to offset the deferred tax assets related to state tax loss carryforwards. If management determines that we may be able to realize all or part of the state deferred tax asset in the future, a credit to income tax expense may be required to increase the recorded value of the state net deferred tax asset to the expected realizable amount.

#### *Loan income recognition*

Interest income on loans is accrued at the contractual rate based on the principal outstanding. Loan origination fees and

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

### Financial Condition

The Company's total assets were \$1.397 billion at June 30, 2006, compared to \$1.362 billion at December 31, 2005, increasing \$34.154 million or 2.5% for the first six months of 2006. Earning assets increased \$36.492 million or 2.9% to \$1.277 billion from \$1.240 billion. The increase in assets was primarily due to increases in short-term investments (+\$10.777 million), loans held for sale (+\$27.054 million), and net loans outstanding (+\$8.793 million), partially offset by declines in cash and due from banks (-\$9.673 million) and securities available for sale (-\$10.300 million). The growth in assets was funded by increases in deposits (+\$6.758 million) and short-term borrowings (+\$21.966 million).

#### *Investment securities available for sale*

We utilize the investment portfolio as part of our overall asset/liability management practices to enhance interest revenue while providing necessary liquidity for the funding of loan growth or deposit withdrawals. Total investment securities declined \$10.300 million due to normal principal payments on mortgage-backed securities, scheduled maturities of other investments, and a decline in market values, offset by additional purchases of securities of \$5.250 million. At June 30, 2006, our unrealized loss on securities classified as available for sale totaled \$8.436 million, compared to \$5.402 million at December 31, 2005. The decline resulted from increases in short-term and long-term interest rates from December 31, 2005 to June 30, 2006, which resulted in lower market valuation of our fixed income investments. We consider the decline in market values to be temporary and do not expect to realize losses on any of the securities currently in the investment portfolio. The investment portfolio composition is as follows:

<i>(dollars in thousands)</i>	June 30, 2006		December 31, 2005		
	Balance	Percent of Total	Balance	Percent of Total	
Investment securities available for sale:					
Mortgage-backed securities	\$ 145,733	54.6	% \$ 161,112	58.2	%
Trust preferred securities	38,708	14.5	% 34,087	12.3	%
US government agency notes	68,258	25.6	% 68,271	24.7	%
US Treasury securities	988	0.4	% 986	0.3	%
Obligations of state and municipal subdivisions	2,930	1.1	% 2,969	1.1	%
Corporate obligations	1,893	0.7	% 1,777	0.6	%
Equity securities	1,409	0.5	% 1,310	0.5	%
Foreign government bonds	1,750	0.7	% 1,481	0.5	%
Other investment securities	4,970	1.9	% 4,946	1.8	%
Total investment securities available for sale	\$ 266,639	100.0	% \$ 276,939	100.0	%

#### *Loans*

Total loans increased \$9.162 million during the first six months of 2006. Growth was realized in our residential mortgage loan portfolio (+\$5.790 million), commercial construction portfolio (+\$8.375 million), commercial portfolio (+\$7.268 million), consumer loan portfolio (+\$8.497 million) and second mortgages on real estate portfolio (+\$4.503 million). Our loans secured by deposits and other also increased by \$241,000. The growth in these loan types was offset by decreases in our commercial real estate portfolio (-\$16.155 million) and consumer residential construction portfolio (-\$9.352 million). The total loan portfolio was comprised of the following:





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<i>(dollars in thousands)</i>	June 30, 2006		December 31, 2005	
	Balance	Percent of Total	Balance	Percent of Total
Loans secured by first mortgages on real estate:				
Residential	\$ 46,718	5.4	% \$ 40,928	4.8 %
Commercial	334,073	38.8	% 350,228	41.1 %
Consumer residential construction	117,140	13.6	% 126,492	14.8 %
Commercial/residential construction	121,770	14.1	% 113,395	13.3 %
	619,701	71.9	% 631,043	74.0 %
Commercial	75,086	8.7	% 67,818	8.0 %
Loans secured by second mortgages on real estate	101,249	11.8	% 96,746	11.4 %
Consumer loans	64,116	7.4	% 55,619	6.5 %
Loans secured by deposits	1,334	0.2	% 1,093	0.1 %
Total loans	861,486	100.0	% 852,319	100.0 %
Unamortized loan discounts	(172 )		(121 )	
Unearned loan fees, net	(566 )		(612 )	
	\$ 860,748		\$ 851,586	