

FIRST MARINER BANCORP  
Form 10-Q  
November 07, 2011

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

**FORM 10-Q**

(Mark One)

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

**For the quarterly period ended September 30, 2011.**

☐ **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)

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

**21224**

**410-342-2600**

(Address of principal executive offices)

(Zip Code)

(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 has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes ☒ No ☐ (Not Applicable)

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

Large accelerated filer ☐ Accelerated filer ☐ Non-accelerated filer ☐ Smaller reporting company ☒

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

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The number of shares of common stock outstanding as of November 3, 2011 is 18,860,482 shares.

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**FIRST MARINER BANCORP AND SUBSIDIARIES  
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**CAUTIONARY NOTE REGARDING FORWARD-LOOKING STATEMENTS**

Some of our statements contained in, or incorporated by reference into, this Quarterly Report on Form 10-Q are forward-looking statements within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934. We intend such forward-looking statements to be covered by the safe harbor provisions for forward-looking statements contained in the Private Securities Litigation Reform Act of 1995 and are including this statement for purposes of invoking these safe harbor provisions. Forward-looking statements are not guarantees of performance or results. When we use words like may, plan, contemplate, anticipate, believe, intend, expect, project, predict, estimate, target, could, is likely, should, would, will, and similar expressions, you should consider the forward-looking statements, although we may use other phrasing. These forward-looking statements involve risks and uncertainties and are based on our beliefs and assumptions and on the information available to us at the time that these disclosures were prepared. These forward-looking statements involve risks and uncertainties and may not be realized due to a variety of factors, including, but not limited to, the following:

the strength of the United States economy in general, the strength of the local economies in which we conduct operations, and the unfavorable effects of future economic conditions, including inflation, recession, or a continuing decrease in real estate values;

geopolitical conditions, including acts or threats of terrorism, actions taken by the United States or other governments in response to acts or threats of terrorism and/or military conflicts, which could impact business and economic conditions in the United States and abroad;

the effects of, and changes in, trade, monetary, and fiscal policies and laws, including interest rate policies of the Federal Reserve Board, inflation, interest rate, market, and monetary fluctuations;

the risks of changes in interest rates on the level and composition of deposits, loan demand, and the values of loan collateral, securities, and interest sensitive assets and liabilities;

the effect of changes in accounting policies and practices, as may be adopted from time-to-time by bank regulatory agencies, the Securities and Exchange Commission, the Financial Accounting Standards Board, or other accounting standards setters;

adverse changes in the securities markets;

the effects of competition from other commercial banks, thrifts, mortgage-banking firms, consumer finance companies, credit unions, securities brokerage firms, insurance companies, money market and other mutual funds, and other financial institutions operating in our market area and elsewhere, including institutions operating regionally, nationally, and internationally, together with competitors offering banking products and services by mail, telephone, and the Internet;

costs and potential disruption or interruption of operations due to cyber security incidents;

a decline in demand for our products and services;

an inability to attract and retain deposits;

the timely development of competitive new products and services and the acceptance of these products and services by new and existing customers;

changes in consumer spending and savings habits;

the effect of any mergers, acquisitions, or other transactions to which we or our subsidiary may from time to time be a party;

our ability to effectively manage market risk, credit risk, and operational risk;

unanticipated regulatory or judicial proceedings;

the success and timing of our business strategies and our ability to effectively carry out our business and capital plans;

our ability to continue to operate as a going concern;

our inability to realize the benefits from our cost saving initiatives;

our ability to meet our interest payment obligations on our junior subordinated deferrable interest debentures upon expiration of the deferral period in 2013;

All written or oral forward-looking statements attributable to us are expressly qualified in their entirety by this Cautionary Note. Our actual results may differ significantly from those we discuss in these forward-looking statements. For other factors, risks, and uncertainties that could cause our actual results to differ materially from estimates and projections contained in these forward-looking statements, please read the

Risk Factors in Item 1A in Part II of this Quarterly Report on Form 10-Q, Item 1A in Part II of the Quarterly Reports on Form 10-Q for the quarters ended March 31, 2011 and June 30, 2011, and in Item 1A in Part I of our Annual Report on Form 10-K as of and for the year ended December 31, 2010. Any forward-looking statement speaks only as of the date which such statement was made, and, except as required by law, we expressly disclaim any obligation or undertaking to disseminate any updates or revisions to any forward-looking statement to reflect events or circumstances after the date on which such statement is made or to reflect the occurrence of unanticipated events.

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

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

|                                                                                                                                                                                | <b>September<br/>30,<br/>2011</b> | <b>December 31,<br/>2010</b> |
|--------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|-----------------------------------|------------------------------|
|                                                                                                                                                                                | <u>(unaudited)</u>                |                              |
| <b>ASSETS</b>                                                                                                                                                                  |                                   |                              |
| Cash and due from banks                                                                                                                                                        | \$ 152,224                        | \$ 169,557                   |
| Federal funds sold and interest-bearing deposits                                                                                                                               | 34,440                            | 48,404                       |
| Securities available for sale, at fair value                                                                                                                                   | 22,646                            | 27,826                       |
| Loans held for sale, at fair value                                                                                                                                             | 126,191                           | 140,343                      |
| Loans receivable                                                                                                                                                               | 736,672                           | 811,687                      |
| Allowance for loan losses                                                                                                                                                      | (14,112)                          | (14,115)                     |
|                                                                                                                                                                                | <u>722,560</u>                    | <u>797,572</u>               |
| Loans, net                                                                                                                                                                     | 722,560                           | 797,572                      |
| Real estate acquired through foreclosure                                                                                                                                       | 24,739                            | 21,185                       |
| Restricted stock investments                                                                                                                                                   | 6,969                             | 7,095                        |
| Premises and equipment, net                                                                                                                                                    | 38,927                            | 41,068                       |
| Accrued interest receivable                                                                                                                                                    | 3,848                             | 3,844                        |
| Bank-owned life insurance                                                                                                                                                      | 37,172                            | 36,188                       |
| Prepaid expenses and other assets                                                                                                                                              | 27,945                            | 16,555                       |
|                                                                                                                                                                                | <u>1,197,661</u>                  | <u>1,309,637</u>             |
| <b>Total assets</b>                                                                                                                                                            | <b>\$ 1,197,661</b>               | <b>\$ 1,309,637</b>          |
| <b>LIABILITIES AND STOCKHOLDERS (DEFICIT) EQUITY</b>                                                                                                                           |                                   |                              |
| <b>Liabilities:</b>                                                                                                                                                            |                                   |                              |
| <b>Deposits:</b>                                                                                                                                                               |                                   |                              |
| Noninterest-bearing                                                                                                                                                            | \$ 103,153                        | \$ 103,450                   |
| Interest-bearing                                                                                                                                                               | 928,725                           | 1,018,439                    |
|                                                                                                                                                                                | <u>1,031,878</u>                  | <u>1,121,889</u>             |
| Total deposits                                                                                                                                                                 | 1,031,878                         | 1,121,889                    |
| Short-term borrowings                                                                                                                                                          | 44,062                            | 84,399                       |
| Long-term borrowings                                                                                                                                                           | 73,746                            | 33,888                       |
| Junior subordinated deferrable interest debentures                                                                                                                             | 52,068                            | 52,068                       |
| Accrued expenses and other liabilities (\$48 and \$137 at fair value, respectively)                                                                                            | 17,479                            | 13,647                       |
|                                                                                                                                                                                | <u>1,219,233</u>                  | <u>1,305,891</u>             |
| <b>Total liabilities</b>                                                                                                                                                       | <b>1,219,233</b>                  | <b>1,305,891</b>             |
| <b>Stockholders (deficit) equity:</b>                                                                                                                                          |                                   |                              |
| Common stock, \$.05 par value; 75,000,000 shares authorized; 18,860,482 and 18,050,117 shares issued and outstanding at September 30, 2011 and December 31, 2010, respectively | 939                               | 902                          |
| Additional paid-in capital                                                                                                                                                     | 80,102                            | 79,667                       |
| Retained deficit                                                                                                                                                               | (99,479)                          | (73,210)                     |
| Accumulated other comprehensive loss                                                                                                                                           | (3,134)                           | (3,613)                      |
|                                                                                                                                                                                | <u>(21,572)</u>                   | <u>3,746</u>                 |
| <b>Total stockholders (deficit) equity</b>                                                                                                                                     | <b>(21,572)</b>                   | <b>3,746</b>                 |

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|                                                     |              |              |
|-----------------------------------------------------|--------------|--------------|
| Total liabilities and stockholders (deficit) equity | \$ 1,197,661 | \$ 1,309,637 |
|-----------------------------------------------------|--------------|--------------|

*See accompanying notes to the consolidated financial statements*

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

|                                                                            | <b>Three Months Ended<br/>September 30,</b> |             | <b>Nine Months Ended<br/>September 30,</b> |             |
|----------------------------------------------------------------------------|---------------------------------------------|-------------|--------------------------------------------|-------------|
|                                                                            | <b>2011</b>                                 | <b>2010</b> | <b>2011</b>                                | <b>2010</b> |
|                                                                            | <i>(unaudited)</i>                          |             | <i>(unaudited)</i>                         |             |
| Interest income:                                                           |                                             |             |                                            |             |
| Loans                                                                      | \$ 11,222                                   | \$ 13,270   | \$ 33,867                                  | \$ 39,531   |
| Investments and other earning assets                                       | 455                                         | 509         | 1,651                                      | 1,945       |
| Total interest income                                                      | 11,677                                      | 13,779      | 35,518                                     | 41,476      |
| Interest expense:                                                          |                                             |             |                                            |             |
| Deposits                                                                   | 3,625                                       | 4,895       | 12,217                                     | 15,957      |
| Short-term borrowings                                                      | 61                                          | 99          | 232                                        | 232         |
| Long-term borrowings                                                       | 852                                         | 932         | 2,476                                      | 3,583       |
| Total interest expense                                                     | 4,538                                       | 5,926       | 14,925                                     | 19,772      |
| Net interest income                                                        | 7,139                                       | 7,853       | 20,593                                     | 21,704      |
| Provision for loan losses                                                  | 5,000                                       | 9,750       | 11,580                                     | 16,290      |
| Net interest income (loss) after provision for loan losses                 | 2,139                                       | (1,897)     | 9,013                                      | 5,414       |
| Noninterest income:                                                        |                                             |             |                                            |             |
| Total other-than-temporary impairment ( OTTI ) charges                     | (299)                                       | (302)       | (327)                                      | (609)       |
| Less: Portion included in other comprehensive income (pre-tax)             | (382)                                       | (514)       | (491)                                      | (640)       |
| Net OTTI charges on securities available for sale                          | (681)                                       | (816)       | (818)                                      | (1,249)     |
| Mortgage-banking revenue                                                   | 4,609                                       | 8,804       | 7,942                                      | 13,499      |
| ATM fees                                                                   | 755                                         | 745         | 2,314                                      | 2,279       |
| Gain on debt exchange                                                      |                                             |             |                                            | 958         |
| Service fees on deposits                                                   | 717                                         | 933         | 2,194                                      | 3,109       |
| Gain on financial instruments carried at fair value                        |                                             | 331         |                                            | 1,661       |
| Gain on sale of securities available for sale                              | 638                                         |             | 781                                        | 54          |
| Gain on sale of premises and equipment                                     | 2                                           | 2           | 4                                          | 192         |
| Commissions on sales of nondeposit investment products                     | 75                                          | 110         | 347                                        | 381         |
| Income from bank-owned life insurance                                      | 316                                         | 353         | 984                                        | 1,066       |
| Other                                                                      | 1,289                                       | 154         | 1,779                                      | 589         |
| Total noninterest income                                                   | 7,720                                       | 10,616      | 15,527                                     | 22,539      |
| Noninterest expense:                                                       |                                             |             |                                            |             |
| Salaries and employee benefits                                             | 5,876                                       | 6,501       | 18,003                                     | 19,409      |
| Occupancy                                                                  | 2,202                                       | 2,297       | 6,407                                      | 6,863       |
| Furniture, fixtures, and equipment                                         | 426                                         | 585         | 1,357                                      | 1,800       |
| Professional services                                                      | 1,259                                       | 838         | 3,742                                      | 2,149       |
| Advertising                                                                | 219                                         | 153         | 470                                        | 420         |
| Data processing                                                            | 393                                         | 460         | 1,237                                      | 1,343       |
| ATM servicing expenses                                                     | 217                                         | 227         | 655                                        | 655         |
| Write-downs, losses, and costs of real estate acquired through foreclosure | 3,218                                       | 1,849       | 6,635                                      | 6,393       |
| FDIC insurance premiums                                                    | 878                                         | 1,029       | 3,390                                      | 2,927       |
| Service and maintenance                                                    | 594                                         | 559         | 1,872                                      | 1,756       |

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|                                                                                     |                |                |                 |                 |
|-------------------------------------------------------------------------------------|----------------|----------------|-----------------|-----------------|
| Corporate insurance                                                                 | 388            | 301            | 1,069           | 902             |
| Consulting fees                                                                     | 377            | 333            | 1,042           | 745             |
| Loan collection expenses                                                            | 329            | 785            | 608             | 1,176           |
| Other                                                                               | 1,443          | 1,862          | 4,322           | 4,668           |
|                                                                                     | <u>17,819</u>  | <u>17,779</u>  | <u>50,809</u>   | <u>51,206</u>   |
| Total noninterest expense                                                           |                |                |                 |                 |
| Net loss from continuing operations before income taxes and discontinued operations | (7,960)        | (9,060)        | (26,269)        | (23,253)        |
| Income tax benefit - continuing operations                                          |                | (4,452)        |                 | (10,748)        |
|                                                                                     | <u>(7,960)</u> | <u>(4,608)</u> | <u>(26,269)</u> | <u>(12,505)</u> |
| Net loss from continuing operations                                                 |                |                |                 |                 |
| Loss from discontinued operations                                                   |                |                |                 | (200)           |
|                                                                                     | <u></u>        | <u></u>        | <u></u>         | <u></u>         |
| Net loss                                                                            | \$ (7,960)     | \$ (4,608)     | \$ (26,269)     | \$ (12,705)     |
|                                                                                     | <u></u>        | <u></u>        | <u></u>         | <u></u>         |

**First Mariner Bancorp and Subsidiary**  
**Consolidated Statements of Operations (Continued)**

|                                                         | <b>Three Months Ended<br/>September 30,</b> |             | <b>Nine Months Ended<br/>September 30,</b> |             |
|---------------------------------------------------------|---------------------------------------------|-------------|--------------------------------------------|-------------|
|                                                         | <b>2011</b>                                 | <b>2010</b> | <b>2011</b>                                | <b>2010</b> |
|                                                         | <i>(unaudited)</i>                          |             | <i>(unaudited)</i>                         |             |
| Net loss per common share from continuing operations:   |                                             |             |                                            |             |
| Basic                                                   | \$ (0.42)                                   | \$ (0.26)   | \$ (1.41)                                  | \$ (0.92)   |
| Diluted                                                 | \$ (0.42)                                   | \$ (0.26)   | \$ (1.41)                                  | \$ (0.92)   |
| Net loss per common share from discontinued operations: |                                             |             |                                            |             |
| Basic                                                   | \$                                          | \$          | \$                                         | \$ (0.01)   |
| Diluted                                                 | \$                                          | \$          | \$                                         | \$ (0.01)   |
| Net loss per common share:                              |                                             |             |                                            |             |
| Basic                                                   | \$ (0.42)                                   | \$ (0.26)   | \$ (1.41)                                  | \$ (0.93)   |
| Diluted                                                 | \$ (0.42)                                   | \$ (0.26)   | \$ (1.41)                                  | \$ (0.93)   |

*See accompanying notes to the consolidated financial statements.*

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**First Mariner Bancorp and Subsidiary**  
**Consolidated Statements of Changes in Stockholders' (Deficit) Equity**  
*(dollars in thousands except per share data)*

**For the Nine Months Ended September 30, 2011 (unaudited)**

|                                                          | <b>Number of<br/>Shares of<br/>Common<br/>Stock</b> | <b>Common<br/>Stock</b> | <b>Additional<br/>Paid-in<br/>Capital</b> | <b>Retained<br/>Deficit</b> | <b>Accumulated<br/>Other<br/>Comprehensive<br/>Loss</b> | <b>Total<br/>Stockholders'<br/>(Deficit) Equity</b> | <b>Comprehensive<br/>Loss</b> |
|----------------------------------------------------------|-----------------------------------------------------|-------------------------|-------------------------------------------|-----------------------------|---------------------------------------------------------|-----------------------------------------------------|-------------------------------|
| Balance at December 31, 2010                             | 18,050,117                                          | \$ 902                  | \$ 79,667                                 | \$ (73,210)                 | \$ (3,613)                                              | \$ 3,746                                            |                               |
| Net loss                                                 |                                                     |                         |                                           | (26,269)                    |                                                         | (26,269)                                            | \$ (26,269)                   |
| Common stock issued, net of costs                        | 810,365                                             | 37                      | 430                                       |                             |                                                         | 467                                                 |                               |
| Stock-based compensation expense                         |                                                     |                         | 5                                         |                             |                                                         | 5                                                   |                               |
| Changes in unrealized losses on securities, net of taxes |                                                     |                         |                                           |                             | 479                                                     | 479                                                 | 479                           |
| Comprehensive loss                                       |                                                     |                         |                                           |                             |                                                         |                                                     | \$ (25,790)                   |
| Balance at September 30, 2011                            | 18,860,482                                          | \$ 939                  | \$ 80,102                                 | \$ (99,479)                 | \$ (3,134)                                              | \$ (21,572)                                         |                               |

**For the Nine Months Ended September 30, 2010 (unaudited)**

|                                                          | <b>Number of<br/>Shares of<br/>Common<br/>Stock</b> | <b>Common<br/>Stock</b> | <b>Additional<br/>Paid-in<br/>Capital</b> | <b>Retained<br/>Deficit</b> | <b>Accumulated<br/>Other<br/>Comprehensive<br/>Loss</b> | <b>Total<br/>Stockholders'<br/>Equity</b> | <b>Comprehensive<br/>Loss</b> |
|----------------------------------------------------------|-----------------------------------------------------|-------------------------|-------------------------------------------|-----------------------------|---------------------------------------------------------|-------------------------------------------|-------------------------------|
| Balance at December 31, 2009                             | 6,452,631                                           | \$ 323                  | \$ 56,771                                 | \$ (26,621)                 | \$ (3,486)                                              | \$ 26,987                                 |                               |
| Net loss                                                 |                                                     |                         |                                           | (12,705)                    |                                                         | (12,705)                                  | \$ (12,705)                   |
| Common stock issued, net of costs                        | 11,509,818                                          | 570                     | 22,704                                    |                             |                                                         | 23,274                                    |                               |
| Stock-based compensation expense                         |                                                     |                         | 21                                        |                             |                                                         | 21                                        |                               |
| Other                                                    |                                                     |                         | 231                                       | (231)                       |                                                         |                                           |                               |
| Changes in unrealized losses on securities, net of taxes |                                                     |                         |                                           |                             | 1,194                                                   | 1,194                                     | 1,194                         |
| Comprehensive loss                                       |                                                     |                         |                                           |                             |                                                         |                                           | \$ (11,511)                   |
| Balance at September 30, 2010                            | 17,962,449                                          | \$ 893                  | \$ 79,727                                 | \$ (39,557)                 | \$ (2,292)                                              | \$ 38,771                                 |                               |

See accompanying notes to the consolidated financial statements.

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

|                                                                                       | <b>Nine Months Ended September 30,</b> |             |
|---------------------------------------------------------------------------------------|----------------------------------------|-------------|
|                                                                                       | <b>2011</b>                            | <b>2010</b> |
|                                                                                       | <i>(unaudited)</i>                     |             |
| Cash flows from operating activities:                                                 |                                        |             |
| Net loss                                                                              | \$ (26,269)                            | \$ (12,705) |
| Adjustments to reconcile net loss to net cash from operating activities:              |                                        |             |
| Loss from discontinued operations                                                     |                                        | 200         |
| Stock-based compensation                                                              | 5                                      | 21          |
| Depreciation and amortization                                                         | 2,472                                  | 2,947       |
| Amortization of unearned loan fees and costs, net                                     | 283                                    | 144         |
| Amortization (accretion) of premiums and discounts on mortgage-backed securities, net | 29                                     | (22)        |
| Gain on financial instruments carried at fair value                                   |                                        | (1,661)     |
| Origination fees and gain on sale of mortgage loans                                   | (6,750)                                | (11,481)    |
| Gain on debt exchange                                                                 |                                        | (958)       |
| Net OTTI charges on securities available for sale                                     | 818                                    | 1,249       |
| Gain on sale of securities available for sale                                         | (781)                                  | (54)        |
| (Increase) decrease in accrued interest receivable                                    | (4)                                    | 715         |
| Provision for loan losses                                                             | 11,580                                 | 16,290      |
| Write-downs and losses on sale of real estate acquired through foreclosure            | 5,704                                  | 4,936       |
| Gain on sale of premises and equipment                                                | (4)                                    | (192)       |
| Increase in cash surrender value of bank-owned life insurance                         | (984)                                  | (1,066)     |
| Originations of mortgage loans held for sale ( LHFS )                                 | (691,831)                              | (915,771)   |
| Proceeds from sales of mortgage LHFS                                                  | 710,702                                | 897,714     |
| Net increase in accrued expenses and other liabilities                                | 4,318                                  | 735         |
| Net increase in prepaids and other assets                                             | (11,716)                               | (6,561)     |
| Net cash used in operating activities                                                 | (2,428)                                | (25,520)    |
| Cash flows from investing activities:                                                 |                                        |             |
| Loan principal repayments, net                                                        | 49,542                                 | 32,441      |
| Repurchase of loans previously sold                                                   | (435)                                  | (1,208)     |
| Sale of restricted stock investments                                                  | 126                                    | 564         |
| Purchases of premises and equipment                                                   | (336)                                  | (1,070)     |
| Proceeds from disposals of premises and equipment                                     | 9                                      | 775         |
| Sales of trading securities                                                           |                                        | 10,083      |
| Maturities/calls/repayments of trading securities                                     |                                        | 735         |
| Activity in securities available for sale:                                            |                                        |             |
| Maturities/calls/repayments                                                           | 16,206                                 | 4,280       |
| Sales                                                                                 | 49,511                                 | 8,011       |
| Purchases                                                                             | (59,799)                               | (8,090)     |
| Additional funds disbursed on real estate acquired through foreclosure                | (1,754)                                |             |
| Proceeds from sales of real estate acquired through foreclosure                       | 8,570                                  | 12,974      |
| Net cash provided investing activities                                                | 61,640                                 | 59,495      |
| Cash flows from financing activities:                                                 |                                        |             |
| Net decrease in deposits                                                              | (90,010)                               | (40,000)    |
| Net decrease in other borrowed funds                                                  | (479)                                  | (887)       |
| Net (costs of) proceeds from stock issuance                                           | (20)                                   | 10,453      |
| Net cash used in financing activities                                                 | (90,509)                               | (30,434)    |

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|                                                    |            |            |
|----------------------------------------------------|------------|------------|
| (Decrease) increase in cash and cash equivalents   | (31,297)   | 3,541      |
| Cash and cash equivalents at beginning of period   | 217,961    | 173,703    |
| Cash and cash equivalents at end of period         | \$ 186,664 | \$ 177,244 |
| Supplemental information:                          |            |            |
| Interest paid on deposits and borrowed funds       | \$ 13,997  | \$ 20,420  |
| Real estate acquired in satisfaction of loans      | \$ 16,073  | \$ 17,919  |
| Transfers of loans held for sale to loan portfolio | \$ 2,031   | \$         |

*See accompanying notes to the consolidated financial statements*

**First Mariner Bancorp and Subsidiary**  
**Notes to Consolidated Financial Statements**  
*(Information as of and for the three and nine months  
ended September 30, 2011 and 2010 is unaudited)*

**(1) Summary of Significant Accounting Policies**

***Basis of Presentation***

The accompanying consolidated financial statements for First Mariner Bancorp 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 ( U.S. ) ( GAAP ). The consolidated financial statements should be read in conjunction with the audited financial statements included in First Mariner Bancorp's Annual Report on Form 10-K as of and for the year ended December 31, 2010. When used in these notes, the terms the Company, we, us, and our refer to First Mariner Bancorp and, unless the context requires otherwise, its consolidated subsidiary.

The consolidated financial statements include the accounts of First Mariner and its wholly owned subsidiary, 1<sup>st</sup> Mariner Bank (the Bank ). All significant intercompany accounts and transactions have been eliminated in consolidation. Events occurring after the date of the financial statements were considered in the preparation of the financial statements. Certain reclassifications have been made to amounts previously reported to conform to classifications made in 2011.

The consolidated financial statements as of September 30, 2011 and for the three and nine months ended September 30, 2011 and 2010 are unaudited but include all adjustments, consisting only of normal recurring adjustments, which we consider necessary for a fair presentation of financial position and results of operations for those periods. The results of operations for the three and nine months ended September 30, 2011 are not necessarily indicative of the results that will be achieved for the entire year or any future interim period.

The preparation of the financial statements in conformity with GAAP 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 loan losses (the allowance ), loan repurchases and related valuations, real estate acquired through foreclosure, impairment of securities available for sale ( AFS ), valuations of financial instruments, and deferred income taxes. In connection with these determinations, management evaluates historical trends and ratios and, where appropriate, obtains independent appraisals for significant properties and prepares fair value analyses. Actual results could differ significantly from those estimates.

**(2) Going Concern Consideration**

Due to the conditions and events discussed later in Note 6, substantial doubt exists as to our ability to continue as a going concern. Management is taking various steps designed to improve the Bank's capital position. The Bank has developed a written alternative capital plan designed to improve the Bank's capital ratios. Such plan is dependent upon a capital infusion to meet the capital requirements of the various regulatory agreements (see Note 6 for more information on the agreements). The Company continues to work with its advisors in an attempt to improve capital ratios. The Company has entered into a definitive agreement regarding the raising of additional capital (see Note 6); however, no assurances can be made that the Company will ultimately meet the provisions and deadlines of the agreement.

The consolidated financial statements presented above and the accompanying Notes have been prepared on a going concern basis, which contemplates the realization of assets and the discharge of liabilities in the normal course of business for the foreseeable future, and does not include any adjustment to reflect the possible future effects on the recoverability and classification of assets, or the amounts and classification of liabilities that may result from the outcome of any extraordinary regulatory action, which would affect our ability to continue as a going concern.

**(3) Securities**

The composition of our securities portfolio (all AFS) is as follows:

## September 30, 2011

| <i>(dollars in thousands)</i>    | <b>Amortized<br/>Cost</b> | <b>Unrealized<br/>Gains</b> | <b>Unrealized<br/>Losses</b> | <b>Estimated<br/>Fair Value</b> |
|----------------------------------|---------------------------|-----------------------------|------------------------------|---------------------------------|
| Mortgage-backed securities       | \$ 1,846                  | \$ 117                      | \$                           | \$ 1,963                        |
| Trust preferred securities       | 13,443                    | 85                          | 3,310                        | 10,218                          |
| U.S. government agency notes     | 8,511                     | 9                           | 7                            | 8,513                           |
| U.S. Treasury securities         | 1,015                     |                             |                              | 1,015                           |
| Equity securities - banks        | 215                       |                             | 64                           | 151                             |
| Equity securities - mutual funds | 750                       | 36                          |                              | 786                             |
|                                  | <b>\$ 25,780</b>          | <b>\$ 247</b>               | <b>\$ 3,381</b>              | <b>\$ 22,646</b>                |

## December 31, 2010

| <i>(dollars in thousands)</i>    | <b>Amortized<br/>Cost</b> | <b>Unrealized<br/>Gains</b> | <b>Unrealized<br/>Losses</b> | <b>Estimated<br/>Fair Value</b> |
|----------------------------------|---------------------------|-----------------------------|------------------------------|---------------------------------|
| Mortgage-backed securities       | \$ 2,216                  | \$ 109                      | \$                           | \$ 2,325                        |
| Trust preferred securities       | 14,269                    | 101                         | 3,906                        | 10,464                          |
| U.S. government agency notes     | 12,075                    | 12                          | 16                           | 12,071                          |
| U.S. Treasury securities         | 1,000                     | 1                           |                              | 1,001                           |
| Corporate obligations            | 913                       | 97                          |                              | 1,010                           |
| Equity securities - banks        | 215                       | 11                          | 29                           | 197                             |
| Equity securities - mutual funds | 750                       | 8                           |                              | 758                             |
|                                  | <b>\$ 31,438</b>          | <b>\$ 339</b>               | <b>\$ 3,951</b>              | <b>\$ 27,826</b>                |

The amount of OTTI recorded as accumulated other comprehensive loss for the three months ended September 30, 2011 and 2010 was \$382,000 and \$514,000, respectively, on trust preferred securities. For the nine months ended September 30, 2011 and September 30, 2010, such amounts were \$491,000 and \$640,000, respectively, on trust preferred securities.

Contractual maturities of debt securities at September 30, 2011 are shown below. Actual maturities may differ from contractual maturities because borrowers have the right to call or prepay obligations with or without call or prepayment penalties.

| <i>(dollars in thousands)</i>          | <b>Amortized<br/>Cost</b> | <b>Estimated<br/>Fair<br/>Value</b> |
|----------------------------------------|---------------------------|-------------------------------------|
| Due in one year or less                | \$ 9,526                  | \$ 9,528                            |
| Due after one year through five years  | 502                       | 511                                 |
| Due after five years through ten years | 1,024                     | 920                                 |
| Due after ten years                    | 11,917                    | 8,787                               |
| Mortgage-backed securities             | 1,846                     | 1,963                               |
|                                        | <b>\$ 24,815</b>          | <b>\$ 21,709</b>                    |

The following table shows the level of our gross unrealized losses and the fair value of the associated securities by type and maturity for AFS securities at September 30, 2011 and December 31, 2010:



## September 30, 2011

| (dollars in thousands)       | Less than 12 months |              | 12 months or more |                 | Total           |                 |
|------------------------------|---------------------|--------------|-------------------|-----------------|-----------------|-----------------|
|                              | Estimated           | Unrealized   | Estimated         | Unrealized      | Estimated       | Unrealized      |
|                              | Fair Value          | Losses       | Fair Value        | Losses          | Fair Value      | Losses          |
| Trust preferred securities   | \$ 920              | \$ 80        | \$ 4,524          | \$ 3,230        | \$ 5,444        | \$ 3,310        |
| U.S. government agency notes | 1,993               | 7            |                   |                 | 1,993           | 7               |
| Equity securities - banks    |                     |              | 151               | 64              | 151             | 64              |
|                              | <u>\$ 2,913</u>     | <u>\$ 87</u> | <u>\$ 4,675</u>   | <u>\$ 3,294</u> | <u>\$ 7,588</u> | <u>\$ 3,381</u> |

## December 31, 2010

| (dollars in thousands)       | Less than 12 months |              | 12 months or more |                 | Total            |                 |
|------------------------------|---------------------|--------------|-------------------|-----------------|------------------|-----------------|
|                              | Estimated           | Unrealized   | Estimated         | Unrealized      | Estimated        | Unrealized      |
|                              | Fair Value          | Losses       | Fair Value        | Losses          | Fair Value       | Losses          |
| Trust preferred securities   | \$ 340              | \$ 14        | \$ 5,722          | \$ 3,892        | \$ 6,062         | \$ 3,906        |
| U.S. government agency notes | 4,984               | 16           |                   |                 | 4,984            | 16              |
| Equity securities - banks    |                     |              | 105               | 29              | 105              | 29              |
|                              | <u>\$ 5,324</u>     | <u>\$ 30</u> | <u>\$ 5,827</u>   | <u>\$ 3,921</u> | <u>\$ 11,151</u> | <u>\$ 3,951</u> |

The trust preferred securities that we hold in our securities portfolio are issued by other banks, bank holding companies, and insurance companies. Certain of these securities have experienced declines in value since acquisition. These declines have occurred due to changes in the market which has limited the demand for these securities and reduced their liquidity. We recorded net OTTI charges of \$681,000 and \$818,000 for the three and nine months ended September 30, 2011, respectively, and \$816,000 and \$1.2 million during the three and nine months ended September 30, 2010, respectively.

The following shows the activity in OTTI related to credit losses for the three and nine months ended September 30:

| (dollars in thousands)                  | Three Months Ended September 30, |                 | Nine Months Ended September 30, |                 |
|-----------------------------------------|----------------------------------|-----------------|---------------------------------|-----------------|
|                                         | 2011                             | 2010            | 2011                            | 2010            |
|                                         |                                  |                 |                                 |                 |
| Balance at beginning of period          | \$ 8,029                         | \$ 7,076        | \$ 7,892                        | \$ 6,643        |
| Additional OTTI taken for credit losses | 681                              | 816             | 818                             | 1,249           |
| Balance at end of period                | <u>\$ 8,710</u>                  | <u>\$ 7,892</u> | <u>\$ 8,710</u>                 | <u>\$ 7,892</u> |

All of the remaining securities that are temporarily impaired are impaired due to declines in fair values resulting from changes in interest rates or increased credit/liquidity spreads since the time they were purchased. We have the intent to hold these debt securities to maturity, and, for debt and equity securities in a loss position, for the foreseeable future and do not intend, nor do we believe it is more likely than not, that we will be required to sell the securities before anticipated recovery. We expect these securities will be repaid in full, with no losses realized. As such, management considers the impairments to be temporary.

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We purchased securities of \$2.0 million and \$59.8 million during the three and nine months ended September 30, 2011, respectively, and sold securities of \$26.8 million and \$49.5 million during the three and nine months ended September 30, 2011, respectively. We purchased securities of \$5.6 million and \$8.1 million during the three and nine months ended September 30, 2010, respectively. We sold AFS securities of \$8.0 million and trading securities of \$10.1 million during the nine months ended September 30, 2010. We did not sell any securities during the three months ended September 30, 2010.

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At September 30, 2011, we held securities with an aggregate carrying value (fair value) of \$17.0 million that we have pledged as collateral for certain hedging activities, borrowings, government deposits, and customer deposits.

### (4) Loans Receivable and Allowance for Loan Losses

Loans receivable are summarized as follows:

| <i>(dollars in thousands)</i> | <b>September 30,<br/>2011</b> | <b>December 31,<br/>2010</b> |
|-------------------------------|-------------------------------|------------------------------|
| Commercial                    | \$ 62,751                     | \$ 78,607                    |
| Commercial mortgage           | 335,389                       | 349,691                      |
| Commercial construction       | 54,112                        | 58,742                       |
| Consumer construction         | 21,814                        | 31,107                       |
| Residential mortgage          | 124,511                       | 144,194                      |
| Consumer                      | 137,124                       | 148,166                      |
| <b>Total loans</b>            | <b>735,701</b>                | <b>810,507</b>               |
| Unearned loan fees, net       | 971                           | 1,180                        |
|                               | <b>\$ 736,672</b>             | <b>\$ 811,687</b>            |

Included in consumer loan totals in the above table are overdrawn commercial and retail checking accounts totaling \$143,000 as of September 30, 2011 and \$186,000 as of December 31, 2010.

### *Transferred Loans*

In accordance with the Financial Accounting Standards Board ( FASB ) guidance on mortgage-banking activities, any loan which is originally originated for sale into the secondary market and which we subsequently elect to transfer into the Company's loan portfolio is valued at fair value at the time of the transfer with any decline in value recorded as a charge against earnings.

Information on the activity in transferred loans and related accretable yield is as follows for the three months ended September 30:

| <i>(dollars in thousands)</i> | <b>Loan Balance</b> |                  | <b>Accretable Yield</b> |               | <b>Total</b>     |                  |
|-------------------------------|---------------------|------------------|-------------------------|---------------|------------------|------------------|
|                               | <b>2011</b>         | <b>2010</b>      | <b>2011</b>             | <b>2010</b>   | <b>2011</b>      | <b>2010</b>      |
| Beginning balance             | \$ 26,783           | \$ 22,198        | \$ 110                  | \$ 267        | \$ 26,673        | \$ 21,931        |
| Loans transferred             | 1,053               |                  |                         |               | 1,053            |                  |
| Charge-offs                   |                     |                  | (10)                    |               | 10               |                  |
| Payments/amortization         | (10)                | (382)            | (10)                    | (48)          |                  | (334)            |
| <b>Ending balance</b>         | <b>\$ 27,826</b>    | <b>\$ 21,816</b> | <b>\$ 90</b>            | <b>\$ 219</b> | <b>\$ 27,736</b> | <b>\$ 21,597</b> |

Information on the activity in transferred loans and related accretable yield is as follows for the nine months ended September 30:

| <i>(dollars in thousands)</i>                           | <b>Loan Balance</b> |             | <b>Accretable Yield</b> |             | <b>Total</b> |             |
|---------------------------------------------------------|---------------------|-------------|-------------------------|-------------|--------------|-------------|
|                                                         | <b>2011</b>         | <b>2010</b> | <b>2011</b>             | <b>2010</b> | <b>2011</b>  | <b>2010</b> |
| Beginning balance                                       | \$ 26,219           | \$ 24,575   | \$ 178                  | \$ 423      | \$ 26,041    | \$ 24,152   |
| Loans transferred                                       | 2,031               |             |                         |             | 2,031        |             |
| Loans moved to real estate acquired through foreclosure | (83)                | (281)       |                         | (8)         | (83)         | (273)       |

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|                       |                   |                   |                   |                   |                   |                   |
|-----------------------|-------------------|-------------------|-------------------|-------------------|-------------------|-------------------|
| Charge-offs           | (302)             | (962)             | (16)              | (33)              | (286)             | (929)             |
| Payments/amortization | (39)              | (1,516)           | (72)              | (163)             | 33                | (1,353)           |
|                       | <u>          </u> | <u>          </u> | <u>          </u> | <u>          </u> | <u>          </u> | <u>          </u> |
| Ending balance        | \$ 27,826         | \$ 21,816         | \$ 90             | \$ 219            | \$ 27,736         | \$ 21,597         |
|                       | <u>          </u> | <u>          </u> | <u>          </u> | <u>          </u> | <u>          </u> | <u>          </u> |

As of September 30, 2011 and December 31, 2010, we maintained servicing on mortgage loans sold to the Federal National Mortgage Association ( FNMA ) of approximately \$2.6 million and \$323.3 million, respectively. We sold the majority of our servicing rights to Next Generation Financial Services ( NGFS ) during the second quarter of 2011 in conjunction with the closing of that sales transaction in the third quarter of 2011.

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At September 30, 2011, we have pledged loans with a carrying value of \$116.7 million as collateral for Federal Home Loan Bank ( FHLB ) advances.

### *Credit Quality*

Management has an established methodology to determine the adequacy of the allowance for loan losses that assesses the risks and losses inherent in the loan portfolio. For purposes of determining the allowance for loan losses, we have segmented our loan portfolio by product type. Our portfolio loan segments are commercial, commercial mortgage, commercial construction, consumer construction, residential mortgage, and consumer. We have looked at all segments to determine if subcategorization into classes is warranted based upon our credit review methodology. We have divided consumer loans into two classes, (1) home equity and second mortgage loans and (2) other consumer loans.

To establish the allowance for loan losses, loans are pooled by portfolio class and an historical loss percentage is applied to each class. The historical loss percentage is based upon a rolling 24 month history. This rolling history is utilized so that we have the most current and relevant charge-off trend data. These charge-offs are segregated by loan segment and compared to their respective loan segment average balances for the same period in order to calculate the charge-off percentage. That percentage is then applied to the current period loan balances to determine the required reserve. That calculation determines the required allowance for loan loss level. We then apply additional loss multipliers to the different classes of loans to reflect various environmental factors. This amount is considered our unallocated reserve. For individually evaluated loans (impaired loans), we do additional analyses to determine the impairment. In general, this impairment is included as part of the allowance for loan losses (specific reserve) for modified loans and is charged-off for all other impaired loans. These loss estimates are performed under multiple economic scenarios to establish a range of potential outcomes for each criterion. Management applies judgment to develop its own view of loss probability within that range, using external and internal parameters with the objective of establishing an allowance for loss inherent within these portfolios as of the reporting date.

The following table presents by portfolio segment, the changes in the allowance for loan losses, and the recorded investment in loans:

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As of and for the three and nine months ended September 30, 2011:

Three months ended September 30, 2011

| <i>(dollars in thousands)</i>           | <b>Commercial</b> | <b>Commercial Mortgage</b> | <b>Commercial Construction</b> | <b>Consumer Construction</b> | <b>Residential Mortgage</b> | <b>Consumer</b> | <b>Unallocated</b> | <b>Total</b> |
|-----------------------------------------|-------------------|----------------------------|--------------------------------|------------------------------|-----------------------------|-----------------|--------------------|--------------|
| Beginning Balance                       | \$ 233            | \$ 2,586                   | \$ 1,782                       | \$ 360                       | \$ 2,895                    | \$ 3,089        | \$ 3,170           | \$ 14,115    |
| Charge-offs                             | (2,368)           | (1,325)                    | (131)                          |                              | (669)                       | (590)           |                    | (5,083)      |
| Recoveries                              |                   |                            | 24                             |                              | 23                          | 33              |                    | 80           |
| Net charge-offs                         | (2,368)           | (1,325)                    | (107)                          |                              | (646)                       | (557)           |                    | (5,003)      |
| Provision for (reversal of) loan losses | 4,824             | 605                        | (7)                            | (125)                        | 975                         | 92              | (1,364)            | 5,000        |
| Ending Balance                          | \$ 2,689          | \$ 1,866                   | \$ 1,668                       | \$ 235                       | \$ 3,224                    | \$ 2,624        | \$ 1,806           | \$ 14,112    |

Nine months ended September 30, 2011

| <i>(dollars in thousands)</i>                               | <b>Commercial</b> | <b>Commercial Mortgage</b> | <b>Commercial Construction</b> | <b>Consumer Construction</b> | <b>Residential Mortgage</b> | <b>Consumer</b> | <b>Unallocated</b> | <b>Total</b> |
|-------------------------------------------------------------|-------------------|----------------------------|--------------------------------|------------------------------|-----------------------------|-----------------|--------------------|--------------|
| Beginning Balance                                           | \$ 291            | \$ 2,542                   | \$ 2,053                       | \$ 817                       | \$ 3,032                    | \$ 2,417        | \$ 2,963           | \$ 14,115    |
| Charge-offs                                                 | (5,240)           | (1,834)                    | (728)                          | (24)                         | (2,209)                     | (2,021)         |                    | (12,056)     |
| Recoveries                                                  |                   | 168                        | 24                             |                              | 37                          | 244             |                    | 473          |
| Net charge-offs                                             | (5,240)           | (1,666)                    | (704)                          | (24)                         | (2,172)                     | (1,777)         |                    | (11,583)     |
| Provision for (reversal of) loan losses                     | 7,638             | 990                        | 319                            | (558)                        | 2,364                       | 1,984           | (1,157)            | 11,580       |
| Ending Balance                                              | \$ 2,689          | \$ 1,866                   | \$ 1,668                       | \$ 235                       | \$ 3,224                    | \$ 2,624        | \$ 1,806           | \$ 14,112    |
| Ending balance - individually evaluated for impairment      | \$ 4              | \$ 89                      |                                | \$ 1                         | \$ 352                      | \$ 4            |                    | \$ 450       |
| Ending balance - collectively evaluated for impairment      | \$ 2,685          | \$ 1,777                   | \$ 1,668                       | \$ 234                       | \$ 2,872                    | \$ 2,620        | \$ 1,806           | \$ 13,662    |
| Ending loan balance - individually evaluated for impairment | \$ 4,400          | \$ 24,302                  | \$ 11,701                      | \$ 757                       | \$ 19,742                   | \$ 1,595        |                    | \$ 62,497    |
| Ending loan balance - collectively evaluated for impairment | 58,375            | 310,804                    | 42,375                         | 20,836                       | 104,836                     | 136,949         |                    | 674,175      |
|                                                             | \$ 62,775         | \$ 335,106                 | \$ 54,076                      | \$ 21,593                    | \$ 124,578                  | \$ 138,544      |                    | \$ 736,672   |

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As of and for the three and nine months ended September 30, 2010:

Three months ended September 30, 2010

| <i>(dollars in thousands)</i>           | Commercial | Commercial Mortgage | Commercial Construction | Consumer Construction | Residential Mortgage | Consumer | Unallocated | Total     |
|-----------------------------------------|------------|---------------------|-------------------------|-----------------------|----------------------|----------|-------------|-----------|
| Beginning Balance                       | \$ 877     | 3,358               | 1,458                   | 217                   | 1,861                | 1,145    | 3,102       | \$ 12,018 |
| Charge-offs                             | (1,904)    |                     | (3,103)                 | (12)                  | (431)                | (1,568)  |             | (7,018)   |
| Recoveries                              |            |                     | 7                       |                       | 8                    | 411      |             | 426       |
| Net charge-offs                         | (1,904)    |                     | (3,096)                 | (12)                  | (423)                | (1,157)  |             | (6,592)   |
| Provision for (reversal of) loan losses | 1,515      | (1,010)             | 3,691                   | 747                   | 1,869                | 2,361    | 577         | 9,750     |
| Ending Balance                          | \$ 488     | \$ 2,348            | \$ 2,053                | \$ 952                | \$ 3,307             | \$ 2,349 | \$ 3,679    | \$ 15,176 |

Nine months ended September 30, 2010

| <i>(dollars in thousands)</i>                               | Commercial | Commercial Mortgage | Commercial Construction | Consumer Construction | Residential Mortgage | Consumer   | Unallocated | Total      |
|-------------------------------------------------------------|------------|---------------------|-------------------------|-----------------------|----------------------|------------|-------------|------------|
| Beginning Balance                                           | \$ 817     | 3,336               | 1,647                   | 293                   | 2,062                | 882        | 2,602       | \$ 11,639  |
| Charge-offs                                                 | (1,904)    | (454)               | (3,967)                 | (297)                 | (3,562)              | (3,160)    |             | (13,344)   |
| Recoveries                                                  |            |                     | 7                       |                       | 97                   | 487        |             | 591        |
| Net charge-offs                                             | (1,904)    | (454)               | (3,960)                 | (297)                 | (3,465)              | (2,673)    |             | (12,753)   |
| Provision for (reversal of) loan losses                     | 1,575      | (534)               | 4,366                   | 956                   | 4,710                | 4,140      | 1,077       | 16,290     |
| Ending Balance                                              | \$ 488     | \$ 2,348            | \$ 2,053                | \$ 952                | \$ 3,307             | \$ 2,349   | \$ 3,679    | \$ 15,176  |
| Ending balance - individually evaluated for impairment      | \$         | \$ 70               | \$ 214                  | \$                    | \$ 291               | \$         | \$          | \$ 575     |
| Ending balance - collectively evaluated for impairment      | \$ 488     | \$ 2,278            | \$ 1,839                | \$ 952                | \$ 3,016             | \$ 2,349   | \$ 3,679    | \$ 14,601  |
| Ending loan balance - individually evaluated for impairment | \$ 1,150   | \$ 24,609           | \$ 9,978                | \$ 1,600              | \$ 24,741            | \$ 2,618   |             | \$ 64,696  |
| Ending loan balance - collectively evaluated for impairment | 73,090     | 348,216             | 46,978                  | 32,695                | 117,909              | 149,318    |             | 768,206    |
|                                                             | \$ 74,240  | \$ 372,825          | \$ 56,956               | \$ 34,295             | \$ 142,650           | \$ 151,936 |             | \$ 832,902 |

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We use creditworthiness categories to grade commercial loans. Our internal grading system is based on experiences with similarly graded loans. Category ratings are reviewed each quarter. Our internal risk ratings are as follows:

*Superior Credit Quality ( RR1 )* This category includes credits that are secured by up to 95% advance against cash balances, municipal or corporate bonds carrying an A rating or better (subject to maturity), U.S. Government securities (subject to maturity), and fully marketable securities of companies with an A or better debt rating. In addition, the borrower must have a reasonable financial condition evidenced by complete financial statements.

*High Credit Quality ( RR2 )* This category includes credits that are secured by up to 70% advance against municipal or corporate bonds carrying an A rating or better, U.S. Government securities, and marketable securities of companies with an A or better debt rating. For individual credits, the credit must be secured by any of the aforementioned items or first deed of trust on residential owner-occupied property with a loan-to-value ( LTV ) ratio of 80% or less and adequate cash flow to service the debt. Permanent real estate loans on fully leased properties with A-rated tenants and a 70% or less LTV ratio with income coverage of 1.25 times or higher may qualify for this rating, with confirmation of tenants' financial condition. No commercial construction loans may carry this rating at inception. At September 30, 2011 and December 31, 2010, none of our loans carried this risk rating.

*Above Average Credit Quality ( RR3 )* This category includes business loans to publicly traded companies with a B rating or better, commercial construction loans with a contingent-free take-out or substantial pre-leasing (75% or more of leasable space) with a LTV ratio of 70% or less, residential construction loans with pre-sold units and a LTV ratio of 70% or less as long as sales are on a noncontingent basis and the overall project is progressing on schedule as originally determined, loans to individuals with liquid assets and strong net worth and the additional ability to service the debt from sources unrelated to the purpose of the credit extension, and monitored credits to borrowers of sound financial condition with approved advance rates providing adequate margin so that collateral can be easily liquidated within 90 days or less.

*Average/Satisfactory Credit Quality ( RR4 )* In general, this category includes small-to-medium sized companies with satisfactory financial condition, cash flow, profitability, and balance sheet and income statement ratios, term loans and revolving credits with annual clean-up requirements, the majority of retail commercial credits, loans to partnerships or small businesses, most wholesale sales finance lines, wholesale distributors whose capital position and profitability are at Robert Morris and Associates averages, and loans to individuals with acceptable financial condition and sufficient net cash flow to service the debt as long as the source of repayment is identifiable and sufficient to liquidate the debt within an acceptable period of time and a secondary source of repayment is evident.

*Acceptable With Care ( RR5 )* This category includes secured loans to small or medium sized companies which have suffered a financial setback where a convincing plan for correction demonstrates the deficiency is temporary in nature, loans with debt service coverage ratios below or LTV ratios above policy guidelines, most construction and development loans, permanent loans underwritten based on pro forma rents as opposed to historical or actual rents, real estate loans where the project is moderately off the original projections as to cost estimates or absorption, and loans where the interest reserve is no longer adequate, but the customer or guarantor has a proven ability to carry the interest expense out of pocket for an extended time period without undue financial strain. These credits require additional attention by the account officer and/or loan administration.

*Watch Credits ( RR6 )* This category includes loans to borrowers who have experienced a temporary setback or deterioration in financial condition that should correct itself during the next twelve months, companies whose financial condition has been marginally acceptable for a period of time and prospects for significant improvement are limited, loans to individuals with marginal financial condition, and most credits for start-up operations. Also included in this category are real estate loans where the project is moderately off original projections, interest reserve may be depleted, with the borrower or guarantor having a questionable or unproved ability to pay interest out of pocket. Such loans may have modest cost overruns that will cause a shortage in the budget, raising question as to how the project will be completed. These loans may have a good collateral position, additional collateral, or strong guarantors to mitigate the risk. These credits are considered marginally acceptable, and greater than usual attention is warranted by the account officer and/or loan operations.

*Special Mention ( RR7 )* special mention credits are characterized as adequately covered by collateral (if any) and/or the paying capacity of the borrower, but are subject to one or more deteriorating trends. These credits constitute an undue and unwarranted credit risk, but not to the point of justifying a classification of substandard. These credits have potential weaknesses which, if not examined and corrected, may weaken the asset or inadequately protect the Bank's credit position at some future date. This category should not be used to list assets that bear risks usually associated with the particular type of financing. Assets with this rating may have the potential for significant weakness. Loans where weaknesses are evident and significant must be considered for more serious criticism. Examples of credits carried in special mention may include the following:

Loans which are fully covered by collateral and cash flow, but where margins are inadequate;

Loans to borrowers with a strong capital base, who are experiencing modest losses;

Loans to borrowers with very strong cash flows, but experiencing modest losses;

Credits that are subject to manageable, but excessive, leverage;

Credits with material collateral documentation exceptions, but which appear to be strong credits. If the documentation exception results in an unperfected/under secured collateral position, the credit may be risk rated as if it were under secured until such time as the exception is corrected;

Credits to customers who have not provided the Bank with current or satisfactory financial data (unless the credit is secured by liquid marketable collateral or guaranteed by financially sound parties);

Credits that the account officer may be unable to supervise properly because of a lack of expertise or lack of control over the collateral and/or its condition;

Loans with deficient documentation or other deviations from prudent lending practices; and

Loans with strong guarantors and/or secondary sources of cash flow are the support for repayment.

*Substandard ( RR8 )* Substandard loans are inadequately protected by the current sound worth and paying capacity of the obligor or the collateral pledged, if any. Loans so classified have a well-defined weakness or weaknesses, which jeopardize the orderly liquidation of the debt. They are characterized by the distinct possibility that the Bank will sustain some loss if the deficiencies are not corrected. The borrower's financial condition indicates an inability to repay, even if restructured. Prospects for improvement in the borrower's financial condition are poor. Primary repayment source appears to be shifting from cash flow to liquidation of collateral. Examples of substandard credits may include the following:

Credits adequately covered by collateral value, where repayment is dependent upon the sale of nonliquid collateral, nontrading assets, or from guarantors;

Loans secured by collateral greater than the amount of the credit, but where cash flow is inadequate to amortize the debt over a reasonable period of time;

Credits with negative financial trends coupled with material collateral documentation deficiencies or where there is a high potential for loss of principal;

Unsecured loans to borrowers whose financial condition does not warrant unsecured advances;

Credits where the borrower is in bankruptcy or the work out effort is proceeding toward legal remedies including foreclosure; and

All nonaccrual loans.

*Doubtful ( RR9 )* Doubtful classifications have all the weaknesses inherent in those classified substandard with the added characteristic that the weaknesses make collection or liquidation in full on the basis of currently known facts, conditions, and values highly questionable and improbable. A doubtful classification may be appropriate in cases where significant risk exposures are perceived, but loss cannot be determined because of specific, reasonable, and pending factors which may strengthen and work to the advantage of the credit in the near term. Account officers attempt to identify any principal loss in the credit, where possible, thereby limiting the excessive use of the doubtful classification. The classification is a deferral of the estimated loss until its more exact status may be determined. Pending factors include proposed mergers, acquisition or liquidation procedures, new capital injection, perfecting liens on additional collateral, and refinancing plans. At September 30, 2011 and December 31, 2010, none of our loans carried this risk rating.

*Loss ( RR10 )* Losses must be taken as soon as they are realized. In some instances and on a temporary basis, a portion of a loan may receive this rating (split rating) when the actual loss cannot be currently identified. In these instances, additional facts or information is necessary to determine the final amount to be charged against the loan loss reserve. When applied for these purposes, this risk rating may be used for a period not to exceed nine months. Subsequent to the identification of this split rating, the remaining balance will be risk rated substandard. This category includes advances in excess of calculated current fair value which are considered uncollectible and do not warrant continuance as bankable assets. This classification does not mean that the loan has absolutely no recovery or salvage value, but rather it is not practical or desirable to defer writing off this basically worthless asset even though partial recovery may occur in the future. Credits to distressed borrowers lacking an identifiable and realistic source of repayment are generally charged-off. Loans where repayment is dependent upon events that are not predictable in terms of result or timing (such as protracted litigation) are generally charged-off. At September 30, 2011 and December 31, 2010, none of our loans carried this risk rating.

The following table shows the credit quality breakdown of our commercial loan portfolio by class as of September 30, 2011 and December 31, 2010:



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|     | Commercial |           | Commercial Mortgage |            | Commercial Construction |           | Consumer Construction |           | Total      |            |
|-----|------------|-----------|---------------------|------------|-------------------------|-----------|-----------------------|-----------|------------|------------|
|     | 2011       | 2010      | 2011                | 2010       | (dollars in thousands)  |           | 2011                  | 2010      | 2011       | 2010       |
| RR8 | \$ 6,268   | \$ 1,939  | \$ 29,947           | \$ 33,492  | \$ 12,245               | \$ 14,677 | \$ 1,150              | \$ 48,460 | \$ 51,258  |            |
| RR7 | 9,174      | 7,241     | 16,202              | 10,921     | 18,275                  | 6,686     | 136                   | 136       | 43,787     | 24,984     |
| RR6 | 8,016      | 9,174     | 37,135              | 23,097     | 8,734                   | 15,081    | 1,025                 | 98        | 54,910     | 47,450     |
| RR5 | 11,815     | 22,417    | 116,442             | 126,297    | 10,075                  | 13,811    |                       |           | 138,332    | 162,525    |
| RR4 | 26,483     | 36,257    | 133,792             | 155,336    | 4,747                   | 8,509     | 20,432                | 29,408    | 185,454    | 229,510    |
| RR3 | 1,000      | 1,000     | 1,588               | 268        |                         |           |                       |           | 2,588      | 1,268      |
| RR1 | 19         | 773       |                     |            |                         |           |                       |           | 19         | 773        |
|     | \$ 62,775  | \$ 78,801 | \$ 335,106          | \$ 349,411 | \$ 54,076               | \$ 58,764 | \$ 21,593             | \$ 30,792 | \$ 473,550 | \$ 517,768 |

We do not individually grade residential mortgage or consumer loans. Such loans are classified as performing or nonperforming. Loan performance is reviewed each quarter. The following table shows performing and nonperforming (nonaccrual) residential mortgage and consumer loans by class as of September 30, 2011 and December 31, 2010

|                        | Residential Mortgage |            | Home Equity & 2nd Mortgage |            | Other Consumer |           | Total      |            |
|------------------------|----------------------|------------|----------------------------|------------|----------------|-----------|------------|------------|
| (dollars in thousands) | 2011                 | 2010       | 2011                       | 2010       | 2011           | 2010      | 2011       | 2010       |
| Nonaccruing loans      | \$ 9,678             | \$ 11,877  | \$ 1,384                   | \$ 946     | \$             | \$        | \$ 11,062  | \$ 12,823  |
| Performing loans       | 114,900              | 132,332    | 112,537                    | 119,874    | 24,623         | 28,890    | 252,060    | 281,096    |
|                        | \$ 124,578           | \$ 144,209 | \$ 113,921                 | \$ 120,820 | \$ 24,623      | \$ 28,890 | \$ 263,122 | \$ 293,919 |

The following tables show the aging of our loans receivable by class. Also included are loans that are 90 days or more past due as to interest and principal and still accruing because they are well-secured and in the process of collection.

As of September 30, 2011:

| (dollars in thousands)       | 31-59 Days Past Due | 60-89 Days Past Due | 90 Days or More Past Due | Total Past Due | Current    | Total Loans | 90 Days or More and Accruing |
|------------------------------|---------------------|---------------------|--------------------------|----------------|------------|-------------|------------------------------|
| Commercial                   | \$ 97               | \$                  | \$ 4,356                 | \$ 4,453       | \$ 58,322  | \$ 62,775   | \$ 118                       |
| Commercial mortgage          | 14,022              | 2,243               | 21,406                   | 37,671         | 297,435    | 335,106     | 1,281                        |
| Commercial construction      | 2,478               | 361                 | 6,549                    | 9,388          | 44,688     | 54,076      |                              |
| Consumer construction        | 359                 | 916                 | 488                      | 1,763          | 19,830     | 21,593      |                              |
| Residential mortgage         |                     | 6,289               | 11,293                   | 17,582         | 106,996    | 124,578     | 1,615                        |
| Home equity and 2nd mortgage | 2,342               | 777                 | 1,693                    | 4,812          | 109,109    | 113,921     | 309                          |
| Other consumer               | 394                 | 155                 |                          | 549            | 24,074     | 24,623      |                              |
|                              | \$ 19,692           | \$ 10,741           | \$ 45,785                | \$ 76,218      | \$ 660,454 | \$ 736,672  | \$ 3,323                     |

As of December 31, 2010:

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| <i>(dollars in thousands)</i> | <b>31-59 Days<br/>Past Due</b> | <b>60-89 Days<br/>Past Due</b> | <b>90 Days<br/>or More<br/>Past Due</b> | <b>Total<br/>Past Due</b> | <b>Current</b>    | <b>Total<br/>Loans</b> | <b>90 Days<br/>or More<br/>and Accruing</b> |
|-------------------------------|--------------------------------|--------------------------------|-----------------------------------------|---------------------------|-------------------|------------------------|---------------------------------------------|
| Commercial                    | \$ 1,626                       | \$ 169                         | \$ 1,501                                | \$ 3,296                  | \$ 75,505         | \$ 78,801              | \$                                          |
| Commercial mortgage           | 4,957                          | 2,706                          | 28,943                                  | 36,606                    | 312,805           | 349,411                | 1,952                                       |
| Commercial construction       |                                |                                | 8,237                                   | 8,237                     | 50,527            | 58,764                 | 250                                         |
| Consumer construction         | 2,168                          | 379                            | 1,257                                   | 3,804                     | 26,988            | 30,792                 |                                             |
| Residential mortgage          | 10,919                         | 7,789                          | 12,653                                  | 31,361                    | 112,848           | 144,209                | 776                                         |
| Home equity and 2nd mortgage  | 3,221                          | 390                            | 946                                     | 4,557                     | 116,263           | 120,820                |                                             |
| Other consumer                | 125                            | 592                            |                                         | 717                       | 28,173            | 28,890                 |                                             |
|                               | <u>\$ 23,016</u>               | <u>\$ 12,025</u>               | <u>\$ 53,537</u>                        | <u>\$ 88,578</u>          | <u>\$ 723,109</u> | <u>\$ 811,687</u>      | <u>\$ 2,978</u>                             |

Impaired loans include nonaccrual loans and troubled debt restructurings ( TDR or TDRs ). The following tables show the breakout of impaired loans by class:

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September 30, 2011

| <i>(dollars in thousands)</i> | <b>Recorded<br/>Investment</b> | <b>Unpaid<br/>Principal<br/>Balance</b> | <b>Related<br/>Allowance</b> | <b>Average<br/>Recorded<br/>Investment</b> | <b>Interest<br/>Income<br/>Recognized</b> | <b>Charge-Offs</b> |
|-------------------------------|--------------------------------|-----------------------------------------|------------------------------|--------------------------------------------|-------------------------------------------|--------------------|
| With no related allowance:    |                                |                                         |                              |                                            |                                           |                    |
| Commercial                    | \$ 4,239                       | \$ 4,239                                | \$                           | \$ 2,197                                   | \$ 7                                      | \$ 5,240           |
| Commercial mortgage           | \$ 19,553                      | \$ 19,553                               | \$                           | \$ 20,948                                  | \$ 58                                     | \$ 1,706           |
| Commercial construction       | \$ 11,701                      | \$ 11,701                               | \$                           | \$ 12,376                                  | \$ 69                                     | \$ 728             |
| Consumer construction         | \$ 351                         | \$ 351                                  | \$                           | \$ 874                                     | \$ 1                                      | \$ 24              |
| Residential mortgage          | \$ 7,658                       | \$ 7,658                                | \$                           | \$ 10,402                                  | \$ 85                                     | \$ 1,506           |
| Home equity & 2nd mortgage    | \$ 1,520                       | \$ 1,520                                | \$                           | \$ 915                                     | \$ 5                                      | \$ 2,021           |
| Other consumer                | \$                             | \$                                      | \$                           | \$ 168                                     | \$                                        | \$                 |
| With a related allowance:     |                                |                                         |                              |                                            |                                           |                    |
| Commercial                    | 157                            | 161                                     | 4                            | 39                                         | 2                                         |                    |
| Commercial mortgage           | 4,660                          | 4,749                                   | 89                           | 3,876                                      | 74                                        | 128                |
| Commercial construction       |                                |                                         |                              | 333                                        |                                           |                    |
| Consumer construction         | 405                            | 406                                     | 1                            | 140                                        | 16                                        |                    |
| Residential mortgage          | 11,732                         | 12,084                                  | 352                          | 12,139                                     | 388                                       | 703                |
| Home equity & 2nd mortgage    | 71                             | 75                                      | 4                            | 18                                         | 3                                         |                    |
| Other consumer                |                                |                                         |                              |                                            |                                           |                    |
| Totals:                       |                                |                                         |                              |                                            |                                           |                    |
| Commercial                    | \$ 4,396                       | \$ 4,400                                | \$ 4                         | \$ 2,236                                   | \$ 9                                      | \$ 5,240           |
| Commercial mortgage           | \$ 24,213                      | \$ 24,302                               | \$ 89                        | \$ 24,824                                  | \$ 132                                    | \$ 1,834           |
| Commercial construction       | \$ 11,701                      | \$ 11,701                               | \$                           | \$ 12,709                                  | \$ 69                                     | \$ 728             |
| Consumer construction         | \$ 756                         | \$ 757                                  | \$ 1                         | \$ 1,014                                   | \$ 17                                     | \$ 24              |
| Residential mortgage          | \$ 19,390                      | \$ 19,742                               | \$ 352                       | \$ 22,541                                  | \$ 473                                    | \$ 2,209           |
| Home equity & 2nd mortgage    | \$ 1,591                       | \$ 1,595                                | \$ 4                         | \$ 933                                     | \$ 8                                      | \$ 2,021           |
| Consumer                      | \$                             | \$                                      | \$                           | \$ 168                                     | \$                                        | \$                 |

December 31, 2010

| <i>(dollars in thousands)</i> | <b>Recorded<br/>Investment</b> | <b>Unpaid<br/>Principal<br/>Balance</b> | <b>Related<br/>Allowance</b> | <b>Average<br/>Recorded<br/>Investment</b> | <b>Interest<br/>Income<br/>Recognized</b> | <b>Charge-Offs</b> |
|-------------------------------|--------------------------------|-----------------------------------------|------------------------------|--------------------------------------------|-------------------------------------------|--------------------|
| With no related allowance:    |                                |                                         |                              |                                            |                                           |                    |
| Commercial                    | \$ 1,501                       | \$ 1,501                                | \$                           | \$ 2,069                                   | \$ 40                                     | \$ 1,979           |
| Commercial mortgage           | \$ 26,534                      | \$ 26,534                               | \$                           | \$ 17,437                                  | \$ 811                                    | \$ 1,232           |
| Commercial construction       | \$ 12,814                      | \$ 12,814                               | \$                           | \$ 10,647                                  | \$ 310                                    | \$ 2,320           |
| Consumer construction         | \$ 1,257                       | \$ 1,257                                | \$                           | \$ 2,200                                   | \$ 35                                     | \$ 804             |
| Residential mortgage          | \$ 11,877                      | \$ 11,877                               | \$                           | \$ 11,973                                  | \$ 381                                    | \$ 3,757           |
| Home equity & 2nd mortgage    | \$ 1,067                       | \$ 1,067                                | \$                           | \$ 1,385                                   | \$ 15                                     | \$ 3,787           |
| Other consumer                | \$                             | \$                                      | \$                           | \$ 13                                      | \$                                        | \$                 |
| With a related allowance:     |                                |                                         |                              |                                            |                                           |                    |
| Commercial                    |                                |                                         |                              |                                            |                                           |                    |
| Commercial mortgage           | 3,226                          | 3,314                                   | 88                           | 2,864                                      | 73                                        | 163                |
| Commercial construction       | 445                            | 459                                     | 14                           | 2,567                                      | 18                                        | 1,932              |
| Consumer construction         |                                |                                         |                              |                                            |                                           |                    |
| Residential mortgage          | 12,661                         | 13,147                                  | 486                          | 5,339                                      | 695                                       |                    |
| Home equity & 2nd mortgage    |                                |                                         |                              | 2,065                                      |                                           |                    |
| Other consumer                |                                |                                         |                              | 1                                          |                                           |                    |
| Total:                        |                                |                                         |                              |                                            |                                           |                    |
| Commercial                    | \$ 1,501                       | \$ 1,501                                | \$                           | \$ 2,069                                   | \$ 40                                     | \$ 1,979           |
| Commercial mortgage           | \$ 29,760                      | \$ 29,848                               | \$ 88                        | \$ 20,301                                  | \$ 884                                    | \$ 1,395           |

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|                            |    |        |    |        |    |     |    |        |    |       |    |       |
|----------------------------|----|--------|----|--------|----|-----|----|--------|----|-------|----|-------|
| Commercial construction    | \$ | 13,259 | \$ | 13,273 | \$ | 14  | \$ | 13,214 | \$ | 328   | \$ | 4,252 |
| Consumer construction      | \$ | 1,257  | \$ | 1,257  | \$ |     | \$ | 2,200  | \$ | 35    | \$ | 804   |
| Residential mortgage       | \$ | 24,538 | \$ | 25,024 | \$ | 486 | \$ | 17,312 | \$ | 1,076 | \$ | 3,757 |
| Home equity & 2nd mortgage | \$ | 1,067  | \$ | 1,067  | \$ |     | \$ | 3,450  | \$ | 15    | \$ | 3,787 |
| Consumer                   | \$ |        | \$ |        | \$ |     | \$ | 14     | \$ |       | \$ |       |

The following table shows loans in nonaccrual status by class:

| <i>(dollars in thousands)</i> | September<br>30,<br>2011 | December<br>31,<br>2010 | September<br>30,<br>2010 |
|-------------------------------|--------------------------|-------------------------|--------------------------|
| Commercial                    | \$ 4,238                 | \$ 1,501                | \$ 1,150                 |
| Commercial mortgage           | 20,125                   | 26,991                  | 22,610                   |
| Commercial construction       | 6,549                    | 7,987                   | 7,386                    |
| Consumer construction         | 488                      | 1,257                   | 1,600                    |
| Residential mortgage          | 9,678                    | 11,877                  | 13,237                   |
| Home equity and 2nd mortgage  | 1,384                    | 946                     | 1,146                    |
| Other consumer                |                          |                         | 1,472                    |
|                               | <u>\$ 42,462</u>         | <u>\$ 50,559</u>        | <u>\$ 48,601</u>         |

The interest which would have been recorded on nonaccrual loans if those loans had been performing in accordance with their contractual terms for the nine months ended September 30, 2011 and 2010 was approximately \$1.4 million and \$2.2 million, respectively, and the actual interest income recorded on such loans for the nine months ended September 30, 2011 and 2010 was approximately \$235,000 and \$812,000, respectively.

The following table shows the breakdown of loans we modified during the three and nine months ended September 30:

| <b>Three Months Ended September 30,</b> |                                    |                                                              |                                                           |                                    |                                                              |                                                           |
|-----------------------------------------|------------------------------------|--------------------------------------------------------------|-----------------------------------------------------------|------------------------------------|--------------------------------------------------------------|-----------------------------------------------------------|
| <i>(dollars in thousands)</i>           | <b>2011</b>                        |                                                              |                                                           | <b>2010</b>                        |                                                              |                                                           |
|                                         | <b>Number of<br/>Modifications</b> | <b>Recorded<br/>Investment<br/>Prior to<br/>Modification</b> | <b>Recorded<br/>Investment<br/>After<br/>Modification</b> | <b>Number of<br/>Modifications</b> | <b>Recorded<br/>Investment<br/>Prior to<br/>Modification</b> | <b>Recorded<br/>Investment<br/>After<br/>Modification</b> |
| Commercial                              | 1                                  | \$ 297                                                       | \$ 22                                                     |                                    | \$                                                           | \$                                                        |
| Residential mortgage                    |                                    |                                                              |                                                           | 6                                  | 2,261                                                        | 2,275                                                     |
| Home equity and 2nd mortgage            |                                    |                                                              |                                                           | 4                                  | 207                                                          | 207                                                       |
|                                         | <u>1</u>                           | <u>\$ 297</u>                                                | <u>\$ 22</u>                                              | <u>10</u>                          | <u>\$ 2,468</u>                                              | <u>\$ 2,482</u>                                           |

| <b>Nine Months Ended September 30,</b> |                                    |                                                              |                                                           |                                    |                                                              |                                                           |
|----------------------------------------|------------------------------------|--------------------------------------------------------------|-----------------------------------------------------------|------------------------------------|--------------------------------------------------------------|-----------------------------------------------------------|
| <i>(dollars in thousands)</i>          | <b>2011</b>                        |                                                              |                                                           | <b>2010</b>                        |                                                              |                                                           |
|                                        | <b>Number of<br/>Modifications</b> | <b>Recorded<br/>Investment<br/>Prior to<br/>Modification</b> | <b>Recorded<br/>Investment<br/>After<br/>Modification</b> | <b>Number of<br/>Modifications</b> | <b>Recorded<br/>Investment<br/>Prior to<br/>Modification</b> | <b>Recorded<br/>Investment<br/>After<br/>Modification</b> |
| Commercial                             | 2                                  | \$ 460                                                       | \$ 185                                                    |                                    | \$                                                           | \$                                                        |
| Commercial mortgage                    | 2                                  | 2,197                                                        | 2,197                                                     | 2                                  | 2,316                                                        | 2,370                                                     |
| Commercial construction                |                                    |                                                              |                                                           | 6                                  | 5,177                                                        | 5,508                                                     |
| Residential mortgage                   | 1                                  | 566                                                          | 579                                                       | 16                                 | 9,027                                                        | 9,033                                                     |
| Home equity and 2nd mortgage           |                                    |                                                              |                                                           | 10                                 | 1,148                                                        | 1,148                                                     |

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|   |    |       |    |       |    |    |        |    |        |
|---|----|-------|----|-------|----|----|--------|----|--------|
| 5 | \$ | 3,223 | \$ | 2,961 | 34 | \$ | 17,668 | \$ | 18,059 |
|---|----|-------|----|-------|----|----|--------|----|--------|

The majority of our TDRs are the result of renewals where the only concession is that the interest rate is not considered to be a market rate. As such, the best illustration of the financial impact of the TDRs is the effect on the allowance for loan losses.

During the nine months ended September 30, 2011, a total of \$65,000 (\$4,000 for commercial, \$40,000 for commercial mortgage, and \$21,000 for residential mortgage) was added to the allowance for loan losses for TDRs. During the three months ended September 30, 2010, a total of \$96,000 for residential mortgage loans was added to the allowance for loan losses for TDRs. During the nine months ended September 30, 2010, \$226,000 (\$15,000 for commercial mortgage loans and \$211,000 for residential mortgage loans) was added to the allowance for loan losses for TDRs. There were no additional effects on the allowance for TDRs during the three months ended September 30, 2011. Additionally, during the three and nine months ended September 30, 2011, we charged-off approximately \$275,000 of a TDR commercial loan.

There were no defaults in 2011 of modifications made during 2010. Additionally, there were no defaults during the three months ended September 30, 2010 of modifications made during 2009. The following table shows defaults during the nine months ended September 30, 2010 of modifications made during 2009:

| <i>(dollars in thousands)</i> | <b>Number of<br/>Modifications</b> | <b>Recorded<br/>Investment</b> |
|-------------------------------|------------------------------------|--------------------------------|
| Commercial                    | 2                                  | \$ 2,850                       |
| Commercial mortgage           |                                    |                                |
| Commercial construction       |                                    |                                |
| Consumer construction         |                                    |                                |
| Residential mortgage          | 3                                  | 857                            |
| Home equity and 2nd mortgage  |                                    |                                |
| Other consumer                |                                    |                                |
|                               | <b>5</b>                           | <b>\$ 3,707</b>                |

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Total TDRs as of September 30, 2011 and December 31, 2010 amounted to \$24.7 million and \$24.2 million, respectively, of which \$4.6 million and \$2.8 million, respectively, were also in nonaccrual status.

### (5) Junior Subordinated Deferrable Interest Debentures

The following table shows the subordinated debt issued by First Mariner Bancorp and the related trust preferred securities ( Trust Preferred Securities ) issued at both September 30, 2011 and December 31, 2010:

| Trust      | Subordinated<br>Debt Issued<br>to Trust | Trust<br>Preferred<br>Securities<br>Issued by<br>Trust | Date of<br>Original Issue | Optional<br>Redemption<br>Date | Stated<br>Maturity    |
|------------|-----------------------------------------|--------------------------------------------------------|---------------------------|--------------------------------|-----------------------|
| MCT II     | \$ 6,186                                | \$ 6,000                                               | December 10,<br>2002      | December 15,<br>2007           | December 10,<br>2032  |
| MCT III    | 14,949                                  | 14,500                                                 | June 18, 2003             | July 7, 2008                   | July 7, 2033          |
| MCT IV     | 5,158                                   | 5,000                                                  | August 18, 2003           | August 18, 2008                | August 18, 2033       |
| MCT V      | 10,310                                  | 10,000                                                 | September 25,<br>2003     | October 8, 2008                | October 8, 2033       |
| MCT VI     | 10,310                                  | 10,000                                                 | October 21, 2004          | January 7, 2010                | January 7, 2035       |
| MCT<br>VII | 5,155                                   | 5,000                                                  | August 18, 2005           | September 15,<br>2010          | September 15,<br>2035 |
|            | <u>\$ 52,068</u>                        | <u>\$ 50,500</u>                                       |                           |                                |                       |

First Mariner issued junior subordinated deferrable interest debentures to six statutory trust subsidiaries, Mariner Capital Trust ( MCT ) II, MCT III, MCT IV, MCT V, MCT VI, and MCT VII (collectively, the Trusts ). The Trusts are Delaware business trusts for which all the common securities are owned by First Mariner and which were formed for the purpose of issuing trust preferred securities. In accordance with FASB guidance, we have deconsolidated the Trusts, and their financial position and results of operations are not included in our consolidated financial position and results of operations. The payment and redemption terms of the debentures and related Trust Preferred Securities are substantially identical.

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

As of September 30, 2011, all of the Trust Preferred Securities are Floating Rate Trust Preferred Securities, which accrue interest equal to the 3-month LIBOR rate plus varying basis points as follows: MCT II 335 basis points; MCT III 325 basis points; MCT IV 305 basis points; MCT V 310 basis points; MCT VI 205 basis points; and MCT VII 195 basis points.

The interest expense (including amortization of the cost of issuance) on junior subordinated deferrable interest debentures was \$406,000 and \$1.2 million, respectively, for the three and nine months ended September 30, 2011, and \$436,000 and \$1.5 million, respectively, for the three and nine months ended September 30, 2010. In 2009, we elected to defer interest payments on the debentures. This deferral is permitted by the terms of the debentures and does not constitute an event of default thereunder. Interest on the debentures and dividends on the related Trust Preferred Securities continue to accrue and will have to be paid in full prior to the expiration of the deferral period. The total deferral period may not exceed 20 consecutive quarters and expires with the last quarter of 2013.

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

Under applicable regulatory guidelines, a portion of the Trust Preferred Securities may qualify as Tier I capital, and the remaining portion may qualify as Tier II capital, with certain limitations. At September 30, 2011, none of our outstanding Trust Preferred Securities qualify as either Tier I or Tier II capital due to limitations.

During 2010, we executed Exchange agreements (the Exchanges ) with our Chairman and Chief Executive Officer ( CEO ), Edwin F. Hale, Sr. and with an unaffiliated third party. The agreements exchanged trust preferred securities for shares of common stock and warrants of the Company. Upon completion of the Exchanges, the Company canceled the trust preferred securities and the related accrued interest on the

securities in exchanges for the common stock and warrants, eliminating the long term debt. The transaction with the unaffiliated third party resulted in a gain of \$571,000, net of taxes of \$387,000.

**(6) Regulatory Matters, Capital Adequacy, and Liquidity**

***Regulatory matters and capital adequacy***

Various regulatory capital requirements administered by the federal banking agencies apply to First Mariner and the Bank. 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 our 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 assets, liabilities, and certain off-balance sheet items as calculated under regulatory accounting practices. The Bank's capital amounts and classification are also subject to qualitative judgments by the regulators about components, risk weightings, and other factors.

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Quantitative measures established by regulation to ensure capital adequacy require the Bank to maintain minimum amounts and ratios of Total and Tier 1 capital to risk-weighted assets, and of Tier 1 capital to average quarterly assets. As of September 30, 2011 and December 31, 2010, the Bank was under capitalized under the regulatory framework for prompt corrective action.

Our regulatory capital amounts and ratios as of September 30, 2011 and December 31, 2010 were as follows:

|                                               |               |        | Minimum Requirements for Capital Adequacy Purposes |       | To be Well Capitalized Under Prompt Corrective Action Provision |       |
|-----------------------------------------------|---------------|--------|----------------------------------------------------|-------|-----------------------------------------------------------------|-------|
| (dollars in thousands)                        | Actual Amount | Ratio  | Amount                                             | Ratio | Amount                                                          | Ratio |
| As of September 30, 2011                      |               |        |                                                    |       |                                                                 |       |
| Total capital (to risk-weighted assets):      |               |        |                                                    |       |                                                                 |       |
| Consolidated                                  | \$ (18,455)   | (2.1)% | \$ 69,074                                          | 8.0%  | \$ 86,342                                                       | 10.0% |
| Bank                                          | 50,091        | 5.8%   | 69,048                                             | 8.0%  | 86,310                                                          | 10.0% |
| Tier 1 capital (to risk-weighted assets):     |               |        |                                                    |       |                                                                 |       |
| Consolidated                                  | (18,455)      | (2.1)% | 34,537                                             | 4.0%  | 51,805                                                          | 6.0%  |
| Bank                                          | 39,237        | 4.5%   | 34,524                                             | 4.0%  | 51,786                                                          | 6.0%  |
| Tier 1 capital (to average quarterly assets): |               |        |                                                    |       |                                                                 |       |
| Consolidated                                  | (18,455)      | (1.6)% | 45,949                                             | 4.0%  | 57,436                                                          | 5.0%  |
| Bank                                          | 39,237        | 3.4%   | 45,932                                             | 4.0%  | 57,415                                                          | 5.0%  |
| As of December 31, 2010                       |               |        |                                                    |       |                                                                 |       |
| Total capital (to risk-weighted assets):      |               |        |                                                    |       |                                                                 |       |
| Consolidated                                  | \$ 19,344     | 2.1%   | \$ 74,825                                          | 8.0%  | \$ 93,531                                                       | 10.0% |
| Bank                                          | 75,277        | 8.0%   | 74,832                                             | 8.0%  | 93,540                                                          | 10.0% |
| Tier 1 capital (to risk-weighted assets):     |               |        |                                                    |       |                                                                 |       |
| Consolidated                                  | 9,672         | 1.0%   | 37,412                                             | 4.0%  | 56,119                                                          | 6.0%  |
| Bank                                          | 63,544        | 6.8%   | 37,416                                             | 4.0%  | 56,124                                                          | 6.0%  |
| Tier 1 capital (to average quarterly assets): |               |        |                                                    |       |                                                                 |       |
| Consolidated                                  | 9,672         | 0.7%   | 53,780                                             | 4.0%  | 67,226                                                          | 5.0%  |
| Bank                                          | 63,544        | 4.7%   | 53,926                                             | 4.0%  | 67,407                                                          | 5.0%  |

The Federal Deposit Insurance Corporation ( FDIC ), through the Deposit Insurance Fund, insures deposits of accountholders up to \$250,000, with the exception of noninterest-bearing transaction accounts, which are insured without limit through December 31, 2012. The Bank pays an annual premium to provide for this insurance.

The Bank is a member of the FHLB System and is required to maintain an investment in the stock of the FHLB based on specific percentages of outstanding mortgages, total assets, or FHLB advances. Purchases and sales of stock are made directly with the Bank at par value.

On September 18, 2009, the Bank entered into an Agreement with the FDIC and the Commissioner of Financial Regulation for the state of Maryland (the Commissioner ), pursuant to which it consented to the entry of an Order to Cease and Desist ( the September Order ), which directs the Bank to (i) increase its capitalization, (ii) improve earnings, (iii) reduce nonperforming loans, (iv) strengthen management policies and practices, and (v) reduce reliance on noncore funding. The September Order required the Bank to adopt a plan to achieve and maintain a Tier I leverage capital ratio of at least 7.5% and a total risk-based capital ratio of at least 11% by June 30, 2010. We did not meet the requirements at June 30, 2010, December 31, 2010, or September 30, 2011. The failure to achieve these capital requirements could result in further action by our regulators.

As part of the September Order, within 30 days after the end of each calendar year, the Bank must submit an annual budget and profit plan and a plan that takes into account the Bank's pricing structure, the Bank's cost of funds and how this can be reduced, and the level of provision expense for adversely classified loans. To address reliance on noncore funding, the Bank was required to submit a liquidity plan intended to reduce the Bank's reliance on noncore funding, wholesale funding sources, and high-cost rate-sensitive deposits. While the September Order is in

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effect, the Bank may not pay dividends or management fees without the FDIC's prior consent, may not accept, renew, or roll over any brokered deposits, and is restricted in the yields that it may pay on deposits.

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First Mariner Bancorp is also a party to agreements with the Federal Reserve Bank ( FRB ) (the FRB Agreements ), which, together, require it to: (i) develop and implement a strategic business plan that includes (a) actions that will be taken to improve our operating performance and reduce the level of parent company leverage, (b) a comprehensive budget and an expanded budget review process, (c) a description of the operating assumptions that form the basis for major projected income and expense components and provisions needed to maintain an adequate loan loss reserve, and (d) a capital plan incorporating all capital needs, risks, and regulatory guidelines; and (ii) submit plans to improve enterprise-wide risk management and effectiveness of internal audit programs. First Mariner Bancorp has also agreed to provide the FRB with advance notice of any significant capital transactions. The FRB Agreements also prohibit First Mariner and the Bank from taking any of the following actions without the FRB's prior written approval: (i) declaring or paying any dividends; (ii) taking dividends from the Bank; (iii) making any distributions of interest, principal, or other sums on First Mariner's subordinated debentures or trust preferred securities; (iv) incurring, increasing, or guaranteeing any debt; or (v) repurchasing or redeeming any shares of its stock. To satisfy the FRB's minimum capital requirements, First Mariner's consolidated Tier I capital to average quarterly assets, Tier I capital to risk-weighted assets, and total capital to risk-weighted assets ratios at each quarter end must be at least 4.0%, 4.0%, and 8.0%, respectively. At September 30, 2011, those capital ratios were (1.6)%, (2.1)%, and (2.1)%, respectively, which were not in compliance with the minimum requirements. The failure to achieve these capital requirements could result in further action by our regulators.

The foregoing will subject us to increased regulatory scrutiny and may have an adverse impact on our business operations. Failure to comply with the provisions of these regulatory requirements may result in more restrictive actions from our regulators, including more severe and restrictive enforcement actions.

Management believes the ultimate successful satisfaction of the September Order's requirements and the requirements of the FRB Agreements will strengthen the financial condition of the Bank and Company for future periods.

### *Securities Purchase Agreement*

On April 19, 2011, the Company and the Bank entered into a securities purchase agreement with Priam Capital Fund I, LP, which was subsequently amended on September 21, 2011 to, among other things, extend the agreement to November 30, 2011. For a description of the material terms of the securities purchase agreement, see the Company's Current Report on Form 8-K filed with the Securities and Exchange Commission on April 25, 2011. For additional information on the terms of the amendment, see Exhibit 10.1 to this Form 10-Q and the Company's Current Report on Form 8-K filed with the Securities and Exchange Commission on September 27, 2011.

### *Liquidity*

The Bank's principal sources of liquidity are cash and cash equivalents (which are cash on hand and amounts due from financial institutions, federal funds sold, money market mutual funds, and interest bearing deposits), AFS securities, deposit accounts, and borrowings. The levels of such sources are dependent on the Bank's operating, financing, and investing activities at any given time. We attempt to primarily rely on core deposits from customers to provide stable and cost-effective sources of funding to support our loan growth. We also seek to augment such deposits with longer term and higher yielding certificates of deposit. Cash and cash equivalents, which totaled \$186.7 million at September 30, 2011, have immediate availability to meet our short-term funding needs. Our entire investment portfolio is classified as AFS, is highly marketable (excluding our holdings of pooled trust preferred securities), and is available to meet our liquidity needs. Additional sources of liquidity include loans held for sale, which totaled \$126.2 million at September 30, 2011, are committed to be sold into the secondary market, and generally are funded within 60 days and our residential real estate portfolio includes loans that are underwritten to secondary market criteria. Additionally, our residential construction loan portfolio provides a source of liquidity as construction periods generally range from 9-12 months, and these loans are subsequently refinanced with permanent first-lien mortgages and sold into the secondary market. Our loan to deposit ratio stood at 71.4% at September 30, 2011 and 72.4% at December 31, 2010.

## **(7) Employee Benefit Plans**

### *Profit Sharing Plan*

We established a defined contribution plan in 1997, covering our employees meeting certain age and service eligibility requirements. The Plan provides for cash deferrals qualifying under Section 401(k). In December 31, 2008, we suspended the company-match contributions.

### *Stock Options and Warrants*

We have stock option plans, which provide for the granting of options to acquire First Mariner common stock to our directors and key employees. Option exercise prices are equal to or greater than the fair market value of the common stock on the date of the grant.

We account for stock options issued under our stockholder-approved Long-Term Incentive Plan (the Plan ) in accordance with FASB guidance on share-based payments. The plan permits the granting of share options and shares to our directors and key employees. We recognized stock based compensation costs of \$7,000 for the three months ended September 30, 2010 and \$5,000 and \$21,000 for the nine

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months ended September 30, 2011 and 2010, respectively. We did not record any stock compensation expense during the third quarter of 2011. As of September 30, 2011, all compensation expense related to currently outstanding options and warrants has been recognized.

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During 2010, we issued warrants to purchase 366,174 shares of common stock in Exchange transactions with Mr. Hale, the Company's CEO, and with an unaffiliated third party (see additional information in Note 5). The warrants vested immediately upon issuance.

As of September 30, 2011, all options and warrants to purchase shares of common stock were fully vested. All options expire 10 years after the date of grant. The warrants expire five years after date of issuance.

Information with respect to stock options and warrants is as follows for the nine months ended September 30, 2011 and 2010:

|                                     | 2011                |                                           |                                                                     |                                                      | 2010                |                                           |                                                                        |                                                   |
|-------------------------------------|---------------------|-------------------------------------------|---------------------------------------------------------------------|------------------------------------------------------|---------------------|-------------------------------------------|------------------------------------------------------------------------|---------------------------------------------------|
|                                     | Number<br>of Shares | Weighted-<br>Average<br>Exercise<br>Price | Weighted-<br>Average<br>Remaining<br>Contractual<br>Term (in years) | Aggregate<br>Intrinsic<br>Value<br>(in<br>thousands) | Number<br>of Shares | Weighted-<br>Average<br>Exercise<br>Price | Weighted-<br>Average<br>Remaining<br>Contractual<br>Term (in<br>years) | Aggregate<br>Intrinsic<br>Value<br>(in thousands) |
| Outstanding at<br>beginning of year | 930,228             | \$ 7.92                                   |                                                                     |                                                      | 668,593             | \$ 12.20                                  |                                                                        |                                                   |
| Granted                             |                     |                                           |                                                                     |                                                      | 366,174             | 1.15                                      |                                                                        |                                                   |
| Forfeited/cancelled                 | (89,650)            | 2.65                                      |                                                                     |                                                      | (103,339)           | 11.63                                     |                                                                        |                                                   |
| Outstanding at end<br>of year       | 840,578             | 8.02                                      | 3.0                                                                 | \$                                                   | 931,428             | 7.92                                      | 3.6                                                                    | \$                                                |
| Exercisable at end<br>of year       | 840,578             | 8.02                                      | 3.0                                                                 | \$                                                   | 926,428             | 7.93                                      | 3.6                                                                    | \$                                                |

The weighted average fair value of the warrants issued for the nine months ended September 30, 2010 was \$0.74. There were no options granted or warrants issued in 2011. The fair value of the warrants was calculated using the Black-Scholes-Merton option-pricing model with the following weighted average assumptions for the nine months ended September 30, 2010:

|                                                                  |         |
|------------------------------------------------------------------|---------|
| Dividend yield                                                   |         |
| Expected volatility                                              | 92.87%  |
| Risk-free interest rate                                          | 2.60%   |
| Expected lives                                                   | 5 years |
| There were no options or warrants exercised during 2011 or 2010. |         |

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Options and warrants outstanding are summarized as follows at September 30, 2011:

| Exercise Price | Options and<br>Warrants<br>Outstanding<br>and Exercisable<br><i>(shares)</i> | Weighted<br>Average<br>Remaining<br>Contractual Life<br><i>(in years)</i> |
|----------------|------------------------------------------------------------------------------|---------------------------------------------------------------------------|
| \$ 1.09        | 18,348                                                                       | 3.7                                                                       |
| 1.15           | 347,826                                                                      | 3.5                                                                       |
| 4.15           | 11,200                                                                       | 6.6                                                                       |
| 5.41           | 2,754                                                                        | 6.2                                                                       |
| 5.70           | 34,500                                                                       | 6.5                                                                       |
| 9.16           | 850                                                                          | 0.2                                                                       |
| 9.86           | 1,350                                                                        | 1.0                                                                       |
| 10.45          | 91,250                                                                       | 0.3                                                                       |
| 10.70          | 650                                                                          | 0.5                                                                       |
| 11.68          | 125,250                                                                      | 1.3                                                                       |
| 11.95          | 600                                                                          | 1.3                                                                       |
| 12.03          | 2,500                                                                        | 0.6                                                                       |
| 13.00          | 700                                                                          | 1.5                                                                       |
| 13.33          | 7,300                                                                        | 5.6                                                                       |
| 13.52          | 3,000                                                                        | 1.6                                                                       |
| 16.67          | 4,800                                                                        | 3.6                                                                       |
| 16.70          | 1,800                                                                        | 4.1                                                                       |
| 16.95          | 2,300                                                                        | 2.1                                                                       |
| 17.45          | 18,500                                                                       | 4.2                                                                       |
| 17.77          | 133,100                                                                      | 3.3                                                                       |
| 18.20          | 4,950                                                                        | 2.6                                                                       |
| 18.38          | 18,650                                                                       | 2.3                                                                       |
| 18.94          | 2,350                                                                        | 5.1                                                                       |
| 19.30          | 6,050                                                                        | 4.6                                                                       |
|                | 840,578                                                                      |                                                                           |

### (8) Comprehensive Loss

Comprehensive loss is defined as net loss plus transactions and other occurrences which are the result of nonowner changes in equity. Our nonowner equity changes are comprised of unrealized gains or losses on AFS securities that are accumulated with net loss in determining comprehensive loss.

Components of our comprehensive loss are as follows for the three and nine months ended September 30:

|                                                                                                                                                           | Three Months Ended<br>September 30, |            | Nine Months Ended<br>September 30, |             |
|-----------------------------------------------------------------------------------------------------------------------------------------------------------|-------------------------------------|------------|------------------------------------|-------------|
| <i>(dollars in thousands)</i>                                                                                                                             | 2011                                | 2010       | 2011                               | 2010        |
| Net loss                                                                                                                                                  | \$ (7,960)                          | \$ (4,608) | \$ (26,269)                        | \$ (12,705) |
| Other comprehensive income items:                                                                                                                         |                                     |            |                                    |             |
| Unrealized holding (losses) gains on securities arising during the period (net of tax (benefit) expense of \$(219), \$73, \$309, and \$326, respectively) | (324)                               | 108        | 457                                | 481         |
| Reclassification adjustment for net losses on securities (net of tax benefit of (\$17, \$329, \$15, and \$482, respectively) included in net loss         | 26                                  | 487        | 22                                 | 713         |

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|                                         |            |            |             |             |
|-----------------------------------------|------------|------------|-------------|-------------|
| Total other comprehensive (loss) income | (298)      | 595        | 479         | 1,194       |
| Total comprehensive loss                | \$ (8,258) | \$ (4,013) | \$ (25,790) | \$ (11,511) |

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## (9) Loss Per Share

Basic loss per share is computed by dividing loss available to common stockholders by the weighted-average number of common shares outstanding. Diluted loss per share is computed after adjusting the denominator of the basic loss 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- and six-month periods ended September 30, 2011 and 2010, all options and warrants were antidilutive and excluded from the computations due to our realized net losses.

Information relating to the calculation of loss per common share is summarized as follows for the three and nine months ended September 30:

|                                                          | Three Months Ended September<br>30, |            | Nine Months Ended September<br>30, |             |
|----------------------------------------------------------|-------------------------------------|------------|------------------------------------|-------------|
| <i>(dollars in thousands, except for per share data)</i> | 2011                                | 2010       | 2011                               | 2010        |
| Weighted-average share outstanding - basic and dilutive  | 18,860,482                          | 17,871,565 | 18,637,600                         | 13,674,155  |
| Net loss from continuing operations                      | \$ (7,960)                          | \$ (4,608) | \$ (26,269)                        | \$ (12,505) |
| Net loss from discontinued operations                    |                                     |            |                                    | (200)       |
| Net loss                                                 | \$ (7,960)                          | \$ (4,608) | \$ (26,269)                        | \$ (12,705) |
| Basic:                                                   |                                     |            |                                    |             |
| Net loss from continuing operations                      | \$ (0.42)                           | \$ (0.26)  | \$ (1.41)                          | \$ (0.92)   |
| Net loss from discontinued operations                    |                                     |            |                                    | (0.01)      |
| Net loss                                                 | \$ (0.42)                           | \$ (0.26)  | \$ (1.41)                          | \$ (0.93)   |
| Diluted:                                                 |                                     |            |                                    |             |
| Net loss from continuing operations                      | \$ (0.42)                           | \$ (0.26)  | \$ (1.41)                          | \$ (0.92)   |
| Net loss from discontinued operations                    |                                     |            |                                    | (0.01)      |
| Net loss                                                 | \$ (0.42)                           | \$ (0.26)  | \$ (1.41)                          | \$ (0.93)   |

## (10) Fair Value of Financial Instruments

We group financial assets and financial liabilities measured 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 fair value. These levels are:

Level 1 Valuations for assets and liabilities traded in active exchange markets. Valuations are obtained from readily available pricing sources for market transactions involving identical assets or liabilities.

Level 2 Valuations for assets and liabilities traded in less active dealer or broker markets. Valuations are obtained from third party pricing services for identical or comparable assets or liabilities which use observable inputs other than Level 1 prices, such as quoted prices for similar assets or liabilities; quoted prices in markets that are not active; or other inputs that are observable or can be corroborated by observable market data for substantially the full term of the assets or liabilities.

Level 3 Unobservable inputs that are supported by little or no market activity and that are significant to the fair value of the assets or liabilities.

### *Financial Instruments Measured on a Recurring Basis*



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The following table presents fair value measurements for assets, liabilities, and off-balance sheet items that are measured at fair value on a recurring basis:

September 30, 2011

| <i>(dollars in thousands)</i>                                                       | Carrying Value   | Quoted Prices (Level 1) | Significant Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) | Total Changes In Fair Values Included In Period Losses |
|-------------------------------------------------------------------------------------|------------------|-------------------------|-----------------------------------------------|-------------------------------------------|--------------------------------------------------------|
| Securities:                                                                         |                  |                         |                                               |                                           |                                                        |
| Mortgage-backed securities                                                          | \$ 1,963         | \$                      | \$ 1,963                                      | \$                                        | \$                                                     |
| Trust preferred securities                                                          | 10,218           |                         | 9,517                                         | 701                                       | (818)(1)                                               |
| U.S. government agency notes                                                        | 8,513            |                         | 8,513                                         |                                           |                                                        |
| U.S. Treasury securities                                                            | 1,015            |                         | 1,015                                         |                                           |                                                        |
| Equity securities - banks                                                           | 151              |                         | 151                                           |                                           |                                                        |
| Equity securities - mutual funds                                                    | 786              |                         | 786                                           |                                           |                                                        |
|                                                                                     | <u>\$ 22,646</u> | <u>\$</u>               | <u>\$ 21,945</u>                              | <u>\$ 701</u>                             | <u>\$ (818)</u>                                        |
| Warrants                                                                            | \$ 48            | \$                      | \$                                            | \$ 48                                     | \$                                                     |
| LHFS                                                                                | 126,191          |                         | 126,191                                       |                                           | 4,080                                                  |
| Interest rate lock commitments ( IRLC or IRLCs ) (notional amount of \$183,564)     | 187,205          |                         | 187,205                                       |                                           | 3,116                                                  |
| Forward contracts to sell mortgage-backed securities (notional amount of \$146,500) | 144,052          |                         | 144,052                                       |                                           | (7,922)                                                |

(1) Represents net OTTI charges taken on certain Level 3 securities

December 31, 2010

| <i>(dollars in thousands)</i>    | Carrying Value   | Quoted Prices (Level 1) | Significant Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) | Total Changes In Fair Values Included In Period Losses |
|----------------------------------|------------------|-------------------------|-----------------------------------------------|-------------------------------------------|--------------------------------------------------------|
| Securities:                      |                  |                         |                                               |                                           |                                                        |
| Mortgage-backed securities       | \$ 2,325         | \$                      | \$ 2,325                                      | \$                                        | \$                                                     |
| Trust preferred securities       | 10,464           |                         | 9,477                                         | 987                                       | (1,249)(1)                                             |
| U.S. government agency notes     | 12,071           |                         | 12,071                                        |                                           |                                                        |
| U.S. Treasury securities         | 1,001            |                         | 1,001                                         |                                           |                                                        |
| Corporate obligations            | 1,010            |                         | 1,010                                         |                                           |                                                        |
| Equity securities - banks        | 197              |                         | 197                                           |                                           |                                                        |
| Equity securities - mutual funds | 758              |                         | 758                                           |                                           |                                                        |
|                                  | <u>\$ 27,826</u> | <u>\$</u>               | <u>\$ 26,839</u>                              | <u>\$ 987</u>                             | <u>\$ (1,249)</u>                                      |
| Mortgage servicing rights        | \$ 1,309         | \$                      | \$                                            | \$ 1,309                                  | \$ (309)                                               |

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|                                                                                     |         |         |         |
|-------------------------------------------------------------------------------------|---------|---------|---------|
| Warrants                                                                            | 137     | 137     |         |
| LHFS                                                                                | 140,343 | 140,343 | (655)   |
| IRLCs (notional amount of \$71,228)                                                 | 71,753  | 71,753  | 479     |
| Forward contracts to sell mortgage-backed securities (notional amount of \$125,500) | 127,424 | 127,424 | (3,288) |

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(1) Represents net OTTI charges taken on certain Level 3 securities  
*Level 3 Financial Instruments*

Financial instruments are considered Level 3 when their values are determined using pricing models, discounted cash flow methodologies, or similar techniques and at least one significant model assumption or input is unobservable. Level 3 financial instruments also include those for which the determination of fair value requires significant management judgment or estimation.

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## Securities AFS

The fair value of AFS securities is based on bid quotations received from securities dealers, bid prices received from an external pricing service, or modeling utilizing estimated cash flows, depending on the circumstances of the individual security.

As of September 30, 2011, \$701,000 (\$10.9 million par value) of our AFS securities (four securities) were classified as Level 3, all of which are pooled trust preferred securities. The market environment has continued to be inactive for these security types and made fair value pricing more subjective. The amount of Level 3 securities will likely continue to be a function of market conditions and additional security transfers from Level 2 to Level 3 could result if further market inactivity occurs.

The following table details the four Level 3 securities:

| <i>(dollars in thousands)</i> | Class | Remaining<br>Par<br>Value | Current<br>Rating/Outlook (1) |       | Maturity   | (2)<br>Auction<br>Call Date | (3)<br>Index |
|-------------------------------|-------|---------------------------|-------------------------------|-------|------------|-----------------------------|--------------|
|                               |       |                           | Moody's                       | Fitch |            |                             |              |
| ALESCO Preferred Funding VII  | C-1   | \$ 1,000                  | Ca                            | C     | 7/23/2035  | MAR 2015                    | 3ML + 1.5%   |
| ALESCO Preferred Funding XI   | C-1   | 4,938                     | C                             | C     | 12/23/2036 | JUNE 2016                   | 3ML + 1.2%   |
| MM Community Funding          | B     | 2,500                     | Ca                            | C     | 8/1/2031   | N/A                         | 6ML + 3.1%   |
| MM Community Funding IX       | B-1   | 2,500                     | Caa3                          | C     | 5/1/2033   | N/A                         | 3ML + 1.8%   |

(1) Ratings as of September 30, 2011.

(2) Under the terms of the offering, if the notes have not been redeemed in full prior to the indicated call date then an auction of the collateral debt securities will be conducted and the collateral will be sold and the notes redeemed. If the auction is not successful, the collateral manager will conduct auctions on a quarterly basis until the rated notes are redeemed in full.

(3) 3/6ML - 3 or 6 Month LIBOR; LIBOR (London Interbank Offered Rate) - daily reference rate based on the interest rates at which banks offer to lend unsecured funds to other banks in the London wholesale money market or interbank market.

Classification of Level 3 indicates that significant valuation assumptions are not consistently observable in the market and, as such, fair values are derived using the best available data. We calculated fair value for these four securities by using a present value of future cash flows model, which incorporated assumptions as follows as of September 30, 2011:

### Key Model Assumptions Used In Pricing

|                              | Cumulative<br>Default (1) | Deferrals<br>Cured (2) | Credit<br>MTM (3) (6) | Liquidity<br>Premium (4) | Liquidity<br>MTM Adj (5)<br>(6) |
|------------------------------|---------------------------|------------------------|-----------------------|--------------------------|---------------------------------|
| ALESCO Preferred Funding VII | 45.0%                     | 2.0%                   | \$ 46.60              | 12.00%                   | \$ 37.78                        |
| ALESCO Preferred Funding XI  | 36.0%                     | 3.6%                   | 46.95                 | 12.00%                   | 38.14                           |
| MM Community Funding         | 72.0%                     | 10.1%                  | 8.67                  | 12.00%                   | 5.51                            |
| MM Community Funding IX      | 60.0%                     | 8.9%                   | 34.62                 | 12.00%                   | 30.67                           |

(1) The anticipated level of total defaults from the issuers within the pool of performing collateral as of September 30, 2011. There are no recoveries assumed on any default.

(2) Deferrals that are cured occur 60 months after the initial deferral starts.

(3) The credit mark to market represents the discounted value of future cash flows after the assumption of current and future defaults discounted at the book rate of interest on the security.

(4) The risk of being unable to sell the instrument for cash at short notice without significant costs, usually indicative of the level of trading activity for a specific security or class of securities.

(5)

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The liquidity mark to market adjustment on the security represents the difference between the value of the discounted cash flows based on the book interest rate and the value discounted at the liquidity premium. The credit MTM less the liquidity MTM equals the estimated fair value price of the security.

(6) Price per \$100

|                              | September 30, 2011  |                              | December 31, 2010         |                              |
|------------------------------|---------------------|------------------------------|---------------------------|------------------------------|
|                              | Model<br>Result (1) | Fair Value<br>(in thousands) | Model<br>Result<br>(1)(2) | Fair Value<br>(in thousands) |
| ALESCO Preferred Funding VII | \$ 8.82             | \$ 88                        | \$ 9.38                   | \$ 94                        |
| ALESCO Preferred Funding XI  | 8.81                | 435                          | 7.81                      | 386                          |
| MM Community Funding         | 3.16                | 79                           | 9.88                      | 247                          |
| MM Community Funding IX      | 3.95                | 99                           | 10.41                     | 260                          |
|                              |                     | <u>\$ 701</u>                |                           | <u>\$ 987</u>                |

(1) Price per \$100

(2) Based on December 31, 2010 assumptions

During 2011 and 2010, we determined that OTTI had occurred in our pooled trust preferred security portfolio. The amount of OTTI that is recognized through earnings is determined by comparing the present value of the expected cash flows to the amortized cost of the security. The discount rate used to determine the credit loss is the expected book yield on the security. The credit loss estimated under the aforementioned method that was charged to operating earnings totaled \$681,000 and \$818,000 for the three and nine months ended September 30, 2011, respectively, and \$816,000 and \$1.2 million for the three and nine months ended September 30, 2010, respectively.

#### Warrants

As of September 31, 2011, certain warrants were classified as Level 3. See Note 7 for information related to the calculation of fair value of the warrants.

The table below presents a reconciliation of financial instruments measured at fair value on a recurring basis using significant unobservable inputs (Level 3) during the three months ended September 30, 2011 and 2010:

|                                                               | 2011          |              | 2010          |               |               |
|---------------------------------------------------------------|---------------|--------------|---------------|---------------|---------------|
| (dollars in thousands)                                        | Securities    | Warrants     | Securities    | MSRs          | Warrants      |
| Balance at beginning of period                                | \$ 959        | \$ 162       | \$ 1,125      | \$ 1,009      | \$ 251        |
| Originated mortgage servicing rights ( MSR or MSRs )          |               |              |               | 1             |               |
| MSR amortization                                              |               |              |               | (63)          |               |
| Change in fair value included in additional paid-in capital   |               | (114)        |               |               | (52)          |
| Total realized losses included in other comprehensive income  | (681)         |              | (816)         | (5)           |               |
| Total unrealized gains included in other comprehensive income | 423           |              | 576           |               |               |
| Balance at end of period                                      | <u>\$ 701</u> | <u>\$ 48</u> | <u>\$ 885</u> | <u>\$ 942</u> | <u>\$ 199</u> |

The table below presents a reconciliation of financial instruments measured at fair value on a recurring basis using significant unobservable inputs (Level 3) during the nine months ended September 30, 2011 and 2010:

| (dollars in thousands)                                        | 2011       |          |          | 2010       |          |          |
|---------------------------------------------------------------|------------|----------|----------|------------|----------|----------|
|                                                               | Securities | MSRs     | Warrants | Securities | MSRs     | Warrants |
| Balance at beginning of period                                | \$ 987     | \$ 1,309 | \$ 137   | \$ 1,432   | \$ 1,176 | \$       |
| Warrants issued                                               |            |          |          |            |          | 251      |
| Originated MSRs                                               |            |          |          |            | 1        |          |
| MSR amortization                                              |            | (135)    |          |            | (218)    |          |
| Change in fair value included in additional paid-in capital   |            |          | (89)     |            |          | (52)     |
| Total realized losses included in other comprehensive income  | (818)      |          |          | (1,249)    | (17)     |          |
| Reduction due to transfer of servicing rights to NGFS         |            | (1,174)  |          |            |          |          |
| Total unrealized gains included in other comprehensive income | 532        |          |          | 702        |          |          |
| Balance at end of period                                      | \$ 701     | \$       | \$ 48    | \$ 885     | \$ 942   | \$ 199   |

There were no transfers between any of Levels 1, 2, and 3 during either the three or nine months ended September 30, 2011 or September 30, 2010. During the second quarter of 2011, we sold our MSRs to NGFS in conjunction with the imminent closing of that sales transaction, which occurred during the third quarter of 2011.

#### *Other Financial Instruments Measured on a Recurring Basis*

##### Loans Held for Sale

Loans held for sale are carried at fair value, which is determined based on outstanding investor commitments or, in the absence of such commitments, based on current investor yield requirements or third party pricing models.

##### IRLCs

We engage an experienced independent third party to estimate the fair market value of our IRLC. IRLCs are valued based upon mandatory pricing quotes from correspondent lenders less estimated costs to process and settle the loan. Fair value is adjusted for the estimated probability of the loan closing with the borrower.

##### Forward Contracts to Sell Mortgage-Backed Securities

Fair value of these commitments is determined based upon the quoted market values of the securities.

#### *Financial Instruments Measured on a Nonrecurring Basis*

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We may be required, from time to time, to measure certain other financial assets and liabilities at fair value on a nonrecurring basis. These adjustments to fair value usually result from application of lower-of-cost-or-market accounting or write-downs of individual assets. For assets measured at fair value on a nonrecurring basis, the following tables provide the level of valuation assumptions used to determine each adjustment and the carrying value of the assets:

| September 30, 2011                       |                   |                               |                                                           |                                                    |
|------------------------------------------|-------------------|-------------------------------|-----------------------------------------------------------|----------------------------------------------------|
| (dollars in thousands)                   | Carrying<br>Value | Quoted<br>Prices<br>(Level 1) | Significant<br>Other<br>Observable<br>Inputs<br>(Level 2) | Significant<br>Unobservable<br>Inputs<br>(Level 3) |
| Impaired loans                           | \$ 62,497         | \$                            | \$                                                        | \$ 62,497                                          |
| Real estate acquired through foreclosure | 24,739            |                               |                                                           | 24,739                                             |

| December 31, 2010                        |                   |                               |                                                           |                                                    |
|------------------------------------------|-------------------|-------------------------------|-----------------------------------------------------------|----------------------------------------------------|
| (dollars in thousands)                   | Carrying<br>Value | Quoted<br>Prices<br>(Level 1) | Significant<br>Other<br>Observable<br>Inputs<br>(Level 2) | Significant<br>Unobservable<br>Inputs<br>(Level 3) |
| Impaired loans                           | \$ 71,970         | \$                            | \$                                                        | \$ 71,970                                          |
| Real estate acquired through foreclosure | 21,185            |                               |                                                           | 21,185                                             |
| <i>Impaired Loans</i>                    |                   |                               |                                                           |                                                    |

Allowable methods for estimating fair value for impaired loans include using the fair value of the collateral for collateral dependent loans or, where a loan is determined not to be collateral dependent, using the discounted cash flow method.

If the impaired loan is identified as collateral dependent, then the fair value method of measuring the amount of impairment is utilized. This method requires obtaining a current independent appraisal or utilizing some other method of valuation for the collateral and applying a discount factor to the value based on our loan review policy and procedures.

If the impaired loan is determined not to be collateral dependent, then the discounted cash flow method is used. This method requires the impaired loan to be recorded at the present value of expected future cash flows discounted at the loan's effective interest rate. The effective interest rate of a loan is the contractual interest rate adjusted for any net deferred loan fees or costs, premiums, or discounts existing at origination or acquisition of the loan.

For all loans other than TDRs, a partial charge-off is recorded to reduce the carrying amount of the loan to its fair value. For TDRs that have an estimated fair value that is below the carrying value, a specific reserve is established and remains part of the allowance until such time that it is determined the loan will proceed to foreclosure. Total impaired loans had a carrying value of \$62.5 million and \$72.0 million as of September 30, 2011 and December 31, 2010, respectively, with specific reserves of \$450,000 and \$588,000 as of September 30, 2011 and December 31, 2010, respectively.

### *Real Estate Acquired Through Foreclosure*

We record foreclosed real estate assets at the lower of cost or estimated fair value ( LCM ) on their acquisition dates and at the lower of such initial amount or estimated fair value less estimated selling costs thereafter. Estimated fair value is generally based upon independent appraisal of the collateral or listing prices supported by broker recommendation. We consider these collateral values to be estimated using Level 3 inputs. We held real estate acquired through foreclosure of \$24.7 million as of September 30, 2011 and \$21.2 million as of December 31, 2010. During 2011, we added \$16.1 million to real estate acquired through foreclosure and recorded write-downs and losses on sales, included in noninterest expense, of \$5.7 million. We disposed of \$8.6 million of foreclosed properties during 2011.

### *Other Financial Instruments*

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The carrying value and estimated fair value of financial instruments are summarized in the following table. Certain financial instruments disclosed previously in this footnote are excluded from this table.

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|                                                    | September 30, 2011 |                      | December 31, 2010 |                      |
|----------------------------------------------------|--------------------|----------------------|-------------------|----------------------|
|                                                    | Carrying Value     | Estimated Fair Value | Carrying Value    | Estimated Fair Value |
| <i>(dollars in thousands)</i>                      |                    |                      |                   |                      |
| <b>Assets:</b>                                     |                    |                      |                   |                      |
| Cash and cash equivalents                          | \$ 186,664         | \$ 186,664           | \$ 217,961        | \$ 217,961           |
| Loans receivable                                   | 736,672            | 738,225              | 811,687           | 812,417              |
| Restricted stock investments                       | 6,969              | 6,969                | 7,095             | 7,095                |
| <b>Liabilities:</b>                                |                    |                      |                   |                      |
| Deposits                                           | 1,031,878          | 1,045,956            | 1,121,889         | 1,141,321            |
| Long- and short-term borrowings                    | 117,808            | 119,244              | 118,287           | 120,150              |
| Junior subordinated deferrable interest debentures | 52,068             | 35,390               | 52,068            | 32,060               |

Pricing or valuation models are applied using current market information to estimate fair value. In some cases considerable judgment is required to interpret market data to develop the estimates of fair value. Accordingly, the estimates presented herein are not necessarily indicative of the amounts the Company could realize in a current market exchange. The use of different market assumptions and/or estimation methods may have a material effect on the estimated fair value amounts.

#### *Cash and Cash Equivalents*

The carrying amount for cash and cash equivalents approximates fair value due to the short maturity of these instruments.

#### *Loans Receivable*

Loans were segmented into portfolios with similar financial characteristics. Loans were also segmented by loan class. Each loan class was further segmented by fixed and adjustable rate interest terms and performing and nonperforming categories. The fair value of each loan class was calculated by discounting anticipated cash flows based on weighted-average contractual maturity, weighted-average coupon, and discount rate.

The fair value for nonperforming loans was determined utilizing FASB guidance on loan impairment.

#### *Restricted Stock Investments*

The carrying value of restricted stock investments is a reasonable estimate of fair value as these investments do not have a readily available market.

#### *Deposits*

The fair value of deposits with no stated maturity, such as noninterest-bearing deposits, interest-bearing NOW accounts, money market, and savings accounts, is deemed to be equal to the carrying amounts. The fair value of certificates of deposit is based on the discounted value of contractual cash flows. The discount rate for certificates of deposit was estimated using the rate currently offered for deposits of similar remaining maturities.

#### *Long- and Short-Term Borrowings and Junior Subordinated Deferrable Interest Debentures*

Long- and short-term borrowings and junior subordinated notes were segmented into categories with similar financial characteristics. Carrying values were discounted using a cash flow approach based on market rates.

#### *Other Off-Balance Sheet Financial Instruments*

The disclosure of fair value amounts does not include the fair values of any intangibles, including core deposit intangibles. Core deposit intangibles represent the value attributable to total deposits based on an expected duration of customer relationships.

#### *Limitations*

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Fair value estimates are made at a specific point in time, based on relevant market information and information about financial instruments. These estimates do not reflect any premium or discount that could result from a one-time sale of our total holdings of a particular financial instrument. Because no market exists for a significant portion of our financial instruments, fair value estimates are based on judgments regarding future expected loss experience, current economic conditions, risk characteristics of various financial instruments, and other factors. These estimates are subjective in nature and involve uncertainties and matters of significant judgment and therefore cannot be determined with precision. Changes in assumptions could significantly affect estimates.

**(11) Segment Information**

We are in the business of providing financial services, and we operate in two business segments commercial and consumer banking and mortgage-banking. Commercial and consumer banking is conducted through 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.

The following tables present certain information regarding our business segments:

***For the nine month period ended September 30, 2011:***

| <i>(dollars in thousands)</i>                       | <b>Commercial and<br/>Consumer<br/>Banking</b> | <b>Mortgage-<br/>Banking</b> | <b>Total</b> |
|-----------------------------------------------------|------------------------------------------------|------------------------------|--------------|
| Interest income                                     | \$ 33,309                                      | \$ 2,209                     | \$ 35,518    |
| Interest expense                                    | 14,042                                         | 883                          | 14,925       |
| Net interest income                                 | 19,267                                         | 1,326                        | 20,593       |
| Provision for loan losses                           | 11,580                                         |                              | 11,580       |
| Net interest income after provision for loan losses | 7,687                                          | 1,326                        | 9,013        |
| Noninterest income                                  | 7,585                                          | 7,942                        | 15,527       |
| Noninterest expense                                 | 44,321                                         | 6,488                        | 50,809       |
| Net intersegment income                             | 1,674                                          | (1,674)                      |              |
| Net (loss) income before income taxes               | \$ (27,375)                                    | \$ 1,106                     | \$ (26,269)  |
| Total assets                                        | \$ 1,071,470                                   | \$ 126,191                   | \$ 1,197,661 |

***For the nine month period ended September 30, 2010:***

| <i>(dollars in thousands)</i>                       | <b>Commercial and<br/>Consumer<br/>Banking</b> | <b>Mortgage-<br/>Banking</b> | <b>Total</b> |
|-----------------------------------------------------|------------------------------------------------|------------------------------|--------------|
| Interest income                                     | \$ 38,328                                      | \$ 3,148                     | \$ 41,476    |
| Interest expense                                    | 17,567                                         | 2,205                        | 19,772       |
| Net interest income                                 | 20,761                                         | 943                          | 21,704       |
| Provision for loan losses                           | 16,290                                         |                              | 16,290       |
| Net interest income after provision for loan losses | 4,471                                          | 943                          | 5,414        |
| Noninterest income                                  | 9,040                                          | 13,499                       | 22,539       |
| Noninterest expense                                 | 44,417                                         | 6,789                        | 51,206       |
| Net intersegment income                             | 1,775                                          | (1,775)                      |              |
| Net (loss) income before income taxes               | \$ (29,131)                                    | \$ 5,878                     | \$ (23,253)  |
| Total assets                                        | \$ 1,181,716                                   | \$ 151,623                   | \$ 1,333,339 |

**(12) Recent Accounting Pronouncements**

***Pronouncements Adopted***

In July, 2010, the FASB issued Accounting Standards Update ( ASU ) No. 2010-20, *Disclosures about the Credit Quality of Financing Receivables and the Allowance for Credit Losses*, which requires companies to improve their disclosures about the credit quality of their financing receivables and the credit reserves held against them. The standard is effective for interim and annual reporting periods ending after December 15, 2010. In January of 2011, this standard was updated by ASU No. 2011-01, *Receivables (Topic 310) Deferral of the Effective Date of Disclosure about Troubled Debt Restructurings in Update No. 2010-20*, which temporarily delays the provisions of ASU No. 2010-20 for troubled debt restructurings until the FASB clarifies the guidance for determining what constitutes a troubled debt restructuring in order to ensure more consistent disclosures about troubled debt restructurings. The effective date for the new TDR guidance is for interim and annual periods ending after June 15, 2011. We began providing the aforementioned disclosures in the Consolidated Financial Statements as of and for the three years ended December 31, 2010.

In April 2011, the FASB issued Accounting Standards Update ( ASU ) No. 2011-02, *A Creditor's Determination of Whether a Restructuring Is a Troubled Debt Restructuring*. ASU No. 2011-02 provides additional guidance and clarification to help creditors in determining whether a creditor

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has granted a concession and whether a debtor is experiencing financial difficulties for purposes of determining whether a restructuring constitutes a troubled debt restructuring. The provisions of ASU No. 2011-02 were effective for the Company's reporting period ended September 30, 2011 and were applied retrospectively to January 1, 2011. The adoption of this ASU did not have a material impact on the Company's statements of operations or financial condition.

### ***Pronouncements Issued***

In June 2011, the FASB issued guidance on the reporting and presentation of comprehensive income. This guidance eliminates the option to present the components of other comprehensive income as part of the statement of changes in stockholders' equity and requires an entity to present items of net income, other comprehensive income and total comprehensive income either in a single continuous statement of comprehensive income or in two separate but consecutive statements. The guidance also requires companies to display reclassification adjustments for each component of other comprehensive income in both net income and other comprehensive income. The amendments in this guidance do not change the items that must be reported in other comprehensive income or when an item of other comprehensive income must be reclassified to net income. The new guidance was originally proposed to be effective for fiscal years, and interim periods within those years, beginning after December 15, 2011 and applied retrospectively. In October 2011, the FASB proposed to defer the effective date of certain provisions in the guidance related to the presentation of reclassification adjustments. No effective date has been announced. As the new guidance requires additional presentation only, there will be no impact to the Company's consolidated results of operations or financial position.

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

When used in this report, the terms "the Company," "we," "us," and "our" refer to First Mariner Bancorp and, unless the context requires otherwise, its consolidated subsidiary. 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 First Mariner Bancorp's Annual Report on Form 10-K for the year ended December 31, 2010.

### ***Recent Developments***

#### ***NASDAQ Delisting***

On August 30, 2011, we received a letter from NASDAQ notifying us that NASDAQ had determined to deny our request for continued listing on NASDAQ. NASDAQ indicated that it would suspend the trading of the shares of Company common stock effective at the open of business on September 1, 2011. The Company's common stock was quoted on the Over-the-Counter Bulletin Board ("OTCBB") starting on September 1. NASDAQ's determination was based on the Company's failure to comply with: (1) NASDAQ Listing Rule 5450(b), which requires maintenance of a minimum of \$2.5 million in shareholders' equity; and (2) NASDAQ Listing Rule 5450(a)(1), which requires maintenance of a minimum bid price of \$1.00 per share.

#### ***Securities Purchase Agreement***

On April 19, 2011, the Company and the Bank entered into a securities purchase agreement with Priam Capital Fund I, LP, which was subsequently amended on September 21, 2011 to, among other things, extend the agreement to November 30, 2011. For a description of the material terms of the securities purchase agreement, see the Company's Current Report on Form 8-K filed with the Securities and Exchange Commission on April 25, 2011. For additional information on the terms of the amendment, see Exhibit 10.1 to this Form 10-Q and the Company's Current Report on Form 8-K filed with the Securities and Exchange Commission on September 27, 2011.

### ***The Company***

First Mariner Bancorp is a bank holding company incorporated under the laws of Maryland and registered under the federal Bank Holding Company Act of 1956, as amended. First Mariner Bancorp's business is conducted primarily through its wholly-owned subsidiary, First Mariner Bank (the "Bank"). The Company had over 520 employees (approximately 508 full-time equivalent employees) as of September 30, 2011.

The Bank, with assets exceeding \$1.1 billion as of September 30, 2011, 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. 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 and portions of Maryland's eastern shore. Products and services of the Bank include traditional deposit products, a variety of consumer and commercial loans, residential and commercial mortgage and construction loans, wire transfer services, nondeposit 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. The Bank is an independent community bank and its deposits are insured by the Federal Deposit Insurance Corporation (the "FDIC").



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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 into the secondary market. First Mariner Mortgage had assets of \$126.2 million and \$140.3 million as of September 30, 2011 and December 31, 2010, respectively, and generated revenue of \$10.2 million and \$16.6 million, respectively, for the nine months ended September 30, 2011 and 2010. They recognized income before income taxes of \$1.1 million and \$5.9 million during the nine months ended September 30, 2011 and 2010, respectively. Origination volume during the nine months ended September 30, 2011 and 2010 was \$691.8 million and \$915.8 million, respectively. During 2011, 69% of the originations were made in the state of Maryland, 12% in the immediately surrounding states and Washington, DC., and the remaining 19% in other states throughout the country. First Mariner Mortgage has offices in Maryland, Delaware, Virginia, and North Carolina. See Note 11 to the Consolidated Financial Statements for more detailed information on the results of our mortgage-banking operations.

Next Generation Financial Services ( NGFS ), a former division of the Bank, engages in the origination of reverse and conventional mortgage loans, providing these products directly through commission based loan officers throughout the United States. The final settlement of sale on this division occurred during the third quarter of 2011. We transferred all Mortgage Servicing Rights ( MSR or MSRs ) to the buyer of NGFS during the second quarter of 2011 and finalized the sale during the third quarter of 2011. We have not realized any significant benefit or loss from the sale of NGFS.

### ***Critical Accounting Policies***

The Company's consolidated financial statements are prepared in accordance with accounting principles generally accepted in the United States of America ( GAAP ) 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 consolidated financial statements and accompanying notes. These estimates, assumptions, and judgments are based on information available as of the date of the consolidated financial statements; accordingly, as this information changes, the consolidated 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 consolidated 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*

Our allowance for loan losses represents an estimated amount that, in management's judgment, will be adequate to absorb probable incurred losses on existing loans. The allowance for loan losses consists of an allocated component and an unallocated component. Management uses a disciplined process and methodology to establish the allowance for losses each quarter. To determine the total allowance for loan losses, we estimate the reserves needed for each class of the portfolio, including loans analyzed individually and loans analyzed on a pooled basis. The allowance for loan losses consists of amounts applicable to: (1) the commercial loan portfolio; (2) the commercial mortgage loan portfolio; (3) the construction loan portfolios (both commercial and consumer); (4) the residential mortgage loan portfolio; (5) the home equity and second mortgage loan portfolio; and (6) the other consumer loan portfolio.

To determine the balance of the allowance account, loans are pooled by portfolio class and losses are modeled using historical experience, quantitative analysis, and other mathematical techniques over the loss emergence period. For each class of loan, significant judgment is exercised to determine the estimation method that fits the credit risk characteristics of its portfolio segment. We use internally developed models in this process. Management must use judgment in establishing additional input metrics for the modeling processes. The models and assumptions used to determine the allowance are validated and reviewed to ensure that their theoretical foundation, assumptions, data integrity, computational processes, reporting practices, and end-user controls are appropriate and properly documented.

The establishment of the allowance for loan losses relies on a consistent process that requires multiple layers of management review and judgment and responds timely to changes in economic conditions and other influences. From time to time, events or economic factors may affect the loan portfolio, causing management to provide additional amounts to or release balances from the allowance for loan losses.

Management monitors differences between estimated and actual incurred loan losses, utilizing charge-off history. Loans deemed uncollectible are charged against, while recoveries are credited to, the allowance. Management adjusts the level of the allowance through the provision for loan losses, which is recorded as a current period operating expense.

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Commercial (including commercial mortgages) and construction loans (including both commercial and consumer) are generally evaluated for impairment when the loan becomes 90 days past due and/or is rated as substandard. The difference between the fair value of the collateral, less estimated selling costs and the carrying value of the loan is charged-off at that time. Residential mortgage loans are generally charged down to their fair value when the loan becomes 120 days past due or is placed in nonaccrual status, whichever is earlier. Consumer loans are generally charged-off when the loan becomes 120 days past due or when it is determined that the amounts due are uncollectible (whichever is earlier). The above charge-off guidelines may not apply if the loan is both well secured and in the process of collection. These charge-off policies have not changed in the last three years.

As an additional portion of the allowance for loan losses, we also estimate probable losses related to unfunded loan commitments. These commitments are subject to individual review and are analyzed for impairment the same as a correspondent loan would be.

### *Securities available for sale ( AFS )*

We designate securities into one of three categories at the time of purchase. Debt securities that we have the intent and ability to hold to maturity are classified as held to maturity and recorded at amortized cost. Debt and equity securities are classified as trading if bought and held principally for the purpose of sale in the near term. Trading securities are reported at estimated fair value, with unrealized gains and losses included in earnings. Debt securities not classified as held to maturity and debt and equity securities not classified as trading securities are considered AFS and are reported at estimated fair value, with unrealized gains and losses reported as a separate component of stockholders equity, net of tax effects, in accumulated other comprehensive loss.

Securities AFS 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 security.

The initial indications of other-than-temporary impairment ( OTTI ) for both debt and equity securities are a decline in the market value below the amount recorded for an investment and the severity and duration of the decline. In determining whether an impairment is other than temporary, we consider the length of time and the extent to which the market value has been below cost, recent events specific to the issuer, including investment downgrades by rating agencies and economic conditions of its industry, our intent to sell the security, and if it is more likely than not that we will be required to sell the security before recovery of its amortized cost basis. For marketable equity securities, we also consider the issuer's financial condition, capital strength, and near-term prospects. For debt securities and for perpetual preferred securities that are treated as debt securities for the purpose of OTTI analysis, we also consider the cause of the price decline (general level of interest rates and industry- and issuer-specific factors), the issuer's financial condition, near-term prospects and current ability to make future payments in a timely manner, the issuer's ability to service debt, and any change in agencies' ratings at evaluation date from acquisition date and any likely imminent action. Once a decline in value is determined to be other than temporary, the security is segmented into credit- and noncredit-related components. Any impairment adjustment due to identified credit-related components is recorded as an adjustment to current period earnings, while noncredit-related fair value adjustments are recorded through accumulated other comprehensive loss. In situations where we intend to sell or it is more likely than not that we will be required to sell the security, the entire OTTI loss must be recognized in earnings.

Gains or losses on the sales of securities are calculated using a specific-identification basis and are determined on a trade-date basis. Premiums and discounts on securities are amortized (accreted) over the term of the security using methods that approximate the interest method. Gains and losses on trading securities are recognized regularly in income as the fair value of those securities changes.

### *Income Taxes*

Deferred income taxes are recognized for the tax consequences of temporary differences between financial statement carrying amounts and the tax bases of assets and liabilities. Deferred income taxes are provided on income and expense items when they are reported for financial statement purposes in periods different from the periods in which these items are recognized in the income tax returns. Deferred tax assets are recognized only to the extent that it is more likely than not that such amounts will be realized based upon consideration of available evidence, including tax planning strategies and other factors.

We recognize a tax position as a benefit only if it is more likely than not that the tax position would be sustained in a tax examination, with a tax examination being presumed to occur. The amount recognized is the largest amount of tax benefit that is greater than 50% likely to be realized on examination. For tax positions not meeting the more likely than not test, no tax benefit is recorded. As of September 30, 2011 and December 31, 2010, we maintained a valuation allowance against the full amount of our deferred tax assets.

The calculation of tax liabilities is complex and requires the use of estimates and judgment since it involves the application of complex tax laws that are subject to different interpretations by us and the various tax authorities. These interpretations are subject to challenge by the tax authorities upon audit or to reinterpretation based on management's ongoing assessment of facts and evolving case law.



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Periodically and in the ordinary course of business, we are involved in inquiries and reviews by tax authorities that normally require management to provide supplemental information to support certain tax positions we take in our tax returns. Uncertain tax positions are initially recognized in the financial statements when it is more likely than not the position will be sustained upon examination by the tax authorities. Such tax positions are initially and subsequently measured as the largest amount of tax benefit that is greater than 50% likely of being realized upon ultimate settlement with the tax authority assuming full knowledge of the position and all relevant facts. Management believes it has taken appropriate positions on its tax returns, although the ultimate outcome of any tax review cannot be predicted with certainty. No assurance can be given that the final outcome of these matters will not be different than what is reflected in the current and historical financial statements.

We recognize interest and penalties related to income tax matters in income tax (benefit) expense.

### *Loan income recognition*

Interest income on loans is accrued at the contractual rate based on the principal outstanding. Loan origination fees and certain direct loan origination costs are deferred and amortized as a yield adjustment over the contractual loan terms or until the date of sale or disposition. Accrual of interest is discontinued when its receipt is in doubt, which typically occurs when a loan becomes impaired. Any interest accrued to income in the year when interest accruals are discontinued is generally 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 collectability has been removed and the borrower has demonstrated the ability to pay and remain current. Payments on nonaccrual loans are applied to principal.

### *Real Estate Acquired Through Foreclosure*

We record foreclosed real estate assets at the lower of cost or estimated fair value ( LCM ) on the acquisition date and at the lower of such initial amount or estimated fair value less estimated selling costs thereafter. Estimated fair value is based upon many subjective factors, including location and condition of the property and current economic conditions, among other things. Because the calculation of fair value relies on estimates and judgments relating to inherently uncertain events, results may differ from our estimates.

Write-downs at time of transfer are made through the allowance for loan losses. Write-downs subsequent to transfer are included in our noninterest expenses, along with operating income, net of related expenses of such properties and gains or losses realized upon disposition.

### *Financial Condition*

At September 30, 2011, our total assets were \$1.2 billion compared to the \$1.3 billion at December 31, 2010. Earning assets decreased \$108.4 million, or 10.5%, to \$926.9 million at September 30, 2011 from \$1.0 billion at December 31, 2010. We experienced decreases in all of our interest-earning asset categories. Deposits and capital decreased \$90.0 million and \$25.3 million, respectively.

### *Securities*

We utilize the securities 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. We continually monitor the credit risk associated with investments and diversify the risk in the securities portfolios. We held \$22.6 million and \$27.8 million, respectively, in securities classified as AFS as of September 30, 2011 and December 31, 2010. During the nine months ended September 30, 2011, we purchased \$59.8 million in U.S. Agency and mortgage-backed securities in order to utilize some of our excess liquidity.

We recorded \$818,000 and \$1.2 million in net OTTI charges during the nine months ended September 30, 2011 and 2010, respectively, related to pooled trust preferred securities. Overall market values of securities have improved as evidenced by a net unrealized loss on securities classified as AFS of \$3.1 million at September 30, 2011 compared to a net unrealized loss of \$3.6 million at December 31, 2010.

The trust preferred securities we hold in our securities portfolio were issued by other banks, bank holding companies, and insurance companies. Certain of these securities have experienced declines in credit ratings from credit rating firms, which have devalued these specific securities. While some of these issuers have reported weaker financial performance since acquisition of these securities, in management's opinion, they continue to possess acceptable credit risk. We monitor the actual default rates and interest deferrals for possible losses and contractual shortfalls of interest or principal, which could warrant further recognition of impairment.

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All of the remaining securities that are temporarily impaired are impaired due to declines in fair values resulting from changes in interest rates or increased credit/liquidity spreads compared to the time they were purchased. We have the intent to hold these securities to maturity and it is more likely than not that we will not be required to sell the securities before recovery of value. As such, management considers the impairments to be temporary.

Our securities AFS portfolio composition is as follows:

| <i>(dollars in thousands)</i>    | <b>September<br/>30,<br/>2011</b> | <b>December<br/>31,<br/>2010</b> |
|----------------------------------|-----------------------------------|----------------------------------|
| Mortgage-backed securities       | \$ 1,963                          | \$ 2,325                         |
| Trust preferred securities       | 10,218                            | 10,464                           |
| U.S. government agency notes     | 8,513                             | 12,071                           |
| U.S. Treasury securities         | 1,015                             | 1,001                            |
| Corporate obligations            |                                   | 1,010                            |
| Equity securities - banks        | 151                               | 197                              |
| Equity securities - mutual funds | 786                               | 758                              |
|                                  | <b>\$ 22,646</b>                  | <b>\$ 27,826</b>                 |

### *Loans Held for Sale ( LHFS )*

We originate residential mortgage loans for sale on the secondary market. At September 30, 2011 and December 31, 2010, such loans held for sale amounted to \$126.2 million and \$140.3 million, respectively.

When we sell mortgage loans we make certain representations to the purchaser related to loan ownership, loan compliance and legality, and accurate documentation, among other things. If a loan is found to be out of compliance with any of the representations subsequent to the date of purchase, we may be required to repurchase the loan or indemnify the purchaser for losses related to the loan, depending on the agreement with the purchaser. In addition other factors may cause us to be required to repurchase or make-whole a loan previously sold.

Prior to January 1, 2008, we used investor contracts that required us to repurchase and make-whole requests on loans sold prior to that date. We experienced losses on loans closed prior to 2008 due to borrower loan payment default. After January 1, 2008, we revised our contract and terms process to include the elimination of early payment default as a risk factor in the majority of our investor contracts and resulting loan sales. The most common reason for a loan repurchase for loans sold since January 1, 2008 is due to a documentation error or disagreement with an investor or on rare occasions for fraud. Repurchase requests are negotiated with each investor at the time we are notified of the demand and an appropriate reserve is taken at that time. Repurchase and or make-whole requests are initially negotiated by the secondary marketing department and monitored by the secondary marketing committee where most disagreements are resolved with no reserve requirement or loss to the Company. In the event there is an unresolved repurchase or make-whole request, the loan is managed by the secondary marketing committee and is elevated to be monitored by the mortgage overview committee to determine the final settlement terms with the investor. Repurchases amounted to \$435,000 and \$1.2 million during the nine months ended September 30, 2011 and 2010, respectively. Our reserve for potential repurchases was \$647,000 and \$127,000 as of September 30, 2011 and December 31, 2010, respectively. These reserves were calculated based upon an analysis of the specific loans in question. We do not foresee increases in repurchases to be a growing trend nor do we see it having a significant impact on our financial results.

### *Loans*

Our loan portfolio is expected to produce higher yields than investment securities and other interest-earning assets; the absolute volume and mix of loans and the volume and mix of loans as a percentage of total earning assets is an important determinant of our net interest margin.

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The following table sets forth the composition of our loan portfolio:

| <i>(dollars in thousands)</i> | <b>September<br/>30,<br/>2011</b> | <b>Percent<br/>of Total</b> | <b>December<br/>31,<br/>2010</b> | <b>Percent<br/>of Total</b> |
|-------------------------------|-----------------------------------|-----------------------------|----------------------------------|-----------------------------|
| Commercial                    | \$ 62,775                         | 8.5%                        | \$ 78,801                        | 9.7%                        |
| Commercial mortgage           | 335,106                           | 45.5%                       | 349,411                          | 43.0%                       |
| Commercial construction       | 54,076                            | 7.4%                        | 58,764                           | 7.2%                        |
| Consumer construction         | 21,593                            | 2.9%                        | 30,792                           | 3.8%                        |
| Residential mortgage          | 124,578                           | 16.9%                       | 144,209                          | 17.8%                       |
| Consumer                      | 138,544                           | 18.8%                       | 149,710                          | 18.5%                       |
| <b>Total loans</b>            | <b>\$ 736,672</b>                 | <b>100.0%</b>               | <b>\$ 811,687</b>                | <b>100.0%</b>               |

Total loans decreased \$75.0 million during the first nine months of 2011. We experienced lower balances in all loan types: commercial (-\$16.0 million), commercial mortgage (-\$14.3 million), commercial construction (-\$4.7 million), consumer construction (-\$9.2 million), residential mortgage (-\$19.6 million), and consumer (-\$11.2 million). During the first nine months of 2011, we were less aggressive in our loan origination activity, as we focused on improving asset quality and controlling our growth of assets to improve our capital ratios.

### Commercial Construction Portfolio

Our commercial construction portfolio consists of construction and development loans for commercial purposes and includes loans made to builders and developers of residential real estate projects. Of the September 30, 2011 total included above, \$23.1 million represents loans made to borrowers for the development of residential real estate. This segment of the portfolio has exhibited greater weakness (relative to our other loan portfolios) during 2010 and 2011 due to overall weakness in the residential housing sector.

The breakdown of the portion of the commercial construction portfolio made to borrowers for residential real estate developments is as follows as of September 30, 2011 and December 31, 2010:

| <i>(dollars in thousands)</i>  | <b>September<br/>30,<br/>2011</b> | <b>December<br/>31,<br/>2010</b> |
|--------------------------------|-----------------------------------|----------------------------------|
| Raw residential land           | \$ 5,949                          | \$ 6,617                         |
| Residential subdivisions       | 4,261                             | 5,653                            |
| Single residential lots        | 3,068                             | 3,589                            |
| Single family construction     | 4,481                             | 4,949                            |
| Townhome construction          | 668                               | 912                              |
| Multi-family unit construction | 4,685                             | 6,135                            |
|                                | <b>\$ 23,112</b>                  | <b>\$ 27,855</b>                 |

### Transferred Loans

In accordance with the Financial Accounting Standards Board ( FASB ) guidance on accounting for certain mortgage-banking activities, any loans which are originally originated for sale into the secondary market and which we subsequently transfer into the Company's loan portfolio are valued at fair value at the time of the transfer with any decline in value recorded as a charge to operating expense. We maintained \$26.6 million in first-lien mortgage loans and \$1.1 million in second-lien mortgage loans that were transferred from loans held for sale to our mortgage and consumer loan portfolios at September 30, 2011.

### Credit Risk Management

Credit risk is the risk of loss arising from the inability of a borrower to meet its obligations and entails both general risks, which are inherent in the process of lending, and risks specific to individual borrowers. Our credit risk is mitigated through portfolio diversification, which limits exposure to any single customer, industry, or collateral type.

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

Management has an established methodology to determine the adequacy of the allowance for loan losses that assesses the risks and losses inherent in the loan portfolio. Our allowance methodology employs management's assessment as to the level of future losses on existing loans based on our internal review of the loan portfolio, including an analysis of the borrowers' current financial position, and the consideration of current and anticipated economic conditions and their potential effects on specific borrowers and/or lines of business. In determining our ability to collect certain loans, we also consider the fair value of any underlying collateral. In addition, we evaluate credit risk concentrations, including trends in large dollar exposures to related borrowers, industry and geographic concentrations, and economic and environmental factors.

For purposes of determining the allowance for loan losses, we have segmented our loan portfolio by product type. Our loan segments are commercial, commercial mortgage, commercial construction, consumer construction, residential mortgage, and consumer. We have looked at all segments to determine if subcategorization into classes is warranted based upon our credit review methodology. As of September 30, 2011, we divided consumer loans into two classes, (1) home equity and second mortgage loans and (2) other consumer loans. For each class of loan, significant judgment is exercised to determine the estimation method that fits the credit risk characteristics of its portfolio segment. We use internally developed models in this process. Management must use judgment in establishing additional input metrics for the modeling processes. The models and assumptions used to determine the allowance are independently validated and reviewed to ensure that their theoretical foundation, assumptions, data integrity, computational processes, reporting practices, and end-user controls are appropriate and properly documented.

The establishment of the allowance for loan losses relies on a consistent process that requires multiple layers of management review and judgment and responds timely to changes in economic conditions and other influences. From time to time, events or economic factors may affect the loan portfolio, causing management to provide additional amounts to or release balances from the allowance for loan losses.

To establish the allowance for loan losses, which we do on a quarterly basis, loans are pooled by portfolio class and an historical loss percentage is applied to each class. The historical loss percentage is based upon a rolling 24 month history, which gives us the most current and relevant charge-off data. The result of that calculation for each loan class is then applied to the current loan portfolio balances to determine the required allowance for loan loss level per loan class. We then apply additional loss multipliers to the different classes of loans to reflect various environmental factors. This amount is considered our unallocated reserve. These factors capture any changes in economic trends, portfolio composition, real estate trends, as well as other factors and are meant to supplement the required reserves. For individually evaluated loans (impaired loans), we do additional analyses to determine the impairment amount (see below for more detail on these calculations). In general, this impairment amount is included as part of the allowance for loan losses for troubled debt restructures (TDR or TDRs) and is charged-off for all other impaired loans. These loss estimates are performed under multiple economic scenarios to establish a range of potential outcomes for each criterion. Management applies judgment to develop its own view of loss probability within that range, using external and internal parameters with the objective of establishing an allowance for loss inherent within these portfolios as of the reporting date.

See our charge-off policies under Critical Accounting Policies Allowance for loan losses above.

See information on partial charge-offs later in this section.

### Commercial

Credit risk in commercial lending, which includes commercial, commercial mortgage, commercial construction, and consumer construction loans, can vary significantly, as losses as a percentage of outstanding loans can shift widely during economic cycles and are particularly sensitive to changing economic conditions.

The risks associated with each portfolio class are as follows:

**Commercial and Commercial Mortgage** - The primary loan-specific risks in commercial and commercial mortgage loans are: deterioration of the business and/or collateral values, deterioration of the financial condition of the borrowers and/or guarantors, which creates a risk of default, and real estate collateral value determined through appraisals are not reflective of the true property values.

Portfolio risk includes condition of the economy, changing demand for these types of loans, large concentration of these types of loans, and geographic concentrations of these types of loans.

**Commercial Construction** loan-specific and portfolio risks related to commercial construction loans also carry the loan-specific and portfolio risks of commercial and commercial mortgage loans as described above. Additional loan-specific risks include budget overruns and performance variables related to the contractor and subcontractors.

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Consumer Construction loan-specific and portfolio risks related to consumer construction loans to builders also carry the loan-specific and portfolio risks of commercial and commercial mortgage loans as described above. An additional loan-specific risk is the risk that the builder has a geographical concentration of developments. The risks related to consumer construction loans to ultimate homeowners carry the same risks as commercial construction loans as described above.

In general, improving economic conditions result in improved operating results on the part of commercial customers, enhancing their ability to meet debt service requirements. However, any improvements in operating cash flows can be offset by the impact of rising interest rates that could occur during improved economic times. Declining economic conditions have an adverse affect on the operating results of commercial customers, reducing their ability to meet debt service obligations.

Our commercial loans are generally reviewed individually, in accordance with FASB guidance on accounting for loan impairment, to determine impairment, accrual status, and the need for specific reserves. We use creditworthiness categories to grade commercial loans. Our internal grading system is based on experiences with similarly graded loans and incorporates a variety of risk considerations, both qualitative and quantitative (see definitions of our various grades and the composition of our loan portfolio within those grades in Note 4 to the Consolidated Financial Statements). Quantitative factors include collateral values, financial condition of borrowers, and other factors. Qualitative factors include judgments concerning general economic conditions that may affect credit quality, credit concentrations, the pace of portfolio growth, and delinquency levels; these qualitative factors are evaluated in connection with the unallocated portion of our allowance for loan losses. We periodically engage outside firms and experts to independently assess our methodology and perform various loan review functions. Commercial loans are generally evaluated for impairment when the loan becomes 90 day past due and/or is placed on nonaccrual status. The difference between that fair value of the collateral and the carrying value of the loan is charged-off at that time.

### Consumer

Our consumer portfolio includes first- and second-lien mortgage loans and other loans to individuals. The risks associated with each portfolio class are as follows:

**Residential Mortgage, Home Equities, and 2<sup>nd</sup> Mortgages** The primary loan-specific risks related to residential mortgage, home equity, and 2<sup>nd</sup> mortgage lending include: unemployment, deterioration in real estate values, our ability to assess the creditworthiness of the customer, deterioration in the borrowers financial condition, whether the result of personal issues or a general economic downturn, and property values determined through appraisals are not reflective of the true property values. The portfolio risks for these types of loans are the same as for commercial and commercial mortgages as described above.

**Other Consumer** - The primary loan-specific risks of consumer loans are: unemployment, deterioration of the borrower's financial condition, whether the result of personal issues or a general economic downturn, and for certain consumer loans such as auto loans and boat loans, there is also a risk of deterioration in the value of the collateral. The portfolio risks for these types of loans are the same as for commercial and commercial mortgages as described above.

Generally, consumer loans are segregated into homogeneous pools with similar risk characteristics. We do not individually grade residential mortgage or consumer loans. Such loans are classified as performing or nonperforming. Trends such as delinquency and loss and current economic conditions in consumer loan pools are analyzed and historical loss experience is adjusted accordingly. Quantitative and qualitative adjustment factors for the different consumer portfolios are consistent with those for the commercial portfolios. Residential mortgage loans are generally charged down to their fair value when the loan becomes 120 days past due or is placed in nonaccrual status, whichever is earlier. Consumer loans are generally charged-off when the loan becomes 120 days past due or when it is determined that the amounts due are uncollectible (whichever is earlier). These charge-off guidelines may not apply if the loan is both well secured and in the process of collection or is a TDR (see discussion on TDRs later in this section).

### Unallocated

The unallocated portion of the allowance is intended to provide for losses that are not identified when establishing the required portion of the allowance and is based upon management's evaluation of various conditions that are not directly measured in the determination of the formula and specific allowances. Such conditions include general economic and business conditions affecting key lending areas, credit quality trends (including trends in delinquencies and nonperforming loans expected to result from existing conditions), loan volumes, loan concentrations by class and geography and any changes in such concentrations, specific industry conditions within portfolio categories, duration of the current business cycle, bank regulatory examination results, and management's judgment with respect to various other conditions including changes in management, including credit, loan administration, and origination staff, changes in underwriting standards, lending policies, and procedures, the impact of any new or modified lines of business, level and trends in nonaccrual and delinquent loans and charge-offs, changes in underlying collateral for collateral dependent loans, and management and the quality of risk identification systems. Executive management reviews these conditions quarterly. Economic factors are an important consideration in determining the adequacy of the loan loss reserve. A strong regional and national economy will reduce the probability of losses. Weaker regional and national economies will usually result in



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higher unemployment, higher vacancies in commercial real estate, and declining values on both commercial and residential properties, which will gradually increase the probably of losses. Key measures of economic strength or weakness are unemployment levels, interest rates, and economic growth and confidence.

The following basis points have been added to the respective portfolios for environmental factors as follows:

### September 30, 2011:

|                                                               | <u>Commercial</u> | <u>Commercial<br/>Mortgage</u> | <u>Commercial<br/>Construction</u> | <u>Consumer<br/>Construction</u> | <u>Residential<br/>Mortgage</u> | <u>Consumer</u> |
|---------------------------------------------------------------|-------------------|--------------------------------|------------------------------------|----------------------------------|---------------------------------|-----------------|
| Concentration of credit and changes in level of concentration |                   | 5                              | 5                                  | 8                                | 10                              |                 |
| Nature and volume of portfolio                                |                   | 25                             | 25                                 | 4                                | 4                               |                 |
| Trends of past due and classified loans                       | 1                 | 10                             | 10                                 | 10                               | 10                              |                 |
| Economic factors                                              | 25                | 25                             | 25                                 | 11                               | 11                              | 45              |
| Value of underlying collateral for collateral dependent loans |                   | 20                             | 20                                 | 20                               | 20                              |                 |
|                                                               | <u>26</u>         | <u>85</u>                      | <u>85</u>                          | <u>53</u>                        | <u>55</u>                       | <u>45</u>       |

### December 31, 2010:

|                                                               | <u>Commercial</u> | <u>Commercial<br/>Mortgage</u> | <u>Commercial<br/>Construction</u> | <u>Consumer<br/>Construction</u> | <u>Residential<br/>Mortgage</u> | <u>Consumer</u> |
|---------------------------------------------------------------|-------------------|--------------------------------|------------------------------------|----------------------------------|---------------------------------|-----------------|
| Concentration of credit and changes in level of concentration |                   | 5                              | 5                                  | 8                                | 10                              |                 |
| Nature and volume of portfolio                                |                   | 25                             | 25                                 | 4                                | 4                               |                 |
| Trends of past due and classified loans                       | 1                 | 10                             | 10                                 | 10                               | 10                              |                 |
| Economic factors                                              | 25                | 25                             | 25                                 | 6                                | 6                               | 40              |
| Value of underlying collateral for collateral dependent loans |                   | 15                             | 15                                 | 15                               | 15                              |                 |
|                                                               | <u>26</u>         | <u>80</u>                      | <u>80</u>                          | <u>43</u>                        | <u>45</u>                       | <u>40</u>       |

Each of the above factors is evaluated quarterly. The factors applied to commercial mortgage and commercial and consumer construction loans were increased in 2011 due to a trend of decreasing appraised values and the general weak economy. The factors applied to residential mortgage and consumer loans were increased in 2011 as a result of increased unemployment rates and the general economic downturn. The factors for the commercial portfolio were unchanged from December 31, 2010 to September 30, 2011.

We have risk management practices designed to ensure timely identification of changes in loan risk profiles; however, undetected losses may exist inherently within the loan portfolio. The assessments aspects involved in analyzing the quality of individual loans and assessing collateral values can also contribute to undetected, but probable, losses.

See additional detail on our allowance methodology and risk rating system in Note 4 to the Consolidated Financial Statements.

The changes in the allowance are presented in the following table for the three and nine months ended September 30:

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|                                                      | Three Months Ended<br>September 30, |            | Nine Months Ended<br>September 30, |            |
|------------------------------------------------------|-------------------------------------|------------|------------------------------------|------------|
|                                                      | 2011                                | 2010       | 2011                               | 2010       |
| <i>(dollars in thousands)</i>                        |                                     |            |                                    |            |
| Allowance for loan losses, beginning of period       | \$ 14,115                           | \$ 12,018  | \$ 14,115                          | \$ 11,639  |
| Charge-offs:                                         |                                     |            |                                    |            |
| Commercial                                           | (2,368)                             | (1,904)    | (5,240)                            | (1,904)    |
| Commercial mortgage                                  | (1,325)                             |            | (1,834)                            | (454)      |
| Commercial construction                              | (131)                               | (3,103)    | (728)                              | (3,967)    |
| Consumer construction                                |                                     | (12)       | (24)                               | (297)      |
| Residential mortgage                                 | (669)                               | (431)      | (2,209)                            | (3,562)    |
| Consumer                                             | (590)                               | (1,568)    | (2,021)                            | (3,160)    |
| Total charge-offs                                    | (5,083)                             | (7,018)    | (12,056)                           | (13,344)   |
| Recoveries:                                          |                                     |            |                                    |            |
| Commercial                                           |                                     |            |                                    |            |
| Commercial mortgage                                  |                                     |            | 168                                |            |
| Commercial construction                              | 24                                  | 7          | 24                                 | 7          |
| Consumer construction                                |                                     |            |                                    |            |
| Residential mortgage                                 | 23                                  | 8          | 37                                 | 97         |
| Consumer                                             | 33                                  | 411        | 244                                | 487        |
| Total recoveries                                     | 80                                  | 426        | 473                                | 591        |
| Net charge-offs                                      | (5,003)                             | (6,592)    | (11,583)                           | (12,753)   |
| Provision for loan losses                            | 5,000                               | 9,750      | 11,580                             | 16,290     |
| Allowance for loan losses, end of period             | \$ 14,112                           | \$ 15,176  | \$ 14,112                          | \$ 15,176  |
| Loans (net of premiums and discounts):               |                                     |            |                                    |            |
| Period-end balance                                   | \$ 736,672                          | \$ 832,902 | \$ 736,672                         | \$ 832,902 |
| Average balance during period                        | 742,173                             | 845,485    | 762,895                            | 863,619    |
| Allowance as a percentage of period-end loan balance | 1.92%                               | 1.82%      | 1.92%                              | 1.82%      |
| Percent of average loans:                            |                                     |            |                                    |            |
| Provision for loan losses                            | 2.67%                               | 4.58%      | 2.03%                              | 2.52%      |
| Net charge-offs                                      | 2.67%                               | 3.09%      | 2.03%                              | 1.97%      |

The following table summarizes our allocation of allowance by loan type:

|                               | September 30, 2011 |                  |                                 | December 31, 2010 |                  |                                 |
|-------------------------------|--------------------|------------------|---------------------------------|-------------------|------------------|---------------------------------|
|                               | Amount             | Percent of Total | Percent of Loans to Total Loans | Amount            | Percent of Total | Percent of Loans to Total Loans |
| <i>(dollars in thousands)</i> |                    |                  |                                 |                   |                  |                                 |
| Commercial                    | \$ 2,689           | 19.1%            | 8.5%                            | \$ 291            | 2.1%             | 9.7%                            |
| Commercial mortgage           | 1,866              | 13.2%            | 45.5%                           | 2,542             | 18.0%            | 43.0%                           |
| Commercial construction       | 1,668              | 11.8%            | 7.4%                            | 2,053             | 14.5%            | 7.2%                            |
| Consumer construction         | 235                | 1.7%             | 2.9%                            | 817               | 5.8%             | 3.8%                            |

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|                      |                   |                   |                   |                   |                   |                   |
|----------------------|-------------------|-------------------|-------------------|-------------------|-------------------|-------------------|
| Residential mortgage | 3,224             | 22.8%             | 16.9%             | 3,032             | 21.5%             | 17.8%             |
| Consumer             | 2,624             | 18.6%             | 18.8%             | 2,417             | 17.1%             | 18.5%             |
| Unallocated          | 1,806             | 12.8%             |                   | 2,963             | 21.0%             |                   |
|                      | <u>          </u> | <u>          </u> | <u>          </u> | <u>          </u> | <u>          </u> | <u>          </u> |
| Total                | \$ 14,112         | 100.0%            | 100.0%            | \$ 14,115         | 100.0%            | 100.0%            |
|                      | <u>          </u> | <u>          </u> | <u>          </u> | <u>          </u> | <u>          </u> | <u>          </u> |

Based upon management's evaluation, provisions are made to maintain the allowance as a best estimate of inherent losses within the portfolio. The allowance for loan losses totaled \$14.1 million as of both September 30, 2011 and December 31, 2010. Any changes in the allowance from period to period reflect management's ongoing application of its methodologies to establish the allowance, which, in 2011, included increases in the allowance for commercial, residential mortgage, and consumer loans. Decreases in the allowance allocated to commercial mortgage and commercial and consumer construction loans are a reflection of the decreases in the corresponding loan balances. Recent economic conditions have had a broad impact on our loan portfolio as a whole. While the Mid-Atlantic region may be not be as adversely affected by the current economic conditions as other markets in the nation, we are experiencing a negative impact from the economic pressures that our borrowers are experiencing.

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The provision for loan losses recognized to maintain the allowance was \$5.0 million and \$11.6 million for the three and nine months ended September 30, 2011, respectively, compared to \$9.8 million and \$16.3 million for the three and nine months ended September 30, 2010, respectively. We recorded net charge-offs of \$11.6 million during the first nine months of 2011 compared to net charge-offs of \$12.8 million during the same period of 2010. During the nine months ended September 30, 2011, net charge-offs as compared to average loans outstanding increased to 2.03%, compared to 1.97% during the same period of 2010. We recorded a significant amount of charge offs as a result of our policy to charge off all fair value deficiencies instead of carrying a specific reserve (except with respect to nonaccrual TDRs). Partial charge-offs of nonaccrual loans decrease the amount of nonperforming and impaired loans, as well as any specific allowance attributable to that loan. They decrease our allowance for loan losses, as well as our allowance for loan losses to nonperforming loans ratio and our allowance for loan losses to total loans ratio. Partial charge-offs increase our net charge-offs to average loans ratio. Total partial charge-offs of nonaccrual loans for the three and nine months ended September 30, 2011 amounted to \$3.8 million and \$5.2 million, respectively. Total partial charge-offs of nonaccrual loans for the three and nine months ended September 30, 2010 amounted to \$3.6 million and \$5.1 million, respectively. The total amount of nonaccrual loans (prior to charge offs) for which we recorded partial charge-offs for the three and nine months ended September 30, 2011 was \$22.2 million and \$37.4 million, respectively, and the total amount of nonaccrual loans for which we recorded partial charge-offs for the three and nine months ended September 30, 2010 was \$8.9 million and \$20.3 million, respectively.

Our allowance as a percentage of outstanding loans has increased from 1.74% as of December 31, 2010 to 1.92% as of September 30, 2011, reflecting the changes in our loss estimates and the results of the application of our loss estimate methodology. Charge-offs and transfers to real estate acquired through foreclosure continued to be significant during 2011.

Although management uses available information to establish the appropriate level of the allowance for loan losses, future additions or reductions to the allowance may be necessary based on estimates that are susceptible to change as a result of changes in economic conditions and other factors. As a result, our allowance for loan losses may not be sufficient to cover actual loan losses, and future provisions for loan losses could materially adversely affect our operating results. In addition, various regulatory agencies, as an integral part of their examination process, periodically review our allowance for loan losses and related methodology. Such agencies may require us to recognize adjustments to the allowance based on their judgments about information available to them at the time of their examination.

Management believes the allowance for loan losses is adequate as of September 30, 2011. Our total allowance at September 30, 2011 is considered by management to be sufficient to address the credit losses inherent in the current loan portfolio. We based this determination on several factors:

We maintain appropriate oversight committees to track deteriorating credits thereby timely identifying potential problems and noting when current appraisals are due;

In accordance with FASB guidance, we individually analyze all nonperforming assets ( NPA or NPAs ) and all credits risk rated 8 or above for impairment. We immediately charge-off any deficiencies in collateral value that is identified in the impairment analysis (thus, placing all NPAs and risk-ratings ( RR ) of RR8 at fair value) (see additional detail related to risk ratings in Note 4 to the Consolidated Financial Statements);

In accordance with FASB guidance, we calculate our required reserves based upon a rolling 24 month average of actual charge-offs, thereby utilizing current trend data of actual losses. These calculated loss percentages are then applied to our current loan balance by loan type to determine the required reserves;

We apply environmental factors to calculate an unallocated reserve range. This unallocated reserve is meant to cover any negative economic and business trends that may develop; and

The combination of the calculated required reserve plus the range of the unallocated reserve results in a total range to our allowance for loan losses. Our allowance for loan losses has been within the estimated ranges.

Our determination of the appropriate allowance level is based upon a number of assumptions we make about future events, which we believe are reasonable, but which may or may not prove valid. Thus, there can be no assurance that our charge-offs in future periods will not exceed our allowance for loan losses or that we will not need to make additional increases in our allowance for loan losses.

### NPAs and Loans 90 Days Past Due and Still Accruing

For smaller loans, we place loans in nonaccrual status when they are contractually past due 90 days as to either principal or interest, unless the loan is well secured and in the process of collection, or earlier, when, in the opinion of management, the collection of principal and interest is in doubt. For larger loans and other individually identified loans, management applies FASB guidance on impaired loan accounting to determine accrual status. Under that guidance, when it is probable that we will be unable to collect all payments due, including interest, we place the loan in nonaccrual status. A loan remains in nonaccrual status until the loan is current as to payment of both principal and interest and the borrower demonstrates the ability to pay and remain current. Specifically, in order for a nonaccrual loan to be returned to accrual status, a borrower must make six consecutive monthly payments and the borrower must demonstrate the ability to keep the loan current going forward.



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Given the volatility of the real estate market, it is very important for us to have current appraisals on our NPAs. All commercial NPAs are required to be appraised no less than annually. For residential and consumer nonperforming loans below \$500,000 an alternative valuation method (AVM) may be used in lieu of an appraisal. AVMs are obtained from an unrelated independent third party company. The third party valuation utilizes a comparative sales based methodology analysis. It also has the ability to handle geographic anomalies, and advanced algorithms which, when coupled with access to multiple data sources, returns accurate and reliable valuation results. The turnaround time for these AVMs is generally within a few minutes of our request. As such, the use of AVMs in no way adversely impacts our overall valuation process, nor does it negatively affect the amount or timing of any provisions or charge-offs. In fact, the quick turnaround time of these AVMs help identify potential losses immediately.

As part of our asset monitoring activities, we maintain a Workout Committee that meets three times per month. During these Workout Committee meetings, all NPAs and loan delinquencies are reviewed. We also produce an NPA report which is distributed weekly to senior management and is also discussed and reviewed at the Workout Committee meetings. This report contains all relevant data on the NPAs, including the latest appraised value and valuation date. Accordingly, these reports identify which assets will require an updated appraisal. As a result, we have not experienced any internal delays in identifying which loans/credits require appraisals. With respect to the ordering process of the appraisals, we have not experienced any delays in turnaround time nor has this been an issue over the past three years. Furthermore, we have not had any delays in turnaround time or variances thereof in our specific operating markets, which are predominantly the Baltimore metropolitan area and surrounding counties, and portions of northern Virginia.

As a result of our ongoing review of the loan portfolio, we may classify loans as nonaccrual even though the presence of collateral or the borrower's financial strength may be sufficient to provide for ultimate repayment. We recognize interest on nonaccrual loans only when it is received. In general, loans are charged off when a loan or a portion thereof is considered uncollectible. We determine that the entire balance of a loan is contractually delinquent for all classes if the minimum payment is not received by the specified due date. Interest and fees continue to accrue on past due loans until the date the loan goes in nonaccrual status.

NPAs, expressed as a percentage of total assets, totaled 5.6% at September 30, 2011, 5.5% at December 31, 2010, and 5.3% at September 30, 2010. The ratio of allowance for loan losses to nonperforming loans was 33.2% at September 30, 2011, 27.9% at December 31, 2010, and 31.2% at September 30, 2010. The increase in this ratio from December 31, 2010 to September 30, 2011 was due primarily to a decrease in the amount of nonperforming loans, but no net change in the allowance for loan losses. Part of the decrease in nonperforming loans was due to full and partial charge-offs of nonperforming loans that existed at December 31, 2010. We record a significant amount of charge offs as it is our policy to charge off all fair value deficiencies instead of carrying a specific reserve (except with respect to nonaccrual TDRs).

The distribution of our NPAs and loans greater than 90 days past due and accruing is illustrated in the following table:

|                                              | September<br>30,<br>2011 | December<br>31,<br>2010 | September<br>30,<br>2010 |
|----------------------------------------------|--------------------------|-------------------------|--------------------------|
| <i>(dollars in thousands)</i>                |                          |                         |                          |
| Nonaccruing loans:                           |                          |                         |                          |
| Commercial                                   | \$ 4,238                 | \$ 1,501                | \$ 1,150                 |
| Commercial mortgage                          | 20,125                   | 26,991                  | 22,610                   |
| Commercial construction                      | 6,549                    | 7,987                   | 7,386                    |
| Consumer construction                        | 488                      | 1,257                   | 1,600                    |
| Residential mortgage                         | 9,678                    | 11,877                  | 13,237                   |
| Consumer                                     | 1,384                    | 946                     | 2,618                    |
|                                              | <u>42,462</u>            | <u>50,559</u>           | <u>48,601</u>            |
| Real estate acquired through foreclosure:    |                          |                         |                          |
| Commercial                                   | 1,463                    |                         |                          |
| Commercial mortgage                          | 8,884                    | 3,317                   | 3,804                    |
| Commercial construction                      | 6,255                    | 7,094                   | 8,485                    |
| Consumer construction                        | 2,910                    | 3,553                   | 5,150                    |
| Residential mortgage                         | 5,227                    | 7,154                   | 4,132                    |
| Consumer                                     |                          | 67                      | 68                       |
|                                              | <u>24,739</u>            | <u>21,185</u>           | <u>21,639</u>            |
| Total nonperforming assets                   | <u>\$ 67,201</u>         | <u>\$ 71,744</u>        | <u>\$ 70,240</u>         |
| Loans past-due 90 days or more and accruing: |                          |                         |                          |
| Commercial                                   | \$ 118                   | \$                      | \$                       |
| Commercial mortgage                          | 1,281                    | 1,952                   | 1,643                    |
| Commercial construction                      |                          | 250                     |                          |
| Consumer construction                        |                          |                         |                          |
| Residential mortgage                         | 1,615                    | 776                     | 2,958                    |
| Consumer                                     | 309                      |                         | 528                      |
|                                              | <u>\$ 3,323</u>          | <u>\$ 2,978</u>         | <u>\$ 5,129</u>          |

Nonaccrual loans decreased \$8.1 million from December 31, 2010 to \$42.5 million at September 30, 2011. The commercial loan nonaccrual balance consisted of 13 loans, with the largest balance amounting to \$1.1 million. Eight loans in the amount of \$3.7 million were placed in nonaccrual status during 2011. All of the remaining nonaccrual commercial loans were in nonaccrual status as of December 31, 2010. Of the \$1.5 million in nonaccrual commercial loans as of December 31, 2010, one loan for \$548,000 was transferred to real estate acquired through foreclosure, \$125,000 were charged off, one loan in the amount of \$162,000 was paid off, and one loan in the amount of \$162,000 was returned to accrual status during 2011.

The commercial mortgage loan nonaccrual balance consisted of 40 loans, with the largest balance amounting to \$3.3 million. We placed 23 commercial mortgage loans totaling \$10.3 million in nonaccrual status in 2011. Of the balance at December 31, 2010, \$7.9 million in commercial mortgage loans were transferred to real estate acquired through foreclosure during the first nine months of 2011, \$3.2 million were charged off, \$2.8 million were paid off, and \$2.2 million were returned to accrual status.

The commercial construction nonaccrual balance consisted of eight loans, with the largest balance amounting to \$4.5 million. We placed four commercial construction loans totaling \$713,000 in nonaccrual status in 2011. All of the remaining nonaccrual commercial construction loans were in nonaccrual status as of December 31, 2010. Of the \$8.0 million in commercial construction loans in nonaccrual status as of December 31, 2010, \$924,000 were charged off, \$903,000 were paid off, and \$323,000 were transferred to real estate acquired through foreclosure during 2011.

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The consumer construction nonaccrual balance consisted of three loans in the amount of \$488,000, all of which were placed in nonaccrual status during 2011. Of the \$1.3 million in consumer construction loans in nonaccrual status at December 31, 2010, we transferred two loans totaling \$315,000 to real estate acquired through foreclosure, charged off one loan totaling \$24,000, and returned one loan in the amount of \$918,000 to accrual status.

The residential mortgage nonaccrual balance consisted of 33 loans, with the largest balance amounting to \$797,000. We placed \$3.4 million of these loans in nonaccrual status during the nine months ended September 30, 2011. Of the \$11.9 million balance of nonaccrual residential mortgage loans at December 31, 2010, we transferred \$4.7 million to real estate acquired through foreclosure, received a pay off on three loans for \$464,000, returned \$337,000 to accrual status, and charged off \$519,000.

The consumer loan nonaccrual balance consisted of seven loans, four of which were placed in nonaccrual status during 2011.

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These loans are well secured and we have determined that they do not require charge-off as of September 30, 2011.

The interest which would have been recorded on nonaccrual loans if those loans had been performing in accordance with their contractual terms for the nine months ended September 30, 2011 and 2010 was approximately \$1.4 million and \$2.2 million, respectively, and the actual interest income recorded on those loans for the nine months ended September 30, 2011 and 2010 was approximately \$235,000 and \$812,000, respectively.

Real estate acquired through foreclosure increased \$3.6 million when compared to December 31, 2010, with increases in commercial and commercial mortgage loan types. We transferred approximately \$6.0 million in commercial mortgage loans to real estate acquired through foreclosure during the nine months ended September 30, 2011. The entire balance of commercial loans acquired through foreclosure was transferred during 2011. The decreases in the remaining loan segments were due to resolution of the properties through foreclosure sales or buyouts.

Loans 90 days delinquent and accruing, which are loans that are well secured and in the process of collection, increased from \$3.0 million at December 31, 2010 to \$3.3 million as of September 30, 2011. The commercial loan total of \$118,000 consists of two loans, the largest of which amounted to \$88,000. The commercial mortgage loan total of \$1.3 million consists of four loans, the largest of which amounted to \$701,000, the residential mortgage loan total of \$1.6 million consisted of six loans, the largest of which amounted to \$547,000, and the consumer loan total consists of one home equity loan and three second mortgage loans.

Not all of the loans newly classified as nonaccrual since December 31, 2010 required impairment reserves, as some of the loans collateral had estimated fair values greater than the carrying amount of the loan or the loan has been written down to its estimated fair value. Additionally, in general, we charge-off all impairment amounts immediately for all loans that are not TDRs.

### TDRs

In situations where, for economic or legal reasons related to a borrower's financial difficulties, management may grant a concession for other than an insignificant period of time to the borrower that would not otherwise be considered, the related loan is classified as a TDR. Such concessions could include reductions in the interest rate, payment extensions, forgiveness of principal, forbearance, or other actions. These loans are excluded from pooled loss forecasts and a separate reserve is provided under the accounting guidance for loan impairment. At the time that a loan is modified, management evaluates any possible impairment based on the present value of expected future cash flows, discounted at the contractual interest rate of the original loan agreement, except when the sole remaining source of repayment for the loan is the liquidation of the collateral. In these cases, we use the current fair value of the collateral, less selling costs, instead of discounted cash flows. Any impairment amount is then charged to the allowance.

Management strives to identify borrowers in financial difficulty early and work with them to modify their loan to more affordable terms before their loan reaches nonaccrual status. These modified terms may include rate reductions, principal forgiveness, payment forbearance, and other actions intended to minimize the economic loss and to avoid foreclosure or repossession of the collateral. In cases where borrowers are granted new terms that provide for a reduction of either interest or principal, management measures any impairment on the restructuring as noted above for impaired loans.

The composition of our TDRs is illustrated in the following table at September 30, 2011 and December 31, 2010:

| <i>(dollars in thousands)</i>   | <b>September<br/>30,<br/>2011</b> | <b>December<br/>31,<br/>2010</b> |
|---------------------------------|-----------------------------------|----------------------------------|
| Commercial:                     |                                   |                                  |
| Nonaccrual                      | \$ 22                             | \$                               |
| 90 days or more and<br>accruing | \$                                | \$                               |
| < 90 days past<br>due/current   | \$ 161                            | \$                               |
|                                 | <u>183</u>                        | <u></u>                          |
| Commercial<br>mortgage:         |                                   |                                  |
| Nonaccrual                      | 1,027                             | 1,490                            |
| 90 days or more and<br>accruing |                                   |                                  |
| < 90 days past<br>due/current   | 4,178                             | 2,856                            |
|                                 | <u>5,205</u>                      | <u>4,346</u>                     |
| Commercial<br>construction:     |                                   |                                  |
| Nonaccrual                      | 103                               | 353                              |
| 90 days or more and<br>accruing |                                   |                                  |
| < 90 days past<br>due/current   | 5,152                             | 5,287                            |
|                                 | <u>5,255</u>                      | <u>5,640</u>                     |
| Consumer<br>construction:       |                                   |                                  |
| Nonaccrual                      |                                   |                                  |
| 90 days or more and<br>accruing |                                   |                                  |
| < 90 days past<br>due/current   | 406                               |                                  |
|                                 | <u>406</u>                        | <u></u>                          |
| Residential<br>mortgage:        |                                   |                                  |
| Nonaccrual                      | 3,284                             |                                  |
| 90 days or more and<br>accruing |                                   | 450                              |
| < 90 days past<br>due/current   | 9,927                             | 12,697                           |
|                                 | <u>13,211</u>                     | <u>13,147</u>                    |
| Consumer:                       |                                   |                                  |
| Nonaccrual                      | 202                               | 923                              |

90 days or more and  
accruing

< 90 days past

due/current

211

121

413

1,044

Totals:

Nonaccrual \$ 4,638 \$ 2,766

90 days or more and  
accruing \$ \$ 450

< 90 days past  
due/current \$ 20,035 \$ 20,961

\$ 24,673 \$ 24,177

The interest income which would have been recorded on TDRs if those loans had performed in accordance with their contractual terms was approximately \$964,000 and \$1.6 million for the nine months ended September 30, 2011 and 2010, respectively. The actual interest income recorded on these loans for the nine months ended September 30, 2011 and 2010 was \$562,000 and \$687,000, respectively.

For a nonaccrual TDR loan to be returned to accrual status, a borrower must make six consecutive monthly payments in accordance with the loan's restructured terms. Additionally, the borrower must demonstrate the ability to keep the loan current going forward.

The following table shows the breakdown of loans modified during the three and nine months ended September 30:

## Three Months Ended September 30,

|                              | 2011                    |                                           |                                        | 2010                    |                                           |                                        |
|------------------------------|-------------------------|-------------------------------------------|----------------------------------------|-------------------------|-------------------------------------------|----------------------------------------|
|                              | Number of Modifications | Recorded Investment Prior to Modification | Recorded Investment After Modification | Number of Modifications | Recorded Investment Prior to Modification | Recorded Investment After Modification |
| (dollars in thousands)       |                         |                                           |                                        |                         |                                           |                                        |
| Commercial                   | 1                       | \$ 297                                    | \$ 22                                  |                         | \$                                        | \$                                     |
| Residential mortgage         |                         |                                           |                                        | 6                       | 2,261                                     | 2,275                                  |
| Home equity and 2nd mortgage |                         |                                           |                                        | 4                       | 207                                       | 207                                    |
|                              | 1                       | \$ 297                                    | \$ 22                                  | 10                      | \$ 2,468                                  | \$ 2,482                               |

## Nine Months Ended September 30,

|                              | 2011                    |                                           |                                        | 2010                    |                                           |                                        |
|------------------------------|-------------------------|-------------------------------------------|----------------------------------------|-------------------------|-------------------------------------------|----------------------------------------|
|                              | Number of Modifications | Recorded Investment Prior to Modification | Recorded Investment After Modification | Number of Modifications | Recorded Investment Prior to Modification | Recorded Investment After Modification |
| (dollars in thousands)       |                         |                                           |                                        |                         |                                           |                                        |
| Commercial                   | 2                       | \$ 460                                    | \$ 185                                 |                         | \$                                        | \$                                     |
| Commercial mortgage          | 2                       | 2,197                                     | 2,197                                  | 2                       | 2,316                                     | 2,370                                  |
| Commercial construction      |                         |                                           |                                        | 6                       | 5,177                                     | 5,508                                  |
| Residential mortgage         | 1                       | 566                                       | 579                                    | 16                      | 9,027                                     | 9,033                                  |
| Home equity and 2nd mortgage |                         |                                           |                                        | 10                      | 1,148                                     | 1,148                                  |
|                              | 5                       | \$ 3,223                                  | \$ 2,961                               | 34                      | \$ 17,668                                 | \$ 18,059                              |

Impaired Loans

We determine a loan to be impaired when, based on current information and events, it is probable that we will be unable to collect all amounts due according to the contractual terms of the loan agreement. In general, impaired loans include nonaccrual loans and TDRs. We do not consider a loan impaired during a period of delay in payment if we expect to collect all amounts due, including interest past-due. Generally we consider a period of delay in payment to include delinquency up to 90 days, but may extend this period if the loan is collateralized by residential or commercial real estate with a low loan-to-value ( LTV ) ratio, and where collection and repayment efforts are progressing. We evaluate our commercial, commercial mortgage, commercial construction, and consumer construction classes of loans individually for impairment. We evaluate larger groups of smaller-balance homogeneous loans, which include our residential mortgage, home equity and second mortgage, and other consumer classes of loans collectively for impairment.

We identify impaired loans and measure impairment (1) at the present value of expected cash flows discounted at the loan's effective interest rate, (2) at the observable market price, or (3) at the fair value of the collateral if the loan is collateral dependent. If our measure of the impaired loan is less than the recorded investment in the loan, we record a charge-off for the deficiency unless it's a TDR, for which we recognize an impairment loss through a specific reserve portion of the allowance.

When the ultimate collectability of an impaired loan's principal is in doubt, wholly or partially, all cash receipts are applied to principal. Once the recorded principal balance has been reduced to zero, future cash receipts are applied to interest income, to the extent any interest has

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been foregone, and then they are recorded as recoveries of any amounts previously charged-off. When this doubt no longer exists, cash receipts are applied under the contractual terms of the loan agreements.

Not all of the loans newly classified as impaired since December 31, 2010 required impairment reserves, as some of the loans' collateral had estimated fair values greater than the carrying amount of the loan or the loan has been written down to its estimated fair value. Additionally, in general, we charge-off all impairment amounts immediately for all loans that are not TDRs.

The following tables show the breakout of impaired loans by class:

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September 30, 2011

| <i>(dollars in thousands)</i> | <b>Recorded<br/>Investment</b> | <b>Unpaid<br/>Principal<br/>Balance</b> | <b>Related<br/>Allowance</b> | <b>Average<br/>Recorded<br/>Investment</b> | <b>Interest<br/>Income<br/>Recognized</b> | <b>Charge-Offs</b> |
|-------------------------------|--------------------------------|-----------------------------------------|------------------------------|--------------------------------------------|-------------------------------------------|--------------------|
| With no related allowance:    |                                |                                         |                              |                                            |                                           |                    |
| Commercial                    | \$ 4,239                       | \$ 4,239                                | \$                           | \$ 2,197                                   | \$ 7                                      | \$ 5,240           |
| Commercial mortgage           | \$ 19,553                      | \$ 19,553                               | \$                           | \$ 20,948                                  | \$ 58                                     | \$ 1,706           |
| Commercial construction       | \$ 11,701                      | \$ 11,701                               | \$                           | \$ 12,376                                  | \$ 69                                     | \$ 728             |
| Consumer construction         | \$ 351                         | \$ 351                                  | \$                           | \$ 874                                     | \$ 1                                      | \$ 24              |
| Residential mortgage          | \$ 7,658                       | \$ 7,658                                | \$                           | \$ 10,402                                  | \$ 85                                     | \$ 1,506           |
| Home equity & 2nd mortgage    | \$ 1,520                       | \$ 1,520                                | \$                           | \$ 915                                     | \$ 5                                      | \$ 2,021           |
| Other consumer                | \$                             | \$                                      | \$                           | \$ 168                                     | \$                                        | \$                 |
| With a related allowance:     |                                |                                         |                              |                                            |                                           |                    |
| Commercial                    | 157                            | 161                                     | 4                            | 39                                         | 2                                         |                    |
| Commercial mortgage           | 4,660                          | 4,749                                   | 89                           | 3,876                                      | 74                                        | 128                |
| Commercial construction       |                                |                                         |                              | 333                                        |                                           |                    |
| Consumer construction         | 405                            | 406                                     | 1                            | 140                                        | 16                                        |                    |
| Residential mortgage          | 11,732                         | 12,084                                  | 352                          | 12,139                                     | 388                                       | 703                |
| Home equity & 2nd mortgage    | 71                             | 75                                      | 4                            | 18                                         | 3                                         |                    |
| Other consumer                |                                |                                         |                              |                                            |                                           |                    |
| Totals:                       |                                |                                         |                              |                                            |                                           |                    |
| Commercial                    | \$ 4,396                       | \$ 4,400                                | \$ 4                         | \$ 2,236                                   | \$ 9                                      | \$ 5,240           |
| Commercial mortgage           | \$ 24,213                      | \$ 24,302                               | \$ 89                        | \$ 24,824                                  | \$ 132                                    | \$ 1,834           |
| Commercial construction       | \$ 11,701                      | \$ 11,701                               | \$                           | \$ 12,709                                  | \$ 69                                     | \$ 728             |
| Consumer construction         | \$ 756                         | \$ 757                                  | \$ 1                         | \$ 1,014                                   | \$ 17                                     | \$ 24              |
| Residential mortgage          | \$ 19,390                      | \$ 19,742                               | \$ 352                       | \$ 22,541                                  | \$ 473                                    | \$ 2,209           |
| Home equity & 2nd mortgage    | \$ 1,591                       | \$ 1,595                                | \$ 4                         | \$ 933                                     | \$ 8                                      | \$ 2,021           |
| Consumer                      | \$                             | \$                                      | \$                           | \$ 168                                     | \$                                        | \$                 |

December 31, 2010

| <i>(dollars in thousands)</i> | <b>Recorded<br/>Investment</b> | <b>Unpaid<br/>Principal<br/>Balance</b> | <b>Related<br/>Allowance</b> | <b>Average<br/>Recorded<br/>Investment</b> | <b>Interest<br/>Income<br/>Recognized</b> | <b>Charge-Offs</b> |
|-------------------------------|--------------------------------|-----------------------------------------|------------------------------|--------------------------------------------|-------------------------------------------|--------------------|
| With no related allowance:    |                                |                                         |                              |                                            |                                           |                    |
| Commercial                    | \$ 1,501                       | \$ 1,501                                | \$                           | \$ 2,069                                   | \$ 40                                     | \$ 1,979           |
| Commercial mortgage           | \$ 26,534                      | \$ 26,534                               | \$                           | \$ 17,437                                  | \$ 811                                    | \$ 1,232           |
| Commercial construction       | \$ 12,814                      | \$ 12,814                               | \$                           | \$ 10,647                                  | \$ 310                                    | \$ 2,320           |
| Consumer construction         | \$ 1,257                       | \$ 1,257                                | \$                           | \$ 2,200                                   | \$ 35                                     | \$ 804             |
| Residential mortgage          | \$ 11,877                      | \$ 11,877                               | \$                           | \$ 11,973                                  | \$ 381                                    | \$ 3,757           |
| Home equity & 2nd mortgage    | \$ 1,067                       | \$ 1,067                                | \$                           | \$ 1,385                                   | \$ 15                                     | \$ 3,787           |
| Other consumer                | \$                             | \$                                      | \$                           | \$ 13                                      | \$                                        | \$                 |
| With a related allowance:     |                                |                                         |                              |                                            |                                           |                    |
| Commercial                    |                                |                                         |                              |                                            |                                           |                    |
| Commercial mortgage           | 3,226                          | 3,314                                   | 88                           | 2,864                                      | 73                                        | 163                |
| Commercial construction       | 445                            | 459                                     | 14                           | 2,567                                      | 18                                        | 1,932              |
| Consumer construction         |                                |                                         |                              |                                            |                                           |                    |
| Residential mortgage          | 12,661                         | 13,147                                  | 486                          | 5,339                                      | 695                                       |                    |
| Home equity & 2nd mortgage    |                                |                                         |                              | 2,065                                      |                                           |                    |
| Other consumer                |                                |                                         |                              | 1                                          |                                           |                    |
| Total:                        |                                |                                         |                              |                                            |                                           |                    |
| Commercial                    | \$ 1,501                       | \$ 1,501                                | \$                           | \$ 2,069                                   | \$ 40                                     | \$ 1,979           |
| Commercial mortgage           | \$ 29,760                      | \$ 29,848                               | \$ 88                        | \$ 20,301                                  | \$ 884                                    | \$ 1,395           |

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|                            |    |        |    |        |    |     |    |        |    |       |    |       |
|----------------------------|----|--------|----|--------|----|-----|----|--------|----|-------|----|-------|
| Commercial construction    | \$ | 13,259 | \$ | 13,273 | \$ | 14  | \$ | 13,214 | \$ | 328   | \$ | 4,252 |
| Consumer construction      | \$ | 1,257  | \$ | 1,257  | \$ |     | \$ | 2,200  | \$ | 35    | \$ | 804   |
| Residential mortgage       | \$ | 24,538 | \$ | 25,024 | \$ | 486 | \$ | 17,312 | \$ | 1,076 | \$ | 3,757 |
| Home equity & 2nd mortgage | \$ | 1,067  | \$ | 1,067  | \$ |     | \$ | 3,450  | \$ | 15    | \$ | 3,787 |
| Consumer                   | \$ |        | \$ |        | \$ |     | \$ | 14     | \$ |       | \$ |       |

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### Deposits

Deposits totaled \$1.0 billion at September 30, 2011, decreasing \$90.0 million or 8.0% from the December 31, 2010 balance of \$1.1 billion. During the nine months ended September 30, 2011, we experienced significant decreases in time deposits. The decrease was primarily rate driven, with a significant amount of the decrease incurred in our nonbrokered national time deposit campaign (1). We experienced additional decreases in time deposits and in other deposit types as customers moved funds out of time deposits and into savings accounts or out of the Bank in search of higher-yielding products. The deposit breakdown is as follows:

| <i>(dollars in thousands)</i>       | September 30, 2011 |                  | December 31, 2010 |                  |
|-------------------------------------|--------------------|------------------|-------------------|------------------|
|                                     | Balance            | Percent of Total | Balance           | Percent of Total |
| NOW & money market savings deposits | \$ 131,417         | 12.8%            | \$ 138,173        | 12.3%            |
| Regular savings deposits            | 57,035             | 5.5%             | 56,652            | 5.1%             |
| Time deposits                       | 740,273            | 71.7%            | 823,614           | 73.4%            |
| Total interest-bearing deposits     | 928,725            | 90.0%            | 1,018,439         | 90.8%            |
| Noninterest-bearing demand deposits | 103,153            | 10.0%            | 103,450           | 9.2%             |
| Total deposits                      | \$ 1,031,878       | 100.0%           | \$ 1,121,889      | 100.0%           |

Core deposits represent deposits that we believe to be less sensitive to changes in interest rates and, therefore, will be retained regardless of the movement of interest rates. We consider our core deposits to be all noninterest-bearing, NOW, money market accounts less than \$100,000, and saving deposits, as well as all time deposits less than \$100,000 that are not scheduled to mature within one year. As of September 30, 2011 and December 31, 2010, our core deposits were \$370.0 million and \$413.3 million, respectively. The remainder of our deposits could be susceptible to attrition due to interest rate movements.

### Borrowings

Our borrowings consist of short-term promissory notes issued to certain qualified investors, short-term and long-term advances from the Federal Home Loan Bank ( FHLB ), and a mortgage loan at September 30, 2011 and December 31, 2010. Our short-term promissory notes are in the form of commercial paper, which reprice daily and have maturities of 270 days or less. Our advances from the FHLB may be in the form of short-term or long-term obligations. Short-term advances have maturities for one year or less and may contain prepayment penalties. Long-term borrowings through the FHLB have original maturities up to 15 years and generally contain prepayment penalties.

The FHLB advances are available under a specific collateral pledge and security agreement, which requires that we maintain collateral for all of our borrowings equal to 125% of advances. We may pledge as collateral specific first- and second-lien mortgage loans or commercial mortgages up to 10% of the Bank's total assets. Long-term FHLB advances are fixed-rate instruments with various call provisions. Generally, short-term advances are in the form of overnight borrowings with rates changing daily. At September 30, 2011, our total available credit line with the FHLB was \$116.5 million. Our outstanding FHLB advance balance at both September 30, 2011 and December 31, 2010 was \$107.0 million.

Long-term borrowings, which totaled \$73.7 million and \$33.9 million at September 30, 2011 and December 31, 2010, respectively, consist of long-term advances from the FHLB and a mortgage loan on our former headquarters building. We held \$65.0 million and \$25.0 million in long-term FHLB advances at September 30, 2011 and December 31, 2010, respectively. As of September 30, 2011 and December 31, 2010, the balance on the mortgage loan was \$8.7 million and \$8.9 million, respectively.

Short-term borrowings consist of short-term promissory notes and short-term advances from the FHLB. These borrowings decreased from \$84.4 million at December 31, 2010 to \$44.1 million at September 30, 2011. We held \$42.0 million and \$82.0 million in short-term FHLB advances at September 30, 2011 and December 31, 2010, respectively.

In the past, to further our funding and capital needs, we raised capital by issuing Trust Preferred Securities through statutory trusts (the Trusts ), which are wholly-owned by First Mariner Bancorp. The Trusts used the proceeds from the sales of the Trust Preferred Securities, combined with First Mariner Bancorp's equity investment in these Trusts, to purchase subordinated deferrable interest debentures from First Mariner Bancorp. The debentures are the sole assets of the Trusts. Aggregate debentures outstanding as of both September 30, 2011 and December 31, 2010 totaled \$52.1 million.

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The Trust Preferred Securities are mandatorily redeemable, in whole or in part, upon repayment of their underlying subordinated debentures at their respective maturities or their earlier redemption. The subordinated debentures are redeemable prior to maturity at First Mariner's option on or after its optional redemption dates. In 2009, we elected to defer interest payments on the debentures. This deferral is permitted by the terms of the debentures and does not constitute an event of default thereunder. Interest on the debentures and dividends on the related Trust Preferred Securities continue to accrue and will have to be paid in full prior to the expiration of the deferral period. The total deferral period may not exceed 20 consecutive quarters and expires with the last quarter of 2013.

- (1) a program where the Bank utilizes several nonbrokered rate listing services to provide incremental funding as needed. We pay an annual subscription fee for the privilege of posting rates on their websites. The subscription-based services allow the Bank to place or receive funds from other subscribers. Requests to invest are placed through the listing website and the account is funded by wire. At the present time, only financial institutions are allowed to place funds with the Bank.

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First Mariner Bancorp has fully and unconditionally guaranteed all of the obligations of the Trusts.

Under applicable regulatory guidelines, a portion of the Trust Preferred Securities may qualify as Tier I capital, and the remaining portion may qualify as Tier II capital, with certain limitations. At September 30, 2011, none of our outstanding Trust Preferred Securities qualify as either Tier I or Tier II capital due to limitations.

During 2010, we executed Exchange agreements (the Exchanges) with our Chairman and Chief Executive Officer (CEO), Edwin F. Hale, Sr. and with an unaffiliated third party. The agreements exchanged trust preferred securities for shares of common stock and warrants of the Company. Upon completion of the Exchanges, the Company canceled the trust preferred securities and the related accrued interest on the securities in exchanges for the common stock and warrants, eliminating the long term debt. The transaction with the unaffiliated third party resulted in a gain of \$571,000, net of taxes of \$387,000.

### Capital Resources

Stockholders' equity decreased \$25.3 million in 2011 to a deficit of \$(21.6) million from \$3.7 million as of December 31, 2010.

Common stock and additional paid-in-capital increased by \$472,000 due to the issuance, net of costs, of common stock to directors and certain employees as part of their compensation as well as the change in the value of the warrants outstanding. We did not repurchase any common stock during 2011, nor was any stock issued through the employee stock purchase plan. Accumulated other comprehensive loss, which is derived from the fair value calculations for securities AFS, decreased by \$479,000. Retained deficit increased by the net loss of \$26.3 million for 2011.

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

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

We regularly monitor the Company's capital adequacy ratios to assure that the Bank meets its regulatory capital requirements. As of September 30, 2011, the Bank was undercapitalized under the regulatory framework for prompt corrective action.

The regulatory capital ratios are shown below:

|                                         | September<br>30,<br>2011 | December 31,<br>2010 | Minimum<br>Regulatory<br>Requirements |
|-----------------------------------------|--------------------------|----------------------|---------------------------------------|
| Regulatory capital ratios:              |                          |                      |                                       |
| Leverage:                               |                          |                      |                                       |
| Consolidated                            | (1.6)%                   | 0.7%                 | 4.0%                                  |
| Bank                                    | 3.4%                     | 4.7%                 | 4.0%                                  |
| Tier 1 capital to risk-weighted assets: |                          |                      |                                       |
| Consolidated                            | (2.1)%                   | 1.0%                 | 4.0%                                  |
| Bank                                    | 4.5%                     | 6.8%                 | 4.0%                                  |
| Total capital to risk-weighted assets:  |                          |                      |                                       |
| Consolidated                            | (2.1)%                   | 2.1%                 | 8.0%                                  |
| Bank                                    | 5.8%                     | 8.0%                 | 8.0%                                  |

On September 18, 2009, the Bank entered into an Agreement with the FDIC and the Commissioner of Financial Regulation for the state of Maryland (the Commissioner), pursuant to which it consented to the entry of an Order to Cease and Desist (the September Order), which directs the Bank to (i) increase its capitalization, (ii) improve earnings, (iii) reduce nonperforming loans, (iv) strengthen management policies and practices, and (v) reduce reliance on noncore funding. The September Order required the Bank to adopt a plan to achieve and maintain a Tier I leverage capital ratio of at least 7.5% and a total risk-based capital ratio of at least 11% by June 30, 2010. We did not meet the requirements at June 30, 2010, December 31, 2010, or September 30, 2011. The failure to achieve these capital requirements could result in further action by our regulators.



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As part of the September Order, within 30 days after the end of each calendar year, the Bank must submit an annual budget and profit plan and a plan that takes into account the Bank's pricing structure, the Bank's cost of funds and how this can be reduced, and the level of provision expense for adversely classified loans. To address reliance on noncore funding, the Bank has adopted and submitted a liquidity plan to reduce the Bank's reliance on noncore funding, wholesale funding sources, and high-cost rate-sensitive deposits. While the September Order is in effect, the Bank may not pay dividends or management fees without the FDIC's prior consent, may not accept, renew, or roll over any brokered deposits, or pay effective yields on deposits that are greater than those generally paid in its markets.

First Mariner Bancorp is also a party to Federal Reserve Bank (FRB) Agreements (the FRB Agreements), which, require it to: (i) develop and implement a strategic business plan that includes (a) actions that will be taken to improve our operating performance and reduce the level of parent company leverage, (b) a comprehensive budget and an expanded budget review process, (c) a description of the operating assumptions that form the basis for major projected income and expense components and provisions needed to maintain an adequate loan loss reserve, and (d) a capital plan incorporating all capital needs, risks, and regulatory guidelines; and (ii) submit plans to improve enterprise-wide risk management and effectiveness of internal audit programs. First Mariner Bancorp has also agreed to provide the FRB with advance notice of any significant capital transactions. The FRB Agreements also prohibit First Mariner and the Bank from taking any of the following actions without the FRB's prior written approval: (i) declaring or paying any dividends; (ii) taking dividends from the Bank; (iii) making any distributions of interest, principal, or other sums on First Mariner's subordinated debentures or trust preferred securities; (iv) incurring, increasing, or guaranteeing any debt; or (v) repurchasing or redeeming any shares of its stock. To satisfy the FRB's minimum capital requirements, First Mariner's consolidated Tier I capital to average quarterly assets, Tier I capital to risk-weighted assets, and total capital to risk-weighted assets ratios at each quarter end must be at least 4.0%, 4.0%, and 8.0%, respectively. At September 30, 2011, those capital ratios were (1.6)%, (2.1)%, and (2.1)%, respectively, which were not in compliance with the minimum requirements. The failure to achieve these capital requirements could result in further action by our regulators.

Management believes the ultimate successful satisfaction of the September Order's requirements and the requirements of the FRB Agreements will strengthen the financial condition of the Bank and Company for future periods.

The foregoing will subject us to increased regulatory scrutiny and may have an adverse impact on our business operations. Failure to comply with the provisions of these regulatory requirements may result in more restrictive actions from our regulators, including more severe and restrictive enforcement actions.

See information related to two Exchange Agreements under Borrowings above. Also, see information regarding the Securities Purchase Agreement included in Note 6 to the Consolidated Financial Statements.

### **Results of Operations**

#### *Net Loss*

#### Nine months Ended September 30:

For the nine months ended September 30, 2011, we realized a net loss of \$26.3 million compared to a net loss of \$12.7 million for the nine month period ended September 30, 2010. Basic and diluted losses per share for 2011 and 2010 totaled \$(1.41) and \$(0.93), respectively.

Return on average assets, the quotient of net income divided by total average assets, measures how effectively we utilize the Company's assets to produce income. Our return on average assets (annualized) for the nine months ended September 30, 2011 was (2.89)% compared to (1.25)% for the corresponding period in 2010. All profitability indicators were significantly affected by our net losses.

#### Three Months Ended September 30:

For the three months ended September 30, 2011, we realized a net loss of \$8.0 million compared to a net loss of \$4.6 million for the three month period ended September 30, 2010. Basic and diluted losses per share for the third quarter of 2011 and 2010 totaled \$(0.42) and \$(0.26), respectively.

Return on average assets (annualized) for the three months ended September 30, 2011 was (2.75)% compared to (1.38)% for the corresponding period in 2010. All profitability indicators were significantly affected by our net losses.

*Net Interest Income*

Our primary source of earnings is net interest income, which is the difference between the interest income we earn on interest-earning assets, such as loans and investment securities, and the interest expense we pay on interest-bearing sources of funds, such as deposits and borrowings. Net interest income is a function of several factors, including changes in the volume and mix of interest-earning assets and funding sources, and market interest rates. While management policies influence these factors, external forces, including customer needs and demands, competition, the economic policies of the federal government, and the monetary policies of the FRB, are also determining factors.

Nine months Ended September 30:

Net interest income for the first nine months of 2011 totaled \$20.6 million, a decrease of \$1.1 million from \$21.7 million for the nine months ended September 30, 2010. The decrease in net interest income during the nine months ended September 30, 2011 was primarily due to a decrease in the volume of interest-earning assets from \$1.0 billion for the nine months ended September 30, 2010 to \$922,000 for the nine months ended September 30, 2011. We also experienced a decrease in the yield earned on interest-earning assets from 5.43% for the nine months ended September 30, 2010 to 5.11% for the nine months ended September 30, 2011. Net interest margin increased to 2.94% from 2.82%.

Interest Income

Total interest income decreased by \$6.0 million for the nine months ended September 30, 2011 due primarily to the decreased volume of interest-earning assets due to our continued attempt to improve the quality of our loan portfolio and slowing of origination activity. Yields on earning assets continue to be affected by the level of NPAs and corresponding interest reversals, resulting in a decrease from 5.43% for the nine months ended September 30, 2010 to 5.11% for the nine months ended September 30, 2011.

Average loans outstanding decreased by \$100.7 million. We experienced decreases in all loan segments: commercial (-\$12.9 million), commercial mortgage (-\$6.9 million), commercial and consumer construction (-\$26.8 million and -\$19.3 million, respectively), residential mortgage (-\$26.0 million), and consumer (-\$8.8 million). These decreases were due primarily to our continued efforts to improve the quality of our loan portfolio as well as a weak real estate market, which has led to the reduction of new real estate loans and reduced values of the collateral of currently-held real estate loans.

Average loans held for sale decreased \$26.8 million, due to lower origination volumes. Average securities increased by \$20.5 million. During 2011, we purchased \$59.8 million in securities in order to better utilize our liquidity.

Interest Expense

Interest expense decreased by \$4.8 million to \$14.9 million for the nine months ended September 30, 2011, compared to \$19.8 million for the same period in 2010. We experienced a decrease in the average rate paid on interest-bearing liabilities, from 2.19% for the nine months ended September 30, 2010 to 1.80% for the nine months ended September 30, 2011. We also experienced a \$100.7 million decrease in the level of interest-bearing liabilities. The decrease in the rate paid on interest-bearing deposits from 2.08% in 2010 to 1.74% in 2011 was due to the decreased rate environment and our reduction in rates due to our high level of liquidity. All deposit types experienced decreased rates during the nine months ended September 30, 2011.

Average interest-bearing deposits decreased by \$91.5 million due to maturing time deposits from our national nonbrokered time deposit program (see description above under Deposits ) combined with decreases in NOW and money market accounts. A decrease in average borrowings of \$9.2 million was due primarily to the cancellation of certain junior subordinated debt (see Borrowings above). We experienced a decrease in the costs of borrowed funds from 2.85% for the nine months ended September 30, 2010 to 2.13% for the same period in 2011 due to the decline in variable-rate trust preferred security costs, decreased junior subordinated debt, and lower short-term borrowing costs.

Three Months Ended September 30:

Net interest income for the third quarter of 2011 totaled \$7.1 million, a decrease of \$714,000 from \$7.9 million for the third quarter of 2010. The decrease in net interest income during the third quarter of 2011 was primarily due to a decrease in average interest-earning assets from \$1.0 billion for the three months ended September 30, 2010 to \$897,000 for the three months ended September 30, 2011 and a decrease in the yield earned on interest-earning assets from 5.26% for the three months ended September 30, 2010 to 5.14% for the three months ended September 30, 2011. The net interest margin increased to 3.13% from 2.98%.

Interest Income

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Total interest income decreased by \$2.1 million for the three months ended September 30, 2011 due primarily to the decreased volume of interest-earning assets. Average interest-earning assets decreased \$135.9 million during the three months ended September 30, 2011.

Average loans outstanding decreased by \$103.3 million, with decreases in all loan segments. The decrease in commercial (including commercial mortgage) and construction (both commercial and consumer) loans was due to management's decision to reduce these types of loan originations to improve asset quality given the current economic environment and the deterioration of the real estate market, respectively. The decrease in residential mortgage and consumer loans was due primarily to decreased portfolio lending activity and write downs of impaired loans.

Average loans held for sale decreased \$49.9 million, due to lower volume and faster execution of loans sales to investors. Average securities increased by \$18.4 million, due to the purchase of securities of \$59.8 million during 2011.

### Interest Expense

Interest expense decreased by \$1.4 million to \$4.5 million for the three months ended September 30, 2011, compared to \$5.9 million for the same period in 2010. We experienced a decrease in the average rate paid on interest-bearing liabilities, from 2.02% for the three months ended September 30, 2010 to 1.72% for the three months ended September 30, 2011, and a lower level of interest-bearing liabilities. The decrease in the rate paid on interest-bearing deposits from 1.95% in 2010 to 1.64% in 2011 was driven by decreases in the rates on all deposit account types. Average interest-bearing deposits decreased by \$115.4 million due to the maturing of time deposits from our national nonbrokered time deposit program as well as decreases in our NOW and money market accounts. A decrease in average borrowings of \$1.3 million was due to the cancellation of certain junior subordinated deferrable interest debentures (see Borrowings above). We experienced a decrease in the costs of borrowed funds from 2.39% for the three months ended September 30, 2010 to 2.13% for the same period in 2011 due to the decline in variable-rate trust preferred security costs and lower short-term borrowing costs.

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

## For the Nine Months Ended September 30,

|                                                      | 2011                   |              |                | 2010                   |              |                |
|------------------------------------------------------|------------------------|--------------|----------------|------------------------|--------------|----------------|
|                                                      | Average<br>Balance (1) | Interest (2) | Yield/<br>Rate | Average<br>Balance (1) | Interest (2) | Yield/<br>Rate |
| <i>(dollars in thousands)</i>                        |                        |              |                |                        |              |                |
| <b>ASSETS</b>                                        |                        |              |                |                        |              |                |
| Loans:                                               |                        |              |                |                        |              |                |
| Commercial                                           | \$ 65,160              | \$ 2,629     | 5.32%          | \$ 78,049              | \$ 2,978     | 5.03%          |
| Commercial mortgage                                  | 339,574                | 15,657       | 6.08%          | 346,499                | 16,209       | 6.17%          |
| Commercial construction                              | 56,160                 | 2,369        | 5.56%          | 82,951                 | 3,240        | 5.15%          |
| Consumer construction                                | 24,198                 | 883          | 4.86%          | 43,476                 | 1,768        | 5.42%          |
| Residential mortgage                                 | 133,615                | 5,228        | 5.22%          | 159,637                | 6,743        | 5.63%          |
| Consumer                                             | 144,188                | 4,882        | 4.52%          | 153,007                | 5,336        | 4.66%          |
| Total loans                                          | 762,895                | 31,648       | 5.49%          | 863,619                | 36,274       | 5.56%          |
| Loans held for sale                                  | 65,250                 | 2,219        | 4.54%          | 92,089                 | 3,257        | 4.72%          |
| Securities, trading and AFS                          | 49,262                 | 1,293        | 3.50%          | 28,753                 | 1,558        | 7.23%          |
| Interest-bearing deposits                            | 37,134                 | 358          | 1.29%          | 21,124                 | 373          | 2.36%          |
| Restricted stock investments, at cost                | 7,046                  |              |                | 7,807                  | 14           | 0.24%          |
| Total earning assets                                 | 921,587                | 35,518       | 5.11%          | 1,013,392              | 41,476       | 5.43%          |
| Allowance for loan losses                            | (14,532)               |              |                | (12,411)               |              |                |
| Cash and other nonearning assets                     | 309,645                |              |                | 362,455                |              |                |
| Total assets                                         | \$ 1,216,700           | 35,518       |                | \$ 1,363,436           | 41,476       |                |
| <b>LIABILITIES AND STOCKHOLDERS (DEFICIT) EQUITY</b> |                        |              |                |                        |              |                |
| Interest-bearing deposits:                           |                        |              |                |                        |              |                |
| NOW deposits                                         | \$ 6,353               | 3            | 0.07%          | \$ 7,461               | 40           | 0.72%          |
| Savings deposits                                     | 57,972                 | 85           | 0.20%          | 56,098                 | 123          | 0.29%          |
| Money market deposits                                | 128,747                | 552          | 0.57%          | 142,821                | 674          | 0.63%          |
| Time deposits                                        | 743,496                | 11,577       | 2.08%          | 821,726                | 15,120       | 2.46%          |
| Total interest-bearing deposits                      | 936,568                | 12,217       | 1.74%          | 1,028,106              | 15,957       | 2.08%          |
| Borrowings                                           | 169,698                | 2,708        | 2.13%          | 178,891                | 3,815        | 2.85%          |
| Total interest-bearing liabilities                   | 1,106,266              | 14,925       | 1.80%          | 1,206,997              | 19,772       | 2.19%          |
| Noninterest-bearing demand deposits                  | 104,272                |              |                | 107,294                |              |                |
| Other noninterest-bearing liabilities                | 12,854                 |              |                | 10,494                 |              |                |
| Stockholders (deficit) equity                        | (6,692)                |              |                | 38,651                 |              |                |
| Total liabilities and stockholders (deficit) equity  | \$ 1,216,700           | 14,925       |                | \$ 1,363,436           | 19,772       |                |
| Net interest income/net interest spread              |                        | \$ 20,593    | 3.31%          |                        | \$ 21,704    | 3.24%          |

|                     |  |       |       |
|---------------------|--|-------|-------|
| Net interest margin |  | 2.94% | 2.82% |
|---------------------|--|-------|-------|

- 
- (1) Nonaccrual loans are included in average loans.  
(2) There are no tax equivalency adjustments

## For the Three Months Ended September 30,

|                                                      | 2011                   |              |                | 2010                   |              |                |
|------------------------------------------------------|------------------------|--------------|----------------|------------------------|--------------|----------------|
|                                                      | Average<br>Balance (1) | Interest (2) | Yield/<br>Rate | Average<br>Balance (1) | Interest (2) | Yield/<br>Rate |
| <i>(dollars in thousands)</i>                        |                        |              |                |                        |              |                |
| <b>ASSETS</b>                                        |                        |              |                |                        |              |                |
| Loans:                                               |                        |              |                |                        |              |                |
| Commercial                                           | \$ 60,831              | \$ 814       | 5.23%          | \$ 76,811              | \$ 924       | 4.71%          |
| Commercial mortgage                                  | 335,168                | 5,129        | 5.99%          | 363,660                | 5,722        | 6.16%          |
| Commercial construction                              | 55,560                 | 822          | 5.79%          | 65,634                 | 890          | 5.31%          |
| Consumer construction                                | 22,310                 | 274          | 4.89%          | 39,041                 | 440          | 4.49%          |
| Residential mortgage                                 | 127,694                | 1,697        | 5.31%          | 148,022                | 2,128        | 5.75%          |
| Consumer                                             | 140,610                | 1,592        | 4.51%          | 152,317                | 1,789        | 4.68%          |
| Total loans                                          | 742,173                | 10,328       | 5.48%          | 845,485                | 11,893       | 5.54%          |
| Loans held for sale                                  | 73,263                 | 894          | 4.88%          | 123,164                | 1,377        | 4.47%          |
| Securities, trading and AFS                          | 39,458                 | 373          | 3.78%          | 21,071                 | 383          | 7.23%          |
| Interest-bearing deposits                            | 35,378                 | 82           | 0.93%          | 35,884                 | 117          | 1.30%          |
| Restricted stock investments, at cost                | 6,997                  |              |                | 7,557                  | 9            | 0.46%          |
| Total earning assets                                 | 897,269                | 11,677       | 5.14%          | 1,033,161              | 13,779       | 5.26%          |
| Allowance for loan losses                            | (15,246)               |              |                | (12,447)               |              |                |
| Cash and other nonearning assets                     | 266,697                |              |                | 302,632                |              |                |
| Total assets                                         | \$ 1,148,720           | 11,677       |                | \$ 1,323,346           | 13,779       |                |
| <b>LIABILITIES AND STOCKHOLDERS (DEFICIT) EQUITY</b> |                        |              |                |                        |              |                |
| Interest-bearing deposits:                           |                        |              |                |                        |              |                |
| NOW deposits                                         | \$ 6,506               | 1            | 0.03%          | \$ 7,468               | 13           | 0.68%          |
| Savings deposits                                     | 56,690                 | 28           | 0.20%          | 56,442                 | 42           | 0.29%          |
| Money market deposits                                | 126,202                | 181          | 0.57%          | 138,216                | 213          | 0.61%          |
| Time deposits                                        | 689,804                | 3,415        | 1.96%          | 792,500                | 4,627        | 2.32%          |
| Total interest-bearing deposits                      | 879,202                | 3,625        | 1.64%          | 994,626                | 4,895        | 1.95%          |
| Borrowings                                           | 169,641                | 913          | 2.13%          | 170,949                | 1,031        | 2.39%          |
| Total interest-bearing liabilities                   | 1,048,843              | 4,538        | 1.72%          | 1,165,575              | 5,926        | 2.02%          |
| Noninterest-bearing demand deposits                  | 102,868                |              |                | 105,290                |              |                |
| Other noninterest-bearing liabilities                | 12,902                 |              |                | 9,206                  |              |                |
| Stockholders (deficit) equity                        | (15,893)               |              |                | 43,275                 |              |                |
| Total liabilities and stockholders (deficit) equity  | \$ 1,148,720           | 4,538        |                | \$ 1,323,346           | 5,926        |                |
| Net interest income/net interest spread              |                        | \$ 7,139     | 3.42%          |                        | \$ 7,853     | 3.24%          |

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Net interest margin

3.13%

2.98%

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(1) Nonaccrual loans are included in average loans.

(2) There are no tax equivalency adjustments

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

|                                       | For the Three Months Ended<br>September 30, 2011 vs. 2010 |            |          | For the Nine Months Ended<br>September 30, 2011 vs. 2010 |            |            |
|---------------------------------------|-----------------------------------------------------------|------------|----------|----------------------------------------------------------|------------|------------|
|                                       | Due to Variances in                                       |            |          | Due to Variances in                                      |            |            |
|                                       | Rate                                                      | Volume     | Total    | Rate                                                     | Volume     | Total      |
| <i>(dollars in thousands)</i>         |                                                           |            |          |                                                          |            |            |
| Interest earned on:                   |                                                           |            |          |                                                          |            |            |
| Loans:                                |                                                           |            |          |                                                          |            |            |
| Commercial                            | \$ 489                                                    | \$ (599)   | \$ (110) | \$ 244                                                   | \$ (593)   | \$ (349)   |
| Commercial mortgage                   | (154)                                                     | (439)      | (593)    | (230)                                                    | (322)      | (552)      |
| Commercial construction               | 374                                                       | (442)      | (68)     | 376                                                      | (1,247)    | (871)      |
| Consumer construction                 | 232                                                       | (398)      | (166)    | (166)                                                    | (719)      | (885)      |
| Residential mortgage                  | (153)                                                     | (278)      | (431)    | (472)                                                    | (1,043)    | (1,515)    |
| Consumer                              | (63)                                                      | (134)      | (197)    | (152)                                                    | (302)      | (454)      |
| Total loans                           | 725                                                       | (2,290)    | (1,565)  | (400)                                                    | (4,226)    | (4,626)    |
| Loans held for sale                   | 729                                                       | (1,212)    | (483)    | (121)                                                    | (917)      | (1,038)    |
| Securities, trading and AFS           | (959)                                                     | 949        | (10)     | (1,355)                                                  | 1,090      | (265)      |
| Interest-bearing deposits             | (33)                                                      | (2)        | (35)     | (288)                                                    | 273        | (15)       |
| Restricted stock investments, at cost | (8)                                                       | (1)        | (9)      | (13)                                                     | (1)        | (14)       |
| Total interest income                 | 454                                                       | (2,556)    | (2,102)  | (2,177)                                                  | (3,781)    | (5,958)    |
| Interest paid on:                     |                                                           |            |          |                                                          |            |            |
| Interest-bearing deposits:            |                                                           |            |          |                                                          |            |            |
| NOW deposits                          | (11)                                                      | (1)        | (12)     | (32)                                                     | (5)        | (37)       |
| Savings deposits                      | (15)                                                      | 1          | (14)     | (45)                                                     | 7          | (38)       |
| Money market deposits                 | (14)                                                      | (18)       | (32)     | (59)                                                     | (63)       | (122)      |
| Time deposits                         | (654)                                                     | (558)      | (1,212)  | (2,187)                                                  | (1,356)    | (3,543)    |
| Total interest-bearing deposits       | (694)                                                     | (576)      | (1,270)  | (2,323)                                                  | (1,417)    | (3,740)    |
| Borrowings                            | (110)                                                     | (8)        | (118)    | (920)                                                    | (187)      | (1,107)    |
| Total interest expense                | (804)                                                     | (584)      | (1,388)  | (3,243)                                                  | (1,604)    | (4,847)    |
| Net interest income                   | \$ 1,258                                                  | \$ (1,972) | \$ (714) | \$ 1,066                                                 | \$ (2,177) | \$ (1,111) |

*Noninterest Income*Nine months Ended September 30:

Noninterest income for the nine months ended September 30, 2011 was \$15.5 million, a decrease of \$7.0 million or 31.1% from the comparable period of 2010 primarily due to decreases in mortgage-banking revenue, revenue from trading assets and liabilities, and deposit service charges and fees, partially offset by a decrease in the amount of net OTTI charges taken during the nine months ended September 30, 2011 and an increase in gains on sales of securities. In addition, during the nine months ended September 30, 2010, we recorded a gain on a debt exchange with no comparable gain in 2011.

Mortgage-banking revenue decreased from \$13.5 million for the nine months ended September 30, 2010 to \$7.9 million for the nine months ended September 30, 2011 due primarily to a decline in the volume of loan originations. The volume of loans sold decreased from \$897.7 million in 2010 to \$710.7 million in 2011. In addition, during 2010, we began valuing loans held for sale at fair value, which resulted in

an acceleration of gains of \$2.2 million.

Deposit service charges declined to \$2.2 million for the nine months ended September 30, 2011 from \$3.1 million for the nine months ended September 30, 2010 due primarily to the implementation of new regulations that limited certain fees on deposit accounts. During the nine months ended September 30, 2010, we experienced a recovery of value of our trading assets and certain long-term borrowings of \$1.7 million. Those trading assets were sold late in 2010 and the related liabilities were refinanced in 2010 with liabilities not recorded at fair value.

We recorded \$818,000 in net OTTI during 2011 compared to \$1.2 million of net OTTI during 2010.

During 2010, we recognized a \$958,000 gain on the extinguishment of a portion of our junior subordinated deferrable interest debentures in an exchange transaction. See Borrowings above for details about the transaction.

We sold securities of \$49.5 million during the nine months ended September 30, 2011, which resulted in a net gain of \$781,000. During the nine months ended September 30, 2010, we recorded a \$54,000 net gain on the sale of \$8.0 million in securities.

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### Three Months Ended September 30:

Noninterest income for the three months ended September 30, 2011 was \$7.7 million, a decrease of \$2.9 million or 27.3% from the comparable period of 2010 due primarily to a decrease in mortgage-banking revenue.

Mortgage-banking revenue decreased from \$8.8 million for the three months ended September 30, 2010 to \$4.6 million for the three months ended September 30, 2011 due primarily to a decline in the volume of loan originations, as well as the \$2.2 gain acceleration from fair value accounting experienced in 2010. Deposit service charges declined to \$717,000 in the third quarter of 2011 from \$933,000 for the third quarter of 2010 due to the implementation of new regulations that limited certain fees on deposit accounts. During the three months ended September 30, 2010, we experienced a recovery of value of our trading assets and certain long-term borrowings of \$331,000 compared with no such gain in 2011 as we sold the trading assets and refinanced the liabilities with ones not recorded at fair value. We recorded \$681,000 in net OTTI during the three months ended September 30, 2011 compared to \$816,000 of net OTTI during the same period of 2010. We recorded gains on the sale of securities of \$638,000 for the three months ended September 30, 2011, with no comparable gain during the same period of 2010. In addition, in 2011, we received an insurance payment of \$1.0 million to settle certain outstanding title insurance claims, included in other income.

### *Noninterest expenses*

### Nine months Ended September 30:

For the nine months ended September 30, 2011, noninterest expenses decreased \$397,000 to \$50.8 million compared to \$51.2 million for the same period of 2010.

The decreases in salaries and benefits, occupancy, and furniture and equipment costs were a reflection of our continuing efforts in reducing controllable costs. In addition, salaries and benefit expenses decreased due to the sale of NGFS. Professional service costs increased due to regulatory compliance costs, efforts to raise capital, and legal costs related to loan workouts. Loan collection expenses decreased \$568,000 from 2010 to 2011.

### Three months Ended September 30:

For the three months ended September 30, 2011, noninterest expenses remained relatively stable at \$17.8 for both 2011 and 2010. Write-downs, losses, and costs of real estate acquired through foreclosure increased \$1.4 million, as additional properties were foreclosed and additional valuations were required on existing foreclosed assets due to the current economic climate.

The decreases in salaries and benefits, occupancy, furniture and equipment, and other costs were a reflection of our continuing efforts in reducing controllable costs. In addition, salaries and benefit expenses decreased due to decreased staffing levels.

Professional service costs increased due to regulatory compliance costs, efforts to raise capital, and legal costs related to loan workouts. Loan collection expenses decreased \$456,000 from 2010 to 2011.

The following table shows the breakout of other noninterest expenses:

|                                 | Three Months Ended<br>September 30, |                 | Nine Months Ended<br>September 30, |                 |
|---------------------------------|-------------------------------------|-----------------|------------------------------------|-----------------|
| (dollars in thousands)          | 2011                                | 2010            | 2011                               | 2010            |
| Office supplies                 | \$ 105                              | \$ 127          | \$ 319                             | \$ 339          |
| Printing                        | 94                                  | 134             | 260                                | 260             |
| Marketing/promotion             | 236                                 | 311             | 606                                | 700             |
| Postage                         | 140                                 | 122             | 455                                | 417             |
| Overnight delivery/courier      | 89                                  | 86              | 285                                | 311             |
| Security                        | 54                                  | 51              | 163                                | 176             |
| Dues and subscriptions          | 91                                  | 128             | 290                                | 318             |
| Director fees                   | 73                                  | 87              | 246                                | 278             |
| Employee education and training | 18                                  | 19              | 42                                 | 83              |
| Automobile expense              | 23                                  | 32              | 80                                 | 99              |
| Travel and entertainment        | 72                                  | 39              | 175                                | 128             |
| Other                           | 448                                 | 726             | 1,401                              | 1,559           |
|                                 | <u>\$ 1,443</u>                     | <u>\$ 1,862</u> | <u>\$ 4,322</u>                    | <u>\$ 4,668</u> |

#### Income Taxes

As we have set up a valuation allowance against all of our deferred taxes, we do not show an income tax benefit for the three or nine months ended September 30, 2011. During the nine months ended September 30, 2010, we recorded an income tax benefit from continuing operations of \$10.7 million on a net loss from continuing operations before income taxes and discontinued operations of \$23.3 million, resulting in an effective tax rate of (46.2)%. During the three months ended September 30, 2010, we recorded an income tax benefit from continuing operations of \$4.5 million on a net loss from continuing operations before income taxes and discontinued operations of \$9.1 million, resulting in an effective tax rate of (49.1)%.

#### Liquidity

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

The borrowing requirements of customers include commitments to extend credit and the unused portion of lines of credit (collectively commitments), which totaled \$284.3 million at September 30, 2011. Historically, many of the commitments expire without being fully drawn; therefore, the total commitment amounts do not necessarily represent future cash requirements. Commitments for real estate development and construction, which totaled \$13.0 million, are generally short-term in nature, satisfying cash requirements with principal repayments as construction properties financed are generally repaid with permanent financing. Available credit lines represent the unused portion of credit previously extended and available to the customer as long as there is no violation of material contractual conditions. Commitments to extend credit for residential mortgage loans of \$183.6 million at September 30, 2011 generally expire within 60 days. Commercial commitments to extend credit and unused lines of credit of \$15.6 million at September 30, 2011 generally do not extend for more than 12 months. Consumer commitments to extend credit and unused lines of credit of \$11.3 million at September 30, 2011 are generally open ended. At September 30, 2011, available home equity lines totaled \$60.8 million. Home equity credit lines generally extend for a period of 10 years.

Capital expenditures for various branch locations and equipment can be a significant use of liquidity. As of September 30, 2011, we anticipate expending approximately \$1.0 million in the next 12 months on our premises and equipment.

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

increase in total customer funding sources.

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The Bank's principal sources of liquidity are cash and cash equivalents (which are cash on hand and amounts due from financial institutions, federal funds sold, money market mutual funds, and interest bearing deposits), AFS securities, deposit accounts, and borrowings. The levels of such sources are dependent on the Bank's operating, financing and investing activities at any given time. We attempt to primarily rely on core deposits from customers to provide stable and cost-effective sources of funding to support our loan growth. We also seek to augment such deposits with longer term and higher yielding certificates of deposit. Cash and cash equivalents, which totaled \$186.7 million at September 30, 2011, have immediate availability to meet our short-term funding needs. Our entire investment portfolio is classified as AFS, is highly marketable (excluding our holdings of pooled trust preferred securities), and available to meet our liquidity needs. Loans held for sale, which totaled \$126.2 million at September 30, 2011, are committed to be sold into the secondary market and generally are funded within 60 days. Our residential real estate portfolio includes loans that are underwritten to secondary market criteria and provide us an additional source of liquidity. Additionally, our residential construction loan portfolio provides a source of liquidity as construction periods generally range from 9-12 months, and these loans are subsequently financed with permanent first-lien mortgages and sold into the secondary market. Our loan to deposit ratio stood at 71.4% at September 30, 2011 and 72.4% at December 31, 2010.

We also have the ability to utilize established credit lines with the FHLB and the FRB as additional sources of liquidity. To utilize the vast majority of our credit lines, we must pledge certain loans and/or securities before advances can be obtained. At September 30, 2011, our total available credit line with the FHLB was \$116.5 million. Our outstanding balance was \$107.0 million at both September 30, 2011 and December 31, 2010. The Bank has been notified by the FRB that it is a secondary credit facility. All future borrowings must be approved by the discount committee of the FRB.

We are not permitted to purchase brokered deposits without first obtaining a regulatory waiver. We are also required to comply with restrictions on deposit rates that we may offer. These factors could significantly affect our ability to fund normal operations. Our ability to acquire deposits or borrow could also be impaired by factors that are not specific to us, such as a severe disruption of the financial markets or negative views and expectations about the prospects for the financial services industry as a whole. At September 30, 2011, management considered the Bank's liquidity level to be sufficient for the purposes of meeting the Bank's cash flow requirements.

First Mariner Bancorp is a separate entity and apart from First Mariner Bank and must provide for its own liquidity. In addition to its operating expenses, First Mariner Bancorp is responsible for the payment of any dividends that may be declared for its shareholders, and interest and principal on outstanding debt. A significant amount of First Mariner Bancorp's revenues are obtained from subsidiary service fees and dividends. Payment of such dividends to First Mariner Bancorp by First Mariner Bank is limited under Maryland law. For a Maryland chartered bank or trust company, dividends may be paid out of undivided profits or, with the prior approval of the Commissioner, from surplus in excess of 100% of required capital stock. If, however, the surplus of a Maryland bank is less than 100% of its required capital stock, cash dividends may not be paid in excess of 90% of net earnings. In addition to these specific restrictions, bank regulatory agencies also have the ability to prohibit proposed dividends by a financial institution which would otherwise be permitted under applicable regulations if the regulatory body determines that such distribution would constitute an unsafe or unsound practice. As noted earlier, First Mariner and its bank subsidiary have entered into agreements with the FRB, FDIC, and the Commissioner that, among other things, require First Mariner and the Bank to obtain the prior approval of its regulators before paying a dividend or otherwise making a distribution on its stock. In addition, First Mariner elected to defer regularly scheduled quarterly interest payments on its junior subordinated debentures issued in connection with its trust preferred securities offerings. First Mariner is prohibited from paying any dividends or making any other distribution on its common stock for so long as interest payments are being deferred.

### ***Inflation***

The consolidated financial statements and related consolidated financial data presented herein have been prepared in accordance with GAAP and practices within the banking industry, which generally require the measurement of financial condition and operating results in terms of historical dollars, without considering the changes in the relative purchasing power of money over time due to inflation. As a financial institution, virtually all of our assets and liabilities are monetary in nature and interest rates have a more significant impact on our performance than the effects of general levels of inflation. A prolonged period of inflation could cause interest rates, wages, and other costs to increase and could adversely affect our results of operations unless mitigated by increases in our revenues correspondingly. However, we believe that the impact of inflation on our operations was not material for 2011 or 2010.

### ***Off-Balance Sheet Arrangements***

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

### ***Credit Commitments***

Credit commitments are agreements to lend to a customer as long as there is no violation of any condition to the contract.



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Loan commitments generally have interest rates fixed at current market amounts, fixed expiration dates, and may require payment of a fee. Lines of credit generally have variable interest rates. Such lines do not represent future cash requirements because it is unlikely that all customers will draw upon their lines in full at any time. Letters of credit are commitments issued to guarantee the performance of a customer to a third party.

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

See detailed information on credit commitments above under *Liquidity*.

### *Derivatives*

We maintain and account for derivatives, in the form of interest rate lock commitments ( IRLC or IRLCs ) and forward sales commitments, in accordance with FASB guidance on accounting for derivative instruments and hedging activities. We recognize gains and losses on IRLCs and forward sales commitments on the loan pipeline through mortgage-banking revenue in the Consolidated Statements of Operations.

The Bank, through First Mariner Mortgage, enters into IRLCs, under which we originate residential mortgage loans with interest rates determined prior to funding. IRLCs on mortgage loans that we intend to sell in the secondary market are considered derivatives. The period of time between issuance of a loan commitment and closing and sale of the loan generally ranges from 14 days to 60 days. For these IRLCs, we protect the Company from changes in interest rates through the use of forward sales of to be issued ( TBA ) mortgage-backed securities.

We are exposed to price risk from the time a mortgage loan closes until the time the loan is sold. To manage this risk, we also utilize forward sales of TBA mortgage-backed securities. During the period of the rate lock commitment and from the time a loan is closed with the borrowers and sold to investors, we remain exposed to basis (execution, timing, and/or volatility) risk in that the changes in value of our hedges may not equal or completely offset the changes in value of the rate commitments being hedged. This can result due to changes in the market demand for our mortgage loans brought about by supply and demand considerations and perceptions about credit risk relative to the agency securities. We also mitigate counterparty risk by entering into commitments with proven counterparties and pre-approved financial intermediaries.

The market value of IRLCs is not readily ascertainable with precision because they are not actively traded in stand-alone markets. The Bank determines the fair value of IRLCs by measuring the change in the value of the underlying asset, while taking into consideration the probability that the IRLCs will close.

Information pertaining to the carrying amounts of our derivative financial instruments follows:

|                                                      | September 30, 2011 |                      | December 31, 2010 |                      |
|------------------------------------------------------|--------------------|----------------------|-------------------|----------------------|
|                                                      | Notional Amount    | Estimated Fair Value | Notional Amount   | Estimated Fair Value |
| (dollars in thousands)                               |                    |                      |                   |                      |
| IRLCs                                                | \$ 183,564         | \$ 187,205           | \$ 71,228         | \$ 71,753            |
| Forward contracts to sell mortgage-backed securities | 146,500            | 144,052              | 125,500           | 127,424              |

Changes in interest rates could materially affect the fair value of the IRLCs or the forward commitments. In the case of the loan related derivatives, fair value is also impacted by the probability that the rate lock commitment will close ( fallout factor ). In addition, changes in interest rates could result in changes in the fallout factor, which might magnify or counteract the sensitivities. This is because the impact of an interest rate shift on the fallout ratio is nonsymmetrical and nonlinear.

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

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

**Interest Rate Risk**

Our profitability is in part a function of the spread between the interest rates earned on assets and the interest rates paid on deposits and other interest-bearing liabilities (net interest income), including advances from the FHLB and other borrowings. Interest rate risk arises from mismatches (i.e., the interest sensitivity gap) between the dollar amount of repricing or maturing assets and liabilities and is measured in terms of the ratio of the interest rate sensitivity gap to total assets. More assets repricing or maturing than liabilities over a given time period is considered asset-sensitive and is reflected as a positive gap, and more liabilities repricing or maturing than assets over a given time period is considered liability-sensitive and is reflected as negative gap. An asset-sensitive position (i.e., a positive gap) will generally enhance earnings in a rising interest rate environment and will negatively impact earnings in a falling interest rate environment, while a liability-sensitive position (i.e., a negative gap) will generally enhance earnings in a falling interest rate environment and negatively impact earnings in a rising interest rate environment. Fluctuations in interest rates are not predictable or controllable. We have attempted to structure our asset and liability management strategies to mitigate the impact on net interest income of changes in market interest rates. However, there can be no assurance that we will be able to manage interest rate risk so as to avoid significant adverse effects on net interest income. At September 30, 2011, we had a one-year cumulative positive gap of approximately \$146.2 million compared to a one-year cumulative positive gap of approximately \$50.2 million at December 31, 2010.

While we monitor interest rate sensitivity gap reports, we primarily test our interest rate sensitivity through the deployment of simulation analysis. We use earnings simulation models to estimate what effect specific interest rate changes would have on our net interest income and net income. Simulation analysis provides us with a more rigorous and dynamic measure of interest sensitivity. Changes in prepayments have been included where changes in behavior patterns are assumed to be significant to the simulation, particularly mortgage related assets. Call features on certain securities and borrowings are based on their call probability in view of the projected rate change, and pricing features such as interest rate floors are incorporated. Our fee income produced by mortgage-banking operations may also be impacted by changes in rates. As long-term rates increase, the volume of fixed rate mortgage loans originated for sale in the secondary market may decline and reduce our revenues generated by this line of business. We attempt to structure our asset and liability management strategies to mitigate the impact on net interest income by changes in market interest rates. However, there can be no assurance that we will be able to manage interest rate risk so as to avoid significant adverse effects on net interest income. At September 30, 2011, the simulation model provided the following profile of our interest rate risk measured over a one-year time horizon, assuming a parallel shift in a yield curve based off the U.S. dollar forward swap curve adjusted for certain pricing assumptions:

|                     | <b>Immediate Rate<br/>Change</b> |               |
|---------------------|----------------------------------|---------------|
|                     | <b>+200BP</b>                    | <b>-200BP</b> |
| Net interest income | (0.97)%                          | (4.27)%       |

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

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

**Item 4 - Controls and Procedures**

(a) Evaluation of disclosure controls and procedures. The Company maintains disclosure controls and procedures that are designed to ensure that information required to be disclosed in our reports filed under the Securities Exchange Act of 1934, such as this Quarterly Report, is recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission rules and forms, and that such information is accumulated and communicated to the Company's management, including the CEO and Chief Financial Officer (CFO), as appropriate, to allow for timely decisions regarding required disclosure. A control system, no matter how well conceived and operated, can provide only reasonable, not absolute, assurance that the objectives of the control system are met. Further, the design of a control

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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.

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The design of any system of controls also is based in part upon certain assumptions about the likelihood of future events, and there can be no assurance that any design will succeed in achieving its stated goals under all potential future conditions; over time, controls may become inadequate because of changes in conditions, or the degree of compliance with the policies or procedures may deteriorate.

An evaluation of the effectiveness of these disclosure controls, as of the end of the period covered by this Quarterly Report on Form 10-Q, was carried out under the supervision and with the participation of the Company's management, including the CEO and CFO. Based on that evaluation, the Company's management, including the CEO and CFO, has concluded that the Company's disclosure controls and procedures are in fact effective at the reasonable assurance level.

(b) Changes in Internal Control Over Financial Reporting. Daniel McKew, President of First Mariner Bank, has submitted his resignation to pursue another professional opportunity. Mark Keidel, the current President of First Mariner Bancorp and Chief Operating Officer of First Mariner Bank, has been appointed as Mr. McKew's successor. We do not anticipate this change will have any material effect on our internal control over financial reporting.

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

## PART II OTHER INFORMATION

### Item 1 - Legal Proceedings

None

### Item 1A Risk Factors

The risks and uncertainties to which our financial condition and operations are subject are discussed in detail in Item 1A of Part I of the Annual Report of First Mariner Bancorp on Form 10-K for the year ended December 31, 2010, Item 1A of the Company's Quarterly Report on Form 10-Q for the three months ended March 31, 2011, and Item 1A of the Company's Quarterly Report on Form 10-Q for the three and six months ended June 30, 2011. The following discussion is an update to certain risk factors contained in the Annual Report on Form 10-K.

***There may be a limited market for our common stock, which may adversely affect our stock price.***

Effective September 1, 2011, our stock was delisted from the NASDAQ Stock Market and began trading on the Over-the-Counter Bulletin Board. The delisting from the NASDAQ Stock Market may make the market for our stock more illiquid and our shares might not be actively traded in the future. If an active trading market for our common stock does not develop, you may not be able to sell all of your shares of common stock on short notice, and the sale of a large number of shares at one time could temporarily depress the market price. There may be a wide spread between the bid and ask price for our common stock. When there is a wide spread between the bid and ask price, the price at which you may be able to sell our common stock may be significantly lower than the price at which you could buy it at that time.

***As of September 30, 2011, the Bank's and the Company's capital levels were not sufficient to achieve compliance with the higher capital requirements we were required to meet by June 30, 2010. The failure to maintain these capital requirements could result in further action by our regulators.***

In the September Order, the FDIC and the Commissioner directed the Bank to raise its Tier I leverage and total risk-based capital ratios to 6.5% and 10%, respectively, by March 31, 2010 and to 7.5% and 11%, respectively, by June 30, 2010. We did not meet these requirements. We have been in regular communication with the staffs of the FDIC and the Commissioner regarding efforts to satisfy the higher capital requirements.

First Mariner currently does not have any capital available to invest in the Bank and any further increases to our allowance for loan losses and operating losses would negatively impact our capital levels and make it more difficult to achieve the capital levels directed by the FDIC and the Commissioner.

Because we have not met all of the capital requirements set forth in the September Order within the prescribed timeframes, if our revised capital plan is not approved or if we are not granted a waiver of such requirements, the FDIC and the Commissioner could take additional enforcement action against us, including the imposition of monetary penalties, as well as further operating restrictions. The FDIC or the Commissioner could direct us to seek a merger partner or possibly place the Bank in receivership. If the Bank is placed into receivership, the Company would cease operations and liquidate or seek bankruptcy protection. If the Company were to liquidate or seek bankruptcy protection, we do not believe that there would be assets available to holders of the capital stock of the Company.

Additionally, on November 24, 2009, First Mariner's primary regulator, the FRB, required the Company to enter into the New FRB Agreement. In accordance with the requirements of the New FRB Agreement, the Company submitted a written plan to maintain sufficient capital at the holding company level, such that First Mariner satisfies the FRB's minimum capital requirements. As of the date of this document, the FRB is reviewing the Company's revised capital plan. To satisfy these requirements, First Mariner's consolidated Tier I capital to average quarterly assets, Tier I capital to risk-weighted assets and total capital to risk-weighted assets ratios must be at least 4.0%, 4.0%, and 8.0%, respectively. At September 30, 2011, those capital ratios were (1.6)%, (2.1)%, and (2.1)%, respectively, which were not in compliance with the minimum requirements. As further described above, the failure to meet all of the capital ratios could subject us to additional enforcement actions.

***We are subject to restrictions and conditions of a Cease and Desist Order issued by the FDIC and the Commissioner ( September Order ), and agreements with the FRB ( FRB Agreement and New FRB Agreement ) and have incurred and expect to continue to incur significant additional regulatory compliance expense in connection with these enforcement actions.***

The FDIC and the Commissioner have issued Cease and Desist Orders against the Bank and the Company. The Bank and the Company have also entered into the FRB Agreement and the New FRB Agreement. The September Order contains a number of significant directives, including higher capital requirements, requirements to reduce the level of our classified assets, operating restrictions, and restrictions on dividend payments by the Bank. These restrictions may impede our ability to operate our business. If we fail to comply with the terms and conditions of the September Order or the New FRB Agreement, the appropriate regulatory authority could take additional enforcement action against us, including the imposition of further operating restrictions, monetary penalties, or possibly place the Bank in receivership. We could also be directed to seek a merger partner. We have incurred and expect to continue to incur significant additional regulatory compliance expense in connection with the enforcement actions, and we will incur ongoing expenses attributable to compliance with the terms of the enforcement actions. Although we do not expect it, it is possible regulatory compliance expenses related to the enforcement actions could have a material adverse impact on us in the future.

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In addition, our ability to independently make certain changes to our business is restricted by the terms of the September Order and the New FRB Agreement, which could negatively impact the scope and flexibility of our business activities. While we believe that we will be able to take actions that will result in the September Order and the New FRB Agreement being terminated in the future, we cannot guarantee that such actions will result in the termination of the September Order and/or the New FRB Agreement. Further, the imposition of the September Order and the New FRB Agreement may make it more difficult to attract and retain qualified employees. Specifically, the significant terms of the September Order are as follows:

- increase capitalization,
- improve earnings,
- reduce nonperforming loans,
- strengthen management policies and practices, and
- reduce reliance on noncore funding.

We have taken steps to increase capitalization through a stock offering in 2010 and through potential private capital infusions (see Note 6 to the Consolidated Financial Statements). We are attempting to improve earnings by reducing our nonperforming loans through workouts and other resolutions, including accelerated write-downs and sales of foreclosed assets. In addition, we are attempting to conservatively increase loan origination in order to improve our interest income. We have adopted a plan to improve enterprise-wide risk management and effectiveness of internal audit programs. To address our reliance on noncore funding, we have adopted a liquidity plan intended to reduce the Bank's reliance on noncore funding, wholesale funding sources, and high-cost rate-sensitive deposits. We have eliminated all brokered deposits.

The significant terms of the New FRB Agreement are as follows:

- develop and implement a strategic business plan that includes (a) actions that will be taken to improve operating performance and reduce the level of parent company leverage, (b) a comprehensive budget and an expanded budget review process, (c) a description of the operating assumptions that form the basis for major projected income and expense components and provisions needed to maintain an adequate loan loss reserve, and (d) a capital plan incorporating all capital needs, risks, and regulatory guidelines;
- submit plans to improve enterprise-wide risk management and effectiveness of internal audit programs;
- prohibits First Mariner and the Bank from taking any of the following actions without the FRB's prior written approval: (i) declaring or paying any dividends; (ii) taking dividends from the Bank; (iii) making any distributions of interest, principal, or other sums on First Mariner's subordinated debentures or trust preferred securities; (iv) incurring, increasing, or guaranteeing any debt; or (v) repurchasing or redeeming any shares of its stock;
- adopt a plan to achieve and maintain a Tier 1 leverage capital ratio of at least 7.5% and a total risk-based capital ratio of at least 11%.

We have adopted all plans required by the New FRB Agreement and have not taking any of the prohibited actions. We have taken steps to increase capitalization (and therefore, our capital ratios) through a stock offering in 2010 and through potential private capital infusions (see Note 6 to the Consolidated Financial Statements).

### Item 2 - Unregistered Sales of Equity Securities and Use of Proceeds

There were no repurchases of the Company's common stock during the three months ended September 30, 2011.

### Item 3 - Defaults Upon Senior Securities

None

### Item 4 - [REMOVED AND RESERVED]

### Item 5 - Other Information

None

### Item 6 - Exhibits

- 3.1 Amended and Restated Bylaws of First Mariner Bancorp (Incorporated by reference to Exhibit 3.1 of the Company's Form 10-Q filed on May 16, 2011)

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- 10.1 Amendment to Securities Purchase Agreement, dated September 21, 2011, by and among First Mariner Bancorp, First Mariner Bank and Priam Capital Fund I, LP, filed herewith
- 10.2 Securities Purchase Agreement, dated April 19, 2011, by and among First Mariner Bancorp, First Mariner Bank and Priam Capital Fund I, LP, together with the Form of Articles Supplementary to the Company's Charter setting forth the terms of the Series A Preferred Stock, Form of Warrant, Form of Registration Rights Agreement, and term sheet for post-closing arrangements with Mr. Hale (Incorporated by reference to Exhibit 10.1 of the Company's Form 8-K filed on April 25, 2011)
- 31.1 Certifications of Chief Executive Officer pursuant to Rule 13a-14(a) and Rule 15d-14(a), promulgated under the Securities Exchange Act of 1934, as amended, filed herewith
- 31.2 Certifications of Chief Financial Officer pursuant to Rule 13a-14(a) and Rule 15d-14(a), promulgated under the Securities Exchange Act of 1934, as amended, filed herewith
- 32.1 Certification of Chief Executive Officer pursuant to 18 U.S.C. Section 1350 as adopted pursuant to section 906 of the Sarbanes-Oxley Act of 2002, furnished herewith
- 32.2 Certification of Chief Financial Officer pursuant to 18 U.S.C. Section 1350 as adopted pursuant to section 906 of the Sarbanes-Oxley Act of 2002, furnished herewith
- 101.0\* The following materials from the Company's Quarterly Report on Form 10-Q for the quarter ended September 30, 2011 formatted in XBRL (Extensible Business Reporting Language): (i) Consolidated Statements of Financial Condition; (ii) Consolidated Statements of Operations; (iii) Consolidated Statements of Changes on Stockholders' Equity; (iv) Consolidated Statements of Cash Flows; and (v) related notes.

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\* Furnished, not filed.

### SIGNATURES

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

#### FIRST MARINER BANCORP

Date: November 7, 2011

By: /s/ Edwin F. Hale Sr.

Edwin F. Hale Sr.  
Chairman and Chief Executive Officer

Date: November 7, 2011

By: /s/ Paul B. Susie

Paul B. Susie  
Chief Financial Officer and Principal Accounting Officer

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### Exhibit Index

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