

MERCANTILE BANKSHARES CORP
Form 10-K
March 14, 2006

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-K

(Mark One)

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

For the fiscal year ended December 31, 2005

OR

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

For the transition period from to

Commission file number 0-5127

MERCANTILE BANKSHARES CORPORATION

(Exact name of registrant as specified in its charter)

Maryland
(State or other jurisdiction of
incorporation or organization)

52-0898572
(I.R.S. Employer
Identification No.)

Two Hopkins Plaza

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Baltimore, Maryland 21201

(Address of principal executive offices) (Zip Code)

(410) 237-5900

(Registrant's telephone number, including area code)

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

Title of each class
None

Name of each exchange on which registered
None

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

Common Stock (\$2 par value)

(Title of class)

1.1 Stock Purchase Rights

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(Title of class)

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

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes No

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

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

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

Large accelerated filer Accelerated filer Non-accelerated filer

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

At June 30, 2005, the last business day of registrant's most recently completed second fiscal quarter, the aggregate market value of shares of common stock held by non-affiliates of registrant (1) (including fiduciary accounts administered by affiliates) was \$4,091,276,550 based on the last sale price on the Nasdaq National Market on June 30, 2005.

As of March 9, 2006, 123,296,036 shares of common stock were outstanding.

(1) Excludes 3,879,543 shares of common stock held by directors, executive officers, and shares held in fiduciary accounts by the Registrant and subsidiaries of the registrant with discretionary power to vote or dispose of such shares as of June 30, 2005. Exclusion of shares held by any person should not be construed to indicate that such person possesses the power, direct or indirect, to direct or cause the direction of the management or policies of the registrant, or that such person is controlled by or under common control with the registrant.

Documents Incorporated by Reference: Portions of the registrant's Definitive Proxy Statement of Registrant to be filed with the Securities and Exchange Commission under Regulation 14A within 120 days after the end of the Registrant's fiscal

year covered by this Annual Report on Form 10-K are incorporated by reference into Part III of this Annual Report on Form 10-K.

2005 ANNUAL REPORT ON FORM 10-K

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PART I

ITEM 1. BUSINESS

General

Mercantile Bankshares Corporation, with \$16.4 billion in assets for the year ended December 31, 2005, is a regional multibank holding company with headquarters in Baltimore, Maryland. It is comprised of 11 banks (the Banks) and a mortgage banking company. Eight banks are headquartered in Maryland, two are in Virginia and one is in Delaware. At December 31, 2005, Bankshares' largest bank, Mercantile-Safe Deposit and Trust Company (MSD&T), represented approximately 45% of total assets and operated 40 offices in Maryland, 13 in Virginia, two in Washington, D.C. and one in Pennsylvania. MSD&T provides nearly all of Bankshares' substantial wealth management operations and specialized corporate banking services. Mercantile Bankshares Corporation was incorporated under the laws of Maryland on May 27, 1969. Mercantile Bankshares Corporation along with its consolidated subsidiaries is referred to in this report as Bankshares, we or Registrant.

Washington Expansion and Affiliate Consolidation

In 2004, Bankshares initiated a significant reorganization within its Banking network. In a move designed to create banks of sufficient size and depth to compete more effectively today and in the future, Bankshares combined 11 affiliate banks to create four new organizations, all with a more prominent Mercantile identity. This reorganization has enabled Bankshares to operate more effectively and efficiently in the face of increased competitive and regulatory pressures. Fewer, larger banks allow better leverage of our branch network, reduce administrative and operational redundancies and increase the breadth and depth of expertise within our banks. All banks that were combined are geographically contiguous, share increasingly common market dynamics and offer the opportunity to create scale efficiencies.

To capitalize on the potential in affluent, fast growing metropolitan Washington, D.C., in 2004 Bankshares consolidated most of its retail and small business, commercial lending and real estate operations in the Washington region into its affiliate bank headquartered in Montgomery County, Maryland, and renamed the bank Mercantile Potomac Bank (Mercantile Potomac). In the second quarter of 2005, Bankshares consolidated Fidelity Bank, its bank subsidiary in western Maryland, into Farmers & Mechanics Bank (Farmers), its subsidiary bank based in Frederick, Maryland. The consolidation of these banks enables the surviving bank to serve its local customers with greater scale and expertise. Also, in the second quarter of 2005, Mercantile Potomac merged into MSD&T, and continues to do business in the Washington metropolitan region as a division of MSD&T under the Mercantile Potomac Bank name. This combination enables Bankshares to provide the capital resources necessary for greater expansion into the Washington, D.C. and Northern Virginia markets.

On May 18, 2005, Bankshares completed its acquisition of Community Bank of Northern Virginia (CBNV), a bank headquartered in Sterling, Virginia, which was merged into MSD&T and became part of MSD&T's Mercantile Potomac Bank. CBNV operated 14 branch offices in the Northern Virginia metropolitan market at the time of the acquisition. The primary reason for the merger with CBNV was to expand Bankshares distribution network in Northern Virginia, a higher growth market. The total consideration paid to CBNV shareholders in connection with the acquisition was \$82.9 million in cash and 3.7 million shares of Bankshares' common stock, which reflects the adjustment for the three-for-two stock split announced by Bankshares on January 10, 2006. CBNV transactions have been included in Bankshares' financial results subsequent to May 18, 2005. The assets and liabilities of CBNV were recorded on the Consolidated Balance Sheet at their respective fair values. The fair values have been determined as of May 18, 2005 and are subject to refinement, as further information becomes available. The transaction resulted in total assets acquired as of May 18, 2005 of \$888.2 million, including \$671.0 million of loans and leases; liabilities assumed were

\$842.3 million, including \$626.9 million of deposits.

Affiliate Bank Network

Bankshares places particular emphasis on long-term customer relationships by providing value-added services through its extensive affiliate bank network. Each of its affiliate Banks has its own identity, management team and board of directors. Perhaps most importantly, each Bank has strong historical ties to the families and businesses in the community it serves. Through its association with Bankshares, each Bank is able to provide its customers with the sophisticated banking services and financial resources of a major banking organization.

Bankshares directly owns all of the outstanding stock of the Banks and directly or indirectly owns all of the outstanding stock of certain other affiliates. The principal components of our banking and nonbanking network are listed below.

Lead Bank and Affiliates

Mercantile-Safe Deposit and Trust Company

Mercantile Mortgage Corporation (MMC)

Mercantile Mortgage, LLC (49.9% owned by MMC)

Columbia National Real Estate Finance LLC (60% owned by MMC)

West River LLC

HarborPoint Capital, GP LLC

HarborPoint Capital LP (75% owned by MMC)

Mercantile Brokerage Services Holdings, LLC

Mercantile Brokerage Services, Inc.

Mercantile Capital Advisors, Inc.

Mercantile/Cleveland, LLC

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Boyd Watterson Asset Management, LLC

MBC Agency, Inc.

Mercantile Life Insurance Company

Community Banks

The Annapolis Banking and Trust Company	Annapolis, Maryland
The Citizens National Bank	Laurel, Maryland
Farmers & Mechanics Bank	Frederick, Maryland
Keller Stonebraker Insurance, Inc.	Hagerstown, Maryland
Potomac Basin Group Associates, Inc.	Beltsville, Maryland
Marshall National Bank and Trust Company	Marshall, Virginia
Mercantile County Bank	Elkton, Maryland
Mercantile Eastern Shore Bank	Chestertown, Maryland
Mercantile Peninsula Bank	Selbyville, Delaware
Mercantile Southern Maryland Bank	Leonardtown, Maryland
The National Bank of Fredericksburg	Fredericksburg, Virginia
Westminster Union Bank	Westminster, Maryland

For purposes of segment reporting, two operating components have been identified: Banking and Investment & Wealth Management. For segment reporting information, see Note No. 16 (Segment Reporting) to the financial statements in Item 8 of this Annual Report and information under the heading *Segment Reporting* in the sections captioned *Analysis of Operating Results for 2005 to 2004* and *Review of Earnings and Balance Sheet for 2004 to 2003*, in Item 7 of this Annual Report. Bankshares periodically reviews and considers possible acquisitions of banks and other entities performing related activities and discusses such possible acquisitions with management of the subject companies, and such acquisitions, which may be material, may be made from time to time. Acquisitions are normally subject to regulatory approval.

Banking Services

Retail Banking

The Banks offer numerous services to meet the checking, savings, investment and credit needs of individuals in their communities. Retail banking services include checking, savings and money market accounts, Individual Retirement Accounts, and time deposits. The Banks offer home equity loans and lines of credit, installment loans and lines of credit, and equipment and transportation (auto, marine, recreational vehicles, aircraft) loans to meet a variety of borrowing needs.

Through the affiliate bank network, customers have no-fee access to their accounts at 250 Mercantile BANKING TWENTY-FOURSM ATMs, and they can perform many routine transactions at any of the 240 affiliate-banking offices. For added convenience, substantially all of Bankshares affiliates provide customers with toll-free telephone access to a centralized Customer Service Center and a voice-response account information system. BANKING TWENTY-FOUR ONLINE® enables customers to access their personal accounts online to pay bills, verify account balances, track recent account activity and perform selected transactions. BANKING TWENTY-FOUR ONLINE offers sole proprietors similar capabilities specifically tailored to meet small business needs.

Small Business Banking

The Banks offer numerous services to meet the deposit, credit and service needs of businesses with annual revenues up to \$3.0 million or credit needs up to \$750.0 thousand. Each Bank works closely with customers to provide cash management services and extend credit for such purposes as receivables and inventory financing, equipment leases and real estate financing. Where appropriate, the Banks are adept at employing government guarantee programs, such as those available from the Small Business Administration.

Commercial Banking

Commercial banking services include commercial deposit, lending and commercial real estate solutions provided to businesses with annual revenues between \$4.0 million and \$50.0 million.

Cash management services help business customers collect, transfer and invest their cash. Through a variety of electronic payment and account management tools, customers are able to monitor and manage cash flows conveniently and efficiently.

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With their local knowledge and focus, our Banks are well suited to meet the traditional credit needs of businesses in their market areas. Each Bank works closely with customers to extend credit for general business purposes, such as working capital, plant expansion or equipment purchases, and for financing industrial and commercial real estate. When local commercial customers do not qualify for traditional financing, we can help them convert the value of their accounts receivable, inventory and equipment into cash for operations. Additionally, we can arrange more sophisticated financing in the areas of acquisitions and management buyouts. We provide land acquisition and development, construction and interim financing to commercial real estate investors and developers.

In addition to extending credit to the businesses in its own market area, MSD&T works in collaboration with other affiliates when their customers' credit needs exceed the affiliate bank's lending limit or when there is a more specialized commercial banking need. To supplement traditional credit products, the Banks offer capital market products such as municipal bond underwriting, interest rate risk management and financial advisory services through the MSD&T Capital Markets Group. These services include underwriting and remarketing tax-exempt and taxable municipal variable-rate demand bonds for nonprofit organizations such as senior living and health care providers, private schools, health and social welfare organizations and cultural institutions. By working directly with borrowers, we can evaluate and recommend financing and interest rate risk management strategies, which include interest rate swaps, caps and collars.

Mortgage Banking

Residential mortgages are provided through Mercantile Mortgage, LLC, a joint venture between Mercantile Mortgage Corporation (Mercantile Mortgage), a subsidiary of MSD&T, and Wells Fargo Ventures, LLC. A wide variety of competitively priced fixed- and variable-rate products are available, including jumbo loans. Residential mortgage loans also are available through the Banks. Mercantile Mortgage also makes loans for land acquisition, development and construction of single-family and multifamily housing.

Risks associated with residential mortgage lending include interest rate risk, which is mitigated through the sale of the majority of all conforming fixed-rate loans, and default risk by the borrower, which is mitigated through underwriting procedures and credit quality standards, among other things.

Permanent financing for multifamily projects and long-term, nonrecourse financing for commercial real estate are provided through Columbia National Real Estate Finance, LLC (CNREF), a joint venture, the majority of which is owned by Mercantile Mortgage. CNREF is a Freddie Mac Program Plus Seller Servicer and is a MAP (Multifamily Accelerated Processing) approved lender for HUD. It has correspondent relationships with approximately 12 life insurance companies and services a loan portfolio in excess of \$6.1 billion. Permanent financing for multifamily projects nationwide is also provided through HarborPoint Capital, LP, a joint venture, the majority of which is owned by Mercantile Mortgage. HarborPoint Capital, LP, headquartered in Dallas, Texas, is one of the nation's few Fannie Mae DUS (Delegated Underwriting and Servicing) lenders.

Insurance Products

Keller Stonebraker Insurance, Inc., an independent, wholly owned subsidiary of Farmers & Mechanics Bank, arranges a full line of consumer insurance products through offices in Hagerstown and Cumberland, Maryland, and Keyser, West Virginia. Consumer insurance products include annuities, homeowners, automobile, life and personal umbrellas. MBC Agency, Inc. provides as agent, under group policies, credit life insurance in connection with extensions of credit by the Banks. Mercantile Life Insurance Company reinsures the insurance provided by MBC Agency, Inc.

Potomac Basin Group Associates, Inc. operates as an independent, wholly owned subsidiary of Farmers & Mechanics Bank and is an independent insurance agency specializing in corporate employee benefit plans through its offices in Beltsville and Ellicott City, Maryland. Keller Stonebraker provides commercial products that include property and casualty packages, workers' compensation, professional liability and umbrella coverage, bonds and 401(k) and other benefit plans.

Investment and Wealth Management Services

Bankshares offers investment and wealth management services through the Investment & Wealth Management division (IWM) of MSD&T. IWM continues to build on a more than 140-year tradition of providing investment and wealth management services to private individuals, family groups and institutions.

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Today, Bankshares provides a range of wealth management services. Over the past several years, IWM has developed risk management and asset allocation analyses to complement the investment advice we offer. An open architecture platform enables Bankshares to offer an array of proprietary investment products and carefully selected outside managers in a range of asset classes, including equity, fixed-income and alternative investment products. Bankshares' investment platform provides a range of investment vehicles, from separate account management to mutual funds. Investment and wealth management services are available through professional advisors at MSD&T, through the affiliate bank network and through Baltimore-based Mercantile Brokerage Services, Inc. (MBSI). Asset allocation and risk management capabilities, coupled with a range of proprietary and nonproprietary investment alternatives and investment vehicles, enable Bankshares to provide high quality, advice-driven, risk-managed solutions to meet clients' investment objectives. At December 31, 2005, Bankshares had \$20.6 billion of discretionary assets under management and \$46.5 billion in assets under administration.

Retail Brokerage Services

On November 12, 2004, Mercantile consolidated its brokerage activities by merging Mercantile Securities, Inc., into Peremel & Company, Inc. The resulting entity is Mercantile Brokerage Services, Inc., a general securities broker-dealer that offers full-service, discount and online brokerage capabilities and account services. Our customers can choose from investments in stocks, bonds, proprietary and nonproprietary mutual funds, and fixed or variable annuities.

Private Wealth Management Services

When managing a client's assets as part of an investment management or trustee relationship, Bankshares focuses on consistent investment performance and an asset allocation that is individually designed to meet each client's risk/return parameters and investment objectives. Professional advisors, working in partnership with our clients, provide access to proprietary and third-party separate account management, the family of Mercantile Funds, nonproprietary mutual funds and a variety of alternative investments. In addition, IWM provides a wide range of sophisticated fiduciary and client administrative services, including trust administration, protection and continuity of trust structures, estate settlement, estate advice and planning, tax advice and planning and charitable giving programs. IWM also acts in a custodial capacity for its clients, providing safekeeping of assets, transaction execution, income collection, preparation of tax returns and recordkeeping. IWM also specializes in services designed to meet the unique needs of families with substantial wealth. We provide a full range of services required to manage seamlessly our client's complex, multigenerational financial circumstances. We also provide guidance in more sophisticated investment strategies, incorporating nontraditional asset classes such as private equity, real estate and hedge fund investing.

Private Banking Services

The Private Banking Group provides one point of contact for its clients' deposit, investment and credit needs, ensuring that these services are delivered within an overall asset management plan. Private bankers can coordinate cash flows, arrange investment of short- and long-term funds and structure credit arrangements to meet short- to long-term needs. In the fourth quarter of 2005, the Private Banking Group of MSD&T was consolidated into the Private Banking Group of IWM. This organizational change will provide private banking customers with Bankshares' full range of financial services.

Institutional Investment Management

Bankshares, through IWM, the Banks and Boyd Watterson Asset Management, LLC, works to provide businesses and charitable organizations with investment management and administrative services for their employee retirement plans, profit sharing plans and endowments. Clients include state and local government entities, unions, charitable organizations and military institutions. For example, IWM is trustee for a group trust that focuses on commercial real estate investments for Taft-Hartley pension plans. IWM also can help nonprofit organizations, such as charitable and philanthropic groups, with annual giving and capital campaigns, pooled income funds, gift annuities and charitable remainder trusts. Bankshares offers corporations 401(k) programs tailored to their specific needs.

Mercantile Funds

We offer a full spectrum of mutual funds - from equity funds designed to grow clients' money over time, to taxable and tax-exempt bond funds designed to offer regular income payments, to money market funds designed to help clients build a cash reserve. The Mercantile Funds help clients create well-rounded portfolios around their goals - with the level of risk and potential for return that makes the most sense for them.

Managed by Mercantile Capital Advisors, Inc., an affiliate of MSD&T, Mercantile Funds utilize the same investment foundation that has brought Mercantile regional prominence: risk management, in-depth fundamental research and a product line designed to meet clients' needs.

Private Equity

Bankshares, in partnership with MSD&T, began a focused private equity investment initiative in 2000 with two objectives: provide an alternative method of funding to develop additional long-term client relationships with emerging companies in Bankshares' market area and

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provide an alternative use of capital to generate long-term returns. The primary investments are private equity limited partnerships located, or seeking investment opportunities, within Bankshares' geographic trade area and, to a lesser extent, direct investments in privately held companies within the region. The private equity funds include small- and middle-market buyout funds, mezzanine funds and late-stage venture funds in which the target investments of the funds are or have the potential to become Bankshares customers. For more information on private equity investments, see Notes No. 1, 6 and 10 of the financial statements.

Statistical Information

The statistical information required in this Item 1 is set forth in Items 6, 7 and 8 of this Annual Report on Form 10-K, as follows.

Disclosure Required by Guide 3	Reference to Caption in Item 6 or 7, or Note in Item 8
(I) Distribution of Assets, Liabilities and Stockholders Equity; Interest Rates and Interest Differentials	Analysis of Interest Rates and Interest Differentials (Item 7) Rate/Volume Analysis (Item 7) Nonperforming Assets (Item 7)
(II) Investment Portfolio	Bond Investment Portfolio (Item 7) Notes to Financial Statement, Note No. 3, Investment Securities
(III) Loan Portfolio	Year-End Loan Data (Item 6) Loan Maturity Schedule (Item 7) Interest Rate Risk (Item 7) Nonperforming Assets (Item 7)
(IV) Summary of Loan Loss Experience	Allowance for Loan Losses (Item 7) Credit Risk Analysis (Item 7) Allocation of Allowance for Loan Losses (Item 7)
(V) Deposits	Analysis of Interest Rates and Interest Differentials (Item 7) Notes to Financial Statements, Note No. 7, Deposits
(VI) Return on Equity and Assets	Return on Equity and Assets (Item 6)
(VII) Short-Term Borrowings	Notes to Financial Statements, Note No. 8, Short-Term Borrowings

Employees

At December 31, 2005, Bankshares and its affiliates had approximately 3,606 employees.

Competition

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The banking business is highly competitive. Within their service areas, the Banks compete with commercial banks (including local banks and branches or affiliates of other larger banks), savings and loan associations and credit unions for loans and deposits, and with insurance companies and other financial institutions for various types of loans. There is also competition for commercial and retail banking business from banks and financial institutions located outside our service areas. Interstate banking is an established part of the competitive environment.

Bankshares is a financial holding company and is the largest independent bank holding company headquartered in Maryland. Measured in terms of assets under management and administration, MSD&T believes it is one of the largest trust institutions in the mid-Atlantic region of the United States. MSD&T and its subsidiaries (i.e., Boyd Watterson & Mercantile Capital Advisors, Inc.) compete for various classes of fiduciary and investment advisory business with other banks and trust companies, insurance companies, investment counseling firms, mutual funds and others. Mercantile Mortgage is one of many competitors in its area of activity. MBC Agency, Inc. is limited to providing life, health and accident insurance in connection with credit extended by the Banks.

The Banks ranged in asset size from approximately \$178.7 million to \$7.2 billion, at December 31, 2005. They face competition in their own local service areas as well as from the larger competitors mentioned above.

Supervision and Regulation

Bankshares

Bankshares, as a registered bank holding company, is subject to regulation and examination by the Board of Governors of the Federal Reserve System (the Federal Reserve Board) under the Bank Holding Company Act of 1956, as amended (the BHC Act) and is required to file with the Federal Reserve Board quarterly and annual reports and such additional information as the Federal Reserve Board may require pursuant to the BHC Act. Among other provisions, the BHC Act and regulations promulgated thereunder require prior approval of the Federal Reserve Board of the acquisition by Bankshares of more than 5% of any class of the voting shares of any bank holding company, bank, or savings association.

Capital Adequacy. The Banks include seven banks chartered by the state of Maryland (two of which are members of the Federal Reserve System), a Delaware-chartered bank, and three national banks (additional information about the chartering of the Banks is contained in *The Banks*, below). The Federal Reserve Board, regulator of bank holding companies and state-chartered banks that are members of the Federal Reserve System, the Office of the Comptroller of the Currency (the OCC), the federal regulator of national banks, and the Federal Deposit Insurance Corporation (the FDIC), federal regulator of state-chartered banks that are not members of the Federal Reserve System and insurer of the deposits of all U.S. commercial banks, have issued substantially similar risk-based and leverage capital guidelines applicable to United States banking organizations. In addition, these regulatory agencies may from time to time require that a banking organization maintain capital above the minimum levels, whether because of its financial condition or actual or anticipated growth.

The Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA), among other things, identifies five capital categories for insured depository institutions (well capitalized, adequately capitalized, undercapitalized, significantly undercapitalized and critically undercapitalized) and requires the respective federal regulatory agencies to implement systems for prompt corrective action for insured depository institutions that do not meet minimum capital requirements within such categories. FDICIA imposes progressively more restrictive constraints on operations, management and capital distributions, depending on the category in which an institution is classified. Failure to meet the capital guidelines could also subject a banking institution to requirements to raise capital.

The various regulatory agencies have adopted substantially similar regulations that define the five capital categories identified by FDICIA, using the total risk-based capital, Tier 1 risk-based capital and leverage capital ratios as the relevant capital measures. Such regulations establish various degrees of corrective action to be taken when an institution is considered undercapitalized. Under the regulations, a well capitalized institution must have a Tier 1 risk-based capital ratio of at least six percent, a total risk-based capital ratio of at least ten percent and a leverage ratio of at least five percent and not be subject to a capital directive order. As of December 31, 2005, the most recent notification from the primary regulators for each of Bankshares' subsidiary banks categorized them as well capitalized under the prompt corrective action regulations.

Changes to the risk-based capital regime for banking organizations are proposed or implemented from time to time. The minimum risk-based capital requirements that are currently in effect for U.S. banking organizations follow the Capital Accord issued in 1988 by the Basel Committee on Banking Supervision, which is comprised of bank supervisors and central banks from the major industrialized countries, including the United States. The Basel Committee issued a proposed replacement for the 1988 Capital Accord in 2001 (Basel II), and work has continued on the details of Basel II and the timing of its implementation since that time. What form any changes to the risk-based capital requirements may take, the extent of their applicability to a bank holding company such as Bankshares, and the impact they might have on Bankshares and its subsidiaries cannot be determined at this time. Additional information regarding capital requirements for bank holding companies and tables reflecting Bankshares' regulatory capital position at December 31, 2005 can be found in Note No. 11 (Shareholders' Equity) to the financial statements in Item 8 of this Annual Report.

The Gramm-Leach-Bliley Act. The Gramm-Leach-Bliley Act of 1999 (the GLB Act) was adopted on November 12, 1999 and amended several of the federal banking laws, including the BHC Act and the Banking Act of 1933 (generally known as Glass-Steagall), that affect Bankshares and its subsidiaries. Prior to the adoption of the GLB Act, the activities of bank holding companies and their subsidiaries were restricted to banking, the business of managing and controlling banks, and other activities that the Federal Reserve Board had determined were so closely related to banking or managing or controlling banks as to be a proper incident thereto. In particular, Glass-Steagall and the BHC Act imposed important restrictions on the ability of bank holding companies or their subsidiaries to engage in the securities or insurance business.

The GLB Act repealed the provisions of Glass-Steagall and restrictions in the BHC Act that limited affiliations among, and overlapping business activities between the banking business and, respectively, the securities and insurance industries. With the adoption of the GLB Act, a bank holding company that makes an effective election to become a financial holding company may, within a holding company system, (a) engage in banking, or managing or controlling banks; (b) perform certain servicing activities for subsidiaries; and (c) engage in any activity, or acquire and retain the shares of any company engaged in any activity that is either (i) financial in nature or incidental to such financial activity, as determined by the Federal Reserve Board in consultation with the Secretary of the Treasury or (ii) complementary to a financial activity and that does not pose a substantial risk to the safety and soundness of depository institutions or the financial system generally, as determined by the Federal Reserve Board. Activities that are financial in nature include activities specified in the GLB Act and those activities that the Federal Reserve Board had determined, by order or regulation in effect prior to enactment of the GLB Act, to be so closely related to banking or managing or controlling banks as to be a proper incident thereto. Thus, a financial holding company may engage in a full range of banking, securities and insurance activities, including securities and insurance underwriting, as well as, subject to certain restrictions, merchant banking activities. The election to become a financial holding company is only available to bank holding companies whose bank and thrift subsidiaries are well capitalized, well managed, and have satisfactory Community Reinvestment Act ratings.

With exceptions for insurance underwriting, merchant banking and real estate investment and development, the GLB Act also permits comparable expansion of national bank activities by banks meeting similar criteria, together with certain additional firewalls and other requirements, through financial subsidiaries of national banks. Similarly, as a matter of Federal law, but still subject to State law, the GLB Act expands the potential financial activities of subsidiaries of State banks. Bankshares filed an election and, on December 20, 2002, became a financial holding company.

The GLB Act also imposed a general scheme of functional regulation with respect to the activities of bank holding companies and their bank and nonbank subsidiaries to ensure that banking activities are regulated by bank regulators, securities activities are regulated by securities regulators, and insurance activities are regulated by insurance regulators, although the Federal Reserve Board retains its role as the umbrella supervisor for bank holding companies. Consequently, various securities activities of bank subsidiaries of Bankshares are now subject to regulation by the Securities and Exchange Commission and the National Association of Securities Dealers, Inc. The functional regulation of the securities brokerage activities of banks is not yet fully implemented.

As a result of the functional regulation imposed by the GLB Act, the Banks have moved certain securities activities that have become subject to Securities and Exchange Commission regulation into separate securities subsidiaries or affiliates. For example, MSD&T has two subsidiaries that engage in securities activities: Mercantile Capital Advisors, Inc., a registered investment adviser that advises the Mercantile family of mutual funds and certain other institutional accounts; and Mercantile Brokerage Services, Inc. (formerly Mercantile Securities, Inc. or Hopkins Plaza Securities, Inc.), a registered broker-dealer that facilitates the purchase of shares of mutual funds by bank customers and may engage in certain other activities in the future.

The GLB Act also implements a number of requirements designed to protect the privacy of customer information. A financial institution must inform its customers at the outset of the customer relationship, and at least annually thereafter, of the institution's privacy policies and procedures

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with respect to the customer's nonpublic personal financial information. With certain exceptions, an institution may not provide any nonpublic personal information to unaffiliated third parties unless the customer has been informed that such information may be so provided and the customer has been given the opportunity to opt out. Furthermore, the GLB Act limits a financial institution's use of a customer's account information for marketing purposes and imposes criminal penalties for the use of fraudulent or deceptive means to obtain personal customer financial information. The GLB Act permits states to adopt more rigorous laws with respect to privacy of customer information.

The Fair Credit Reporting Act and the Fair and Accurate Transactions Act of 2003. The Fair Credit Reporting Act (FCRA), among other provisions, restricts any bank from sharing with its affiliates certain information relating to its individual customers' creditworthiness and certain other matters with various exceptions. FCRA preempts state laws that purport to restrict further such information sharing among affiliated institutions. The Fair and Accurate Transactions Act of 2003 (the FACT Act), which was signed into law on December 4, 2003, amended FCRA in various respects, including to enhance the ability of consumers to combat identity theft, increase the accuracy of consumer credit reports, and allow consumers to exercise greater control over the type and amount of marketing solicitations that they receive. The new marketing restrictions, with some exceptions, would prevent banks from using certain information received from an affiliate for marketing to a consumer unless the consumer was given notice and an opportunity to opt out. The FACT Act also restricts the sharing of certain types of consumer medical information among affiliates. These new restrictions on sharing or using information shared among affiliates must be implemented by regulations, which were issued for public comment but have not yet been finalized. More generally, the Federal Reserve Board and the Federal Trade Commission issued joint final rules establishing December 1, 2004 as the effective date for many of the provisions of the FACT.

In December 2004, implementing section 216 of the FACT Act, the federal bank regulatory agencies announced interagency final rules to require financial institutions to adopt measures for properly disposing of consumer information derived from credit reports. Federal banking law requires financial institutions to protect customer information by implementing information security programs. The rules adopted by the banking agencies require institutions to make certain adjustments to their information security programs to include measures for the proper disposal of consumer information. The rules define consumer information to mean any record about an individual, whether in paper, electronic, or other form, that is a consumer report or is derived from a consumer report and that is maintained or otherwise possessed by or on behalf of the [institution] for a business purpose, and include a compilation of such records, but exclude any record that does not identify an individual. The rules took effect on July 1, 2005. Federal regulators have pursued enforcement action against U.S. banks and other entities for failing to properly safeguard customers' information.

The USA PATRIOT ACT. Congress adopted the USA PATRIOT ACT (the Patriot Act) on October 26, 2001 in response to the terrorist attacks that occurred on September 11, 2001. Under the Patriot Act, banks are required to maintain and prepare additional records and reports that are designed to assist the government's efforts to combat terrorism. The Patriot Act includes sweeping anti-money laundering and financial transparency laws and required additional regulations, including, among other things, standards for verifying client identification when opening an account and rules to promote cooperation among financial institutions, regulators and law enforcement entities in identifying parties that may be involved in terrorism or money laundering. Specifically, the customer identification program (CIP) regulation issued under the Patriot Act requires each bank to implement a written CIP appropriate for its size and type of business that includes certain minimum requirements. The CIP must be incorporated into the bank's anti-money laundering compliance program, which is subject to approval by the bank's board of directors. The regulation applies to all federally regulated banks and savings associations, credit unions, and non-federally regulated private banks, trust companies, and credit unions. All banks were required to comply with the CIP regulation for all accounts established on or after October 1, 2003.

Interstate Banking. Pursuant to the Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994 (the Interstate Banking and Branching Act), a bank holding company may acquire banks located in states other than its home state without regard to the permissibility of such acquisitions under state law, but subject to any state requirement that the bank has been organized and operating for a minimum period of time, not to exceed five years, and the requirement that the bank holding company, after the proposed acquisition, controls no more than 10% of the total amount of

deposits of insured depository institutions in the United States and no more than 30% or such lesser or greater amount set by state law of such deposits in that state.

Subject to certain restrictions, the Interstate Banking and Branching Act also authorizes banks to merge across state lines to create interstate banks. The Interstate Banking and Branching Act also permits a bank to open new branches in a state in which it does not already have banking operations if such state enacts a law permitting de novo branching.

Other Regulatory Matters. Bankshares is a separate and distinct legal entity from its subsidiaries. It receives substantially all of its revenue from dividends from its subsidiaries and interest payments from the Banks on subordinated debt. These dividends are the principal source of funds to pay dividends on Bankshares common stock and interest on its debt. The payment of dividends by a bank is subject to federal law restrictions as well as to the laws of its state of incorporation in the case of a state-chartered bank. Also, a parent company's right to participate in a distribution of assets upon a subsidiary's

liquidation or reorganization is subject to the prior claims of the subsidiary's creditors. It is Federal Reserve Board policy that a bank holding company should serve as a source of financial and managerial strength for, and commit resources to support each, of its subsidiary banks even in circumstances in which it might not do so (or may not legally be required or financially able to do so) absent such a policy.

Changes in control of Bankshares and the Banks are regulated under the BHC Act, the Change in Bank Control Act of 1978 and various state laws.

In addition to the specific laws and regulations discussed above, there are numerous federal and state laws and regulations which regulate the activities of Bankshares and the Banks, including requirements and limitations relating to reserves, permissible investments and lines of business, transactions with officers, directors and affiliates, loan limits, consumer protection laws, privacy of financial information, predatory lending, fair lending, mergers and acquisitions, issuances of securities, dividend payments, inter-affiliate liabilities, extensions of credit and branch banking. The BHC Act and the Federal Reserve Board's regulations limit the ability of bank subsidiaries of bank holding companies to engage in certain tie-in arrangements with bank holding companies and their nonbank subsidiaries in connection with any extension of credit or provision of any property or services, subject to various exceptions.

The laws and regulations to which Bankshares is subject are constantly under review by Congress, regulatory agencies and state legislatures. The likelihood and timing of any bank-related proposals or legislation and the impact they might have on Bankshares and its subsidiaries cannot be determined at this time.

As a general matter, the recent regulatory environment for banking organizations has included significant enforcement actions by banking regulators and other federal and state agencies, involving such matters as alleged shortcomings in anti-money laundering policies and procedures, inadequate protection of confidential customer information, and violations of securities or other laws. As a result of this regulatory environment, banking organizations may experience increases in compliance requirements and associated costs.

The Banks

All the Banks, with the exception of The Citizens National Bank, The National Bank of Fredericksburg, Marshall National Bank and Trust Company and Mercantile Peninsula Bank are Maryland banks, subject to the banking laws of Maryland and to regulations issued by the Commissioner of Financial Regulation of Maryland, who is required by statute to make at least one examination in each calendar year (or at 18-month intervals if the Commissioner determines that an examination is unnecessary in a particular calendar year). Their deposits are insured by, and they are subject to certain provisions of federal law and regulations and examination by, the FDIC.

In addition, The Annapolis Banking and Trust Company and Farmers & Mechanics Bank are members of the Federal Reserve System and are thereby subject to regulation by the Federal Reserve Board.

The Citizens National Bank, The National Bank of Fredericksburg and Marshall National Bank and Trust Company are national banks subject to regulation and regular examination by the OCC in addition to regulation and examination by the FDIC, which insures their deposits.

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Mercantile Peninsula Bank is a Delaware bank, subject to the banking laws of Delaware and to regulation by the Delaware State Bank Commissioner, who is required by statute to make periodic examinations. Its deposits are insured by, and it is subject to certain provisions of federal law and regulation and examination by, the FDIC.

Bankshares and its affiliates are subject to the provisions of Section 23A and Section 23B of the Federal Reserve Act and the Federal Reserve Board's Regulation W, which implements Sections 23A and 23B. Section 23A, among other things, limits the amount of loans or extensions of credit by the Banks to, and their investments in, Bankshares and the nonbank affiliates of the Banks, while Section 23B generally requires that transactions between the Banks and Bankshares and its nonbank affiliates be on terms and under circumstances that are substantially the same as with non-affiliates. Under the cross-guarantee provisions of the Federal Deposit Insurance Act, in the event of a loss suffered or anticipated by the FDIC either as a result of default of a bank subsidiary or related to FDIC assistance provided to a bank subsidiary in danger of default the Banks may be assessed for the FDIC's loss, subject to certain exceptions.

Other Affiliates

As affiliates of Bankshares, the nonbank affiliates are subject to examination by the Federal Reserve Board and, as affiliates of the Banks, they are subject to examination by the FDIC, the Commissioner of Financial Regulation of Maryland and the OCC, as the case may be. In addition, MBC Agency, Inc. and Mercantile Life Insurance Company are subject to licensing and regulation by state insurance authorities. Mercantile Capital Advisors, Inc., Boyd Watterson and Mercantile Brokerage Services, Inc. are subject to regulation by the Securities and Exchange Commission and state securities law authorities, and Mercantile Brokerage Services, Inc. is also subject to regulation by the National Association of Securities Dealers, Inc. Retail sales of insurance and securities products by Mercantile Brokerage Services, Inc. are also subject to the requirements of the Interagency Statement on Retail Sales of Nondeposit Investment Products promulgated in 1994 by the FDIC, the Federal Reserve Board, the Comptroller of the Currency and the Office of Thrift Supervision.

Effects of Monetary Policy

All commercial banking operations are affected by the Federal Reserve System's conduct of monetary policy and its policies change from time to time based on changing circumstances. The Federal Reserve Board effectively controls the supply of bank credit in order to achieve economic results it deems appropriate, including efforts to combat unemployment, recession or inflationary pressures. Among the instruments of monetary policy used to advance these objectives are open market operations in the purchase and sale of U.S. Government securities, changes in the discount rate charged on bank borrowings and changes in reserve requirements against bank deposits. These means are used in varying combinations to influence the general level of interest rates and the general availability of credit. More specifically, actions by the Federal Reserve Board influence the levels of interest rates paid on deposits and other bank funding sources and charged on bank loans as well as the availability of bank funds with which loans and investments can be made.

Cautionary Statement

This Annual Report on Form 10-K contains forward-looking statements, within the meaning of and pursuant to the safe harbor provisions of the Private Securities Litigation Reform Act of 1995. A forward-looking statement encompasses any estimate, prediction, opinion or statement of belief contained in this report and the underlying management assumptions. These forward-looking statements include such words as believes, expects, anticipates, intends and similar expressions. Examples of forward-looking statements in this Annual Report on Form 10-K are statements concerning competitive conditions, effects of monetary policy, the potential impact of legislation, identification of trends, loan growth, customer borrowing trends, anticipated levels of interest rates, business strategies and services, continuation or development of specified lending and other activities, credit quality, predictions or assessments related to the determination and adequacy of loan loss allowances, monitored loans, internal controls, tax accounting, importance and effects of capital levels, effects of asset sensitivity and interest rates, earnings simulation model projections, efforts to mitigate market and liquidity risks, dividend payments and impact of FASB pronouncements. These statements are based on current expectations and assessments of potential developments affecting market conditions, interest rates and other economic conditions, and results may ultimately vary from the statements made in this report. The following factors, among others, could cause actual results to differ materially from the anticipated results or other expectations expressed in the forward-looking statements: (1) the interest rate environment may further compress margins and adversely affect net interest income; (2) results may be adversely affected by continued diversification of assets and adverse changes in credit quality; (3) economic slowdown could adversely affect credit quality and loan originations; (4) loan growth may not improve to a degree that would help offset continuing pressure on net interest margin; (5) adverse governmental or regulatory policies may be enacted; (6) the expected growth opportunities or cost savings from our merger with Community Bank of Northern Virginia may not be fully realized or may take longer to realize than expected; (7) Community Bank of Northern Virginia's actual earnings may not be as strong as initially projected; (8) declines in equity and bond markets may adversely affect IWM revenues; and (9) the inability to manage adequately the spread between yields on earning assets and cost of funds could adversely affect results.

Website Access To Information

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Bankshares' annual reports on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K and all amendments to those reports may be accessed through Bankshares' website as soon as reasonably practicable after such material is electronically filed with or furnished to the Securities and Exchange Commission. Bankshares' website is www.mercantile.com.

ITEM 1A. RISK FACTORS

The following is a summary of the risk factors that we believe are most relevant to our business. These are factors that, individually or in the aggregate, we think could cause our actual results to differ significantly from anticipated or historical results. You should understand that it is not possible to predict or identify all such factors. Consequently, you should not consider the following to be a complete discussion of all potential risks or uncertainties. We undertake no obligation to publicly update forward-looking statements, whether as a result of new information, future events, or otherwise. You are advised, however, to consult any further disclosure we make on related subjects in our reports on forms 10-Q and 8-K filed with the SEC.

Bankshares Is Subject To Interest Rate Risk

Our earnings depend largely on the relationship between the yield on our interest-earning assets and our cost of funds. This relationship, known as the interest rate spread, is subject to fluctuation and is affected by economic and competitive factors which influence market interest rates, the volume and mix of interest-earning assets and interest-bearing liabilities, and the level of non-performing assets. Fluctuations in market interest rates also affect our customers' demand for our products and services. See the sections entitled "Net Interest Income and Net Interest Margin" and "Interest Rate Risk" in Item 7 "Management's Discussion and Analysis of Financial Condition and Results of Operations" located elsewhere in this report for further discussion related to Bankshares' management of interest rate risk.

Bankshares Is Subject To Lending Risk

There are inherent risks associated with Bankshares' lending activities. These risks include, among other things, the impact of changes in interest rates and changes in the economic conditions in the markets in which Bankshares operates. Increases in interest rates and/or weakening economic conditions could adversely affect the ability of borrowers to repay outstanding loans or the value of the collateral securing these loans. Commercial loans, including commercial real estate loans are typically subject to a higher credit risk than other types of loans, including residential real estate or consumer loans, because they usually involve larger loan balances to a single borrower and are more susceptible to a risk of default during an economic downturn. Because Bankshares' loan portfolio contains a significant number of commercial and industrial, construction and commercial real estate loans with relatively large balances, the deterioration of one or a few of these loans could cause a significant increase in nonperforming loans. These types of loans are also typically larger than residential real estate loans and consumer loans. An increase in nonperforming loans could result in a net loss of earnings from these loans, an increase in the provision for possible loan losses and an increase in loan charge offs, all of which could have a material adverse effect on Bankshares' financial condition and results of operations. See the section captioned "Loans" in Item 7. "Management's Discussion and Analysis of Financial Condition and Results of Operations" located elsewhere in this report for further discussion related to commercial and industrial, construction and commercial real estate loans.

Bankshares' Allowance For Possible Loan Losses May Be Insufficient

In an attempt to mitigate our loan and lease losses, we maintain an allowance for loan and lease losses based on, among other things, national and regional economic conditions, historical loss experience and delinquency trends. However, we cannot predict loan and lease losses with certainty, and we cannot assure you that charge-offs in future periods will not exceed the allowance for loan and lease losses. If our allowance for loan and lease losses were not sufficient to cover actual loan and lease losses, our earnings would decrease. In addition, regulatory agencies, as an integral part of their examination process, review our allowance for loan and lease losses and may require additions to the allowance based on their judgment about information available to them at the time of their examination. Factors that require an increase in our allowance for loan and lease losses could reduce our earnings.

Bankshares' Profitability Depends Significantly On Economic Conditions

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The economic impact of the United States military operations in Iraq, as well as the war on terrorism and the possibility of any terrorist attacks in response to these operations, is uncertain but could have a material effect on general economic conditions, consumer confidence and market liquidity. Further, the geographic concentration of our business in the vicinity of the nation's capital may place our business at greater risk of terrorist activity. A deterioration in economic conditions in the Washington-Baltimore metropolitan area could have a material adverse effect on the quality of our loan portfolio and the

demand for our products and services, and, accordingly, on our results of operations. No assurance can be given as to the effect of these events on the performance of our business. Furthermore, a significant decline in general economic conditions, caused by inflation, recession, unemployment, changes in securities markets or other factors could impact local economic conditions and, in turn, have a material adverse effect on Bankshares' financial condition and results of operations.

Bankshares Operates In A Highly Competitive Industry and Market Area

Bankshares faces substantial competition in all areas of its operations from a variety of competitors, many of which are larger and may have more financial resources. Such competitors primarily include national, regional, and community banks within the various markets in which Bankshares operates. Bankshares also faces competition from many other types of financial institutions, including, without limitation, savings and loans, credit unions, finance companies, brokerage firms, insurance companies, factoring companies and other financial intermediaries. The financial services industry could become even more competitive as a result of legislative, regulatory and technological changes and continued consolidation. Banks, securities firms and insurance companies can merge under the umbrella of a financial holding company, which can offer virtually any type of financial service, including banking, securities underwriting, insurance (both agency and underwriting) and merchant banking. Also, technology has lowered barriers to entry and made it possible for nonbanks to offer products and services traditionally provided by banks, such as automatic funds transfer and automatic payment systems. Many of Bankshares' competitors have fewer regulatory constraints and may have lower cost structures. Additionally, due to their size, many competitors may be able to achieve economies of scale and, as a result, may offer a broader range of products and services as well as better pricing for those products and services than Bankshares can. Bankshares' ability to compete successfully depends on a number of factors, including, among other things:

The ability to develop, maintain and build upon long-term customer relationships based on top quality service, high ethical standards and safe, sound assets.

The ability to expand Bankshares' market position.

The scope, relevance and pricing of products and services offered to meet customer needs and demands.

The rate at which Bankshares introduces new products and services relative to its competitors.

Customer satisfaction with Bankshares' level of service.

Industry and general economic trends.

Failure to perform in any of these areas could significantly weaken Bankshares' competitive position, which could adversely affect Bankshares' growth and profitability, which, in turn, could have a material adverse effect on Bankshares' financial condition and results of operations.

Bankshares Is Subject To Extensive Government Regulation and Supervision

Financial institution regulation has been the subject of significant legislation in recent years and may be the subject of further significant legislation in the future, none of which is within our control. Significant new laws or changes in, or repeals of, existing laws, including with respect to federal and state taxation, may cause our results of operations to differ materially. Further, federal monetary policy, particularly as implemented through the Federal Reserve, significantly affects credit conditions for our affiliated banks, primarily through open market operations in U.S. government securities and the discount rate for bank borrowings and reserve requirements. A material change in any of these conditions would have a material impact on our results of operations. Furthermore, failure to comply with laws, regulations or policies could result in sanctions by regulatory agencies, civil money penalties and/or reputation damage, which could have a material adverse effect on Bankshares' business, financial condition and results of operations. While Bankshares has policies and procedures designed to prevent any such

violations, there can be no assurance that such violations will not occur. See the section captioned "Supervision and Regulation" in Item 1 Business located elsewhere in this report.

Bankshares Controls And Procedures May Fail Or Be Circumvented

Management regularly reviews and updates Bankshares' internal controls, disclosure controls and procedures, and corporate governance policies and procedures. Any system of controls, however well designed and operated, is based in part on certain assumptions and can provide only reasonable, not absolute, assurances that the objectives of the system will be met. Any failure or circumvention of Bankshares' controls and procedures or failure to comply with regulations related to controls and procedures could have a material adverse effect on Bankshares' business, results of operations and financial condition.

Potential Acquisitions May Disrupt Bankshares' Business And Dilute Stockholder Value

Bankshares seeks merger or acquisition partners that are culturally similar and have experienced management and possess either significant market presence or have potential for improved profitability through financial management, economies of scale or expanded services. Acquiring other banks, businesses, or branches involves various risks commonly associated with acquisitions, including, among other things:

Potential exposure to unknown or contingent liabilities of the target company.

Exposure to potential asset quality issues of the target company.

Difficulty and expense of integrating the operations and personnel of the target company.

Potential disruption to Bankshares' business.

Potential diversion of Bankshares' management's time and attention.

The possible loss of key employees and customers of the target company.

Difficulty in estimating the value of the target company.

Potential changes in banking or tax laws or regulations that may affect the target company.

Bankshares regularly evaluates merger and acquisition opportunities and conducts due diligence activities related to possible transactions with other financial institutions and financial services companies. As a result, merger or acquisition discussions and, in some cases, negotiations may take place and future mergers or acquisitions involving cash, debt or equity securities may occur at any time. Acquisitions typically involve the payment of a premium over book and market values and, therefore, some dilution of Bankshares' tangible book value and net income per common share may occur in connection with any future transaction.

Furthermore, failure to realize the expected revenue increases, cost savings, increases in geographic or product presence, and/or other projected benefits from an acquisition could have a material adverse effect on Bankshares' financial condition and results of operations. See Note No. 2 "Business Combinations" in the notes to consolidated financial statements included in Item 8. Financial Statements and Supplementary Data, which is located elsewhere in this report.

Bankshares May Not Be Able To Attract And Retain Skilled People

Bankshares' success depends, in large part, on its ability to attract and retain key people. Competition for the best people in the business conducted by Bankshares can be intense and Bankshares may not be able to hire people or to retain them. The unexpected loss of services of one or more of Bankshares' key personnel could have a material adverse impact on Bankshares' business because of their skills, knowledge of Bankshares' market, years of industry experience and the difficulty of promptly finding qualified replacement personnel.

Bankshares' Information Systems May Experience An Interruption Or Breach In Security

Bankshares relies heavily on communications and information systems to conduct its business. Any failure, interruption or breach in security of these systems could result in failures or disruptions in Bankshares' customer relationship management, general ledger, deposit, loan and other systems. While Bankshares has policies and procedures designed to prevent or limit the effect of the failure, interruption or security breach of its information systems, there can be no assurance that any such failures, interruptions or security breaches will not occur or, if they do occur, that they will be adequately addressed. The occurrence of any failures, interruptions or security breaches of Bankshares' information systems could damage Bankshares' reputation, result in a loss of business, subject Bankshares to additional regulatory scrutiny, or expose Bankshares to civil litigation and possible financial liability, any of which could have a material adverse effect on Bankshares' financial condition and results of operations.

Bankshares Continually Encounters Technological Change

The financial services industry is continually undergoing rapid technological change with frequent introductions of new technology driven products and services. The effective use of technology increases efficiency and enables financial institutions to serve customers better and to reduce costs. Bankshares' future success depends, in part, upon its ability to address the needs of its customers by using technology to provide products and services that will satisfy customer demands, as well as to create additional efficiencies in Bankshares' operations. Many of Bankshares' competitors have substantially greater resources to invest in technological improvements. Bankshares may not be able to effectively implement new technology driven products and services or be successful in marketing these products and services to its customers. Failure to keep pace successfully with technological change affecting the financial services industry could have a material adverse impact on Bankshares' business and, in turn, Bankshares' financial condition and results of operations.

Bankshares Is Subject To Claims and Litigation Pertaining To Fiduciary Responsibility

From time to time, customers make claims and take legal action pertaining to Bankshares' performance of its fiduciary responsibilities. Whether customer claims and legal action related to Bankshares' performance of its fiduciary responsibilities are founded or unfounded, if such claims and legal actions are not resolved in a manner favorable to Bankshares they may result in significant financial liability and/or adversely affect the market perception of Bankshares and its products and services as well as affect customer demand for those products and services. Any financial liability or reputation damage could have a material adverse effect on Bankshares' business, which, in turn, could have a material adverse effect on Bankshares' financial condition and results of operations.

Severe Weather, Natural Disasters, Acts Of War Or Terrorism And Other External Events Could Significantly Impact Bankshares Business

Severe weather, natural disasters, acts of war or terrorism and other adverse external events could have a significant impact on Bankshares' ability to conduct business. Such events could affect the stability of Bankshares' deposit base, impair the ability of borrowers to repay outstanding loans, impair the value of collateral securing loans, cause significant property damage, result in loss of revenue and/or cause Bankshares to incur additional expenses. Although management has established disaster recovery policies and procedures, the occurrence of any such event could have a material adverse effect on Bankshares' business, which, in turn, could have a material adverse effect on Bankshares' financial condition and results of operations.

Bankshares Relies On Dividends From Its Subsidiaries For Most Of Its Revenue

We are a financial holding company and a bank holding company and as a result, much of our income consists of dividends received from our affiliated banks. This means we rely primarily upon dividends from our affiliated banks to pay dividends to Bankshares' common stockholders. Federal and state bank regulations restrict the amounts when our affiliated banks pay dividends directly or indirectly to us, when making any extensions of credit to us, when transferring assets to us and when investing in our stock or securities. These regulations also prevent us from borrowing from our affiliated banks unless the loans are secured by collateral. In addition, we cannot assure that our affiliated banks will be able to continue to pay dividends to us at past levels, if at all. If we do not receive sufficient cash dividends or borrowings from our affiliate banks, we may not have sufficient funds to pay dividends on common stock.

ITEM 1B. UNRESOLVED STAFF COMMENTS

There were no unresolved staff comments as of December 31, 2005.

ITEM 2. PROPERTIES

The main offices of Bankshares and MSD&T are located in a 21-story building at Two Hopkins Plaza in Baltimore, Maryland, which is owned by MBC Realty, LLC, a wholly owned subsidiary of Harbor Group International, L.L.C. Pursuant to a lease agreement by and between MBC Realty, LLC (which was previously owned by Bankshares) and MSD&T, effective as of December 13, 2004, MSD&T agreed to lease up to approximately 179,000 square feet of prime office space and approximately 27,000 square feet of back-office and storage space at Two Hopkins Plaza, for a term of ten years. At December 31, 2005, MSD&T and Bankshares occupied approximately 206,000 square feet. The lease agreement contains two five-year renewal options. The lease agreement requires aggregate annual rent of approximately \$3.9 million in 2005. At December 31, 2005, Bankshares also occupied approximately 132,000 square feet of leased space in a building located in Linthicum, Maryland, in which its operations and certain other departments are located, and a 7,000 square

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foot call center facility in Federalsburg, Maryland. The Linthicum and Federalsburg properties are owned by Bankshares. Of the 240 banking offices, 112 are owned in fee, 33 are owned subject to ground leases and 95 are leased, with aggregate annual rentals, not including the branch located at Two Hopkins Plaza, of approximately \$10.6 million as of December 31, 2005.

ITEM 3. LEGAL PROCEEDINGS

Between 2001 and 2003, on behalf of either individual plaintiffs or a putative class of plaintiffs, eight separate actions were filed in state and federal court against Community Bank of Northern Virginia (CBNV) and other defendants challenging the validity of second mortgage loans the defendants made to the plaintiffs. All of the cases were either filed in or removed to the federal district court for the Western District of Pennsylvania. In June 2003, the parties to the various actions informed the court that they had reached an agreement in principle to settle the various actions. On July 17, 2003, the court conditionally certified a class for settlement purposes, preliminarily approved the class settlement, and directed the issuance of notice to the class.

Thereafter, certain plaintiffs who had initially opted out of the proposed settlement and other objectors challenged the validity of the settlement in the district court. The district court denied their arguments and approved the settlement. These opt out plaintiffs and other objectors appealed the district court's approval of the settlement to the Third Circuit Court of Appeals. In August 2005, the Third Circuit reversed the district court's approval of the settlement and remanded the case to the district court with instructions to consider and address certain specific issues when re-evaluating the settlement. Certain individuals who were excluded from the settlement class have filed two actions on behalf of a putative class of plaintiffs alleging claims similar to those raised in the initial filing. These actions recently were consolidated in the Western District of Pennsylvania.

ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

No matter was submitted during the fourth quarter of the fiscal year covered by this Report to a vote of security holders, which is required to be disclosed pursuant to the instructions contained in the form for this Report.

SPECIAL ITEM: EXECUTIVE OFFICERS OF THE REGISTRANT

The Bankshares officers who file reports under Section 16 of the Securities Exchange Act of 1934 are:

Name	Position	Age
Edward J. Kelly, III	Chairman of the Board, President and Chief Executive Officer	52
Alexander T. Mason	Vice Chairman and Chief Operating Officer	54
Jay M. Wilson	Vice Chairman and Chairman and Chief Executive Officer, Investment & Wealth Management	59
J. Marshall Reid	Executive Vice President, Banking	60
Peter W. Floeckher, Jr.	Executive Vice President, Affiliate Management	56
Terry L. Troupe	Executive Vice President and Chief Financial Officer	58

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John L. Unger	Executive Vice President, General Counsel and Secretary	52
Michael M. Paese	Executive Vice President, Chief Administrative Officer, Chief Risk Officer and Deputy General Counsel	38
Deborah A. Kakaris	Executive Vice President, Operations and Technology Services	42
Kaye A. Simmons	Senior Vice President and Treasurer, Bankshares	50
William T. Skinner, Jr.	Senior Vice President and Controller	58

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No family relationships, as defined by the rules and regulations of the Securities and Exchange Commission, exist

among any of the Executive Officers. All officers are elected annually by the Board of Directors and hold office at the pleasure of the Board.

Effective March 1, 2001, Mr. Kelly became President and Chief Executive of Bankshares and Chairman of the Board and Chief Executive Officer of MSD&T. In addition, effective March 1, 2003 Mr. Kelly became Chairman of Bankshares. Mr. Kelly served as Managing Director, Head of Global Financial Institutions, and as Co-Head of Investment Banking Client Management of J. P. Morgan, Chase & Co. during January 2001. Prior thereto, he was a Managing Director of J. P. Morgan & Co. Incorporated and held the following additional positions with that Company: Head, Global Financial Institutions from February, 2000 through December, 2000; Co-Head, Global Financial Institutions and Head, Latin America Investment Banking from December 1997 through February 2000; Member, Global Investment Banking Committee from December 1997 through December 2000; and Co-Head, Financial Institutions (Americas) from February 1996 through December 1997.

Mr. Mason joined Bankshares in November 2003, and is Vice Chairman of Bankshares. Effective January 2, 2004, he was named Bankshares Chief Operating Officer. Prior to joining Bankshares, he was Vice Chairman of Deutsche Bank in the Americas and Managing Director of Deutsche Bank Securities. He also served as chief operating officer of the firm's Global Corporate Finance Department and headed up the firm's Global Industry Group practice. He was elected a director of MSD&T in January 2005, and a director of Bankshares in January 2005.

Mr. Wilson has been a Vice Chairman of Bankshares and Chief Executive Officer of the Investment and Wealth Management Division of MSD&T since January 2005. From September 1998 until December 2004, he was General Partner of Spring Capital Partners, L.P., a private equity fund providing expansion and acquisition capital to emerging growth companies. He was elected a director of MSD&T in January 2005, and a director of Bankshares in January 2005.

Mr. Reid was elected President and Chief Operating Officer of MSD&T in September 1997. He joined MSD&T as a Senior Vice President in 1993 and served as an Executive Vice President from 1994 until September 1997.

Mr. Floeckher was appointed Executive Vice President and Head of the Affiliates for Bankshares in November 2003. He served as President and Chief Executive Officer of Citizens National Bank from 1995 until November 2003.

Mr. Floeckher is responsible for oversight of the Banks, which includes risk management, compliance and enhanced performance through coordinated sharing of best practices.

Mr. Troupe has been Chief Financial Officer of Bankshares and MSD&T since he joined the Bank in September 1996.

Mr. Unger became General Counsel on March 23, 2002 and was elected Secretary of Bankshares and MSD&T on July 1, 2002. Prior to joining Bankshares, Mr. Unger was General Counsel to IMI Resort Holdings, Inc., a privately held real estate company in Greenville, South Carolina.

Mr. Paese was named Chief Administrative Officer of Bankshares in November 2004 and became Chief Risk Officer on January 2, 2005. He joined MSD&T as a Senior Vice President and Deputy General Counsel in January 2003. Before joining Mercantile, Mr. Paese was Senior Counsel to the Financial Services Committee of the U.S. House of Representatives (minority). Mr. Paese advised the Committee on legal and

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policy issues relating to U.S. capital markets and corporate governance. Prior thereto, Mr. Paese was a Vice President in equity capital markets, at J. P. Morgan & Co. Incorporated. Prior thereto, Mr. Paese was an associate at Davis Polk & Wardwell.

Mrs. Kakaris has been an Executive Vice President of Bankshares and MSD&T since 2002. She is responsible for Operations and Technology Services. Mrs. Kakaris joined the bank in 1988 and served as a Senior Vice President from 1997 until March 2002.

Ms. Simmons joined Bankshares in 2003, after the merger with F&M Bancorp. She had been Treasurer of F&M Bancorp since 2000 and Executive Vice President and Chief Financial Officer of Farmers & Mechanics Bank since 2000. Prior to that time, Ms. Simmons served as Senior Vice President of Finance and Treasurer of Citizens Bancorp from 1989 to 1997.

Mr. Skinner has been Senior Vice President and Controller of Bankshares since 1998. He served as Controller of MSD&T since 1996. Mr. Skinner joined MSD&T in 1979.

PART II

ITEM 5. MARKET FOR REGISTRANT'S COMMON EQUITY, RELATED STOCKHOLDER MATTERS AND ISSUER PURCHASES

For information regarding market prices, dividends on Bankshares common stock, and the number of Bankshares stockholders, see the information set forth under the captions "Dividends" and "Recent Common Stock Prices" in Item 7 of this Annual Report.

Item 6. Selected Financial Data

Five-Year Selected Financial Data

Years Ended December 31, (Dollars in thousands, except per share data)	2005	2004	2003	2002	2001
OPERATING RESULTS					
Net interest income	\$ 617,126	\$ 545,781	\$ 472,349	\$ 441,035	\$ 417,327
Net interest income - taxable equivalent	623,973	552,525	479,109	447,228	423,751
Provision for loan losses	1,576	7,221	12,105	16,378	13,434
Noninterest income	243,120	213,929	183,572	144,519	146,404
Noninterest expense	420,821	391,958	337,447	272,608	263,959
Net income	276,319	229,407	196,814	190,238	181,295
PER COMMON SHARE DATA (1)					
Basic net income	\$ 2.28	\$ 1.93	\$ 1.80	\$ 1.82	\$ 1.71
Diluted net income	2.26	1.92	1.79	1.81	1.70
Dividends paid	0.99	0.92	0.86	0.79	0.73
Book value at period end	17.81	16.12	15.39	12.83	11.75
Market value at period end	37.63	34.80	30.39	25.73	28.69
Market range:					
High	40.09	35.39	30.63	30.24	29.67
Low	32.27	26.87	20.11	21.38	22.42
BALANCE SHEET DATA AT PERIOD END					
Total loans	\$ 11,607,845	\$ 10,228,433	\$ 9,272,160	\$ 7,312,027	\$ 6,906,246
Total investment securities	3,106,287	2,928,870	3,070,645	2,550,491	2,327,760
Total assets	16,421,729	14,425,690	13,695,472	10,790,376	9,928,786
Total deposits	12,077,350	10,799,199	10,262,553	8,260,940	7,447,372
Shareholders' equity	2,194,722	1,917,683	1,841,441	1,324,358	1,230,206
PROFITABILITY RATIOS					
Return on average assets	1.78%	1.64%	1.64%	1.88%	1.96%
Return on average equity	13.18	12.26	13.15	15.12	15.15
Return on average tangible equity	19.54	18.00	16.55	16.69	17.67
Net interest rate spread - taxable equivalent	3.88	3.99	3.92	4.05	3.79
Net interest margin on earning assets - taxable equivalent	4.44	4.35	4.32	4.65	4.83
Efficiency ratio	48.53	51.14	50.92	46.07	46.30
Cash operating efficiency ratio	47.61	49.63	49.52	45.80	45.10
CAPITAL RATIOS					
Average equity to average assets	13.51%	13.38%	12.51%	12.43%	12.97%
Average tangible equity to average tangible assets	9.70	9.70	10.34	11.45	11.89
Dividend payout ratio (1)	43.42	47.67	47.78	43.41	42.69
Risk-based capital:					
Tier 1 capital ratio	11.82	12.33	12.46	15.00	15.41
Total capital ratio	15.37	16.23	16.63	16.29	16.72
Leverage ratio	9.81	10.02	9.60	11.20	11.60
Bank offices	240	226	227	185	188
Employees	3,606	3,479	3,565	2,885	2,949

**CREDIT QUALITY DATA AT PERIOD
END**

Net charge-offs	\$	991	\$	13,556	\$	8,574	\$	19,240	\$	10,583
Nonaccrual loans		22,565		30,898		50,352		33,371		32,919
Other real estate owned, net		667		212		191		132		181
Total nonperforming assets		23,232		31,110		50,543		33,503		33,100

CREDIT QUALITY RATIOS

Net charge-offs as a percent of period-end loans		0.01%		0.13%		0.09%		0.26%		0.15%
Allowance for loan losses as a percent of period-end loans		1.35		1.46		1.68		1.90		2.05
Allowance for loan losses as a percent of nonperforming loans		694.32		482.24		308.50		415.33		429.73
Nonperforming assets as a percent of period-end loans and other real estate owned		0.20		0.30		0.55		0.46		0.48

(1) On January 10, 2006, Bankshares announced a three-for-two stock split on its common stock. Per share amounts and other applicable information have been adjusted to give effect to the split.

Five-Year Summary of Consolidated Income

Years Ended December 31, (Dollars in thousands)	2005	2004	2003	2002	2001
INTEREST INCOME					
Interest and fees on loans	\$ 700,832	\$ 546,531	\$ 472,943	\$ 468,678	\$ 543,242
Interest on securities	112,769	111,003	113,254	112,091	99,624
Other interest income	2,436	1,503	3,397	4,848	5,986
Total interest income	816,037	659,037	589,594	585,617	648,852
INTEREST EXPENSE					
Interest on deposits	139,917	83,403	93,190	122,569	199,703
Interest on short-term borrowings	26,266	7,844	5,604	11,259	25,120
Interest on long-term debt	32,728	22,009	18,451	10,754	6,702
Total interest expense	198,911	113,256	117,245	144,582	231,525
NET INTEREST INCOME	617,126	545,781	472,349	441,035	417,327
Provision for loan losses	1,576	7,221	12,105	16,378	13,434
NET INTEREST INCOME AFTER PROVISION FOR LOAN LOSSES	615,550	538,560	460,244	424,657	403,893
NONINTEREST INCOME					
Investment and wealth management	95,756	90,050	78,933	68,435	69,331
Service charges on deposit accounts	43,885	44,263	39,194	33,539	30,101
Other income	103,479	79,616	65,445	42,545	46,972
Total noninterest income	243,120	213,929	183,572	144,519	146,404
NONINTEREST EXPENSES					
Salaries and employee benefits	246,397	232,297	198,043	165,371	152,887
Net occupancy and equipment expenses	60,255	55,746	52,366	40,368	38,448
Amortization of goodwill					9,072
Other expenses	114,169	103,915	87,038	66,869	63,552
Total noninterest expenses	420,821	391,958	337,447	272,608	263,959
Income before income taxes	437,849	360,531	306,369	296,568	286,338
Applicable income taxes	161,530	131,124	109,555	106,330	105,043
NET INCOME	\$ 276,319	\$ 229,407	\$ 196,814	\$ 190,238	\$ 181,295

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

I. EXECUTIVE OVERVIEW

Mercantile Bankshares Corporation (Bankshares) is a regional multibank holding company headquartered in Baltimore, Maryland. At December 31, 2005, Bankshares had \$16.4 billion in assets, \$11.6 billion in loans and \$12.1 billion in deposits. It is the largest bank holding company headquartered in the state of Maryland. The two principal lines of business are Banking and Investment & Wealth Management (IWM), delivered through the lead bank Mercantile-Safe Deposit and Trust Company (MSD&T) and 10 affiliated banks. See Segment Reporting in section II. ANALYSIS OF OPERATING RESULTS FOR 2005 TO 2004 for more information.

On January 10, 2006, Bankshares announced a three-for-two stock split on its common stock, payable in the form of a stock dividend on January 27, 2006 to stockholders of record as of the close of business on January 20, 2006. Certain shares, average shares and per share amounts have been adjusted to give effect to the split.

Bankshares recorded its 30th consecutive year of increased net income in 2005. Net income for Bankshares was \$276.3 million for the year ended December 31, 2005, compared with \$229.4 million for the year 2004, representing a 20.4% increase. Diluted net income per common share for 2005 increased by 17.7% to \$2.26 compared with \$1.92 for 2004. The most noteworthy factors affecting 2005 earnings were the acquisition of Community Bank of Northern Virginia (CBNV), improvement in the net interest margin, growth in loans and improving credit quality.

On May 18, 2005, Bankshares completed its acquisition of CBNV, a bank headquartered in Sterling, Virginia, which was merged into MSD&T. CBNV operated 14 branch offices in the Northern Virginia metropolitan market at the time of the acquisition. The consideration paid to CBNV shareholders in connection with the acquisition was comprised of \$82.9 million in cash and 3.7 million shares of Bankshares common stock as adjusted to give effect to the stock split. CBNV transactions have been included in Bankshares financial results subsequent to May 18, 2005. The assets and liabilities of CBNV were recorded on the Consolidated Balance Sheet at their respective fair values. The fair values were determined as of May 18, 2005, and are subject to refinement as further information becomes available. The transaction resulted in total assets acquired as of May 18, 2005 of \$888.2 million, including \$671.0 million of loans and leases; liabilities assumed were \$842.3 million, including \$626.9 million of deposits. Bankshares recorded \$162.1 million of goodwill and \$4.6 million of core deposit intangible (CDI). CDI is subject to amortization and is being amortized over nine years on a straight-line basis.

The Board of Governors of the Federal Reserve System (Federal Reserve Board) increased short-term rates by 125 basis points in 2004 and 200 basis points in 2005. The net interest margin improved 9 basis points to 4.44% for 2005 from 4.35% for 2004, which compares favorably with the increase of 3 basis points experienced during 2004. The net interest margin for 2003 was 4.32%. The 2005 net interest margin increase was attributable to a 20 basis point increase in the benefit derived from noninterest-bearing sources of funds, which was partially offset by an 11 basis point decline in the spread between the yield on earning assets and the cost of interest-bearing liabilities. Competition to gather deposits increased throughout the year and resulted in higher rates paid on these funds. See Analysis of Interest Rate and Interest Differentials and the discussions of Net Interest Income and Interest Rate Risk found in Item 7 of this report.

At December 31, 2005, loans outstanding were \$11.6 billion, an increase of 13.5% over the \$10.2 billion outstanding at December 31, 2004. Much of the lending growth was driven by strong real estate markets for both commercial and residential properties. Construction loans at December 31, 2005 were \$1.6 billion, an increase of 26.7% from \$1.3 billion at December 31, 2004. Commercial real estate loans were \$3.7

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billion at December 31, 2005, an increase of 18.6% from \$3.1 billion at December 31, 2004. Commercial and industrial loans grew by 3.2%.

Credit quality measures improved on both an absolute and relative basis. Nonperforming loans declined from \$30.9 million at December 31, 2004 to \$22.6 million at December 31, 2005. This is the lowest level reported at year-end since December 31, 1999. Nonperforming loans as a percent of year-end loans were 0.19% at December 31, 2005. On a relative basis, this is their lowest level at year-end in more than 20 years. Reflecting these improvements, the provision for loan losses declined by \$5.6 million to \$1.6 million for the year ended December 31, 2005.

In 2005 Bankshares experienced improvements in return on average assets (ROA) and return on average shareholders' equity (ROE). The 2005 ROA increased to 1.78% from 1.64% in 2004. Bankshares' 2005 ROE increased to 13.18% from 12.26% in 2004. Average shareholders' equity to average assets was at 13.51% for 2005, an increase from 13.38% for 2004.

Bankshares also reports cash operating earnings, defined as GAAP (Generally Accepted Accounting Principles) earnings excluding the amortization of intangible assets associated with purchase accounting for business combinations; securities gains and losses; and other significant gains, losses or expenses (such as those associated with integrating acquired entities' operations into Bankshares) unrelated to Bankshares' core operations. We believe these non-GAAP measures provide information useful to investors in understanding our ongoing core business and operational performance trends. These measures should not be viewed as a substitute for GAAP. Management believes presentations of financial measures excluding the impact of certain items provide useful supplemental

information and better reflect its core operating activities. In order to arrive at core business operating results, the effects of certain noncore business transactions, such as gains and losses on the sales of securities, amortization of intangibles, restructuring charges and merger-related expenses, have been excluded. Management reviews these same measures internally. For instance, the cash operating efficiency ratio, rather than the GAAP basis efficiency ratio, is used to measure management's success at controlling ongoing, core operating expenses. We believe these measures are consistent with how investors and analysts typically evaluate our industry, and by providing these measures, we facilitate their analysis. Cash operating earnings totaled \$279.6 million for 2005, an increase of 18.7% over \$235.5 million for 2004.

Additionally, management believes that reporting several key measures based on tangible assets (total assets less intangible assets) and tangible equity (total equity less intangible assets) is important, as this more closely approximates the basis for measuring the adequacy of capital for regulatory purposes. For the year 2005, the return on average tangible assets was 1.89% compared with 1.75% for 2004. The ratio of average tangible equity to average tangible assets was 9.70% for 2005 and 2004. See Reconciliation of Non-GAAP Measures for the reconciliation of GAAP measures to non-GAAP measures in the section captioned II. ANALYSIS OF OPERATING RESULTS FOR 2005 TO 2004 elsewhere in Item 7.

The remaining sections of Management's Discussion and Analysis of Financial Condition and Results of Operations will provide a more detailed explanation of the important trends and material changes in components of our consolidated financial statements. The discussion suggests that sustaining future earnings growth comparable to our experience in past years will require, among other things, efficient generation of loan growth in a competitive market, while maintaining an adequate spread between yields on earning assets and the cost of funds. Our degree of success in meeting these goals depends on unpredictable factors such as possible changes in prevailing interest rates, the mix of deposits, credit quality and general economic conditions. This discussion and analysis should be read in conjunction with the consolidated financial statements and other financial information presented in this Report.

NET INCOME
(Dollars in millions)
Five-Year Compound Growth Rate: 9.5%

DILUTED EARNINGS PER SHARE
(In dollars)
Five-Year Compound Growth Rate: 6.1%

TOTAL ASSETS
(Dollars in millions) December 31, 2005
Five-Year Compound Growth Rate: 12.9%

INTEREST YIELDS AND RATES
(Tax-equivalent basis)

Critical Accounting Policies and Related Estimates

Set forth below is a discussion of the accounting policies and related estimates that management believes are the most critical to understanding Bankshares' consolidated financial statements, financial condition and results of operations, and which require complex management judgments, uncertainties and/or estimates. Information regarding Bankshares' other accounting policies is included in Note No. 1 (Significant Accounting Policies) of the financial statements.

Investment Securities

Investment securities classified as held-to-maturity are acquired with the intent and ability to hold until maturity and are carried at cost. Investment securities classified as available-for-sale are acquired to be held for indefinite periods and may be sold in response to changes in interest rates and/or prepayment risk or for liquidity management purposes. These securities are carried at fair value. Securities may become impaired on an other-than-temporary basis, which involves a degree of judgment. Therefore, an assessment is made at the end of each quarter to determine whether there have been any events or economic circumstances to indicate that a security is impaired on an other-than-temporary basis. An other-than-temporary impairment may develop if, based on all available evidence, the carrying amount of the investment is not recoverable within a reasonable period. Factors considered in making this assessment include among others, the intent and ability to hold the investment for a period sufficient for a recovery in value, external credit ratings and recent downgrades, market price fluctuations due to factors other than interest rates, and the probability of collection of contractual cash flows. Securities on which there is an unrealized loss deemed to be other-than-temporary are written down to fair value, and the adjustment is recorded as a realized loss.

Allowance for Loan Losses

Arriving at an appropriate level of allowance for loan losses involves a high degree of judgment. Bankshares' allowance for loan losses provides for probable losses based on evaluations of known and inherent risks in the loan portfolio. Management uses historical quantitative information to assess the adequacy of the allowance for loan losses as well as qualitative information about the prevailing economic and business environment among other things. The allowance for loan losses is comprised of specific allocations to impaired loans and general allocations to pools of loans not deemed impaired that include an unallocated amount.

The specific allowance allocation is based on an analysis of the loan portfolio. Each loan with an outstanding balance in excess of a specified threshold that is either in nonaccrual status or on the Watchlist is evaluated. The Watchlist represents loans identified and closely followed by management. They possess certain qualities or characteristics that may lead to collection and loss issues. The identified loans are evaluated for potential loss in accordance with Statement of Financial Accounting Standards (SFAS) No. 114, Accounting for Creditors for Impairment of a Loan and SFAS No. 118, Accounting for Creditors for Impairment of a Loan - Income Recognition and Disclosure by analyzing current collateral values or present value of cash flows, as well as the capacity of the guarantor, as applicable.

The general allowance calculation begins with segmentation of the remaining (unimpaired) portfolio according to loan types. Historical loss factors are maintained for each loan type, providing the starting point of the analysis. Historical loss factors are applied to all non-Watchlist loans. Management is currently utilizing the past five-year loss history specific to each major segment to perform the allocation. Historical loss factors are adjusted to reflect the point in time that management initially identified a potential impairment loss in such risk-rated loans as opposed to when such loss is actually taken as a charge-off against the allowance. This adjustment is necessary, as Bankshares' practice has generally been to work with its borrowers through their economic difficulties and record a charge-off when all recovery efforts have been exhausted. Accordingly, historical losses may tend to lag the national and regional economic cycles. Bankshares also has developed data on probability of default and loss given default, which have been incorporated for the higher risk rated credits, which include Watchlist loans that are not currently impaired. Those loss factors are then applied to all loans within the same risk rating. Qualitative factors that may cause credit losses to deviate from average historical experience are then developed. These include, but are not limited to: changes in the volume and severity of past due loans; changes in the volume of Watchlist loans and nonaccruals; concentrations in a specific industry or geographic location; administrative risk concerns that include changes in the loan review and loan grading system; changes in lending policies and procedures (which include underwriting, collection, charge-off and recovery practices); changes in management or the staff of any previously

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mentioned areas; and current economic conditions and indicators. Both internal and external peer data are utilized as applicable to establish these factors. Management's judgment and experience are key to this process. These factors are revised to address current conditions and trends in the portfolio.

The allowance amount not allocated represents the differential between the combined specific and general allocations and the actual allowance recorded on the books. The unallocated allowance recognizes the imprecision inherent in estimating and measuring loss when allocating the allowance to individual, or pools of, loans. It also takes into consideration the allowance level deemed appropriate by each affiliate based on its local knowledge and input from bank regulators and their view from the standpoint of safety and soundness, among other factors.

For a full discussion of Bankshares' methodology for assessing the adequacy of the allowance for loan losses, see Allowance for Loan Losses found elsewhere in Item 7 and Note No. 1 (Significant Accounting Policies) of the financial statements.

Loans in Nonaccrual Status or Deemed to Be Impaired

A loan asset will be classified and placed into nonaccrual status when the principal or interest payments on any loan (e.g., commercial, mortgage and construction loans) are past due 90 days or more at the end of a calendar quarter or the payment in full of principal or interest is not expected. Any accrued but uncollected interest is reversed at that time. Consumer installment loans are charged off when they become 90 days past due at the end of the quarter. Additionally, a loan may be put on nonaccrual status sooner than 90 days, if in management's judgment, the loan or portion thereof is deemed uncollectible. Bankshares ceases to accrue interest income on such loans. Subsequent receipts on nonaccrual loans are recorded as a reduction of principal, and interest income is recorded only once principal recovery is reasonably assured. Generally, a loan may be restored to accrual status when all past due principal, interest and late charges have been paid and the Bank expects repayment of the remaining contractual principal and interest.

A loan is considered impaired, based on current information and events, if it is probable that Bankshares will not collect all principal and interest payments according to the contractual terms of the loan agreement. Impaired loans do not include large groups of smaller balance homogeneous loans that are evaluated collectively for impairment (e.g., residential mortgages and consumer installment loans). The impairment of a loan is measured based on the present value of expected future cash flows discounted at the loan's effective interest rate, or the fair value of the collateral if the repayment is expected to be provided predominantly by the underlying collateral. A majority of Bankshares' impaired loans are measured by reference to the fair value of the collateral.

Income Taxes

Bankshares recognizes deferred income tax assets and liabilities for the future tax effects of temporary differences, net operating loss carryovers and tax credits. Deferred tax assets are subject to management's judgment, based on available evidence, that future realization is more likely than not. If management determines that Bankshares may be unable to realize all or part of net deferred tax assets in the future, then Bankshares would be required to record a valuation allowance against such deferred tax asset. In such an event, a direct charge to income tax expense may be required to reduce the recorded value of the net deferred tax asset to the expected realizable amount. For more information regarding Bankshares' accounting for income taxes, see Note No. 12 (Income Taxes) of the financial statements.

Valuation of Goodwill/Intangible Assets and Analysis for Impairment

Bankshares has increased its market share, in part, through the acquisition of entire financial institutions accounted for under the purchase method of accounting, as well as from the purchase of other financial institutions' branches (not the entire institution). Bankshares is required to record assets acquired and liabilities assumed at their fair value, which involves an estimate determined by the use of internal or other valuation techniques. See Note No. 19 (Goodwill and Intangible Assets) of the financial statements for further information on the accounting for goodwill and other intangible assets.

II. ANALYSIS OF OPERATING RESULTS FOR 2005 TO 2004

Segment Reporting

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Bankshares reports two distinct business segments, Banking and Investment & Wealth Management, for which financial information is segregated for use in assessing performance and allocating resources when reporting to the Board of Directors. The Banking segment consists of the group of 11 affiliate banks and mortgage-banking activities. A schedule disclosing the details of these operating segments can be found in Note No. 16 (Segment Reporting) of the financial statements. Segment financial information is subjective and, unlike financial accounting, is not necessarily based on GAAP. As a result, financial information of the reporting segments is not necessarily comparable with similar information reported by others and may not be comparable with Bankshares' consolidated results. Certain expense amounts, such as operations overhead, have been reclassified from internal financial reporting in order to provide for proper allocation of costs in the reported data.

In the fourth quarter of 2005, the Private Banking Group of MSD&T was consolidated into the Private Banking Group of IWM. The segment results have been reclassified to conform to current presentation for comparability. Additionally, as loans and deposits are now being reflected in the IWM segment, a funds transfer-pricing model was utilized to match the duration of the funding and investment of the IWM segment's assets and liabilities.

Banking

The Banking segment includes the Retail, Small Business, Commercial and Mortgage Banking lines of business. Banking products include:

Retail Banking: Checking, savings and money market accounts, time deposits and IRAs, insurance, equity lines and loans, lines of credit, and equipment and transportation (auto, recreational vehicle and marine) loans.

Small Business Banking: Deposit and credit products and services to businesses with annual revenues up to \$3.0 million or credit needs up to \$750.0 thousand, including receivables and inventory financing, equipment leases, and real estate financing.

Commercial Banking: Commercial deposit, lending and commercial real estate solutions to businesses typically with annual revenues between \$4.0 million and \$50.0 million, and including commercial loans and lines of credit, letters of credit, asset-based lending, commercial real estate, construction loans, capital market products and insurance.

Mortgage Banking: Commercial, multi-family and residential mortgage loan origination and servicing.

The following table presents selected Banking segment information for the three years ended December 31, 2005.

(Dollars in thousands)	2005	2004	2003
Net interest income	\$ 609,758	\$ 534,468	\$ 469,704
Provision for loan losses	(1,576)	(7,221)	(12,105)
Noninterest income	132,154	114,477	98,426
Noninterest expenses	(341,543)	(318,706)	(268,656)
Adjustments	17,610	18,098	9,941
Income before income taxes	416,403	341,116	297,310
Income tax expense	(145,044)	(120,253)	(104,815)
Net income	\$ 271,359	\$ 220,863	\$ 192,495
Average loans	\$ 10,876,592	\$ 9,591,510	\$ 7,969,464
Average earning assets	13,917,161	12,576,465	10,966,978
Average assets	15,235,634	13,413,992	11,581,942
Average deposits	11,444,361	10,323,349	9,010,069
Average equity	1,891,834	1,449,355	1,280,643

In the second quarter of 2005, Bankshares consolidated Fidelity Bank into Farmers & Mechanics Bank. The consolidation of these banks enables the surviving bank, Farmers & Mechanics, to serve its local customers with greater size and expertise. Also in the second quarter of 2005, Mercantile Potomac Bank merged into MSD&T. This combination allows Bankshares to provide the capital resources necessary for expansion into the Washington, D.C. and Northern Virginia markets. Further, the merger of CBNV into the Mercantile Potomac Division of MSD&T was completed in the second quarter. Mercantile Potomac Bank and Fidelity Bank will continue to serve their respective markets under their own names with local leadership and decision-making.

In the third quarter of 2004, Bankshares consolidated 11 affiliate banks into four banks. The consolidated banks shared common markets. The consolidation of these banks enables the surviving banks to serve their local customers with greater size, scale and expertise. This initiative was not undertaken to reduce operating costs, although some savings arose out of the consolidation. The initiative was undertaken to enable these

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banks to streamline operating processes, controls and compliance efforts; recruit seasoned professionals to these markets; and provide a greater breadth of services at the local level. Bankshares is committed to the affiliate bank model, whereby local boards of directors provide strong oversight, and bank presidents maintain strong relationships within the community. In 2004, Banking incurred approximately \$3.6 million in restructuring charges related to the consolidations. A majority of these costs was in severance charges and other personnel costs of approximately \$2.3 million, with \$1.1 million in legal and consulting fees.

The Banking segment, which contributed 86.0% of total revenue, continued to experience strong loan and deposit growth. The Banking segment was the primary beneficiary of the CBNV acquisition. The addition of CBNV during 2005 had an impact on nearly every line of the consolidated balance sheet and statement of consolidated income, as well as the performance of the Banking segment, as set forth below. Net income for Banking for 2005 increased 22.9% to \$271.4 million from \$220.9 million for 2004. The Banking segment's operating leverage improved over the comparative period, with revenue growth of 15.4% and expense growth of 7.8%, which includes the addition of CBNV. Net interest income for Banking increased 14.1% to \$609.8 million for 2005 from \$534.5 million for 2004. The growth in net interest income in 2005 was largely attributable to a 13.4% increase in average loans outstanding, with the CBNV acquisition contributing approximately 32.1% of this growth. See the analysis of net interest income included in the section captioned "Net Interest Income and Net Interest Margin" included elsewhere in this document.

As a reflection of the overall improvement in the Banking credit quality trends, Banking recorded a decrease of \$5.6 million in the provision for loan losses for 2005. Banking recorded a provision for loan losses of \$1.6 million in 2005 compared with \$7.2 million in 2004. The allowance as a percentage of loans was 1.35% at year-end 2005 compared with 1.46% at year-end 2004.

Average loans outstanding increased 13.6% to \$10.9 billion for 2005. Commercial loans excluding the leasing portfolio (which is in the process of paying down as Bankshares has reduced the scope of this business) increased 5.0%, while commercial real estate increased 19.0% from the 2004 average. Construction loans increased 28.7%, while consumer loans increased 13.0%, from 2004 levels. Residential real estate loans increased 9.1% from 2004. The CBNV acquisition contributed approximately 32.1% of the average loan growth in 2005.

Average deposits for Banking increased 10.9% to \$11.4 billion in 2005. All deposit categories increased from the 2004 average outstandings. The strongest year-over-year growth was in certificates of deposit, noninterest-bearing deposits and money market deposit accounts with growth percentages of 19.9%, 9.3% and 8.5%, respectively. The CBNV acquisition contributed approximately 34.8% of this deposit growth.

The year-over-year increases in noninterest income and noninterest expenses from 2004 are primarily attributable to the CBNV acquisition, increased deposit activities and branch expansion. Noninterest income increased by \$17.7 million in 2005, with gains on sales of bank premises increasing \$2.7 million, mortgage banking fees increasing \$3.5 million, nonmarketable investments increasing \$2.6 million, insurance fees increasing \$1.8 million and electronic banking fees increasing \$2.2 million. These gains were partially offset by a decrease of \$0.6 million in deposit service charges. Noninterest expenses increased by \$22.8 million from 2004. This increase was partially attributable to the \$8.2 million in additional operating expenses related to the CBNV acquisition. More than 41.0% of the increase in total noninterest expense is related to salaries and benefits, which grew by \$11.2 million. Incentive compensation linked to improved operating performance increased \$7.7 million and pension expense increased \$1.3 million. Occupancy expense increased by \$3.6 million and electronic banking costs increased by \$2.4 million.

Investment & Wealth Management

IWM includes Retail Brokerage Services, Private Wealth Management, Institutional Investment Management, Private Banking and Mercantile Funds. IWM provides a full line of investment products and retirement, tax and estate planning services. IWM products include:

Retail Brokerage Services: Stocks, bonds, proprietary and nonproprietary mutual funds, fixed and variable annuities.

Private Wealth Management Services: Proprietary and nonproprietary mutual funds, proprietary and nonproprietary separate account management, customized wealth advisory services, defined benefit and defined contribution retirement services, family office services, individual and institutional trust services and custody services.

Institutional Investment Management: Sophisticated investment management and administrative services for employee retirement plans, profit-sharing plans and endowments.

Private Banking Services: Deposits, loans, and mortgages.

Mercantile Funds: Proprietary stock, taxable and nontaxable fixed income, money market mutual funds and registered hedge funds of funds.

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The following table presents selected IWM segment information for the three years ended December 31, 2005.

(Dollars in thousands)	2005	2004	2003
Net interest income	\$ 7,819	\$ 10,172	\$ 7,803
Provision for loan losses			
Noninterest income	95,958	90,516	78,608
Noninterest expenses	(72,929)	(69,575)	(63,870)
Adjustments	(3,885)	(3,603)	(3,483)
Income before income taxes	26,963	27,510	19,058
Income tax expense	(10,785)	(11,004)	(7,623)
Net income	\$ 16,178	\$ 16,506	\$ 11,435
Average loans	\$ 152,572	\$ 127,739	\$ 119,285
Average earning assets	152,572	127,739	119,285
Average assets	152,941	127,949	119,501
Average deposits	199,159	175,096	132,575
Average equity	34,354	31,219	28,834

In the fourth quarter of 2005, the Private Banking Group of MSD&T was consolidated into the Private Banking Group of IWM. The segment results have been reclassified to conform to current presentation for comparability. Additionally, as loans and deposits are now being reflected in the IWM segment, a funds transfer-pricing model was utilized to match the duration of the funding and investment of the IWM's segment assets and liabilities.

Ongoing progress was made in expanding the IWM business and upgrading client services. Resources related to new business development and client service were added. Product breadth was enhanced with the expansion of the open architecture platform that provides clients with access to a selected group of external separate account managers and mutual funds to complement Bankshares' proprietary products. Resources were also added in the DC/Virginia market, and Bankshares' acquisition of CBNV has provided a larger distribution network in Northern Virginia.

Net income in IWM decreased slightly to \$16.2 million in 2005, from \$16.5 million in 2004 primarily due to a reduction in net interest income in the Private Banking Group. Net interest income declined due to lower earnings attributed to noninterest-bearing demand deposit accounts due to greater volatility in customer balances during 2005. Excluding the Private Banking Group, IWM net income increased \$1.3 million, or 11.5%, from the previous year. Pretax profit margins, prior to corporate overhead allocation, were 29.9% and 31.1% for 2005 and 2004, respectively.

The rise in equity markets immediately following the November 2004 election was sustained through most of 2005. While the S&P 500 ended 2005 only 2.8% ahead of December 2004, most months during the year were 4.0% to 6.0% ahead of the comparable month in 2004. Other major indices had mixed results. Between December 31, 2004 and December 31, 2005, the Dow Jones Industrial Average was down 0.6% and the Nasdaq was up 1.4%. In fixed income markets, the Lehman Aggregate Bond Index was down 2.5% for the year. Given the relatively balanced weighting of equities and fixed income within Bankshares' investment asset base, the markets overall provided a modest boost in 2005. As of December 31, 2005, 44% of IWM's managed assets were invested in equities, including real estate. Approximately 38% of IWM's managed assets were invested in fixed income securities and 18% were invested in cash and other.

Market Indices	As of December 31,		
	2005	2004	2003
Dow Jones Industrial Average	10717	10783	10454
Year-over-Year % Change	-0.6	3.1	25.3
S&P 500 Index-period-end	1248	1214	1112
Year-over-Year % Change	2.8	9.0	26.4
Nasdaq	2205	2175	2003
Year-over-Year % Change	1.4	8.6	50.0
Lehman Brothers US Aggregate Bond Index	101.9	104.6	106.0
Year-over-Year % Change	-2.5	-1.3	-1.9

Revenues increased \$3.1 million, or 3.1%, to \$103.8 million in 2005 from \$100.7 million in 2004. Revenue increases were realized in Private Wealth Management, Institutional Investment Management, Mercantile Funds, and Brokerage. Revenues declined in Private Banking despite strong loan and deposit growth. Growth in IWM revenues was principally due to stronger equity and real estate markets during 2005 compared with 2004, increased new sales in Private Wealth Management and increased brokerage activity.

Private Wealth Management benefited from a modest improvement in the equity markets, 19% growth in annualized revenues from new sales compared with the prior year and the addition of new assets at higher fees than the prevailing average. These trends were partially offset by a decline in income-related fees associated with the current low interest rate environment. The increase in revenues partially reflects a \$0.3 billion, or 2.1%, increase in Personal Assets Under Administration to \$12.5 billion. Personal Assets with Investment Responsibility increased \$0.1 billion, or 1.5%, to \$8.7 billion, while Assets with No Investment Responsibility increased \$0.2 billion, or 4.5%, to \$3.8 billion.

Institutional Investment Management benefited from an increase in real estate pension fees. This was partially offset by a decline in the revenues of our Boyd Watterson Asset Management (Boyd Watterson) subsidiary and the loss of one significant account in the custody area. The decline in revenues at Boyd Watterson is primarily attributable to a decline in equity assets under management and the spin-off of one part of its business. Total Institutional Assets Under Administration (including Boyd Watterson) declined \$1.6 billion, or 4.5%, to \$33.7 billion.

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Institutional Assets with Investment Responsibility declined \$0.6 billion, or 4.9%, to \$11.6 billion. Assets Under Administration with No Investment Responsibility declined \$1.0 billion, or 4.3%, to \$22.1 billion.

The Mercantile Funds benefited from higher assets flows into the funds and improved equity markets. Mercantile Fund assets increased \$0.1 billion, or 3.2%, to \$3.9 billion, driven by an 11.0% increase in personal trust assets. Brokerage commissions and income benefited from growth in the number of accounts and assets held in accounts. Brokerage assets increased 14.0% to \$1.0 billion. In the table below, Mutual Fund assets and Brokerage assets have been allocated to Personal and Institutional.

(Dollars in billions)	Year ended December 31,		
	2005	2004	2003
<i>Personal</i>			
Assets with Investment Responsibility	\$ 8.7	\$ 8.7	\$ 8.7
Assets with No Investment Responsibility	3.8	3.6	3.3
Total Personal	12.5	12.3	12.0
<i>Institutional</i>			
Assets with Investment Responsibility	11.6	12.2	12.2
Assets with No Investment Responsibility	22.1	23.1	21.6
Total Institutional	33.7	35.3	33.8
<i>Mutual Funds Not included Above</i>			
	0.3	0.2	0.2
<i>Total</i>			
Assets with Investment Responsibility	20.6	21.1	21.1
Assets with No Investment Responsibility	25.9	26.7	24.9
Total Assets Under Administration	\$ 46.5	\$ 47.8	\$ 46.0

At December 31, 2005, Assets Under Administration by IWM were \$46.5 billion, a decrease of \$1.3 billion, or 2.7%, from the prior year. Bankshares had investment responsibility for \$20.6 billion, down \$0.5 billion, or 2.4%, compared with the prior year. Additional revenue growth will depend on continued new sales and increased distribution, equity and bond market conditions and acquisitions, if any.

In 2005, expenses increased 4.8%, or \$3.3 million, to \$72.9 million, compared with \$69.6 million in 2004. Increases in personnel-related, technology and occupancy expenses were offset by decreases in professional services, travel and marketing expenses.

Bankshares Earnings Performance

ANALYSIS OF INTEREST RATES AND INTEREST DIFFERENTIALS

The following table presents the distribution of the average consolidated balance sheets, interest income/expense and yields earned and rates paid.

(Dollars in thousands)	Average Balance	2005 Income (1) / Expense	Yield (1) / Rate	Average Balance	2004 Income (1) / Expense	Yield (1) / Rate
Earning assets						
Loans: (2)						
Commercial and leasing	\$ 2,900,598	\$ 186,462	6.43%	\$ 2,725,452	\$ 145,170	5.33%
Commercial real estate	3,444,921	226,356	6.57	2,927,968	173,626	5.93
Construction	1,473,353	102,484	6.96	1,144,044	62,508	5.46
Residential real estate	1,761,955	105,312	5.98	1,643,504	98,596	6.00
Home equity lines	507,153	30,692	6.05	450,244	20,222	4.49
Consumer	941,571	54,283	5.77	828,197	50,940	6.15
Total loans	11,029,551	705,589	6.40	9,719,409	551,062	5.67
Federal funds sold, et al	51,826	2,434	4.70	59,848	1,501	2.51
Securities: (3)						
Taxable securities						
U.S. Treasury	494,763	17,906	3.62	741,127	28,710	3.87
U.S. Government agencies	922,597	30,143	3.27	810,014	28,554	3.53
Mortgage-backed	1,418,144	59,084	4.17	1,250,947	48,159	3.85
Other investments	63,067	2,497	3.96	57,193	2,389	4.18
Tax-exempt securities						
States and political subdivisions	87,992	5,229	5.94	94,308	5,404	5.73
Total securities	2,986,563	114,859	3.85	2,953,589	113,216	3.83
Interest-bearing deposits in other banks						
	197	2	1.21	158	2	1.17
Total earning assets	14,068,137	822,884	5.85	12,733,004	665,781	5.23
Cash and due from banks	309,646			291,540		
Bank premises and equipment, net	143,177			141,368		
Other assets	1,154,561			985,222		
Less: allowance for loan losses	(154,502)			(158,163)		
Total assets	\$ 15,521,019			\$ 13,992,971		
Interest-bearing liabilities						
Deposits:						
Savings	\$ 1,428,445	5,545	0.39	\$ 1,425,423	4,197	0.29
Checking plus interest accounts	1,399,215	2,367	0.17	1,289,295	1,899	0.15
Money market	1,651,513	23,036	1.39	1,571,462	9,584	0.61
Time deposits \$100,000 and over	1,627,194	51,714	3.18	1,314,423	26,101	1.99
Other time deposits	2,142,068	57,255	2.67	1,933,799	41,622	2.15
Total interest-bearing deposits	8,248,435	139,917	1.70	7,534,402	83,403	1.11
Short-term borrowings	1,105,988	26,266	2.37	932,493	7,844	0.84
Long-term debt	749,196	32,728	4.37	645,375	22,009	3.41
Total interest-bearing funds	10,103,619	198,911	1.97	9,112,270	113,256	1.24
Noninterest-bearing deposits	3,165,320			2,879,290		
Other liabilities and accrued expenses						
	155,663			129,741		
Total liabilities	13,424,602			12,121,301		
Shareholders' equity	2,096,417			1,871,670		

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Total liabilities & shareholders equity	\$	15,521,019		\$	13,992,971	
Net interest rate spread	\$	623,973	3.88%	\$	552,525	3.99%
Effect of noninterest-bearing funds			0.56			0.36
Net interest margin on earning assets			4.44%			4.35%
Tax-equivalent adjustment included in:						
Loan income	\$	4,757		\$	4,531	
Investment securities income		2,090			2,213	
Total	\$	6,847		\$	6,744	

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(Dollars in thousands)	2003			2002			2001		
	Average Balance	Income (1) / Expense	Yield (1) / Rate	Average Balance	Income (1) / Expense	Yield (1) / Rate	Average Balance	Income (1) / Expense	Yield (1) / Rate
Earning assets									
Loans: (2)									
Commercial and leasing	\$ 2,478,707	\$ 135,186	5.45%	\$ 2,367,328	\$ 148,380	6.27%	\$ 2,407,097	\$ 190,143	7.90%
Commercial real estate	2,316,627	142,166	6.14	1,915,994	130,995	6.84	1,571,238	127,848	8.14
Construction	929,939	50,324	5.41	733,237	44,667	6.09	795,931	63,359	7.96
Residential real estate	1,350,034	88,292	6.54	1,247,859	91,592	7.34	1,229,755	98,464	8.01
Home equity lines	311,037	13,899	4.47	215,411	11,122	5.16	175,549	13,892	7.91
Consumer	702,638	47,973	6.83	609,015	46,744	7.68	653,286	54,486	8.34
Total loans	8,088,982	477,840	5.91	7,088,844	473,500	6.68	6,832,856	548,192	8.02
Federal funds sold, et al	250,462	3,337	1.33	178,624	4,833	2.71	141,245	5,968	4.38
Securities: (3)									
Taxable securities									
U.S. Treasury	1,021,513	41,233	4.04	1,478,387	67,531	4.57	1,366,245	73,653	5.39
U.S. Government agencies	709,519	32,399	4.57	610,617	30,072	4.92	339,298	19,812	5.84
Mortgage-backed	927,235	36,135	3.90	216,391	12,096	5.59	48,203	3,599	7.47
Other investments	20,804	807	3.88	9,131	628	6.88	8,823	736	8.34
Tax-exempt securities									
States and political subdivisions									
	69,888	4,543	6.50	38,799	3,135	8.08	40,359	3,298	8.17
Total securities	2,748,959	115,117	4.19	2,353,325	113,462	4.82	1,802,928	101,098	5.61
Interest-bearing deposits in other banks									
	9,085	60	0.66	358	15	4.12	365	18	4.98
Total earning assets	11,097,488	596,354	5.37	9,621,151	591,810	6.15	8,777,394	655,276	7.47
Cash and due from banks									
	266,173			227,034			215,852		
Bank premises and equipment, net									
	118,071			101,660			102,993		
Other assets									
	637,461			314,511			273,444		
Less: allowance for loan losses									
	(147,612)			(140,899)			(142,481)		
Total assets	\$ 11,971,581			\$ 10,123,457			\$ 9,227,202		
Interest-bearing liabilities									
Deposits:									
Savings	\$ 1,168,074	4,702	0.40	\$ 966,283	8,405	0.87	\$ 853,911	12,899	1.51
Checking plus interest accounts	1,071,877	2,061	0.19	873,497	2,908	0.33	771,186	5,255	0.68
Money market	1,357,234	9,757	0.72	1,096,417	14,223	1.30	846,577	21,839	2.58
Time deposits \$100,000 and over	1,272,327	29,464	2.32	1,080,347	34,671	3.21	1,145,569	62,350	5.44
Other time deposits	1,852,622	47,206	2.55	1,759,160	62,362	3.54	1,812,589	97,360	5.37
Total interest-bearing deposits	6,722,134	93,190	1.39	5,775,704	122,569	2.12	5,429,832	199,703	3.68
Short-term borrowings	851,348	5,604	0.66	845,938	11,259	1.33	744,907	25,120	3.37
Long-term debt	517,386	18,451	3.57	279,471	10,754	3.85	117,823	6,702	5.69
Total interest-bearing funds	8,090,868	117,245	1.45	6,901,113	144,582	2.10	6,292,562	231,525	3.68
Noninterest-bearing deposits									
	2,269,720			1,856,706			1,618,838		
Other liabilities and accrued expenses									
	113,848			107,671			118,744		
Total liabilities	10,474,436			8,865,490			8,030,144		
Shareholders equity	1,497,145			1,257,967			1,197,058		
Total liabilities & shareholders equity	\$ 11,971,581			\$ 10,123,457			\$ 9,227,202		
Net interest rate spread		\$ 479,109	3.92%		\$ 447,228	4.05%		\$ 423,751	3.79%
Effect of noninterest-bearing funds									
			0.40			0.60			1.04
Net interest margin on earning assets			4.32%			4.65%			4.83%

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Tax-equivalent

adjustment included in:

Loan income	\$ 4,897	\$ 4,822	\$ 4,950
Investment securities income	1,863	1,371	1,474
Total	\$ 6,760	\$ 6,193	\$ 6,424

(1) Presented on a tax-equivalent basis using the statutory federal corporate income tax rate of 35%. See Reconciliation of Non-GAAP Measures.

(2) Nonaccrual loans are included in the respective average loan balances.

(3) Average investment securities are reported at amortized cost and exclude unrealized gains (losses) on securities available-for-sale.

(4) Loan fees of \$12.4 million, \$11.1 million, \$9.3 million, \$9.7 million and \$9.2 million for 2005, 2004, 2003, 2002 and 2001, respectively, are included for rate calculation purposes.

Net Interest Income and Net Interest Margin

Net interest income represents the largest source of Bankshares' revenue. Changes in both the level of interest rates and the amount and composition of interest-earning assets and interest-bearing liabilities affect it. Interest rate risk represents one of the more significant risks facing financial institutions like Bankshares. See additional discussion under the caption "Interest Rate Risk" in section III. ANALYSIS OF FINANCIAL CONDITION. It is measured in terms of the effect changes in market interest rates have on net interest income. Bankshares is slightly asset sensitive, with assets repricing more quickly than liabilities in response to changes in interest rates. In a rising rate environment, Bankshares' net interest margin (net interest income expressed as a percent of average earning assets) expands, causing the growth in net interest income to accelerate. Net interest income, on a fully tax-equivalent basis, was \$624.0 million for 2005. This represents an increase of 12.9%, or \$71.4 million, over the prior year's \$552.5 million. In 2004, fully tax-equivalent net interest income increased by \$73.4 million, or 15.3%, over 2003. As previously noted, net interest income is affected by changes in the volume of earning assets and the net interest margin earned thereon. The "Rate/Volume Analysis" table presents further details supporting this discussion.

Average earning assets increased by \$1.3 billion, or 10.5%, in 2005, due in part to the CBNV acquisition. Average total loans grew \$1.3 billion, or 13.5%, during 2005, of which the CBNV acquisition contributed approximately 32.1%, compared with an increase of \$1.6 billion, or 14.7% in 2004, which included a full year of the Farmers acquisition. Average securities, the other major component of earning assets, increased by \$33.0 million, or 1.1%, in 2005 compared with an increase of \$204.6 million, or 7.4%, in the prior year. The slowing growth of the investment portfolio in 2005 is attributable to liquidity used to fund additional loan growth. See the following section III. ANALYSIS OF FINANCIAL CONDITION for a more in-depth discussion of balance sheet trends. The overall growth in average earning assets added \$60.4 million to net interest income in 2005.

Also contributing to the increase in net interest income was a 9 basis point increase in the net interest margin from 4.35% in 2004 to 4.44% in 2005, compared with a 3 basis-point increase from 4.32% in 2003. The increase was attributable to a 20 basis point increase in the benefit derived from noninterest-bearing sources of funds, which was partially offset by an 11 basis point decline in the spread between the yield on earning assets and the cost of interest-bearing liabilities. The benefit from noninterest-bearing funds increased due primarily to a \$343.8 million increase in net noninterest-bearing funds and the rising rate environment. The decline in the net interest spread resulted from intensified competitive pressure on deposit pricing and the flatness of the yield curve, which caused the overall yield on the investment portfolio to lag the increase in funding costs. The net improvement in the net interest margin of 9 basis points added \$11.0 million to net interest income in 2005.

During 2005, the Federal Reserve Board raised rates eight times, for a total increase of 200 basis points, and the yield curve flattened dramatically. At December 31, 2004, the spread between the 10-year and two-year Treasury note rates was 115 basis points, and by December 31, 2005, the spread had inverted to a negative 2 basis points.

Looking forward to 2006, management anticipates a moderate increase in short-term interest rates in the near term. Given the current rate environment, the shape of the yield curve and the competitive dynamic, it is difficult to predict how these pressures will affect the net interest margin. Management feels that Bankshares' balance sheet is relatively well positioned with respect to Federal Reserve Board interest rate changes; however, competition for customers is expected to remain intense. As Bankshares expands in new markets, it is possible that spreads and margins may compress due to loan and deposit pricing competition and the effort to achieve sensible growth from small existing market positions. For additional information regarding interest rate sensitivity, see the discussion under "Interest Rate Risk" in III. ANALYSIS OF FINANCIAL CONDITION.

SOURCES OF INCOME
(Dollars in millions)

USES OF INCOME
(Dollars in millions)

RATE/VOLUME ANALYSIS

A rate/volume analysis, which demonstrates changes in tax-equivalent interest income and expense for significant assets and liabilities, appears below. The calculation of rate and volume variances is based on a procedure established for banks by the Securities and Exchange Commission.

(Dollars in thousands)	Year ended December 31,					
	Total	2005 vs. 2004 Due to variances in		2004 vs. 2003 Due to variances in		Total
		Rates	Volumes (5)	Rates	Volumes (5)	
Interest earned on:						
Loans:						
Commercial and leasing (1)	\$ 41,292	\$ 30,033	\$ 11,259	\$ 9,984	\$ (3,159)	\$ 13,143
Commercial real estate (2)	52,730	18,762	33,968	31,460	(4,792)	36,252
Construction (3)	39,976	17,070	22,906	12,184	486	11,698
Residential real estate	6,716	(364)	7,080	10,304	(7,302)	17,606
Home equity lines	10,470	7,026	3,444	6,323	71	6,252
Consumer	3,343	(3,193)	6,536	2,967	(4,756)	7,723
Taxable securities (4)	1,818	332	1,486	(2,762)	(10,200)	7,438
Tax-exempt securities (4)	(175)	200	(375)	861	(726)	1,587
Federal funds sold, et al	933	1,310	(377)	(1,836)	704	(2,540)
Interest-bearing deposits in other banks				(58)	1	(59)
Total interest income	157,103	71,176	85,927	69,427	(29,673)	99,100
Interest paid on:						
Savings deposits	1,348	1,336	12	(505)	(1,541)	1,036
Checking plus interest deposits	468	282	186	(162)	(580)	418
Money market accounts	13,452	12,335	1,117	(173)	(1,713)	1,540
Time deposits \$100,000 and over	25,613	15,673	9,940	(3,363)	(4,338)	975
Other time deposits	15,633	10,066	5,567	(5,584)	(7,652)	2,068
Short-term borrowings	18,422	14,302	4,120	2,240	1,706	534
Long-term debt	10,719	6,184	4,535	3,558	(1,006)	4,564
Total interest expense	85,655	60,178	25,477	(3,989)	(15,124)	11,135
Net interest earned	\$ 71,448	\$ 10,998	\$ 60,450	\$ 73,416	\$ (14,549)	\$ 87,965

(1) Tax-equivalent adjustments of \$3.1 million for 2005, 2004 and 2003 are included in the calculation of commercial loan rate variances.

(2) Tax-equivalent adjustments of \$0.6 million for 2005 and \$0.5 million for both 2004 and 2003 are included in the calculation of commercial real estate loan rate variances.

(3) Tax-equivalent adjustments of \$1.0 million for 2005, \$0.9 million for 2004 and \$1.3 million for 2003 are included in the calculation of construction loan rate variances.

(4) Tax-equivalent adjustments of \$2.1 million for 2005, \$2.2 million for 2004 and \$1.9 million for 2003 are included in the calculation of investment securities rate variances.

(5) Changes attributable to mix (rate and volume) are included in the volume variance.

Interest Income

Fully tax-equivalent interest income amounted to \$822.9 million in 2005, an increase of \$157.1 million, or 19.1%, from \$665.8 million in 2004. This compares favorably with the \$69.4 million, or 11.6%, increase in 2004 from 2003. The increase in 2005 was due to growth in average loans and securities that contributed \$85.9 million, and an increase in market interest rates, resulting in a \$71.2 million increase from the higher yield on earning assets. During 2004, the \$99.1 million in additional interest income from growth in average loans and securities was offset by a decline in market interest rates, resulting in a \$29.7 million reduction in interest income from lower earning assets.

At year-end 2005, the prime rate was 7.25%, compared with 5.25% and 4.00% at year-end 2004 and 2003, respectively. The average prime rate was 6.19% for 2005, compared with 4.35% for 2004, an increase of 184 basis points. The yield on average total loans in 2005 was 6.40%, a 73 basis-point increase from 5.67% in 2004. The commercial, construction and home equity loan portfolios are the most sensitive to changes in short-term interest rates. The average yield on the construction and home equity loan portfolios increased 150 basis points and 156 basis points, respectively, while the commercial loan portfolio yield increased 110 basis points over 2004.

The commercial real estate loan portfolio includes both fixed and variable-rate loans and the average portfolio yield increased 64 basis points. The residential real estate and consumer loan portfolios are affected mostly by intermediate and long-term rates and do not move with the prime rate. The yields on the consumer loan portfolio and the residential real estate portfolios decreased by 38 basis points and 2 basis points, respectively.

The yield on investment securities, 3.85% in 2005, increased 2 basis points, from 3.83% in 2004. The yield on the portfolio decreased 36 basis points in 2004 from 4.19% in 2003. Bankshares has been changing the mix of the portfolio to offset the negative impact on interest income from reinvesting at lower yields. During 2005 Bankshares continued to follow a strategy to diversify the portfolio to a mix of U.S. Treasury, U.S. Government agencies and mortgage-backed securities. This has resulted in a mix of 17.0%, 31.0% and 47.0% of treasury, agency and mortgage-backed securities, respectively, in 2005. The other 5.0% of the investment securities was comprised of 3.0% municipals and 2.0% other investments at year-end.

Interest Expense

Total interest expense in 2005 was \$198.9 million, an increase of \$85.7 million, or 75.6%, from \$113.3 million in 2004. The increase in interest expense for 2005 was attributable to an increase in the rate paid on total interest-bearing funds of 73 basis points and a 10.9% growth in average balances. Total interest expense in 2004 was \$4.0 million less than the \$117.2 million reported in 2003. With the expectation that the Federal Reserve Board will increase short-term rates again in 2006, management anticipates that rates paid on managed-rate deposits (savings, checking plus interest and money market accounts) will increase. See the discussion under Interest Rate Risk in III. ANALYSIS OF FINANCIAL CONDITION for further information regarding Bankshares' exposure to changes in interest rates.

The rate paid on average total interest-bearing deposits was 1.70% in 2005, an increase of 59 basis points from 1.11% for the prior year. The rate paid on savings, checking plus interest and money market accounts increased 10 basis points, 2 basis points and 78 basis points, respectively. Certificates of deposit of \$100,000 and over increased 119 basis points, while the rate paid on other time deposits increased 52 basis points in 2005.

The most interest rate sensitive source of funds is short-term borrowings. This category is comprised of federal funds purchased, securities sold under agreements to repurchase and commercial paper. The duration of these funds is very short, with most repricing daily. Reflecting the rate environment, the rate paid on short-term borrowings increased 153 basis points to 2.37% in 2005, after having increased by 18 basis points in 2004 to 0.84%. The rate paid on long-term debt increased 96 basis points in 2005, following a decline of 16 basis points in the prior year. The increase is related primarily to the increase in interest rate swap costs on Bankshares' long-term debt. The \$200.0 million of 10-year debt issued by MSD&T in the fourth quarter of 2001, issued at a fixed rate of 5.70%, were converted to a floating rate through an interest rate swap. The notes reprice quarterly and carried an effective cost of 4.24% during 2005 versus 2.38% in 2004. Additionally, Bankshares issued \$300.0 million of subordinated debt in April 2003. The notes were issued at a fixed rate of 4.63%. Subsequently, \$150.0 million of this debt was converted to a floating rate through interest rate swaps. The effect of the swaps lowered the cost on the \$300.0 million debt to 4.37% during 2005 versus 3.46% in 2004.

NONINTEREST INCOME

A schedule of noninterest income over the past three years is presented below:

(Dollars in thousands)	Year ended December 31,			% Change	
	2005	2004	2003	2005/2004	2004/2003
Investment and wealth management	\$ 95,756	\$ 90,050	\$ 78,933	6.3%	14.1%
Service charges on deposit accounts	43,885	44,263	39,194	(0.9)	12.9
Mortgage banking-related fees:					
Commercial	12,015	8,478	6,645	41.7	27.6
Residential	3,004	3,017	4,466	(0.4)	(32.4)
Total mortgage banking-related fees	15,019	11,495	11,111	30.7	3.5
Net investment securities gains	405	1,239	7,137	(67.3)	(82.6)
Nonmarketable investments:					
Private equity and other investments	10,379	2,569	823	304.0	212.2
Hedge funds	4,720	5,529	6,385	(14.6)	(13.4)
Bank-owned life insurance	4,783	3,324	2,981	43.9	11.5
Total nonmarketable investments	19,882	11,422	10,189	74.1	12.1
Other income:					
Electronic banking fees	23,969	21,766	16,930	10.1	28.6
Charges and fees on loans	12,664	10,833	9,549	16.9	13.4
Insurance	15,017	13,358	4,656	12.4	186.9
All other income	16,523	9,503	5,873	73.9	61.8
Total other income	68,173	55,460	37,008	22.9	49.9
Total	\$ 243,120	\$ 213,929	\$ 183,572	13.6	16.5

Noninterest Income

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Noninterest income for 2005 increased by \$29.2 million, or 13.6%, to \$243.1 million compared with \$213.9 million for 2004. The table above shows the major components of noninterest income. IWM revenue includes personal and institutional fee income related primarily to trust, brokerage and custody services. IWM revenue represented the largest source of noninterest income at 39.4%. Revenues increased 6.3% to \$95.8 million in 2005. Growth in IWM revenue was due principally to stronger equity markets during 2005 compared with 2004, increased new sales in Private Wealth Management and increased brokerage activity. Additional growth will depend on continued new sales and increased distribution, equity and bond market conditions and further acquisitions, if any. See the preceding discussion in Segment Reporting for additional information relating to IWM.

Service charges on deposit accounts decreased slightly from 2004. The decrease was related primarily to increased earnings credits used to calculate service charges to our business customers, which resulted from the rising interest rate environment. Overdraft fees increased \$1.9 million over 2004, partially offsetting the decline in service charges from our business customers.

Mortgage banking fees increased \$3.5 million, or 30.7%, over 2004 due to strong performance in the commercial sector. Bankshares mortgage banking-related revenue is comprised of loan origination fees, which is the largest category, at 65.0%, of total mortgage banking fees; servicing fees; originated mortgage servicing; and net gain on sales of mortgage loans. Commercial mortgage banking-related fees increased \$3.5 million due to higher origination fees of \$2.3 million and increased income of \$1.1 million from originated mortgage servicing. Commercial servicing income was nearly flat compared with the prior year. Commercial mortgages are brokered to an investor base with servicing retained. Residential mortgage banking fees for 2005 were nearly flat compared with 2004.

Investment securities gains in 2005 mostly represent the restructuring of the securities portfolio acquired from CBNV. The gains in 2004 represent sales of equity securities, with the balance related to the continued restructuring of the investment securities held in the available-for-sale portfolios.

Nonmarketable investment income represents revenues derived from investing in private equities, hedge funds-of-funds (hedge funds), Federal Reserve Banks and Federal Home Loan Bank securities acquired to meet various regulatory requirements and bank-owned life insurance (BOLI). In 2005, nonmarketable investment income increased \$8.5 million, or 74.1%, over 2004 as a result of better private equity investment performance and higher income from bank-owned life insurance (BOLI). These increases were partially offset by a decline in hedge fund income. The increase in BOLI revenue was due to better performance and the purchase of an additional \$50.0 million in the third quarter of 2005, bringing total investments in BOLI to \$152.6 million.

Other income includes several categories. Electronic banking fees consist of merchant card processing fees, foreign ATM fees and check card fees. These fees increased by \$2.2 million, or 10.1%, from 2004 due to higher volumes. Charges and fees on loans consist of letters of credit fees, late fees and other assessed loan fees and increased \$1.8 million, primarily due to higher letters of credit fees. Insurance revenues increased \$1.7 million and are derived from fee income related to the sale and servicing of insurance products. All other income increased \$7.0 million over 2004 due primarily to a \$2.7 million increase in gains on sales of bank-owned premises and \$3.3 million in higher capital markets-related revenue.

NONINTEREST EXPENSES

A schedule of noninterest expenses over the past three years is presented below:

(Dollars in thousands)	Year ended December 31,			% Change	
	2005	2004	2003	2005/2004	2004/2003
Salaries	\$ 200,222	\$ 187,621	\$ 160,326	6.7%	17.0%
Employee benefits	46,175	44,676	37,717	3.4	18.5
Net occupancy expense of bank premises	28,596	24,307	20,756	17.6	17.1
Furniture and equipment expenses	31,659	31,439	31,610	0.7	(0.5)
Communications and supplies	16,406	16,904	15,188	(2.9)	11.3
Other expenses:					
Professional services	21,914	25,302	19,500	(13.4)	29.8
Advertising and promotional expenses	9,103	8,418	9,155	8.1	(8.1)
Electronic banking expenses	13,946	11,509	8,621	21.2	33.5
Amortization of intangible assets	8,773	8,142	4,943	7.7	64.7
Outsourcing expenses	11,231	5,342	4,145	110.2	28.9
All other expenses	32,796	28,298	25,486	15.9	11.0
Total other expenses	97,763	87,011	71,850	12.4	21.1
Total	\$ 420,821	\$ 391,958	\$ 337,447	7.4	16.2

Noninterest Expenses

Noninterest expenses increased \$28.9 million, or 7.4%, from 2004. The table above shows the major components of noninterest expenses. The principal reasons for the year-over-year increase were expenses of approximately \$8.0 million related to the acquisition of CBNV; higher incentive compensation related to improved operating performance; base compensation and staffing increases; higher occupancy expense due to the December 2004 sale of Bankshares headquarters building and the outsourcing of IWM back-office functions.

Controlling costs and maintaining operational efficiencies remains a primary objective for Bankshares. A closely monitored key measure is Bankshares overall efficiency ratio. It is computed by dividing noninterest expenses by the sum of net interest income on a tax-equivalent basis and noninterest income. Bankshares efficiency ratio was 48.53% for the year ended December 31, 2005 compared with 51.14% for the year ended December 31, 2004. The cash operating efficiency ratio excludes amortization expense for intangibles and nonoperating income and expenses, such as securities gains and losses and other significant gains, losses or expenses (such as those associated with integrating acquired entities operations into Bankshares) unrelated to Bankshares core operations. When calculating certain performance ratios, Bankshares believes that excluding these costs and income helps the investor to evaluate and compare the results of our core, ongoing business operations. Bankshares cash operating efficiency ratio was 47.61% and 49.63% for the years ended December 31, 2005 and 2004, respectively. See Reconciliation of Non-GAAP Measures found in Item 7.

Salaries, which include base compensation, commissions, incentive compensation and stock-based compensation, are the largest component of noninterest expense at 47.6%. Salaries increased \$12.6 million, or 6.7%. Nearly one-quarter of this increase, (\$3.0 million) was due to the CBNV acquisition. Also contributing to the increase were higher incentive compensation expenses of \$8.3 million related to improved operating performance and \$6.3 million in merit and staffing increases. Stock-based compensation was nearly flat when compared with 2004. Partially offsetting these increases was a reduction in salaries expense by \$2.5 million based on the deferral of loan origination costs. Employee benefit expenses increased nearly \$1.5 million, or 3.4%. This increase was due primarily to higher payroll taxes and pension expense. Partially offsetting this increase was a \$1.3 million rebate from a medical insurance provider due to good claims experience.

Net occupancy expense, which includes premises depreciation, rents, maintenance and utilities, increased due to an increase of approximately \$5.0 million related to the loss of outside tenant income due to the sale of Bankshares' headquarters building in December 2004. The net addition of 14 new branches, primarily from the CBNV acquisition, also contributed to the increase. Furniture and equipment expenses include depreciation, rental and maintenance expense associated with the upkeep and improvement of hardware and computer software.

Other expenses consist of professional services, advertising and promotion, electronic banking, intangible amortization, outsourcing and all other expenses. Other expenses increased \$10.8 million, or 12.4%, in 2005. The CBNV acquisition contributed \$2.4 million to this increase. Professional fees decreased \$3.4 million in 2005 due primarily to a \$1.4 million reduction in fees related to the implementation of compliance measures under The Sarbanes-Oxley Act of 2002 and a decrease of \$1.5 million related to a litigation matter in 2004. The increase in electronic banking expense of \$2.4 million in 2005 was driven by volume increases. This increase was not completely offset by increased revenue generated from these services (referred to in the Noninterest Income section). Amortization of other identifiable intangibles increased to \$8.8 million in 2005, from \$8.1 million in 2004, as a direct result of the CBNV acquisition. The remaining increase in other expenses over 2004 was due primarily to \$5.9 million in higher fees related to the outsourcing of IWM back-office functions.

III. ANALYSIS OF FINANCIAL CONDITION

Investment Securities

Bankshares' investment securities portfolio is structured to manage liquidity, interest rate risk and regulatory capital and to take advantage of market conditions that create more economically attractive returns on investments. At December 31, 2005, the total investment securities portfolio was \$3.1 billion compared with \$2.9 billion at December 31, 2004, with net unrealized losses of \$52.2 million and \$3.2 million for the same periods. The portfolio consists of short-term and intermediate-term U.S. Treasury and U.S. Government agency obligations, adjustable-rate mortgage-backed securities (ARMs) and intermediate average-life agency collateralized mortgage obligations (CMOs). More than 99.5% of the total investment portfolio is classified as available-for-sale.

At year-end 2005, the weighted-average maturity of the debt securities available-for-sale portfolio was 2.3 years compared with 2.4 years at year-end 2004. Since 50.0% of this portfolio was mortgage-backed securities, the expected remaining maturity may differ from contractual maturity because borrowers may have the right to prepay obligations before the underlying mortgages mature. The fair value of the bond securities available-for-sale portfolio at December 31, 2005 was 98.2% of amortized cost, compared with 99.8% at December 31, 2004. The fair value and unrealized loss on securities as of December 31, 2005, segregated by those securities that have been in an unrealized loss position for a year or more, was \$2.0 billion and \$22.0 million, respectively. Because the declines in fair value were due to changes in interest rates, not in estimated cash flows or credit quality, no charge from an other-than-temporary impairment was recorded at December 31, 2005. The reference point for determining those securities in an unrealized loss position is quarter-end. As such, it is possible that a security had a market value that exceeded its amortized cost on other days during the past 12-month period.

The estimated effects of a 200 basis point increase or decrease in interest rates on the fair value and the expected remaining maturity of the mortgage-backed securities available-for-sale portfolio are provided in the table below.

(Dollars in millions)	Fair Value	Net Unrealized Gain (Loss)	Remaining Maturity In Years
At December 31, 2005	\$ 1,544	\$ (37.6)	3.09

Assuming a 200 basis point:

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Increase in interest rates	1,456.3	(137.7)	4.09
Decrease in interest rates	1,613.9	19.9	1.52

More information on the investment portfolio is provided in the following table and in Note No. 3 (Investment Securities) of the financial statements.

BOND INVESTMENT PORTFOLIO

The following summary shows the maturity distribution and average tax-equivalent yields for the bond investment portfolio at December 31, 2005.

(Dollars in thousands)	Within 1 Year	1-5 Years	5-10 Years	After 10 Years	Total
Securities available-for-sale (1)					
U.S. Treasury					
Fair Value	\$ 210,216	\$ 221,820	\$	\$	\$ 432,036
Yield	3.50%	3.84%	%	%	3.65%
U.S. Government agencies					
Fair Value	\$ 366,662	\$ 612,613	\$ 33	\$	\$ 979,308
Yield	2.89%	3.74%	7.54%	%	3.42%
States and political subdivisions					
Fair Value	\$ 5,300	\$ 19,836	\$ 44,999	\$	\$ 70,135
Yield	4.53%	4.87%	5.72%	%	5.39%
Mortgage-backed securities (2)					
Fair Value	\$ 25,668	\$ 1,381,340	\$ 137,253	\$	\$ 1,544,261
Yield	3.84%	4.23%	4.54%	%	4.26%
Other bonds, notes and debentures					
Fair Value	\$ 9,741	\$ 9,127	\$	\$	\$ 18,868
Yield	2.72%	3.57%	%	%	3.13%
Total securities available-for-sale					
Fair Value	\$ 617,587	\$ 2,244,736	\$ 182,285	\$	\$ 3,044,608
Yield	3.14%	4.06%	4.83%	%	3.92%
Securities held-to-maturity					
States and political subdivisions					
Amortized cost	\$ 2,347	\$ 7,353	\$ 6,959	\$	\$ 16,659
Yield	6.20%	6.50%	7.85%	%	7.02%

(1) Investment securities available-for-sale are presented at estimated fair value. Yields on such securities are based on amortized cost.

(2) Maturities are reflected based on projected maturities at time of purchase. Actual maturities will vary as a result of the level of loan prepayments in the underlying mortgage pools.

LOAN COMPOSITION AND GROWTH

Average Loans (Dollars in millions)

Five-Year Compound Growth Rate: 12.3%

Loan Portfolio

A comparative chart of average loan balances is included below; year-end balances are in Note No. 4 (Loans and Allowance for Loan Losses) of the Financial Statements.

Loans totaled \$11.6 billion for the year ended December 31, 2005, an increase of 13.5% over the \$10.2 billion for the year ended December 31, 2004. Loans averaged \$11.0 billion in 2005 compared with \$9.7 billion in 2004, an increase of 13.5%. On average in 2005, commercial loans grew 6.4%; commercial real estate grew 17.7%; construction grew 28.8%; residential real estate loans grew 7.2%; home equity lines grew 12.6%; and consumer loans increased 13.7% over 2004. The increases in the various loan categories resulted from both organic growth and the CBNV acquisition. On an average basis, the percentage of commercial real estate loans to total loans increased to 31.2% in 2005 from 30.0% in 2004. Additionally, construction loans increased in 2005 from 2004, while commercial loans declined to 26.3% in 2005 from 28.1% in 2004. Strong demand continued throughout 2005 for real estate-based loans inclu