

FIRST MARINER BANCORP
Form 10-K
March 16, 2007

UNITED STATES SECURITIES AND EXCHANGE COMMISSION

Washington, D.C.

FORM 10-K

(Mark One)

ANNUAL REPORT UNDER SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934.

For the fiscal year ended December 31, 2006.

or

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

For the transition period from

Commission file number 0-21815

FIRST MARINER BANCORP

(Exact name of registrant as specified in its charter)

Maryland

(State of incorporation)

1501 S. Clinton Street, Baltimore, MD

(Address of principal executive offices)

52-1834860

(IRS Employer Identification Number)

21224

(zip code)

410-342-2600

(Telephone number)

Securities registered under Section 12(b) of the Exchange Act:

Title of each Class
COMMON STOCK, par value \$0.05 per share

Name of each exchange on which registered
The Nasdaq Stock Market LLC

Securities registered under Section 12(g) of the Exchange Act:

None

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

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

Indicate by check mark if disclosure of delinquent filers in response to Item 405 of Regulation S-K is not contained in this form, and no disclosure will 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 Act). Yes No

The aggregate market value of the voting stock held by non-affiliates of the registrant as of the last business day of the registrant's most recently completed second fiscal quarter was approximately \$97.238 million. Shares of Common Stock owned by each executive officer and directors have not been included as such persons are deemed to be affiliates.

The number of shares of common stock outstanding as of March 1, 2007 is 6,420,225 shares.

Documents incorporated by reference:

Proxy Statement Part III.

FIRST MARINER BANCORP

**Annual Report on Form 10-K
December 31, 2006**

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PART I

ITEM 1 BUSINESS

General

First Mariner Bancorp (First Mariner, on a parent only basis, and we, our, or us, on a consolidated basis) is a financial holding company whose business is conducted primarily through its wholly owned operating subsidiaries: First Mariner Bank (the Bank), Finance Maryland LLC (Finance Maryland), and FM Appraisals, LLC (FM Appraisals). We were formed in 1995 and have total assets in excess of \$1.263 billion as of December 31, 2006. Our executive offices are located in the Canton area of Baltimore City at 1501 South Clinton Street, Baltimore, Maryland 21224. Our telephone number is (410) 342-2600. We maintain internet sites located at www.1stmarinerbank.com, www.1stmarinerbancorp.com, www.1stmarinermortgage.com, www.vamortgage.com and www.financemaryland.com.

The Bank is our largest operating subsidiary with assets exceeding \$1.157 billion as of December 31, 2006. The Bank was formed in 1995 through the merger of several small financial institutions. The Bank's primary market area for its core banking operations, which consist of traditional commercial and consumer lending, as well as retail and commercial deposit operations, is central Maryland as well as portions of Maryland's eastern shore. The Bank's mortgage division, First Mariner Mortgage, operates on both a regional and national basis. First Mariner Bank is an independent community bank, and its deposits are insured by the Federal Deposit Insurance Corporation (FDIC). The Bank is engaged in the general commercial banking business, with particular attention and emphasis on the needs of individuals and small to mid-sized businesses, and delivers a wide range of financial products and services that are offered by many larger competitors. Products and services include traditional deposit products, a variety of consumer and commercial loans, residential and commercial mortgage and construction loans, money transfer services, non-deposit investment products, and Internet banking and similar services. Most importantly, the Bank provides customers with access to local Bank officers who are empowered to act with flexibility to meet customers' needs in an effort to foster and develop long-term loan and deposit relationships.

Finance Maryland engages in traditional consumer finance activities, making small direct cash loans to individuals, the purchase of installment loan sales contracts from local merchants and retail dealers of consumer goods, and loans to individuals via direct mail solicitations. Finance Maryland currently operates 17 branches and a central approval office in the state of Maryland and four branches in the state of Delaware, which operate under the trade name Finance Delaware. Finance Maryland had total assets of \$65.911 million as of December 31, 2006.

FM Appraisals is a residential real estate appraisal preparation and management company that is headquartered in Baltimore City. FM Appraisals offers appraisal services for residential real estate lenders, including appraisal preparation, the compliance oversight of sub-contracted appraisers, appraisal ordering and administration, and appraisal review services. FM Appraisals provides these services to First Mariner Mortgage.

Since our formation in 1995, our business strategy has focused on development of an operational and retail distribution infrastructure to create a platform to support the generation of assets and deposits. At our inception, we had 20 employees, four full service branches and two ATMs in the Baltimore region, with total assets of \$35.2 million, loans of \$20.4 million, and deposits of \$24.6 million. At December 31, 2006, we had over 1,000 employees, 25 full service bank branches, 12 mortgage loan offices, 21 consumer finance offices, and approximately 195 ATMs (35 owned by us and 160 available to our customers through third party agreements) with total assets of \$1.263 billion, loans of \$866.459 million and deposits of \$924.938 million. We earned net income of \$1.924 million for the year ending December 31, 2006.

We do not conduct any foreign operations.

Our annual report on Form 10-K, quarterly reports on Form 10-Q, and current reports on Form 8-K and amendments to these reports are available, free of charge, in the investor relations section of our Internet site at www.1stmarinerbancorp.com as soon as reasonably practicable after we have filed them with the Securities and Exchange Commission. The information on the websites listed above is not and should not be considered part of this annual report on Form 10-K and is not incorporated by reference in this document.

Our Business Strategy

Our initial strategy involved building a network of banking branches, mortgage loan offices, and ATMs to capture market share and build a community franchise for our stockholders, customers and employees. Having developed this infrastructure, we are now focused on growing assets and earnings by capitalizing on the broad network of Bank branches, mortgage offices, consumer finance offices and ATMs that we established during our infrastructure expansion phase.

To continue asset growth and profitability, our marketing strategy is targeted to:

- Capitalize on our personal relationship approach that we believe differentiates us from our larger competitors;
- Provide our customers with access to local executives who make key credit and other decisions;
- Pursue commercial lending opportunities with small to mid-sized businesses that are underserved by our larger competitors;
- Develop innovative financial products and services to generate additional sources of revenue;
- Cross-sell our products and services to our existing customers to leverage relationships and enhance our profitability;
- Review our branch performance to evaluate possible consolidations or relocations that may increase our efficiency; and
- Adhere to rigorous credit standards to maintain good quality assets as we implement our growth strategy.

Financial Services We Provide

Commercial Banking. Our commercial loan unit focuses on loan originations from small and mid-sized businesses (generally up to \$20.0 million in annual sales) and such loans are usually accompanied by significant related deposits. Our commercial loan products include commercial mortgage loans for the purchase or refinance of commercial properties; residential and commercial real estate construction loans; working capital loans and lines of credit; demand, term and time loans; and equipment, inventory and accounts receivable financing. We also offer an array of cash management services and deposit products to our commercial customers. Computerized on-line banking is currently available to our commercial customers.

Retail Banking. Our retail banking activities emphasize consumer deposit and checking accounts. We offer an extensive range of services to meet the varied needs of our customers from young persons to senior citizens. In addition to traditional products and services, we offer contemporary products and services, such as debit cards, mutual funds, annuities, insurance products and Internet banking and electronic bill payment services. Our consumer loan products include home equity lines of credit, fixed rate second mortgages, new and used auto loans, new and used boat loans, overdraft protection and unsecured personal credit lines.

Mortgage-Banking. Our mortgage-banking business is structured to provide a source of fee income largely from the process of originating residential mortgage loans for sale on the secondary market, as well as the origination of loans to be held in our loan portfolio. Mortgage-banking products include Federal Housing Administration (FHA) and the federal Veterans Administration (VA) loans, conventional and nonconforming first and second mortgages, reverse mortgages, and construction and permanent financing. We intend to improve our competitive position in our markets by streamlining the mortgage underwriting process through the introduction of advanced technology, and development of new products to meet our customers' needs.

Community Reinvestment Act. We have a strong commitment to our responsibilities under the federal Community Reinvestment Act (the CRA) and actively search for opportunities to meet the development needs of all members of the communities we serve, including persons of low to moderate income in a manner consistent with safe and sound banking practices. We currently fulfill this commitment by participating in loan programs sponsored or guaranteed by the FHA, the VA, the federally funded American Dream Downpayment Initiative, the Maryland Mortgage Program (CDA), the Federal Home Loan Bank of Atlanta Closing Cost Assistance Program, the Section 8 to Home-Ownership Program and the Settlement Expense Loan Program.

Consumer Finance. We offer a wide variety of consumer finance products through Finance Maryland, which is focused on building market share by offering competitive products and services, delivered by experienced personnel who provide responsive service. Loan sizes are generally smaller than those originated by the Bank (approximately \$2,800), and Finance Maryland currently serves approximately 23,000 customers in Maryland and Delaware.

Our Lending Activities

Loan Portfolio Composition. At December 31, 2006, our loan portfolio totaled \$866.459 million, representing approximately 68.6% of our total assets of \$1.263 billion. Our loans are generally secured by residential and commercial real estate, and over 82% of our total loans as of December 31, 2006 were secured by real estate. The majority of our lending activity is in the Mid-Atlantic region. See Item 7 Management's Discussion and Analysis of Financial Condition and Results of Operations for the year ended December 31, 2006 for more detailed information concerning the composition of our loan portfolio.

Real Estate Development and Construction Loans. We provide interim real estate acquisition development and construction loans to builders, developers, and persons who will ultimately occupy their single-family dwellings. These loans are made within the Federal regulatory guidelines for maximum loan to value ratios. Generally, residential construction loans are made for up to 85% of the appraised value of the property, taking into consideration private mortgage insurance. Commercial real estate construction loans are generally made for 80% or less of the appraised value of the property. Development loans, made to improve raw land into lots on which structures may be built, are generally made for 75% or less of the appraised value of the property. Our real estate development and construction loan funds are disbursed periodically at pre-specified stages of completion. We carefully monitor these loans with on-site inspections and control of disbursements.

Loans we provide to individuals for the construction of their primary residences are typically secured by the property under construction, frequently include additional collateral (such as second mortgage on the borrower's present home), and commonly have maturities of 9 to 12 months.

Loans provided by us to residential builders for the construction of residential homes require binding sales contracts on the property and the prospective buyers have been pre-qualified for permanent mortgage financing. Development loans are made only to developers with a proven track record. Generally, these loans are extended only when the borrower provides evidence that the lots under development will be sold to builders satisfactory to us.

We secure development and construction loans with the properties under development or construction and we typically obtain personal guarantees from the principals. Further, to assure that we do not place reliance solely in the value of the underlying property, we consider the financial condition and reputation of the borrower and any guarantors, the amount of the borrower's equity in the project, independent appraisals, costs estimates and pre-construction sale information.

See Item 7 Management's Discussion and Analysis of Financial Condition and Results of Operations for the year ended December 31, 2006 for more detailed information concerning our real estate development and construction lending.

Residential Real Estate Mortgage Loans. We originate adjustable- and fixed-rate residential mortgage loans. Our mortgage loans are generally originated under terms, conditions and documentation acceptable to the secondary mortgage market. We will place some of these loans into our portfolio, although the vast majority are ultimately sold to investors.

Commercial Real Estate Mortgage Loans. We originate mortgage loans secured by commercial real estate. These loans are primarily secured by office buildings, retail buildings, warehouses and general-purpose business space. Although terms may vary, our commercial mortgages generally have maturities of ten years or less. It is our general policy to obtain personal guarantees from the principals of the borrowers and assignments of all leases related to the collateral.

Commercial Loans. We originate a variety of loans for business purposes. Less than one percent of all our commercial loans are unsecured. We make loans to provide working capital to businesses in the form of lines of credit, which may be secured by real estate, accounts receivable, inventory, equipment or other assets. The financial condition and cash flow of our commercial borrowers are closely monitored by the submission of corporate financial statements, personal financial statements and income tax returns. The frequency of submissions of required financial information depends on the size and complexity of the credit and the collateral that secures our loan. It is our general policy to obtain personal guarantees from the principals of our commercial loan borrowers.

Consumer Loans. The Bank and Finance Maryland offer a variety of consumer loans. Consumer loans originated by the Bank are typically secured by residential real estate or personal property, including automobiles and boats. Our home equity loans (closed-end and lines of credit) are typically made up to 80% of the appraised value, less the amount of any existing prior liens on the property and generally have maximum terms of 10 years. We do offer home equity products with loan to value ratios of up to 100%, and mitigate our risk of loss on higher loan to value products with private mortgage insurance. The interest rates on our closed-end home equity loans are generally fixed, while interest rates on our home equity lines of credit are variable. Consumer finance products offered through Finance Maryland include loans for the purchase of consumer goods, direct cash lending, loans for seasonal purposes, home improvement loans, and loans originated through direct mail solicitation. Loans made by Finance Maryland are generally for terms less than five years, carry a fixed rate of interest, and are generally secured by consumer goods, including automobiles. Finance Maryland also originates a limited number of closed-end home equity loans.

Our Credit Administration Process

Our lending activities are subject to written policies approved by our Board of Directors to ensure proper management of credit risk. We make loans that are subject to a well defined credit process that includes credit evaluation of borrowers, risk-rating of credits, establishment of lending limits and application of lending procedures, including the holding of adequate collateral and the maintenance of compensating balances, as well as procedures for on-going identification and management of credit deterioration. We conduct regular portfolio reviews to identify potential under-performing credits, estimate loss exposure, geographic and industry concentrations, and to ascertain compliance with our

policies. For significant problem loans, we review and evaluate the financial strengths of our borrower and the guarantor, the related collateral and the effects of economic conditions.

Commercial and mortgage loan officers have no individual lending authority. Our loan committee of the Board of Directors is authorized to approve loans up to our banking subsidiary's legal lending limit, which approximates \$16.7 million as of December 31, 2006. We have established an in-house limit of \$5.0 million, which is reviewed periodically by the Board of Directors, and do have loans to a limited number of customers in excess of that amount.

We generally do not make loans to be held in our loan portfolio outside our market area unless the borrower has an established relationship with us and conducts its principal business operations within our market area. Consequently, we and our borrowers are affected by the economic conditions prevailing in our market area. Approximately 76% of our residential real estate development and construction loan portfolio consisted of loans to Maryland customers; an additional 20% consisted of loans to customers in the surrounding states and the District of Columbia; and 4% consisted of loans to customers in other states in the country. Approximately 82% of our commercial loan portfolio (commercial, commercial real estate, and commercial construction) consisted of loans to Maryland customers with an additional 16% consisting of loans to customers in the surrounding states and the District of Columbia. Commercial and commercial real estate loans to customers in other states in the country amounted to approximately 2% of our portfolio.

Finance Maryland's lending activities are subject to written policies approved by our Board of Directors. These loans are subject to a well-defined credit process that includes a credit evaluation of the borrower and the adequacy of available collateral. Finance Maryland's loan policy provides various levels of individual lending authority. Finance Maryland purchases installment sales contracts from dealers applying the same criteria. Dealers are subject to pre-approval due diligence and must have a proven track record with management.

Market

We consider our core market area to be the communities within the Baltimore/Washington corridor, including the eastern shore of Maryland and particularly Baltimore City and the counties of Baltimore, Anne Arundel, Harford, and Howard. Lending activities are broader and include areas outside of our core market area such as other Maryland counties, the District of Columbia and certain markets in contiguous states.

Our Competition

Banking and consumer finance. We operate in a highly competitive environment, competing for deposits and loans with commercial banks, thrifts, mortgage companies, finance companies, Internet-based financial companies and other financial entities. Our principal competitors include other community commercial banks and larger financial institutions with branches in our market area. Numerous mergers and consolidations involving banks in our market area have occurred in recent years, requiring us to compete with banks and finance companies with greater resources.

The primary factors we face in competing for deposits are interest rates, personalized service, the quality and range of financial services, convenience of office locations and office hours. Competition for deposits comes primarily from other commercial banks, savings associations, credit unions, money market funds and other investment alternatives. The primary factors in competing for loans are interest rates, loan origination fees, the quality and range of lending services, responsiveness, and personalized service. Competition for loans comes primarily from other commercial banks, savings associations, mortgage-banking firms, credit unions, finance companies and other financial intermediaries. Many of the financial

institutions operating in our market area offer certain services such as trust and international banking, which we do not offer, and have greater financial resources or have substantially higher lending limits.

To compete with other financial services providers, we principally rely upon local promotional activities, personal relationships established by our officers, directors and employees with our customers, and specialized services tailored to meet our customers' needs. In those instances where we are unable to accommodate a customer's needs, we will arrange for those services to be provided by other financial institutions with which we have a relationship.

Current banking laws facilitate interstate branching and merger activity among banks. This may result in an even greater degree of competition in the banking industry and we may be brought into competition with institutions with which we do not currently compete. As a result, intense competition in our market area may be expected to continue for the foreseeable future.

Mortgage-banking. Our mortgage-banking division also operates in an extremely competitive environment. In addition to competing with mortgage-banking divisions of other financial institutions, we compete with mortgage banking firms that are not under the same level of regulation as we are. Without similar regulatory constraints, these lesser regulated firms can be more responsive to customers. Additionally, competition in the mortgage-banking industry comes from the continuing evolution of the secondary mortgage market, the proliferation of mortgage products, increasing interest rate volatility, compounded by homeowners' increasing tendency to refinance their mortgages as the refinance process becomes more efficient and cost effective. These swings in mortgage origination volume have placed significant operational and financial pressures on mortgage lenders.

To compete effectively in this environment, we maintain a very high level of operational, technological and managerial expertise, consistently offer a wide selection of mortgage loans through all marketing channels on a regional scale, provide high-quality service, and price our mortgage loans at competitive rates.

Supervision and Regulation

First Mariner and its subsidiaries are extensively regulated under federal and state law. Generally, these laws and regulations are intended to protect depositors and loan customers, not stockholders. The following is a summary description of certain provisions of certain laws that affect the regulation of financial holding companies, finance companies, and banks. The discussion is qualified in its entirety by reference to applicable laws and regulations. Changes in such laws and regulations may have a material effect on the business and prospects of First Mariner and its subsidiaries.

Federal Financial Holding Company Regulation and Structure. First Mariner is a financial holding company within the meaning of the Bank Holding Company Act of 1956, as amended, and as such, it is subject to regulation, supervision, and examination by the Board of Governors of the Federal Reserve System ("Federal Reserve" or "FRB"). First Mariner is required to file annual and quarterly reports with the Federal Reserve and to provide the Federal Reserve with such additional information as the Federal Reserve may require. The Federal Reserve may conduct examinations of First Mariner and its subsidiaries.

With certain limited exceptions, First Mariner is required to obtain prior approval from the Federal Reserve before acquiring direct or indirect ownership or control of more than 5% of any voting securities or substantially all of the assets of a bank or bank holding company, or before merging or consolidating with another bank holding company. In acting on applications for such approval, the Federal Reserve must consider various statutory factors, including among others, the effect of the proposed transaction on competition in the relevant geographical and product markets, each party's financial condition and management resources and record of performance under the CRA. Additionally, with certain exceptions any person proposing to acquire control through direct or indirect ownership of 25% or more of any voting

securities of First Mariner is required to give 60 days written notice of the acquisition to the Federal Reserve, which may prohibit the transaction, and to publish notice to the public.

With prior approval of the Federal Reserve, First Mariner may acquire more than 5% of the assets or outstanding shares of a company engaging in nonbank activities determined by the Federal Reserve to be closely related to the business of banking or of managing or controlling banks. Under current Federal Reserve regulations, such permissible nonbank activities include mortgage-banking, equipment leasing, securities brokerage and consumer and commercial finance company operations.

First Mariner's subsidiary bank is subject to certain quantitative and qualitative restrictions on extensions of credit to the financial holding company or its subsidiaries, investments in its securities, and the use of its securities as collateral for loans to any borrower. These regulations and restrictions may limit the ability to obtain funds from First Mariner's subsidiary bank for its cash needs including funds for the payment of dividends, interest and operating expenses. Further, a financial holding company and its subsidiaries are prohibited from engaging in certain tie-in arrangements in connection with any extension of credit, lease or sale of property, or furnishing of services. For example, a bank may not generally require a customer to obtain other services from itself or its affiliates, and may not require that a customer promise not to obtain other services from a competitor as a condition to an extension of credit to the customer. The Federal Reserve has ended the anti-tying rules for financial holding companies and their non-banking subsidiaries. Such rules were retained for banks.

Under Federal Reserve policy, a bank holding company is expected to act as a source of financial strength to its subsidiary banks and to make capital injections into a troubled subsidiary bank, and the Federal Reserve may charge the financial holding company with engaging in unsafe and unsound practices for failure to commit resources to a subsidiary bank when required. A required capital injection may be called for at a time when the holding company does not have the resources to provide it. In addition, depository institutions insured by the FDIC can be held liable for any losses incurred by, or reasonably anticipated to be incurred by, the FDIC in connection with the default of, or assistance provided to, a commonly controlled FDIC-insured depository institution. Accordingly, in the event that any insured subsidiary of First Mariner causes a loss to the FDIC, other insured subsidiaries could be required to compensate the FDIC by reimbursing it for the estimated amount of such loss. Such cross guaranty liabilities generally are superior in priority to the obligations of the depository institution to its stockholders due solely to their status as stockholders and obligations to other affiliates.

We have agreed with the Federal Reserve Bank of Richmond (FRB-Richmond) to submit plans to improve our operating performance, reduce parent company leverage, enhance our enterprise-wide risk management and enhance the effectiveness of our internal audit program. We have also agreed to give prior notice to the FRB-Richmond of any potential transaction involving a significant capital expenditure. Management believes it has taken actions to address these issues and these agreements do not restrict or impede our ability to conduct normal business.

State Bank Holding Company Regulation. As a Maryland bank holding company, First Mariner is subject to various restrictions on its activities as set forth in Maryland law, in addition to those restrictions set forth in federal law. Under Maryland law, a bank holding company that desires to acquire a bank or bank holding company that has its principal place of business in Maryland must obtain approval from the Maryland Commissioner of Financial Regulation. Also, a bank holding company and its Maryland chartered bank or trust company cannot directly or indirectly acquire banking or nonbanking subsidiaries or affiliates until the bank or trust company receives the approval of the Maryland Commissioner.

Federal and State Bank Regulation. First Mariner's banking subsidiary is a Maryland chartered trust company, with all the powers of a commercial bank regulated and examined by the Maryland Commissioner and the FDIC. The FDIC has extensive enforcement authority over the institutions it regulates to prohibit or correct activities that violate law, regulation or written agreement with the FDIC.

Enforcement powers also regulate activities that are deemed to constitute unsafe or unsound practices. Enforcement actions may include the appointment of a conservator or receiver, the issuance of a cease and desist order, the termination of deposit insurance, the imposition of civil money penalties on the institution, its directors, officers, employees and institution-affiliated parties, the issuance of directives to increase capital, the issuance of formal and informal agreements, the removal of or restrictions on directors, officers, employees and institution-affiliated parties, and the enforcement of any such mechanisms through restraining orders or other court actions.

In its lending activities, the maximum legal rate of interest, fees, and charges that a financial institution may charge on a particular loan depends on a variety of factors such as the type of borrower, the purpose of the loan, the amount of the loan and the date the loan is made. Other laws tie the maximum amount that may be loaned to any one customer and the related interest to a financial institution's capital levels. The Bank is also subject to certain restrictions on extensions of credit to executive officers, directors, principal stockholders or any related interest of such persons which generally require that such credit extensions be made on substantially the same terms as are available to third persons dealing with the Bank and not involve more than the normal risk of repayment.

The CRA requires that, in connection with the examination of financial institutions within their jurisdictions, the FDIC evaluate the record of the financial institution in meeting the credit needs of their communities, including low and moderate income neighborhoods and families, consistent with the safe and sound operation of those banks. These factors are also considered by all regulatory agencies in evaluating mergers, acquisitions and applications to open a branch or facility. As of the date of its most recent examination report, the Bank has a CRA rating of Satisfactory.

Under the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA), each federal banking agency is required to prescribe, by regulation, noncapital safety and soundness standards for institutions under its authority. The federal banking agencies, including the FDIC, have adopted standards covering internal controls, information and internal audit systems, loan documentation, credit underwriting, interest rate exposure, asset growth, compensation, fees and benefits. FDICIA also imposed new capital standards on insured depository institutions. Institutions that fail to meet those standards may be required by the agency to develop a plan acceptable to the agency, specifying the steps that the institution will take to meet the standards. Failure to submit or implement such a plan may subject the institution to regulatory sanctions. Management believes the Bank meets substantially all standards which have been adopted.

Before establishing new branch offices, the Bank must meet certain minimum capital stock and surplus requirements. With each new branch located outside the municipal area of the Bank's principal banking office, these minimal levels increase by \$120,000 to \$900,000, based on the population size of the municipal area in which the branch will be located. Prior to establishment of the branch, the Bank must obtain Commissioner and FDIC approval. If establishment of the branch involves the purchase of a bank building or furnishings, the total investment in bank buildings and furnishings cannot exceed, with certain exceptions, 50% of the Bank's unimpaired capital and surplus.

Financial Services Modernization. Effective in pertinent part on March 11, 2000, the federal Gramm-Leach-Bliley Act (GLBA) revises the federal Bank Holding Company Act of 1956 and repeals the affiliation provisions of the federal Glass-Steagall Act of 1933, which, taken together, limited the securities, insurance, and other non-banking activities of any company that controls an FDIC insured financial institution. Under the GLBA, bank holding companies can elect, subject to certain qualifications, to become a financial holding company. First Mariner made an election to become a financial holding company in 2002 and, as such, First Mariner may engage in activities that are in addition to the business of banking. The GLBA provides that a financial holding company may engage in a full range of financial activities, including insurance and securities sales and underwriting activities, real estate development, and,

with certain exceptions, merchant banking activities, with new expedited notice procedures. The GLBA also permits certain qualified national banks to form financial subsidiaries, which have broad authority to engage in all financial activities except insurance underwriting, insurance investments, real estate investment or development, and merchant banking, and expands the potential activities of subsidiaries of state banks, subject to applicable state law. The GLBA may increase the competition we encounter.

Deposit Insurance. As an FDIC member institution, deposits of the Bank are currently insured to a maximum of \$100,000 per depositor through the Deposit Insurance Fund (DIF), administered by the FDIC. The FDIC is required to establish the semi-annual assessments for DIF-insured depository institutions at a rate determined to be appropriate to maintain or increase the reserve ratio of the respective deposit insurance funds at or above 1.25% of estimated insured deposits or at such higher percentage that the FDIC determines to be justified for that year by circumstances raising significant risk of substantial future losses to the fund. Assessments are made on a risk-based premium system with nine risk classifications based on certain capital and supervisory measures. Financial institutions with higher levels of capital and involving a low degree of supervisory concern are assessed lower premiums than financial institutions with lower levels of capital or involving a higher degree of supervisory concern.

On February 8, 2006, the Federal Deposit Insurance Reform Act (Reform Act) of 2006 was signed into law. The Reform Act increases the general limit on deposit insurance based on consumer price inflation, with the first increase taking effect on January 1, 2011, and additional adjustments made every five years thereafter. In addition, the Reform Act gives the FDIC the authority to manage its reserves more flexibly and over a longer time horizon by rescinding the automatic trigger of 1.25% of estimated insured deposits.

Limits on Dividends and Other Payments. First Mariner s current ability to pay dividends is largely dependent upon the receipt of dividends from its banking subsidiary. Both federal and state laws impose restrictions on the ability of the Bank to pay dividends. Federal law prohibits the payment of a dividend by an insured depository institution like the Bank if the depository institution is considered undercapitalized or if the payment of the dividend would make the institution undercapitalized. See Federal Deposit Insurance Corporation Improvement Act of 1991 below. We do not anticipate that such provisions will be applied to the Bank. The Federal Reserve has issued a policy statement which provides that, as a general matter, insured banks and bank holding companies may pay dividends only out of prior operating earnings. For a Maryland chartered bank or trust company, dividends may be paid out of undivided profits or, with the prior approval of the Commissioner, from surplus in excess of 100% of required capital stock. If however, the surplus of a Maryland bank is less than 100% of its required capital stock, cash dividends may not be paid in excess of 90% of net earnings. In addition to these specific restrictions, bank regulatory agencies also have the ability to prohibit proposed dividends by a financial institution which would otherwise be permitted under applicable regulations if the regulatory body determines that such distribution would constitute an unsafe or unsound practice.

Capital Requirements. The Federal Reserve and FDIC have adopted certain risk-based capital guidelines to assist in the assessment of the capital adequacy of a banking organization s operations for both transactions reported on the balance sheet as assets and items, such as letters of credit and recourse arrangements, which are recorded as off balance sheet items. Under these guidelines, nominal dollar amounts of assets and credit equivalent amounts of off balance sheet items are multiplied by one of several risk adjustment percentages, which range from 0% for assets with low credit risk, such as certain U.S. Treasury securities to 100% for assets with relatively high credit risk, such as business loans.

A banking organization's risk-based capital ratio is obtained by dividing its qualifying capital by its total risk adjusted assets. The regulators measure risk-adjusted assets, which include off balance sheet items, against both total qualifying capital (the sum of Tier 1 capital and limited amounts of Tier 2 capital) and Tier 1 capital. Tier 1, or core capital, includes common equity, perpetual preferred stock (excluding auction rate issues), trust preferred securities (limited to one-third of other Tier 1 components), and minority interest in equity accounts of consolidated subsidiaries (less goodwill and other intangibles), subject to certain exceptions. Tier 2, or supplementary capital, includes, among other things, limited-life preferred stock, hybrid capital instruments, mandatory convertible securities and trust preferred securities (above amounts not qualifying as Tier 1 capital), qualifying and subordinated debt, and the allowance for loan and lease losses, subject to certain limitations and less required deductions. The inclusion of elements of Tier 2 capital is subject to certain other requirements and limitations of the federal banking agencies. Banks and bank holding companies, subject to the risk-based capital guidelines are required to maintain a ratio of Tier 1 capital to risk-weighted assets of at least 4% and a ratio of total capital to risk-weighted assets of at least 8%. The appropriate regulatory authority may set higher capital requirements when particular circumstances warrant. In addition to risk-based capital, banks and bank holding companies are required to maintain a minimum amount of Tier 1 capital to quarterly average assets, referred to as the leverage capital ratio, of at least 4%. First Mariner and the Bank maintained capital ratios that exceeded these minimum standards. See Item 7 Management's Discussion and Analysis of Financial Condition and Results of Operations, for the year ended December 31, 2006 for more detailed information concerning capital adequacy.

Federal banking agencies have adopted regulations specifying that the agencies will include, in their evaluations of a bank's capital adequacy, an assessment of the bank's interest rate risk (IRR) exposure. The standards for measuring the adequacy and effectiveness of a banking organization's interest rate risk management includes a measurement of board of director and senior management oversight, and a determination of whether a banking organization's procedures for comprehensive risk management are appropriate to the circumstances of the specific banking organization. The Bank utilizes IRR models that are used to measure and monitor IRR. Additionally, the regulatory agencies have been assessing IRR on an informal basis for several years.

Failure to meet applicable capital guidelines could subject a banking organization to a variety of enforcement actions, including limitations on its ability to pay dividends, the issuance by the applicable regulatory authority of a capital directive to increase capital and, in the case of depository institutions, the termination of deposit insurance by the FDIC, as well as the measures described under Federal Deposit Insurance Corporation Improvement Act of 1991 below, as applicable to undercapitalized institutions. In addition, future changes in regulations or practices could further reduce the amount of capital recognized for purposes of capital adequacy. Such a change could affect the ability of the Bank to grow and could restrict the amount of profits, if any, available for the payment of dividends to First Mariner.

Federal Deposit Insurance Corporation Improvement Act of 1991. In December 1991, Congress enacted FDICIA, which substantially revised the bank regulatory and funding provisions of the Federal Deposit Insurance Act and made significant revisions to several other federal banking statutes. FDICIA provides for, among other things, (i) publicly available annual financial condition and management reports for financial institutions, including audits by independent accountants, (ii) the establishment of uniform accounting standards by federal banking agencies, (iii) the establishment of a prompt corrective action system of regulatory supervision and intervention, based on capitalization levels with more scrutiny and restrictions placed on depository institutions with lower levels of capital, (iv) additional grounds for the appointment of a conservator or receiver, and (v) restrictions or prohibitions on accepting brokered deposits, except for institutions which significantly exceed minimum capital requirements. FDICIA also provides for increased funding of the FDIC insurance funds and the implementation of risk-based premiums.

A central feature of FDICIA is the requirement that the federal banking agencies take prompt corrective action with respect to depository institutions that do not meet minimum capital requirements. Pursuant to FDICIA, the federal bank regulatory authorities have adopted regulations setting forth a five-tiered system for measuring the capital adequacy of the depository institutions that they supervise. Under these regulations, a depository institution is classified in one of the following capital categories: well capitalized, adequately capitalized, undercapitalized, significantly undercapitalized, and critically undercapitalized. An institution may be deemed by the regulators to be in a capitalization category that is lower than is indicated by its actual capital position if, among other things, it receives an unsatisfactory examination rating with respect to asset quality, management, earnings, or liquidity.

FDICIA generally prohibits a depository institution from making any capital distribution (including payment of a cash dividend) or paying any management fees to its holding company if the depository institution would thereafter be undercapitalized. Undercapitalized depository institutions are subject to growth limitations and are required to submit capital restoration plans. If a depository institution fails to submit an acceptable plan, it is treated as if it is significantly undercapitalized. Significantly undercapitalized depository institutions may be subject to a number of other requirements and restrictions including orders to sell sufficient voting stock to become adequately capitalized, requirements to reduce total assets and stop accepting deposits from correspondent banks. Critically undercapitalized institutions are subject to the appointment of a receiver or conservator, generally within 90 days of the date such institution is determined to be critically undercapitalized.

FDICIA provides the federal banking agencies with significantly expanded powers to take enforcement action against institutions that fail to comply with capital or other standards. Such action may include the termination of deposit insurance by the FDIC or the appointment of a receiver or conservator for the institution. FDICIA also limits the circumstances under which the FDIC is permitted to provide financial assistance to an insured institution before appointment of a conservator or receiver.

Interstate Banking Legislation. The Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994 (Riegle-Neal) was enacted into law on September 29, 1994. Riegle-Neal authorized federal banking agencies to approve interstate bank merger transactions even if such transactions are prohibited by the laws of a state. An exception to such authorization arises if the home state of one of the banks that is a party to the merger transaction opted out of the merger provisions of Riegle-Neal by adopting a law after the date of the enactment of the Riegle-Neal and prior to June 1, 1997. These laws must apply equally to all out-of-state banks and expressly prohibit merger transactions involving out-of-state banks. Riegle-Neal also permits interstate branch acquisitions if the laws of the state where the branch is located permits interstate branch acquisitions. The interstate merger and branch acquisitions permitted by Riegle-Neal are subject to nationwide and statewide insured deposit limitations as described in Riegle-Neal.

Riegle-Neal also authorizes the federal banking agencies to approve *de novo* interstate branching by national and state banks in states which specifically allow for such branching. To our knowledge, only two states, Texas and Montana, have opted out of the Riegle-Neal provisions relating to interstate mergers, acquisitions of branches and establishment of *de novo* branches. We anticipate that Riegle-Neal may increase competition within our market area, although we cannot predict the timing or the extent of such increased competition.

Privacy Legislation. Current Federal banking rules limit the ability of banks and other financial institutions to disclose non-public personal financial information about customers to non-affiliated third parties. Under these rules, financial institutions must provide initial notices to customers about their privacy policies that provide a description of the conditions under which they may disclose non-public personal information to non-affiliated third parties and affiliates. Institutions must also provide annual notices to current customers that provide a reasonable method for customers to opt out of disclosures to non-affiliated parties. These policies affect how customer information is transmitted through diversified

financial companies and conveyed to third parties. We have implemented our privacy policies in accordance with the law.

USA Patriot Act. The USA Patriot Act of 2001 significantly increased the anti-money laundering and financial transparency laws to require additional due diligence for financial institutions. The law set standards for verifying customer information at account opening and maintenance of records, and created rules to promote cooperation among financial institutions, regulators and law enforcement in identifying parties that may be involved in terrorism or money laundering. The law requires financial businesses to report cash transactions in excess of \$10,000 to the U.S. Treasury Department, and also requires reporting of suspicious customer activities.

Sarbanes-Oxley Act of 2002. The Sarbanes-Oxley Act of 2002 comprehensively revised the laws affecting corporate governance, accounting obligations and corporate reporting for companies, such as the Company, with equity or debt securities registered under the Securities Exchange Act of 1934. In particular, the Sarbanes-Oxley Act established, among other things: 1) new requirements for audit committees, including independence, expertise, and responsibilities; 2) additional responsibilities regarding financial statements for the Chief Executive Officer and Chief Financial Officer of the reporting company; 3) new standards for auditors and regulation of audits; 4) increased disclosure and reporting obligations for the reporting company and its directors and executive officers; and 5) new and increased civil and criminal penalties for violation of the securities laws.

Economic Monetary Policies and Economic Controls

We are affected by monetary policies of regulatory agencies, including the Federal Reserve Board, which regulates the national money supply in order to mitigate recessionary and inflationary pressures. Among the techniques available to the Federal Reserve Board are: engaging in open market transactions in U.S. Government securities, changing the discount rate on bank borrowings, changing reserve requirements against bank deposits, prohibiting the payment of interest on demand deposits, and imposing conditions on time and savings deposits. These techniques are used in varying combinations to influence the overall growth of bank loans, investments and deposits. Their use may also affect interest rates charged on loans or paid on deposits. The effect of governmental policies on our earnings cannot be predicted. However, our earnings will be impacted by movement in interest rates, as discussed in Part II Item 7A- Quantitative and Qualitative Disclosures About Market Risk.

ITEM 1A RISK FACTORS

Our Future Depends on the Successful Growth of the Bank and Finance Maryland

Our primary business activity for the foreseeable future will be to act as a financial holding company. Our future profitability will therefore depend on the success and growth of First Mariner Bank (the Bank) and Finance Maryland, LLC (Finance Maryland). Our growth will depend, in large part, on our ability to leverage our existing infrastructure. The inability of the Bank to expand its business without substantially increasing the number of branches, the inability of our mortgage division to grow its residential mortgage business without substantially increasing its number of offices, or the inability of Finance Maryland to grow its consumer portfolio without substantially increasing its number of offices may prevent us from realizing our growth objectives.

A Significant Amount of Our Business is Concentrated in Real Estate Lending, and Most of this Lending Involves Maryland Real Estate

Approximately 27% of our loan portfolio is comprised of commercial and consumer real estate development and construction loans, which are secured by the real estate being developed in each case. In addition to the risk that the market values of the real estate securing these loans may deteriorate, these loans are also subject to the development risks that the projects will not be completed in a timely manner, or according to original specifications. Real estate development and construction projects that are not completed in a timely manner, or according to original specifications, are generally less marketable than projects that are fully developed. The loans underlying such projects may be subject to greater losses in the event that the real estate collateral becomes the source of repayment.

In addition to the financial strength and cash flow characteristics of the borrower in each case, the Bank often secures its loans with real estate collateral. At December 31, 2006, approximately 82% of the Bank's loans have real estate as a primary, secondary or tertiary component of collateral. The real estate collateral in each case provides an alternate source of repayment in the event of default by the borrower, and may deteriorate in value during the time the credit is extended. If we are required to liquidate the collateral securing a loan during a period of reduced real estate values to satisfy the debt, our earnings and capital could be adversely affected.

We Have A High Percentage Of Commercial, Commercial Real Estate, And Real Estate Acquisition And Development Loans In Relation To Our Total Loans And Total Assets

Our loan portfolio contains a high percentage of commercial, commercial real estate, real estate acquisition and development loans in relation to our total loans and total assets. The Board of Governors of the Federal Reserve System and the Federal Deposit Insurance Corporation, along with other federal banking regulators, issued final guidance on December 6, 2006 entitled, *Concentrations in Commercial Real Estate Lending, Sound Risk Management Practices*, directed at institutions that have particularly high concentrations of commercial real estate loans within their lending portfolios. These types of loans also typically are larger than residential real estate loans and other commercial loans. Because the loan portfolio contains a number of commercial and commercial real estate loans with relatively large balances, the deterioration of one or a few of these loans may cause a significant increase in nonperforming loans. An increase in nonperforming loans could result in a loss of earnings from these loans, an increase in the provision for loan losses, or an increase in loan charge-offs, which could have an adverse impact on financial results.

This recent guidance suggests that institutions whose commercial real estate loans exceed certain percentages of capital should implement heightened risk management practices appropriate to their concentration risk and may be required to maintain higher capital ratios than institutions with lower concentrations in commercial real estate lending. Based on our commercial real estate concentration as of December 31, 2006, we may be subject to further supervisory analysis during future examinations. Although we continuously evaluate our concentration and risk management strategies, we cannot guarantee that any risk management practices we implement will be effective to prevent losses relating to our commercial real estate portfolio. Management cannot predict the extent to which this guidance will impact our operations or capital requirements.

Mortgage-Banking Activities Generate a Significant Portion of Our Noninterest Income

A significant portion of our business involves making residential mortgage loans through our mortgage division, which accounted for approximately 44% and 32% of our noninterest income for the years ended December 31, 2006 and 2005, respectively. Real estate loan origination activity, including refinancings, is generally greater during periods of low or declining interest rates and favorable economic

conditions, which had been favorably affected by relatively lower market interest rates during the past three years. However, we did experience a deterioration in market conditions during 2006 and continued adverse changes in market conditions could have an adverse impact on our earnings. Moreover, most of our residential mortgage loans are secured by Maryland real estate; therefore, a deterioration in local economic conditions could also adversely impact our earnings and has done so in 2006.

We Experience Interest Rate Risk On Our Loans Held For Sale Portfolio

We are exposed to interest rate risk in both our pipeline of mortgage originations (loans that have yet to close with the borrower) and in our warehouse loans (those loans that have closed with the borrower but have yet to be funded by investors). We now manage this interest rate risk primarily in two ways. On the majority of the loans we originate, we enter into agreements to sell our loans through the use of best efforts forward delivery contracts. Under this type of agreement we commit to sell a loan at an agreed price to an investor at the point in time the borrower commits to an interest rate on the loan, with the intent that the buyer assumes the interest rate risk on the loan. Beginning in January 2006, a portion of our mortgage loan pipeline and warehouse were hedged utilizing forward sales of mortgage-backed securities and Eurodollars for loans to be sold under mandatory delivery contracts on a pooled or bulk basis. We expect that these derivative financial instruments (forward sales of mortgage-backed securities and Eurodollars) will experience changes in fair value opposite to the change in fair value of the derivative loan commitments and our warehouse. However, the process of selling loans on a bulk basis and use of forward sales of mortgage-backed securities and Eurodollars to hedge interest rate risk associated with customer interest rate lock commitments involves greater risk than selling loans on an individual basis through best efforts forward delivery commitments. Hedging interest rate risk in bulk sales requires management to estimate the expected fallout (rate lock commitments with customers that do not complete the loan process). Additionally, the fair value of the hedge may not correlate precisely with the change in fair value of the rate lock commitments with the customer due to changes in market conditions, such as demand for loan products, or prices paid for differing types of loan products. Variances from management's estimates for customer fallout or market changes making the forward sale of mortgage-backed securities and/or Eurodollars non-effective may result in higher volatility in our profits from selling mortgage loans originated for sale. We have engaged an experienced third party to assist us in managing our activities in hedging and marketing our bulk sales delivery strategy.

We Experience Credit Risk Related To Our Residential Mortgage Production Activities

We also face credit risk related to our residential mortgage production activities. Credit risk is the potential for financial loss resulting from the failure of a borrower or an institution to honor its contractual obligations to us, including the risk that an investor will fail to honor its obligation under a best efforts forward delivery contract to purchase the loan from us. We manage mortgage credit risk principally by selling substantially all of the mortgage loans that we produce, limiting credit recourse to the Bank in those transactions, and by retaining high credit quality mortgages in our loan portfolio. We also limit our risk of loss on mortgage loan sales by establishing limits on activity to any one investor and by entering into contractual relationships with only those financial institutions that are approved by our Secondary Marketing Committee. While the period of time between closing on a loan commitment with the borrower and funding by the investor ranges from between 15 and 90 days, the process of selling loans on a bulk basis may extend the period of time we hold the loan and exposes us to a greater risk of early delinquency or default.

We Experience Risk Related To Covenants In Our Loan Sales Agreements With Investors

Our sales agreements with investors who buy our loans generally contain covenants which may require us to repurchase loans under certain provisions, including delinquencies, or return premiums paid by these

investors should the loan be paid off early. Any loans we are required to repurchase may be considered impaired loans, with the potential for charge-offs and/or loss provision charges. The addition of these repurchased loans to our portfolio could adversely affect our earnings and asset quality ratios.

There may be certain loans in our portfolio that were originated for sale, but for various reasons, are unable to be sold. These loans are transferred to our loan portfolio at fair market value. Any deterioration in value of the loan during the period held in the portfolio would be charged as a valuation allowance and would reduce our earnings.

We May Experience Loan Losses in Excess of the Allowance

The risk of credit losses on loans varies with, among other things, general economic conditions, the type of loan being made, the creditworthiness of the borrower over the term of the loan and, in the case of a collateralized loan, the value and marketability of the collateral for the loan. Management maintains an allowance for loan losses based upon, among other things, historical loss experience in the loan portfolios, the levels and trends in past-due and nonaccrual loans, the status of nonaccrual loans and other loans identified as having the potential for further deterioration, credit risk and industry concentrations, trends in loan volume, the effects of any changes in lending policies and procedures or underwriting standards, and a continuing evaluation of the economic environment.

Based upon such factors, management makes various assumptions and judgments about the ultimate collectibility of the loan portfolio and provides an allowance for loan losses based upon a percentage of the outstanding balances and for specific loans when their ultimate collectibility is considered questionable. If management's assumptions and judgments prove to be incorrect and the allowance for loan losses is inadequate to absorb future losses, or if regulatory authorities require the Bank or Finance Maryland to increase the allowance for loan losses as a part of their examination process, our earnings and capital could be significantly and adversely affected.

As of December 31, 2006, the allowance for loan losses was \$12.399 million, which represented 1.43% of outstanding loans, net of unearned income. At such date, we had nonaccruing loans totaling \$4.158 million. Management actively administers its nonaccruing loans in an effort to minimize credit losses. Although management believes that its allowance for loan losses is adequate, there can be no assurance that the allowance will prove sufficient to cover future loan losses. Further, although management uses the best information available to make determinations with respect to the allowance for loan losses, future adjustments may be necessary if economic conditions differ substantially from the assumptions used or adverse developments arise with respect to nonperforming or performing loans. Material additions to the allowance for loan losses would result in a decrease in net income and capital, and could have a material adverse effect on us.

We currently hold a significant level of Bank Owned Life Insurance

We currently hold a significant level of Bank Owned Life Insurance on key employees and executives that have cash surrender values of \$33.492 million as of December 31, 2006. The eventual repayment of the cash surrender value is subject to the ability of various insurance companies to pay benefits in the event of the death of an insured employee, or return the cash surrender value to us in the event of our need for liquidity. We continuously monitor the financial strength of the various insurance companies with whom we carry policies. However, there is no assurance that one or more of these companies will not experience a decline in financial strength which could impair its ability to pay benefits or return our cash surrender value. Additionally, should we need to liquidate these policies for liquidity needs, we would be subject to taxation on the increase in cash surrender value as well as penalties for early termination of the insurance contracts. These events would have a negative impact on our earnings.

Economic Conditions and Monetary Policy

Our operating results will depend to a great extent upon the rate differentials between the yields earned on our loans, securities and other earning assets and the rates paid on our deposits and other interest-bearing liabilities. These rate differentials are highly sensitive to many factors beyond our control, including general economic conditions and the policies of various governmental and regulatory authorities, in particular the Federal Reserve Board. The makeup of our loan and deposit portfolios, in particular, determines our sensitivity to these factors. At December 31, 2006, we had a one year cumulative interest sensitivity gap of \$206.053 million. See Item 7A - Quantitative and Qualitative Disclosures About Market Risk Interest Rate Sensitivity.

Like other depository institutions, the Company is affected by the monetary policies implemented by the Federal Reserve Board and other federal entities. A primary instrument of monetary policy employed by the Federal Reserve Board is the restriction or expansion of the money supply through open market operations, including the purchase and sale of government securities and the adjustment of reserve requirements. These actions may at times result in significant fluctuations in interest rates, which could have adverse effects on our operations. In particular, our ability to make loans, attract deposits and realize gains on the sale of residential mortgage loans, as well as public demand for loans, could be adversely affected. See Item 1 - Business Economic Monetary Policies and Economic Controls.

Our Ability to Pay Cash Dividends is Limited

Holders of shares of our common stock are entitled to dividends if declared by our board of directors out of funds legally available for that purpose. Although the board of directors has declared cash dividends in the past, it has discontinued such payments to conserve cash and capital resources, and does not intend to declare cash dividends until current earnings are sufficient to generate adequate internal capital to support growth. Our current ability to pay dividends is largely dependent upon the receipt of dividends from the Bank. Federal and state laws impose restrictions on the ability of the Bank to pay dividends. Additional restrictions are placed upon us by the policies of federal regulators, including the FRB's November 14, 1985 policy statement, which provides that bank holding companies should pay dividends only out of the past year's net income, and then only if their prospective rate of earnings retention appears consistent with their capital needs, asset quality, and overall financial condition.

Our ability to pay dividends is further subject to our ability to make payments of interest under junior subordinated debentures due through 2035 held by our statutory trusts Mariner Capital Trust II, III, IV, V, VI, VII, and VIII (the trusts). These payments are necessary to fund the distributions that the trusts each must pay to holders of its trust preferred securities (collectively, the Mariner Trust Preferred Securities). If we are unable to make such payments, if we determine to defer such payments, or if we default under our other obligations in connection with the Mariner Trust Preferred Securities, we will not be permitted to pay dividends to holders of our common stock until such time as we recommence making payments or are not otherwise in default.

In general, future dividend policy is subject to the discretion of the Board of Directors and will depend upon a number of factors, including the future earnings, capital requirements, regulatory constraints, and our financial condition as well as that of the Bank and Finance Maryland.

Our Management Controls a Significant Percentage of Our Stock

At December 31, 2006, our directors and executive officers beneficially owned approximately 1,869,000 shares of our common stock (either directly or with options), or 29% of our outstanding shares of common stock. Edwin F. Hale, Sr., who is our Chairman, Chief Executive Officer, and largest stockholder, beneficially owns 1,412,941 shares of common stock (with options), or 22% of our outstanding shares of common stock as of December 31, 2006. Because of the large percentage of stock held by our

directors and executive officers, these persons could influence the outcome of any matter submitted to a vote of our stockholders.

Our Stock is Not Heavily Traded

The average daily trading volume of our shares on The Nasdaq National Market for the previous three months was approximately 5,300 shares. Thus, our common stock is not heavily traded and can be more volatile than stock trading in an active public market. Factors such as our financial results, the introduction of new products and services by us or our competitors, and various factors affecting the banking industry generally may have a significant impact on the market price of our common stock. We cannot predict the extent to which an active public market for our common stock will develop or be sustained. In recent years, the stock market has experienced a high level of price and volume volatility, and market prices for the stock of many companies have experienced wide price fluctuations that have not necessarily been related to their operating performance. Therefore, our stockholders may not be able to trade large blocks of shares at the volumes, prices, or times that they desire.

Our Stock is Not Insured

Investments in the shares of our common stock are not deposits and are not insured against loss by the government.

We Operate in a Competitive Market

We operate in a competitive environment, competing for deposits, loans and customers with commercial banks, thrifts, finance companies, and other financial entities. Competition for deposits comes primarily from other commercial banks, savings associations, credit unions, money market, Internet-based deposit intermediaries, mutual funds, and other investment alternatives. Competition for loans comes primarily from other commercial banks, savings associations, mortgage-banking firms, consumer finance companies, credit unions, and other financial intermediaries. Many of the financial intermediaries operating in our market area offer certain services, such as trust, investment, and international banking services, which we do not offer. In addition, companies with a larger capitalization and financial intermediaries not subject to regulatory restrictions, have larger lending limits, and are thereby able to serve the needs of larger customers. Finally, our continued growth and profitability will depend upon our ability to attract and retain skilled managerial, marketing, and technical personnel. Competition for qualified personnel in the banking industry is intense, and there can be no assurance that we will be successful in attracting and retaining such personnel.

Contracts With Our Officers May Discourage a Takeover or Adversely Affect Our Takeover Value

We have entered into change in control agreements with nine of our officers. These agreements provide for a payment to each officer of a multiple (ranging from 1 to 2.99) of his or her salary and bonus upon the occurrence of either a change in control that results in the loss of employment or a significant change in his or her employment. Thus, we may be required to make significant payments in the event that the rights under these agreements are triggered by a change in control. As a result, these contracts may discourage a takeover, or adversely affect the consideration payable to stockholders in the event of a takeover.

Our Articles of Incorporation and Bylaws May Discourage a Corporate Takeover

Our Amended and Restated Articles of Incorporation (Articles), and Amended and Restated Bylaws (Bylaws), contain certain provisions designed to enhance the ability of the Board of Directors to deal with attempts to acquire control of the Company. These provisions provide for the classification of

our Board of Directors into three classes; directors of each class serve for staggered three year periods. The Articles also provide for supermajority voting provisions for the approval of certain business combinations. Although these provisions do not preclude a takeover, they may have the effect of discouraging a future takeover attempt which would not be approved by our Board of Directors, but pursuant to which stockholders might receive a substantial premium for their shares over then-current market prices. As a result, stockholders who might desire to participate in such a transaction might not have the opportunity to do so. Such provisions will also render the removal of our Board of Directors and of management more difficult and, therefore, may serve to perpetuate current management. Further, such provisions could potentially adversely affect the market price of the common stock.

ITEM 1B UNRESOLVED STAFF COMMENTS

There were no unresolved comments from the staff of the Securities and Exchange Commission at December 31, 2006.

ITEM 2 PROPERTIES

We lease our executive offices located at 1501 South Clinton Street, Baltimore, Maryland. This location also houses a headquarters satellite branch office. We occupy approximately 75,500 square feet at this location, which is adjacent to the former headquarters building.

We own our headquarters branch office located at 3301 Boston Street, Baltimore, Maryland. This location also houses drive-up banking and customer parking facilities.

During 2006, we leased an operations facility at 1516 Baylis Street, Baltimore, Maryland. We occupied approximately 34,500 square feet of office space. Rent paid during 2006 was approximately \$209,000 for the office space. We vacated a substantial majority of this space before the end of 2006, moving our operational divisions into the new executive office tower on South Clinton Street and into our old executive office building on Boston Street.

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We operate retail bank branches at the following locations:*

Annapolis(2) 161 A Jennifer Road Annapolis, MD 21401-7923	Loch Raven(1) 1641 East Joppa Road Baltimore, MD 21286-2300
Arbutus(2) 3720 Washington Blvd., Suite 100 Baltimore, MD 21227-1656	Lutherville/Timonium(2) 1738 York Road Lutherville, MD 21093-5606
Bel Air(3) 12 A Bel Air South Parkway Bel Air, MD 21015-3964	Ocean City(2) 12505 Coastal Highway Ocean City, MD 21842-4781
Canton(1) 3301 Boston Street Baltimore, MD 21224-4974	Odenton(1) 1600 Annapolis Road Odenton, MD 21113-1002
Canton Tower/Headquarters(2)(4) 1501 S. Clinton Street Baltimore, MD 21224-4974	Owings Mills(3) 4800 Painters Mill Road Owings Mills, MD 21117-3604
Carroll Island(2) 176 Carroll Island Road Baltimore, MD 21220-2208	Perry Hall (1) 8843 Bel Air Road Perry Hall, MD 21236-2403
Cockeysville(3) 9840 York Road Cockeysville, MD 21030-4914	Pikesville(1) 1013 Reisterstown Road Baltimore, MD 21208-4207
Columbia(2) 8835 Centre Park Drive, Suite 100 Columbia, MD 21045-2114	Pikesville Drive-Thru(2)(4) 1100 Reisterstown Road Baltimore, MD 21208-4207
Crofton(3) 1049 MD Route 3 Gambrills, MD 21054-1722	Randallstown(1) 9833 Liberty Road Randallstown, MD 21133-2034
Downtown Baltimore(2) 300 N. Charles Street Baltimore, MD 21201-4300	Severna Park(2) 366A Gov Ritchie Highway Severna Park, MD 21146-2911
Dundalk(2) 7860 Wise Avenue Baltimore, MD 21222-3338	Shrewsbury(2) Market Square Shopping Center 549 S. Main Street Shrewsbury, PA 17361-1718
Easton(2) 8662 Alica Drive Easton, MD 21601-7184	Towson(1) 115 East Joppa Road Baltimore, MD 21286-3113
Ellicott City(3) 10065 Baltimore National Pike Ellicott City, MD 21042-3611	White Marsh(1) 10101 Philadelphia Road Baltimore, MD 21237-3411
Glen Burnie(2) 305 South Crain Highway Glen Burnie, MD 21061-3110	Woodlawn(3) 7007 Security Boulevard Baltimore, MD 21244-2514

* For our branch hours and remote ATM locations, please refer to our website at www.1stmarinerbank.com.

- (1) Company owns branch
- (2) Company leases branch
- (3) Company owns branch, but leases related land
- (4) Office is a satellite branch

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For more information on our lease commitments and costs see Note 7 of the Notes to Consolidated Financial Statements, included in Item 8 Financial Statements and Supplementary Data.

We operate mortgage offices at the following locations:

Annandale, VA(2)	Loch Raven(1)
7010 Little River Turnpike, Suite 140	1641 East Joppa Road, 2nd Floor
Annandale, VA 22003	Baltimore, MD 21286
Annapolis(2)	Salisbury(2)
2086 Generals Highway, 2nd Floor	309 E. Main Street, Suite 100
Annapolis, MD 21401	Salisbury, MD 21801
Canton/Headquarters(1)	Waldorf(2)
3301 Boston Street	3200 Crain Highway, Suite 102
Baltimore, MD 21224	Waldorf, MD 20603
Crofton(3)	White Marsh(1)
1049 MD Route 3, 2nd floor	10101 Philadelphia Road
Gambrills, MD 21054	White Marsh, MD 21237
Ellicott City(3)	Wilmington(2)
10065 Baltimore National Pike	3301 Lancaster Pike, Suite 5B
Ellicott City, MD 21042	Wilmington, DE 19805
Fairfax Wholesale(2)	Concord, North Carolina(2)
3975 Fair Ridge Dr., Ste 300	1036 Brandview Drive
North Tower Fairfax, VA 22033	Concord, NC 28024

-
- (1) Company owns office
 - (2) Company leases office
 - (3) Company owns office, but leases related land

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We operate consumer finance offices at the following locations which are leased by Finance Maryland:

Bel Air	Overlea
225 Briarhill Place, Suite I-1	7682 Belair Road
Bel Air, MD 21015	Baltimore, MD 21236
Bowie	Randallstown
3440 Crain Highway	3537 Brenbrook Drive
Bowie, MD 20716	Randallstown, MD 21133
Cumberland	Salisbury
1050 West Industrial Blvd. Unit 7	319 B Civic Avenue
Cumberland, MD 21502	Salisbury, MD 21804
Dundalk	Waldorf
1770 Merritt Blvd.	2084 Crain Highway
Baltimore, MD 21222	Waldorf, MD 20610
Easton	Westminster
8223-17 Elliott Road	625 Baltimore Blvd.
Easton, MD 21601	Westminster, MD 21157
Essex	Woodlawn
511A Eastern Blvd.	6666 Security Blvd., Suite 16
Essex, MD 21221	Baltimore, MD 21207
Frederick	Canton/Headquarters/Central Approval
454 Prospect Blvd	3301 Boston Street
Frederick, MD 21702	Baltimore, MD 21224
Glen Burnie	Bear, Delaware
7400 Ritchie Highway, Suite E	1831 Pulaski Highway
Glen Burnie, MD 21061	Bear, DE 19701
Hagerstown	Dover, Delaware
1423 Dual Hwy	222 S. Dupont Hwy, Ste 101
Hagerstown, MD 21740	Dover, DE 19901
Laurel	Milford, Delaware
3421 Fort Meade Rd	975A Dupont Blvd
Laurel, MD 20707	Milford, DE 19963
North East	Seaford, Delaware
113 North East Plaza	1026 West Stein Highway
North East, MD 21901	Seaford, DE 19973

Our bank branches range in total size from 2,000 to 4,000 square feet, mortgage offices generally range from 1,200 to 2,000 square feet and our Finance Maryland offices from 800 to 1,600 square feet. All of our locations are suitable and adequate to conduct business and support growth in customer and transaction volume.

ITEM 3 LEGAL PROCEEDINGS

We are party to legal actions that are routine and incidental to our business. In management's opinion, the outcome of these matters, individually or in the aggregate, will not have a material effect on our results of operations or financial position.

ITEM 4 SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

There was no submission of matters to a vote of securities holders during the fourth quarter of the year ended December 31, 2006.

ITEM 4A EXECUTIVE OFFICERS OF THE REGISTRANT

Edwin F. Hale, Sr. (age 60) has been Chairman and Chief Executive Officer of First Mariner and of the Bank since 1995. Joseph A. Cicero (age 62) has been the President of First Mariner and Chief Operating Officer of the Bank since 1996. George H. Mantakos (age 64) has been Executive Vice President of First Mariner, and the President of the Bank since 1995. Mark A. Keidel (age 45) has been Senior Vice President and Chief Financial Officer of First Mariner and the Bank since June 2000.

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PART II**ITEM 5 MARKET FOR THE REGISTRANT'S COMMON EQUITY, RELATED STOCKHOLDER MATTERS AND ISSUER PURCHASES OF EQUITY SECURITIES****Market for Common Stock**

Our common stock trades on The NASDAQ National Market under the symbol FMAR. The table below sets forth for the periods indicated the low and high market prices of our common stock as reported on The Nasdaq National Market. These over-the-counter market quotations reflect inter-dealer prices and do not include retail mark-up, mark-down or commissions, and they may not necessarily represent actual transactions. We currently have approximately 2,700 stockholders, and we did not pay a cash dividend in 2006 or 2005.

	Low	High
2006 Quarter ended:		
Fourth quarter	\$ 18.36	\$ 20.45
Third quarter	18.51	19.50
Second quarter	18.30	19.60
First quarter	17.26	19.34
2005 Quarter ended:		
Fourth quarter	\$ 16.50	\$ 18.45
Third quarter	16.05	18.86
Second quarter	15.18	17.82
First quarter	17.30	18.30

Equity Compensation Plan Information

The following table sets forth the securities authorized for issuance under the Company's equity compensation plans as of December 31, 2006:

Plan category	(A) Number of securities to be issued upon exercise of outstanding options, warrants and rights	(B) Weighted-average exercise price of outstanding options, warrants and rights	(C) Number of securities remaining available for future issuance under equity compensation plans (excluding securities reflected in column (A))
Equity compensation plans approved by security holders	793,022	\$ 12.84	238,243
Equity compensation plans not approved by security holders			
Total	793,022	\$ 12.84	238,243

Issuer Purchases of Equity Securities(1)

The following table sets forth the Company's purchases of its Common Stock for the most recent fiscal quarter:

	Total Number of Shares Purchased	Average Price Paid Per Share	Total Number of Shares Purchased as Part of Plan	Maximum Number of Shares Yet to Purchase
October 2006			132,425	167,575
November 2006	5,000	\$ 18.75	137,425	162,575
December 2006	25,900	\$ 18.87	163,325	136,675

(1) On July 18, 2006, the Company announced that its Board of Directors approved an extension to its share repurchase program, originally approved on July 20, 2004, of up to 300,000 shares (approximately 5%) of our outstanding common stock, which provides for open market or private purchases of stock over the next 24 months. During the year ended December 31, 2006, the Company repurchased a total of 30,900 shares of our common stock at an approximate cost of \$582,000.

Performance Graph

The following graph compares the performance of the Company's Common Stock, with the performance of a broad market index and a nationally-recognized industry standard assuming in each case both an initial \$100 investment on December 31, 2001 and reinvestment of dividends as of the end of the Company's fiscal years. The Company has selected the Nasdaq Market Index as the relevant broad market index because prices for the Company's Common Stock are quoted on Nasdaq National Market. Additionally, the Company has selected the Nasdaq Bank Index as the relevant industry standard because such index consists of financial institutions which the Company believes generally possess assets, liabilities and operations more similar to the Company than other publicly-available indices. However, given the short history of the Company's operations and its rapid growth, the Company believes no truly appropriate comparative index exists.

	Period Ending					
	12/31/2001	12/31/2002	12/31/2003	12/31/2004	12/31/2005	12/31/2006
First Mariner Bancorp	100	120.2	203.06	191.7	191.05	202.51
NASDAQ Bank Index	100	104.52	135.8	150.73	144.2	160.07
NASDAQ Market Index	100	68.47	102.72	111.54	113.07	123.84

ITEM 6 SELECTED FINANCIAL DATA

	2006	2005	2004	2003	2002
<i>(dollars in thousands, except per share data)</i>					
Consolidated Income Statement Data:					
Net interest income	\$ 49,266	\$ 47,723	\$ 42,441	\$ 34,411	\$ 30,988
Provision for loan losses	2,315	3,287	2,243	2,536	2,175
Noninterest income	23,767	23,015	19,190	21,086	14,994
Noninterest expense	69,159	56,340	50,926	45,883	37,973
Income tax (benefit) expense	(365)	3,289	2,361	1,771	1,930
Net income	1,924	7,822	6,101	5,307	3,904
Consolidated Balance Sheet Data:					
Total assets	\$ 1,263,290	\$ 1,362,478	\$ 1,250,531	\$ 1,057,853	\$ 871,152
Loans receivable, net	854,060	839,843	736,566	601,155	526,777
Deposits	924,938	876,010	825,417	747,733	668,169
Long-term borrowings	132,557	131,000	134,369	110,000	85,000
Stockholders' equity	78,629	72,375	64,314	58,434	51,126
Per Share Data:					
Number of shares of common stock outstanding at year end	6,427,725	6,262,442	5,826,011	5,693,637	5,394,586
Net income per common share:					
Basic	\$ 0.30	\$ 1.28	\$ 1.06	\$ 0.97	\$ 0.73
Diluted	0.29	1.20	0.96	0.88	0.69
Cash dividends declared					
Performance and Capital Ratios:					
Return on average assets	0.14	% 0.59	% 0.54	% 0.57	% 0.49
Return on average equity	2.53	% 11.44	% 10.11	% 9.76	% 8.20
Net interest margin	3.96	% 3.88	% 4.06	% 3.99	% 4.17
Average equity to average assets	5.59	% 5.13	% 5.36	% 5.83	% 5.99
Year-end Tier 1 leverage ratio	8	% 7	% 7	% 8	% 8
Tier 1 capital to risk-weighted assets	10	% 10	% 9	% 10	% 10
Total capital to risk-weighted assets	16	% 15	% 14	% 15	% 13
Asset Quality Ratios:					
Nonperforming assets to total assets	0.52	% 0.29	% 0.38	% 0.48	% 0.40
Allowance for loan losses at year-end to:					
Total loans, net of unearned income	1.43	% 1.38	% 1.28	% 1.43	% 1.35
Nonperforming assets and 90 day past-due loans	36.61	% 244.14	% 150.84	% 118.61	% 55.85
Net charge-offs to average total loans, net of unearned income	0.19	% 0.14	% 0.21	% 0.19	% 0.10

ITEM 7 MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

Forward-Looking Statements

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

The Company

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

The Company's business is conducted primarily through its wholly owned subsidiaries: First Mariner Bank (the Bank), Finance Maryland LLC (Finance Maryland), and FM Appraisals, LLC (FM Appraisals). First Mariner Bank is the largest operating subsidiary of the Company with assets exceeding \$1.157 billion as of December 31, 2006. The Bank was formed in 1995 through the merger of several small financial institutions. The Bank's primary market area for its core banking operations, which consist of traditional commercial and consumer lending, as well as retail and commercial deposit operations, is central Maryland as well as portions of Maryland's eastern shore. The Bank's mortgage division, First Mariner Mortgage, operates on both a regional and national basis. First Mariner Bank is an independent community bank, and its deposits are insured by the FDIC. The Bank is engaged in the general commercial banking business, with particular attention and emphasis on the needs of individuals and small to mid-sized businesses, and delivers a wide range of financial products and services that are offered by many larger competitors. Products and services include traditional deposit products, a variety of consumer and commercial loans, residential and commercial mortgage and construction loans, wire transfer services, non-deposit investment products, and Internet banking and similar services. Most importantly, the Bank

provides customers with access to local Bank officers who are empowered to act with flexibility to meet customers' needs in an effort to foster and develop long-term loan and deposit relationships.

Finance Maryland engages in traditional consumer finance activities, making small direct cash loans to individuals, the purchase of installment loan sales contracts from local merchants and retail dealers of consumer goods, and loans to individuals via direct mail solicitations. Finance Maryland currently operates 17 branches and a central approval office in the state of Maryland and four branches in the state of Delaware, which operate under the trade name Finance Delaware. Finance Maryland had total assets of \$65.911 million as of December 31, 2006.

FM Appraisals is a residential real estate appraisal preparation and management company that is headquartered in Baltimore City. FM Appraisals offers appraisal services for residential real estate lenders, including appraisal preparation, the compliance oversight of sub-contracted appraisers, appraisal ordering and administration, and appraisal review services. FM Appraisals provides these services to First Mariner Mortgage.

Critical Accounting Policies

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

Allowance for loan losses

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

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

Investment securities

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

Deferred income taxes

Under the liability method, deferred tax assets and liabilities are determined based on the difference between the financial statement and tax bases of assets and liabilities. Deferred tax assets are subject to management's judgment based upon available evidence that future realization is more likely than not.

Loan income recognition

Interest income on loans is accrued at the contractual rate based on the principal outstanding. Loan origination fees and certain direct loan origination costs are deferred and amortized as a yield adjustment over the contractual loan terms. Accrual of interest is discontinued when its receipt is in doubt, in accordance with Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards (SFAS) No. 114, *Accounting by Creditors for Impairment of a Loan*. Any interest accrued to income in the year when interest accruals are discontinued is reversed. Management may elect to continue the accrual of interest when a loan is in the process of collection and the estimated fair value of the collateral is sufficient to satisfy the principal balance and accrued interest. Loans are returned to accrual status once the doubt concerning collectibility has been removed and the borrower has demonstrated the ability to pay and remain current. Payments on nonaccrual loans are generally applied to principal.

Derivative Loan Commitments and Hedging Activities

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

Loan Repurchases

Our sales agreements with investors who buy our loans generally contain covenants which may require us to repurchase loans under certain provisions, including delinquencies, or return premiums paid by those investors should the loan be paid off early. These covenants are usual and customary within the mortgage-banking industry and generally apply for the first 90 days after the loan has been purchased by the investor. We maintain a reserve (included in other liabilities) for potential losses relating to these sales covenants, including estimates for the devaluation of loans as a result of their delinquency status.

RESULTS OF OPERATIONS AND FINANCIAL CONDITION

The following discussion compares our financial condition at December 31, 2006 to the financial condition at December 31, 2005 and results of operations for the years ended December 31, 2006, 2005, and 2004. This discussion should be read in conjunction with our accompanying financial statements and related notes as well as statistical information included in this report.

Performance Overview

We recorded net income of \$1.924 million for 2006 compared to \$7.822 million for 2005, a decrease of 75.4%. Diluted earnings per share totaled \$0.29 per share for 2006, a decrease of 75.8% from \$1.20 per diluted share in 2005. The decline in net income and earnings per share resulted due to the fact that our gross revenue (net interest income and noninterest income) increased \$2.295 million or 3.2%, while our noninterest expenses, the provision for loan losses, and income tax expense increased by \$8.193 million or 13.0%.

Net income for 2006 was impacted significantly by a balance sheet restructuring and negative trends in our mortgage-banking operations. In December of 2006, we elected to sell approximately \$100.000 million of securities held in our investment portfolio (yield, 3.85%) and repay an equal amount of short-term borrowings (cost, 5.45%). In conjunction with the restructuring, we realized losses on the sales of securities of \$3.063 million. The restructure is expected to have a positive impact in future periods as the yields on securities sold was significantly lower than borrowings repaid.

During the second half of 2006, our results were negatively impacted by higher delinquency and default levels in loans originated by the Bank in our mortgage-banking division. The higher delinquencies and defaults resulted in the repurchase of loans sold as well as an increase in the volume of loans originated for sale which could not be sold. Loans repurchased or deemed unsalable must be marked to market at the time of repurchase or transfer into the Bank's portfolio. The Bank recorded valuation allowances related to these loans repurchased and expected to be repurchased of \$4.450 million, which reduced reported profits in the third and fourth quarters of 2006.

The impact of both the balance sheet restructuring and the valuation allowance totaled \$7.513 million (\$4.959 million after taxes) and were the primary factors in the significant decline in net income.

Our largest category of revenue, net interest income, grew \$1.543 million or 3.2% due to increased volume of average earning assets from \$1.230 billion in 2005 to \$1.243 billion in 2006 and an increase in our net interest margin from 3.88% in 2005 to 3.96% in 2006. Noninterest income increased \$752,000 or 3.3% due to higher levels of mortgage banking revenue of \$3.199 million. (The increase in noninterest income excluding the loss on investment securities from the balance sheet restructuring was \$3.789 million). We experienced higher income from most major sources of noninterest income.

Our increase in total expenses resulted from higher noninterest expenses (by \$12.819 million), offset by a decrease in our income tax expense of \$3.654 million and a decrease in our provision for loan losses of \$972,000. Noninterest expense growth was primarily the result of higher salaries and benefit costs, higher occupancy costs, as well as \$4.450 million in valuation allowances and secondary marketing reserves for

repurchases and anticipated repurchases of loans previously sold on the secondary market. The decrease in income tax expense was primarily due to lower pretax income and removal of the valuation allowance on the net operating loss carryforward of the Holding Company. The decrease in our provision for loan losses is largely a function of our slower loan growth in 2006 as compared to 2005. The provision recorded resulted in an increase in the allowance for loan losses to 1.43% of total loans as of December 31, 2006 from 1.38% as of December 31, 2005.

The return on average assets was 0.14% for 2006 compared to 0.59% for 2005. The return on average equity for 2006 was 2.53% compared to 11.44% for 2005. Average equity to average assets was 5.59% for 2006 compared to 5.13% for 2005. The decline in both the return on average assets and the return on average equity is primarily a result of recognizing security sales losses and the provision for the valuation allowance and secondary marketing reserve.

Our total assets decreased by \$99.188 million or 7.3%, reflecting the balance sheet restructuring at the end of 2006. We experienced an increase in loans and loans held for sale, which were funded by increases in deposits. Loans outstanding increased by \$14.873 million or 1.7%, and loans held for sale increased by \$2.020 million or 2.2%, while our deposits grew by \$48.928 million or 5.6%. Stockholders' equity increased \$6.254 million or 8.6% reflecting the retention of 2006's earnings, and shares sold and issued upon the exercise of options and warrants and in connection with our employee stock purchase plan. In addition, we experienced an increase in other comprehensive income due to the increase in the market value of securities classified as available for sale, which resulted from the sale of securities with significant losses in market value. These items were offset somewhat by the shares repurchased under our stock repurchase plan.

During 2006, our asset quality deteriorated and we increased our allowance for loan losses to \$12.399 million, which totaled 187.9% of nonperforming assets as of December 31, 2006, compared to 297.3% as of December 31, 2005. Our ratio of net chargeoffs to average total loans was 0.19% in 2006, compared to 0.14% in 2005. Our ratio of nonperforming assets to total assets increased to 0.52% at December 31, 2006 from 0.29% at December 31, 2005. Our level of loans 90 days delinquent and still accruing interest increased to \$27.274 million from \$860,000 in 2005.

Capital adequacy levels remained strong, exceeding the levels we are required to maintain for well-capitalized status as defined by banking regulation. December 31, 2006 ratios for our capital leverage, Tier 1 capital to risk weighted assets, and total capital to risk weighted assets were 7.8%, 10.0%, and 15.6%, respectively, compared to 7.4%, 9.5%, and 14.9%, respectively, at December 31, 2005. Our regulatory capital levels increased as the growth rate of regulatory capital exceeded growth rates in total and risk-adjusted assets.

Results of Operations

Net Interest Income/Margins

Our primary source of earnings is net interest income, which is the difference between the interest income we earn on interest-earning assets, such as loans and investment securities, and the interest expense we pay on interest-bearing sources of funds, such as deposits and borrowings. The level of net interest income we earn is determined mostly by the average balances (volume) and the rate spreads between our interest-earning assets and our funding sources.

Net interest income for 2006 totaled \$49.266 million, an increase of 3.2% over \$47.723 million for 2005. The improvement in net interest income during 2006 was due in large part to an increase in our average earning assets, from the 2005 level of \$1.230 billion to the 2006 level of \$1.243 billion. Our yield on earning assets also increased, from 6.67% for 2005 to 7.70% for 2006. These benefits, plus an increase in average noninterest-bearing deposits, more than offset the higher rates paid on interest-bearing deposits

and borrowings, which increased from 3.16% for 2005 to 4.24% for 2006. As a result, the net interest margin (net interest income divided by average earning assets) increased to 3.96% for 2006, as compared to 3.88% for the comparable period in 2005. Net interest margin is the key performance measure for our net interest income. Our net interest margin is affected by our loan pricing, our mix of earning assets, and our distribution and pricing of deposits and borrowings.

During 2006, we sold approximately \$100.000 million of fixed rate investment securities yielding approximately 3.85% in order to extinguish approximately \$100.000 million in short-term debt costing 5.45%. The restructuring is anticipated to increase net interest income in 2007.

Interest income. Total interest income increased by \$13.688 million primarily due to the increase in the yield on average earning assets. Yields on earning assets for the period increased to 7.70% from 6.67% due to the higher mix of loans and loans held for sale (which carry higher yields than investments and other earning assets) and increases in market interest rates. The yield on total loans increased from 7.70% to 8.69% and reflected increases in the rates for most loan categories. The yield on loans held for sale increased from 6.05% to 7.73%.

Average loans outstanding increased by \$50.488 million, with increases in almost every loan category. Average investment securities decreased \$36.741 million due to the sale of securities during 2006 to restructure the balance sheet, and regular principal reductions on mortgage-backed securities.

Interest expense. Interest expense increased by \$12.145 million, due primarily to an increase in the average rate paid on interest-bearing liabilities, which increased from 3.16% for the year ended December 31, 2005 to 4.24% for the year ended December 31, 2006. We also experienced an increase in average interest-bearing liabilities of \$11.622 million, which was driven by an increase in money market accounts, offset by decreases in NOW, savings, and time deposits, as well as borrowings. The decrease in average borrowings of \$11.997 million was due to repayment of short-term advances from the FHLB in conjunction with our balance sheet restructuring and the decrease in overall average investment securities. The increase in the average rate paid on interest-bearing liabilities was a result of the higher interest rate environment in 2006 and consumer preferences for higher yielding money market products.

The table below sets forth the average balances, net interest income and expense and average yields and rates for our interest-earning assets and interest-bearing liabilities for 2006, 2005, and 2004.

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Comparative Average Balances Yields and Rates

<i>(dollars in thousands)</i>	2006			2005			2004		
	Average	Interest (1)	Yield/ Rate	Average	Interest (1)	Yield/ Rate	Average	Interest (1)	Yield/ Rate
	Balance			Balance			Balance		
ASSETS									
Loans (2):									
Commercial loans and lines of credit	\$ 70,238	\$ 4,803	6.84%	\$ 68,035	\$ 3,791	5.57%	\$ 76,370	\$ 4,474	5.86%
Residential construction - commercial	123,188	10,968	8.90%	88,634	6,987	7.88%	49,328	3,698	7.50%
Commercial mortgages	335,584	24,557	7.32%	331,975	22,899	6.90%	256,960	17,908	6.97%
Residential construction - consumer	113,053	8,977	7.94%	130,535	9,245	7.08%	123,759	8,882	7.18%
Residential mortgages	46,308	2,733	5.90%	41,798	2,499	5.98%	40,880	2,692	6.59%
Consumer	166,836	22,239	13.33%	143,742	16,520	11.49%	105,209	11,431	10.87%
Total loans	855,207	74,277	8.69%	804,719	61,941	7.70%	652,506	49,085	7.52%
Loans held for sale	101,841	7,877	7.73%	102,321	6,195	6.05%	48,791	2,464	5.05%
Securities available for sale, at fair value	262,968	12,365	4.70%	299,709	13,066	4.36%	316,878	13,219	4.17%
Interest-bearing deposits	10,970	529	4.82%	9,428	284	3.01%	19,546	235	1.20%
Restricted stock investments, at cost	12,317	700	5.68%	13,997	574	4.10%	7,507	267	3.56%
Total earning assets	1,243,303	95,748	7.70%	1,230,174	82,060	6.67%	1,045,228	65,270	6.24%
Allowance for loan losses	(12,000)			(10,470)			(8,995)		
Cash and other nonearning assets	129,867			113,118			89,415		
Total assets	\$1,361,170	95,748		\$ 1,332,822	82,060		\$ 1,125,648	65,270	
LIABILITIES AND STOCKHOLDERS EQUITY									
Interest-bearing deposits:									
NOW deposits	\$ 10,945	24	0.22%	\$ 13,065	26	0.20%	\$ 55,488	191	0.34%
Savings deposits	67,164	205	0.31%	71,789	218	0.30%	67,009	235	0.35%
Money market deposits	241,039	7,855	3.26%	203,222	3,215	1.58%	158,802	1,341	0.84%
Time deposits	388,192	15,836	4.08%	395,645	13,270	3.35%	367,847	11,041	3.00%
Total interest-bearing deposits	707,340	23,920	3.38%	683,721	16,729	2.45%	649,146	12,808	1.97%
Borrowings	389,533	22,562	5.79%	401,530	17,608				

