FIRST MARINER BANCORP
Form 10-Q
August 09, 2007

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended June 30, 2007.

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

For the transition period from to

Commission file number: 0-21815

FIRST MARINER BANCORP

(Exact name of registrant as specified in its charter)

Maryland (State of Incorporation)		**52-1834860** (I.R.S. Employer Identification Number)
1501 South Clinton Street, Baltimore, MD (Address of principal executive offices)	**21224** (Zip Code)	**410-342-2600** (Telephone Number)

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

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 o Accelerated filer x Non-accelerated filer o

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

The number of shares of common stock outstanding as of August 3, 2007 is 6,437,181 shares.

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PART I FINANCIAL INFORMATION

Item 1 Financial Statements

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

	June 30, 2007 *(unaudited)*	December 31, 2006
ASSETS		
Cash and due from banks	$ 33,316	$ 36,734
Federal funds sold and interest-bearing deposits	77,798	6,235
Trading securities, at fair value	38,095	
Securities available for sale, at fair value	52,103	147,290
Loans held for sale	97,276	94,371
Loans receivable	826,325	866,459
Allowance for loan losses	(12,550)	(12,399)
Loans, net	813,775	854,060
Other real estate owned	15,388	2,440
Restricted stock investments	5,983	6,449
Premises and equipment, net	52,585	49,062
Accrued interest receivable	8,092	10,579
Deferred income taxes	8,685	6,806
Bank-owned life insurance	34,192	33,492
Prepaid expenses and other assets	14,897	15,772
Total assets	$ 1,252,185	$ 1,263,290
LIABILITIES AND STOCKHOLDERS EQUITY		
Liabilities:		
Deposits:		
Noninterest-bearing	$ 170,660	$ 186,720
Interest-bearing	733,486	738,218
Total deposits	904,146	924,938
Short-term borrowings	42,560	40,884
Long-term borrowings, at fair value	61,296	
Long-term borrowings	85,982	132,557
Junior subordinated deferrable interest debentures	73,724	73,724
Accrued expenses and other liabilities	11,038	12,558
Total liabilities	1,178,746	1,184,661
Stockholders equity:		
Common stock, $.05 par value; 20,000,000 shares authorized; 6,437,181 and 6,427,725 shares issued and outstanding, respectively	322	321
Additional paid-in capital	57,227	57,123
Retained earnings	16,035	22,109
Accumulated other comprehensive loss	(145)	(924)
Total stockholders equity	73,439	78,629
Total liabilities and stockholders equity	$ 1,252,185	$ 1,263,290

See accompanying notes to the consolidated financial statements

First Mariner Bancorp and Subsidiaries

Consolidated Statements of Operations

(dollars in thousands except per share data)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2007 *(unaudited)*	2006	2007 *(unaudited)*	2006
Interest income:				
Loans	$ 19,901	$ 20,668	$ 39,636	$ 39,696
Investments and other earning assets	2,490	3,520	4,734	6,807
Total interest income	22,391	24,188	44,370	46,503
Interest expense:				
Deposits	6,980	5,585	13,909	10,632
Short-term borrowings	302	2,697	617	4,694
Long-term borrowings	3,651	3,264	7,179	6,293
Total interest expense	10,933	11,546	21,705	21,619
Net interest income	11,458	12,642	22,665	24,884
Provision for loan losses	2,515	623	3,053	1,045
Net interest income after provision for loan losses	8,943	12,019	19,612	23,839
Noninterest income:				
Gain on sale of mortgage loans	457	2,263	2,050	3,706
Other mortgage-banking revenue	619	799	1,349	1,424
ATM fees	855	824	1,571	1,609
Service fees on deposits	1,642	1,769	3,113	3,448
Trading gain (loss) on securities and long-term borrowings	47		(64)	
Gain on investment securities, net			887	
Commissions on sales of nondeposit investment products	243	122	550	216
Income from bank-owned life insurance	365	256	700	508
Commissions on sales of other insurance products	746	753	1,333	1,318
Other	435	601	869	1,154
Total noninterest income	5,409	7,387	12,358	13,383
Noninterest expense:				
Salaries and employee benefits	8,961	9,006	18,317	17,438
Occupancy	2,322	1,932	4,563	3,635
Furniture, fixtures and equipment	907	750	1,769	1,550
Professional services	449	257	799	459
Advertising	409	397	920	863
Data processing	485	468	914	917
ATM servicing expenses	279	242	508	525
Write-downs and costs of other real estate owned	837	4	923	
Secondary marketing valuation	2,319		2,352	
Service and maintenance	559	528	1,303	1,066
Other	2,951	2,702	5,756	5,349
Total noninterest expense	20,478	16,286	38,124	31,802
Net (loss) income before income taxes	(6,126)	3,120	(6,154)	5,420
Income tax (benefit) expense	(2,262)	919	(2,390)	1,559
Net (loss) income	$ (3,864)	$ 2,201	$ (3,764)	$ 3,861
Net (loss) income per common share:				
Basic	$ (0.60)	$ 0.35	$ (0.59)	$ 0.62
Diluted	$ (0.60)	$ 0.33	$ (0.59)	$ 0.58

See accompanying notes to the consolidated financial statements.

First Mariner Bancorp and Subsidiaries
Consolidated Statements of Cash Flows

(dollars in thousands)

	Six Months Ended June 30,	
	2007 *(unaudited)*	**2006**
Cash flows from operating activities:		
Net (loss) income	$ (3,764)	$ 3,861
Adjustments to reconcile net (loss) income to net cash from operating activities:		
Stock-based compensation	29	51
Excess tax benefit on share-based compensation		(7)
Depreciation and amortization	2,503	2,200
Amortization of unearned loan fees and costs, net	(305)	(612)
Amortization of premiums and discounts on loans, net	(472)	(368)
Amortization of premiums and discounts on mortgage-backed securities, net	7	115
Loss on trading securities	64	
Gain on sale of securities available for sale	(887)	
Gain on sale of mortgage loans	(2,050)	(3,706)
Decrease (increase) in accrued interest receivable	2,487	(713)
Provision for loan losses	3,053	1,045
Write-downs and losses on sale of other real estate owned	1,030	(9)
Secondary marketing reserve	2,352	
Loss on disposal of premises and equipment		2
Increase in cash surrender value of bank-owned life insurance	(700)	(508)
Originations of mortgage loans held for sale	(495,550)	(615,874)
Proceeds from mortgage loans held for sale	493,694	592,526
Net (decrease) increase in accrued expenses and other liabilities	(5,013)	4,198
Net decrease (increase) in prepaids and other assets	809	(1,360)
Net cash used in operating activities	(2,713)	(19,159)
Cash flows from investing activities:		
Loan principal repayments, net of (disbursements)	52,222	(9,858)
Repurchase of loans previously sold	(29,851)	
Purchases of premises and equipment	(6,047)	(6,030)
Proceeds from disposals of premises and equipment	21	15
Redemptions of restricted stock investments	466	201
Maturities/calls/repayments of trading securities	2,050	
Activity in securities available for sale:		
Sales of securities available for sale	1,301	
Maturities/calls/repayments of securities available for sale	54,656	12,402
Purchase of securities available for sale	(999)	(5,250)
Proceeds from sales of other real estate owned	2,662	875
Net cash provided by (used in) investing activities	76,481	(7,645)
Cash flows from financing activities:		
Net (decrease) increase in deposits	(20,792)	6,759
Net increase in other borrowed funds	15,102	20,795
Excess tax benefit on share-based compensation		7
Proceeds from stock issuance	207	347
Repurchase of common stock, net of costs	(140)	
Net cash (used in) provided by financing activities	(5,623)	27,908
Increase in cash and cash equivalents	68,145	1,104
Cash and cash equivalents at beginning of period	42,969	45,835
Cash and cash equivalents at end of period	$ 111,114	$ 46,939
Supplemental information:		
Interest paid on deposits and borrowed funds	$ 21,633	$ 21,308
Income taxes paid	$	$ 1,616
Real estate acquired in satisfaction of loans	$ 16,640	$ 1,000
Transfer of loans held for sale to loan portfolio	$ 1,001	$

See accompanying notes to the consolidated financial statements.

First Mariner Bancorp and Subsidiaries
Notes to Consolidated Financial Statements

(Information as of and for the three and six months ended June 30, 2007 and 2006 is unaudited)

NOTE 1 SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Basis Of Presentation

The accompanying consolidated financial statements for First Mariner Bancorp (the Company) have been prepared in accordance with the instructions for Form 10-Q and, therefore, do not include all information and notes necessary for a full presentation of financial condition, results of operations and cash flows in conformity with accounting principles generally accepted in the United States of America. The consolidated financial statements should be read in conjunction with the audited financial statements included in our 2006 Annual Report on Form 10-K.

The consolidated financial statements include the accounts of the Company s subsidiaries, First Mariner Bank (the Bank), Mariner Finance, LLC (Mariner Finance) (which changed its name from Finance Maryland, LLC, effective August 1, 2007), and FM Appraisals, LLC (FM Appraisals). All significant intercompany balances and transactions have been eliminated.

The consolidated financial statements as of June 30, 2007 and for the three and six months ended June 30, 2007 and 2006 are unaudited but include all adjustments, consisting only of normal recurring adjustments, which we consider necessary for a fair presentation of financial position and results of operations for those periods. The results of operations for the three and six months ended June 30, 2007 are not necessarily indicative of the results that will be achieved for the entire year.

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

Certain reclassifications have been made to amounts previously reported to conform to the classifications made in 2007.

Investment Securities

We designate securities into one of the three categories at the time of purchase. Debt securities that we have the positive intent and ability to hold to maturity are classified as held to maturity and recorded at amortized cost. Debt and equity securities are classified as trading securities if bought and held principally for the purpose of selling them in the near term. Trading securities are reported at estimated fair value, with unrealized gains and losses included in earnings. Debt securities not classified as held to maturity and debt and equity securities not classified as trading securities are considered available for sale and are reported at estimated fair value, with unrealized gains and losses reported as a separate component of stockholders equity, net of tax effects, in accumulated other comprehensive income. Effective January 1, 2007, we adopted Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards (SFAS) No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities Including an amendment of FASB Statement No. 115,* and designated $42.000 million in securities as trading securities which were previously designated as available for sale. In accordance with SFAS No. 159, we recorded a cumulative effect of accounting change reduction to retained earnings related to the investments in the amount of $993,000 (net of deferred tax impact) as of January 1, 2007.

Borrowings

In conjunction with our adoption of SFAS No. 159 as of January 1, 2007, we began recording certain of our long-term borrowings at fair value, with corresponding changes in fair values recorded in income. On January 1, 2007, we recorded a cumulative effect of accounting change reduction to retained earnings in the amount of $1.251 million (net of deferred tax impact) related to $60.000 million in borrowings that we began recording at fair value.

NOTE 2 COMPREHENSIVE INCOME

The following table shows the Company s comprehensive income for the three and six months ended June 30, 2007 and 2006:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2007	2006	2007	2006
	(dollars in thousands)			
Net income	$ (3,864)	$ 2,201	$ (3,764)	$ 3,861
Other comprehensive income items:				
Cumulative effect of accounting change for certain investments, net of tax expense of $0, $0, $625 and $0, respectively			993	
Unrealized holding gains (losses) arising during the period (net of tax expense (benefit) of $(92), $(426), $208, and $(1,172), respectively)	(147)	(677)	330	(1,862)
Less: reclassification adjustment for gains (net of taxes of $0, $0, $343, and $0, respectively) included in net (loss) income			(544)	
Total other comprehensive (loss) income	(147)	(677)	779	(1,862)
Total comprehensive (loss) income	$ (4,011)	$ 1,524	$ (2,985)	$ 1,999

NOTE 3 PER SHARE DATA

Basic earnings per share is computed by dividing income available to common stockholders by the weighted-average number of common shares outstanding. Diluted earnings per share is computed after adjusting the denominator of the basic earnings per share computation for the effects of all dilutive potential common shares outstanding during the period. The dilutive effects of options, warrants and their equivalents are computed using the treasury stock method. For the three and six month periods ended June 30, 2007, all options were antidilutive and excluded from the computations. For both the three and six month periods ended June 30, 2006, there were 8,600 shares which were antidilutive and excluded from the computations.

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

	Three Months Ended June 30,		Six Months Ended June 30,	
	2007	2006	2007	2006
	(dollars in thousands, except for per share data)			
Net (loss) income - basic and diluted	$ (3,864)	$ 2,201	$ (3,764)	$ 3,861
Weighted-average share outstanding - basic	6,430,015	6,276,362	6,425,439	6,270,629
Dilutive securities - options and warrants		352,783		342,364
Adjusted weighted-average shares outstanding - dilutive	6,430,015	6,629,145	6,425,439	6,612,993
(Loss) earnings per share - basic	$ (0.60)	$ 0.35	$ (0.59)	$ 0.62
(Loss) earnings per share - diluted	$ (0.60)	$ 0.33	$ (0.59)	$ 0.58

NOTE 4 STOCK BASED COMPENSATION

We have stock option award arrangements, which provide for the granting of options to acquire common stock to our directors and key employees. Option prices are equal to or greater than the estimated fair market value of the common stock at the date of the grant. As of June 30, 2007, 793,539 of the outstanding options are fully vested and 5,933 of the outstanding options vest over a three year period. All options expire ten years after the date of grant. There have been no modifications to the existing plan. We recognized stock compensation expense, net of taxes, of $13,000, $51,000, $29,000 and $51,000, for the three and six months ended June 30, 2007 and 2006 respectively. We anticipate incurring an additional $21,000 in compensation expense, net of taxes, over the next three years related to the unvested options.

Information with respect to stock options is as follows for the six months ended June 30, 2007:

	Number of Shares	Weighted-Average Exercise Price	Weighted-Average Remaining Contractual Term *(in years)*	Aggregate Intrinsic Value *(in thousands)*
Outstanding at beginning of period	793,022	$ 12.84		
Granted	11,450	14.58		
Exercised	(2,500)	11.20		
Forfeited/Cancelled	(2,500)	17.76		
Outstanding at end of period	799,472	$ 12.85	5.8	$ 15,704
Exercisable at end of period	793,539	$ 12.85	5.7	$ 12,974

The weighted average fair values of our option grants for the six months ended June 30, 2007 and 2006 were $6.28 and $5.71, respectively, on the dates of grants. The fair values of our options granted were calculated using the Black-Scholes-Merton option-pricing model with the following weighted average assumptions for the six months ended June 30, 2007 and 2006:

	2007	2006
Dividend yield	0.00%	0.00%
Expected volatility	28.38%	15.61%
Risk-free interest rate	4.63%	5.12%
Expected lives	8 years	8 years

The total intrinsic value of options exercised and the related tax benefit during the six months ended June 30, 2007 and 2006 amounted to $11,320, $81,288, $0, and $31,393, respectively, and proceeds from exercises of stock options amounted to $28,005 and $163,692 for the six months ended June 30, 2007 and 2006, respectively.

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

NOTE 5 COMMITMENTS AND CONTINGENT LIABILITIES

We are party to financial instruments with off-balance-sheet risk in the normal course of business in order to meet the financing needs of customers. These financial instruments include commitments to extend credit, available lines of credit and standby letters of credit. Our exposure to credit risk is represented by the contractual amounts of those financial instruments. We apply the same credit policies in making commitments and conditional obligations as we do for on-balance-sheet instruments. A summary of the financial instruments at June 30, 2007 whose contract amounts represent potential credit risk is as follows:

	June 30, 2007 *(dollars in thousands)*	December 31, 2006
Commitments to extend credit (includes unused lines of credit)	$ 232,513	$ 294,227
Standby letters of credit	4,548	4,677

We have established a reserve for potential loan repurchases in the amount of $1.705 million as of June 30, 2007. This reserve is included in other liabilities and is based on projections made by management on the volume of future loans repurchases. These projections contain assumptions that are continually updated as circumstances and experiences change.

NOTE 6 SEGMENT INFORMATION

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

lien residential mortgages for sale in the secondary market and to the Bank. The results of our subsidiary, FM Appraisals, are included in the mortgage-banking segment.

The following table presents certain information regarding our business segments:

For the six month period ended June 30, 2007:

	Commercial and Consumer Banking *(dollars in thousands)*	**Consumer Finance**	**Mortgage-Banking**	**Total**
Interest income	$ 33,625	$ 7,892	$ 2,853	$ 44,370
Interest expense	17,910	1,945	1,850	21,705
Net interest income	15,715	5,947	1,003	22,665
(Recovery of) provision for loan losses	(2,141)	903	4,291	3,053
Net interest income (loss) after provision for loan losses	17,856	5,044	(3,288)	19,612
Noninterest income	7,924	1,561	2,873	12,358
Noninterest expense	24,512	5,177	8,435	38,124
Net intersegment income	83		(83)	
Net income (loss) before income taxes	$ 1,351	$ 1,428	$ (8,933)	$ (6,154)
Total assets	$ 1,082,037	$ 72,872	$ 97,276	$ 1,252,185

For the six month period ended June 30, 2006:

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

NOTE 7 RECENT ACCOUNTING PRONOUNCEMENTS

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

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

value, if practicable. The statement permits the choice between the amortization method and the fair value measurement method for the subsequent measurement of the servicing assets or liabilities and allows for a one-time reclassification of available-for-sale securities to trading securities at initial adoption. The statement also requires separate presentation of servicing assets and servicing liabilities subsequently measured at fair value in the statement of financial position and additional disclosures for all separately recognized servicing assets and servicing liabilities. The statement is effective for fiscal years

beginning after September 15, 2006. The adoption of this standard did not have a material impact on our financial condition, results of operations or liquidity.

In July 2006, the FASB issued FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes an interpretation of FASB Statement No. 109*. The interpretation clarifies the accounting for uncertainty in income taxes recognized in a company s financial statements in accordance with SFAS No. 109, *Accounting for Income Taxes*. The interpretation prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. It also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosures, and transition. In May 2007, the FASB issued FASB Interpretation No. 48-1, *Definition of Settlement in FASB Interpretation No. 48*, which provides guidance on how an enterprise should determine whether a tax position is effectively settled for the purpose of recognizing previously unrecognized tax benefits. These interpretations are effective for fiscal years beginning after December 15, 2006. The adoption of these interpretations did not have a material impact on our financial condition, results of operations or liquidity.

In September 2006, the FASB issued SFAS No. 157, *Fair Value Measurements*. This statement defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles, and expands disclosures about fair value measurements. The statement is effective for financial statements issued for fiscal years beginning after November 15, 2007. We adopted this standard effective January 1, 2007, with no material impact on our financial condition, results of operations or liquidity.

In September 2006, the FASB ratified the consensus reached by the EITF on Issue No. 06-4, *Accounting for Deferred Compensation and Postretirement Benefit Aspects of Endorsement Split-Dollar Life Insurance Arrangements*. EITF 06-4 requires the recognition of a liability and related compensation costs for endorsement split-dollar life insurance policies that provide a benefit to an employee that extends to postretirement periods as defined in SFAS No. 106, *Employers Accounting for Postretirement Benefits Other Than Pensions*. The EITF reached a consensus that Bank Owned Life Insurance policies purchased for this purpose do not effectively settle the entity s obligation to the employee in this regard and, thus, the entity must record compensation costs and a related liability. Entities should recognize the effects of applying this Issue through either, (a) a change in accounting principle through a cumulative-effective adjustment to retained earnings or to other components of equity or net assets in the balance sheet as of the beginning of the year of adoption, or (b) a change in accounting principle through retrospective application to all prior periods. This Issue is effective for fiscal years beginning after December 15, 2007. The adoption of this interpretation is not anticipated to have a material impact on our financial condition, results of operations or liquidity.

In February 2007, the FASB issued SFAS No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities Including an amendment of FASB Statement No. 115*, which generally permits the measurement of selected eligible financial instruments, including investment securities, at fair value as of specified election dates and the reporting of unrealized gains or losses on those instruments in earnings at each subsequent reporting date. Generally, the fair value option may be applied on an instrument by instrument basis but, once applied, the election is irrevocable and is applied to the entire instrument. The statement is effective for fiscal years beginning after November 15, 2007, with early adoption permitted as of the beginning of a fiscal year that begins on or before November 15, 2007.

We adopted SFAS No. 159 on January 1, 2007. The effect of adopting this statement on existing eligible items at the time of adoption is recorded as a cumulative effect of accounting change through retained earnings in the financial statements and is detailed as follows:

	Balance Sheet January 1, 2007 Prior to Adoption *(dollars in thousands)*	**Net Loss Upon Adoption**	**Balance Sheet January 1, 2007 After Adoption of Fair Value Option**
Investment trading securities	$ 42,569	$ (1,618)	$ 40,951
Long-term debt	60,000	(2,038)	62,038
Pre-tax cumulative effect of adoption of the fair value option		(3,656)	
Increase in deferred tax assets		1,412	
Cumulative effect of adoption of the fair value option (charge to retained earnings)		$ (2,244)	

Management believes the adoption was appropriate in order to more closely align the impact of interest rate movements within stockholders equity. Prior to adoption, the securities were marked to market through the Company s stockholders equity, with no offsetting impact of any borrowings or other interest-bearing liabilities, which may act as a natural interest rate risk hedge. By treating certain assets and liabilities with similar characteristics as fair value instruments, both positions will be subject to fair value adjustments through earnings and ultimately stockholders equity. Management believes the adoption will minimize the volatility in reported stockholders equity as the borrowing position will also be subject to fair value treatment.

As a result of our early adoption of SFAS No. 159, we elected to transfer $42.000 million of investment securities previously held as available for sale to trading securities. These securities were selected based upon their yield (under 5%) and quality of available pricing data. The average life of the bonds selected was 5.22 years. In addition, we elected to record $60.000 million of our long-term borrowings at fair value. The borrowings selected were fixed rate (6.07%) with an average remaining life of 3.24 years and have a consistent and reliable pricing source. Retained earnings as of January 1, 2007 was reduced by $2.244 million, net of tax, as a result of the election. This is a permanent adjustment to retained earnings; however, there is no impact to total stockholders equity from the investment reclassification because the market value adjustment of the available for sale securities was already recorded in accumulated other comprehensive loss. This one-time charge will not be recognized in current earnings based upon application of SFAS No. 159. In addition, a pre-tax loss of approximately $64,000 was recognized in the first six months of 2007 due to a net decrease in the fair value of these financial instruments since January 1, 2007.

Interest income on trading securities and interest expense on long-term borrowings at fair value is accrued at the contractual rate based on the principal outstanding. Premiums and discounts related to trading securities are expensed at time of purchase. The interest from trading securities is included in the Statements of Operations in Interest income from investments and other earning assets and the interest on borrowings at fair value is included in the Statements of Operations in Interest expense from long-term borrowings.

The following table shows details of the financial instruments as of June 30, 2007 for which we elected to apply the fair value option:

	Carrying Value (Fair Value)	**Quoted Prices (Level 1)**	**Significant Other Observable Inputs (Level 2)**	**Trading Gains and (Losses)**	**Total Changes In Fair Values Included In Period Earnings**
	(dollars in thousands)				
Trading securities	$ 38,095	$ 38,095	$	$ (806)	$ (806)
Long-term debt at fair value	61,296		61,296	742	742

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

The following discussion should be read and reviewed in conjunction with Management s Discussion and Analysis of Financial Condition and Results of Operations set forth in our Annual Report on Form 10-K for the year ended December 31, 2006.

Forward-Looking Statements

This quarterly report on Form 10-Q may contain forward-looking language within the meaning of The Private Securities Litigation Reform Act of 1995. Statements may include expressions about our confidence, policies, and strategies, provisions and allowance for loan losses, adequacy of capital levels, and liquidity. All statements included or incorporated by reference in this Quarterly Report on Form 10-Q, other than statements that are purely historical, are forward-looking statements. Statements that include the use of terminology such as anticipates, expects, intends, plans, believes, estimates and similar expressions also identify forward-looking statements. The forward-looking statements are based on our current intent, belief and expectations. Forward-looking statements in this Quarterly Report on Form 10-Q include, but are not limited to, statements of our plans, strategies, objectives, intentions, including, among other statements, statements involving our projected loan and deposit growth, loan collateral values, collectibility of loans, anticipated changes in other operating income, payroll and branching expenses, branch, office and product expansion of the Company and its subsidiaries, and liquidity and capital levels. Such forward-looking statements involve certain risks and uncertainties, including general economic conditions, competition in the geographic and business areas in which we operate, inflation, fluctuations in interest rates, legislation and government regulation. These statements are not guarantees of future performance and are subject to certain risks and uncertainties that are difficult to predict. For a more complete discussion of risks and uncertainties that could cause actual results to differ materially from those contained in the forward-looking statements, see Risk Factors filed as Item 1A of Part I in our Form 10-K for the year ended December 31, 2006. 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 bank holding company incorporated under the laws of Maryland and registered under the federal Bank Holding Company Act of 1956, as amended. The Company was organized in 1994 and changed its name to First Mariner Bancorp in May 1995. Since 1995, the Company s strategy has involved building a network of banking branches, ATMs and other financial services outlets to capture market share and build a community franchise for stockholders, customers and employees. The Company is currently focused on growing assets and earnings by capitalizing on the broad network of bank branches, mortgage offices, consumer finance offices, and ATMs established during its infrastructure expansion phase.

The Company s business is conducted primarily through its wholly owned subsidiaries, First Mariner Bank (the Bank), Mariner Finance, LLC (Mariner Finance), and FM Appraisals, LLC (FM Appraisals). The Bank is the largest operating subsidiary of the Company with assets exceeding $1.1 billion as of June 30, 2007. 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 opened its first branch in Pennsylvania during the first quarter of 2007. The Bank is an independent community bank, and its deposits are insured by the Federal Deposit Insurance Corporation (FDIC).

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

First Mariner Mortgage, a division of the Bank, engages in mortgage-banking activities, providing mortgages and associated products to customers and selling most of those mortgages into the secondary market. During 2006, First Mariner Mortgage expanded its secondary marketing activities significantly and began hedging the interest rate risk associated with mortgage-banking activities. During 2007, such activity decreased significantly due to decreased loan demand resulting in a decline in originations, a reduction in the types of products that we offer, and tightening of our underwriting standards. During the second quarter of 2007, we closed the wholesale lending division of First Mariner Mortgage.

Mariner Finance (formerly 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. Mariner Finance currently operates 18 branches, including a central approval office, in the State of Maryland and four branches in the state of Delaware. Mariner Finance had total assets of $72.9 million as of June 30, 2007.

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 Bank regulators, changes in the size and composition of the loan portfolio and peer comparisons are also factors. The analysis also requires consideration of the economic climate and direction and change in the interest rate environment, which may impact a borrower s ability to pay, legislation impacting the banking industry, and environmental and economic conditions specific to the Bank s service areas. Because the calculation of the allowance for loan losses relies on estimates and judgments relating to inherently uncertain events, results may differ from our estimates.

Investment securities

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

Deferred income taxes

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

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, which typically occurs when a loan becomes 90 days past due as to principal or interest. Any interest accrued to income in the year when interest accruals are discontinued is generally reversed. Management may elect to continue the accrual of interest when a loan is in the process of collection and the estimated fair value of the collateral is sufficient to satisfy the principal balance and accrued interest. Loans are returned to accrual status once the doubt concerning 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. 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 30 to 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 and also provide a valuation allowance for the devaluation of repurchased loans as a result of their delinquency status.

Loans repurchased are accounted for under AICPA Statement of Position (SOP) 3-03, *Accounting for Purchases of Impaired Loans.* Under the SOP, loans repurchased must be recorded at market value at the time of repurchase with any deficiency for recording the loan compared to

proceeds paid recorded as a valuation allowance and charged to noninterest expense. Repurchased

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loans are carried on the balance sheet in the loan portfolio. Any further change in the underlying risk profile or further impairment is recorded as a specific reserve in the Company s allowance for loan losses through the provision for loan losses.

Repurchased loans which are foreclosed upon are transferred to Other Real Estate Owned at the time of ratification of foreclosure and recorded at estimated fair value. Any difference between the carrying amount of the loan and its estimated fair value upon foreclosure is charged to the valuation allowance set up for repurchased loans that is separate from the allowance for loan losses. These assets remain in Other Real Estate Owned until their disposition. Any declines in value during this time reduce the carrying amounts through a charge to noninterest expense.

Cumulative Effect of Accounting Change

We adopted SFAS No. 159 effective January 1, 2007. The effect of adopting this statement on existing eligible items at the time of adoption is recorded as a cumulative effect of accounting change in the financial statements through retained earnings and is detailed as follows:

	Balance Sheet January 1, 2007 Prior to Adoption *(dollars in thousands)*	**Net Loss Upon Adoption**	**Balance Sheet January 1, 2007 After Adoption of Fair Value Option**
Investment trading securities	$ 42,569	$ (1,618)	$ 40,951
Long-term debt	60,000	(2,038)	62,038
Pre-tax cumulative effect of adoption of the fair value option		(3,656)	
Increase in deferred tax assets		1,412	
Cumulative effect of adoption of the fair value option (charge to retained earnings)		$ (2,244)	

See Note 7 to the Consolidated Financial Statements above for additional information about our adoption of SFAS No. 159.

Financial Condition

The Company s total assets were $1.252 billion at June 30, 2007, compared to $1.263 billion at December 31, 2006, decreasing $11.105 million for the first six months of 2007. Earning assets decreased $23.224 million or 2.1% to $1.098 billion at June 30, 2007 from $1.121 billion at December 31, 2006. The decrease in assets was due to decreases in cash and due from banks (-$3.418 million), investment securities, both trading and available for sale (-$57.092 million), and net loans outstanding (-$40.285 million), partially offset by increases in loans held for sale (+$2.905 million) and short-term investments (+$71.563 million). We also experienced decreases in deposits (-$20.792 million), partially offset by increases in short-term (+$1.676 million) and long-term (+$14.721 million) borrowings.

Investment securities available for sale

We utilize the investment portfolio as part of our overall asset/liability management practices to enhance interest revenue while providing necessary liquidity for the funding of loan growth or deposit withdrawals. Investment securities available for sale declined $95.187 million due to the transfer of securities available for sale to the trading securities portfolio, security sales of $1.301 million, and normal principal payments on mortgage-backed securities and scheduled maturities of other investments ($54.656 million). These decreases were offset by additional purchases of securities of $999,000. At June 30, 2007, our unrealized loss on securities classified as available for sale totaled $232,000, compared to a loss of $1.505 million at December 31, 2006. The improvement resulted from the transfer of certain securities to the trading portfolio.

The investment securities available for sale portfolio composition is as follows:

	June 30, 2007 Balance	Percent of Total	December 31, 2006 Balance	Percent of Total
	(dollars in thousands)			
Investment securities available for sale:				
Mortgage-backed securities	$ 18,581	35.7 %	$ 62,281	42.3 %
Trust preferred securities	24,433	46.9 %	33,028	22.4 %
US government agency notes			39,894	27.1 %
US Treasury securities	999	1.9 %	998	0.7 %
Obligations of state and municipal subdivisions	2,960	5.7 %	2,965	2.0 %
Corporate obligations	1,979	3.8 %	1,988	1.3 %
Equity securities	652	1.2 %	1,395	1.0 %
Foreign government bonds	1,500	2.9 %	1,750	1.2 %
Other investment securities	999	1.9 %	2,991	2.0 %
Total investment securities available for sale	$ 52,103	100.0 %	$ 147,290	100.0 %

Loans

Total loans decreased $40.134 million during the first six months of 2007. Higher balances occurred in our residential mortgage loan portfolio (+$6.120 million) primarily due to repurchases of loans previously sold on the secondary market. Our loans secured by second mortgages, consumer loans, and our loans secured by deposits and other increased by $7.307 million, $824,000, and $411,000, respectively. The growth in these loan types was offset by decreases in our commercial real estate portfolio (-$36.873 million), commercial construction portfolio (-$5.932 million), consumer residential construction portfolio (-$4.204 million), and our commercial portfolio (-$8.437 million). The total loan portfolio was comprised of the following:

	June 30, 2007 Balance	Percent of Total	December 31, 2006 Balance	Percent of Total
	(dollars in thousands)			
Loans secured by first mortgages on real estate:				
Residential	$ 62,844	7.6 %	$ 56,724	6.5 %
Commercial	281,363	34.0 %	318,236	36.7 %
Consumer residential construction	93,802	11.3 %	98,006	11.3 %
Commercial/residential construction	131,837	16.0 %	137,769	15.9 %
	569,846	68.9 %	610,735	70.4 %
Commercial	70,564	8.5 %	79,001	9.1 %
Loans secured by second mortgages on real estate	109,674	13.3 %	102,367	11.8 %
Consumer loans	74,014	9.0 %	73,190	8.5 %
Loans secured by deposits and other	2,368	0.3 %	1,957	0.2 %
Total loans	826,466	100.0 %	867,250	100.0 %
Unamortized loan discounts	(322)		(220)	
Unearned loan fees, net	181		(571)	
	$ 826,325		$ 866,459	

Credit Risk Management

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

We provide for loan losses through the establishment of an allowance for loan losses (the allowance) by provisions charged against earnings. Our allowance for loan losses represents an estimated reserve for existing losses in the loan portfolio. We deploy a systematic methodology for determining our allowance for loan losses that includes a quarterly review process, risk rating,

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and adjustment to our allowance. We classify our portfolios as either consumer or commercial and monitor credit risk separately as discussed below. We evaluate the adequacy of our allowance for loan losses continually based on a review of all significant loans, with a particular emphasis on nonaccruing, past due, and other loans that we believe require special attention.

The allowance for loan losses consists of three elements: (1) specific reserves and valuation allowances for individual credits; (2) general reserves for types or portfolios of loans based on historical loan loss experience, judgmentally adjusted for current conditions and credit risk concentrations; and (3) unallocated reserves. Combined specific reserves and general reserves by loan type are considered allocated reserves. All outstanding loans are considered in evaluating the adequacy of the allowance.

Commercial

Our commercial portfolio includes all secured and unsecured loans to borrowers for commercial purposes, including commercial lines of credit and commercial real estate. Our process for evaluating commercial loans includes performing updates on all loans that we have rated for risk. Our commercial loans are generally reviewed individually, in accordance with SFAS No. 114, *Accounting by Creditors for Impairment of a Loan,* to determine impairment, accrual status and the need for specific reserves. Our methodology incorporates a variety of risk considerations, both qualitative and quantitative. Quantitative factors include our historical loss experience by loan type, collateral values, financial condition of borrowers, and other factors. Qualitative factors include judgments concerning general economic conditions that may affect credit quality, credit concentrations, the pace of portfolio growth, and delinquency levels; these qualitative factors are evaluated in connection with our unallocated portion of our allowance for loan losses. We periodically engage outside firms and experts to independently assess our methodology, and perform various loan review functions.

The process of establishing the allowance with respect to our commercial loan portfolio begins when a loan officer initially assigns each loan a risk grade, using established credit criteria. Risk grades are subject to review and validation annually by an independent consulting firm, as well as periodically by our internal credit review function. Our methodology employs management s judgment as to the level of future losses on existing loans based on our internal review of the loan portfolio, including an analysis of the borrowers current financial position, and the consideration of current and anticipated economic conditions and their potential effects on specific borrowers and or lines of business. In determining our ability to collect certain loans, we also consider the fair value of any underlying collateral. We also evaluate credit risk concentrations, including trends in large dollar exposures to related borrowers, industry and geographic concentrations, and economic and environmental factors.

A commercial loan is determined to be impaired when, based on current information and events, it is probable that we will be unable to collect all amounts due according to the contractual terms of the loan agreement. Such a loan is not considered impaired during a period of delay in payment if we expect to collect all amounts due, including past-due interest. We generally consider a period of delay in payment to include delinquency up to 90 days. During the first six months of 2007, management considered eleven commercial construction loans and nine commercial mortgage loans to be impaired under this criteria. As of June 30, 2007, we had impaired loans of $16.224 million, $13,334 million of which has been classified as nonaccrual. The valuation allowance for impaired loans was $1.100 million as of June 30, 2007.

We place impaired loans on nonaccrual status when it is probable that we will be unable to collect any accrued and unpaid interest. Once a loan is placed on nonaccrual, it remains in nonaccrual status until the loan is current as to payment of both principal and interest and the borrower demonstrates the ability to pay and remain current. As a result of our ongoing review of the loan portfolio, we may classify loans as nonaccrual even though the presence of collateral or the borrowers financial strength may be sufficient to provide for ultimate repayment. All payments made on nonaccrual loans are applied to the principal balance of the loan.

Consumer

Our consumer portfolio includes residential mortgage loans and other loans to individuals. Consumer and residential mortgage loans, excluding repurchased residential first- and second-lien loans, are segregated into homogeneous pools with similar risk characteristics. Trends and current conditions in consumer and residential mortgage pools are analyzed and historical loss experience is adjusted accordingly. Adjustment factors for the consumer and residential mortgage portfolios are consistent with those for the commercial portfolios. Certain loans in the consumer portfolio identified as having the potential for further deterioration are analyzed individually to confirm the appropriate risk grading and accrual status, and to determine the need for a specific reserve. We follow the same guidelines with regard to consumer nonaccrual loans as we do for commercial nonaccrual loans. Consumer loans, being pools of smaller-balance homogeneous loans are collectively evaluated for impairment. See discussion below under Valuation Reserves on Repurchased Loans for detailed discussion on determining reserves on repurchased loans.

Unallocated

The unallocated portion of the allowance is intended to provide for losses that are not identified when establishing the specific and general portions of the allowance and is based upon management s evaluation of various conditions that are not directly measured in the determination of the formula and specific allowances. Such conditions include general economic and business conditions affecting key lending areas, credit quality trends (including trends in delinquencies and nonperforming loans expected to result from existing conditions), loan volumes and concentrations, specific industry conditions within portfolio categories, recent loss

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experience in particular loan categories, duration of the current business cycle, bank regulatory examination results, findings of external loan review examiners, and management s judgment with respect to various other conditions including loan administration and management and the quality of risk identification systems. Executive management reviews these conditions quarterly. We have risk management practices designed to ensure timely identification of changes in loan risk profiles; however, undetected losses may exist inherently within the loan portfolios. The judgmental aspects involved in applying the risk grading criteria, analyzing the quality of individual loans, and assessing collateral values can also contribute to undetected, but probable, losses.

Valuation Reserves on Repurchased Loans

In accordance with AICPA Statement of Position (SOP) 3-03, *Accounting for Purchases of Impaired Loans*, we establish valuation reserves for repurchased loans originated for sale or transfer of loans from loans held for sale to the loan portfolio. These reserves are in addition to and separate from the allowance for loan losses, and represent the difference between the principal and accrued interest on the repurchased loan, and the loan s estimated fair value at the time of repurchase. The valuation reserves ($3.084 million as of June 30, 2007) are not part of our allowance for loan losses of $12.550 million, but are in addition to it.

In establishing the valuation reserves, management needed to make significant assumptions concerning the ultimate collectibility of loans currently delinquent and their ultimate realizable value. Additionally, a portion of these reserves are based upon projected volume of repurchases. While these projections were made with the most current data available to management, actual realized losses could differ due to the changes in the borrowers willingness or ability to resolve the delinquency status, changes in the actual volume of future repurchases, or changes in market values of those loans which are liquidated. Management will update these assumptions continually as greater experience becomes available.

As of June 30, 2007, we maintained $20.098 million in loans that we have repurchased from investors in accordance with certain covenants in our sales agreements, net of a valuation allowance for these loans in the amount of $2.989 million that is in addition to and separate from the allowance for loan losses. The following table shows the total portfolio of repurchased loans and their status as of June 30, 2007.

	Principal Balance	Valuation Allowance	Carrying Value	Additional Specific Reserves(1)
	(dollars in thousands)			
Nonaccrual loans	$ 4,001	$ 2,080	$ 1,921	$ 1,921
Delinquent 1st mortgages	9,868	500	9,368	197
Modifications	7,930	409	7,521	406
Current loans	1,288		1,288	26
	$ 23,087	$ 2,989	$ 20,098	$ 2,550

(1) Additional specific reserves are included in the allowance for loan losses

The nonaccrual, delinquent and modified loans are currently in the process of collection and the resolution of many of these loans may be through foreclosure of the property. The purchased and accrued interest receivable relating to the delinquent and accruing first-lien mortgage loans is $625,000. The modifications in the table represent repurchased loans we have renegotiated at below market rates in order to improve the borrower s ability to pay. All of these loans are less than 60 days past due as of June 30, 2007.

We also maintain $707,000, net of a valuation allowance of $96,000, in second-lien mortgage loans that we transferred from loans held for sale to our consumer loan portfolio. These are loans similar to those that have been repurchased, but they were never sold. Of the $707,000, $62,000 have been placed on nonaccrual, net of a valuation allowance of $78,000. A substantial amount of these loans are on properties located in Northern Virginia, where the housing market has declined dramatically.

Our total allowance at June 30, 2007 is considered by management to be sufficient to address the credit losses inherent in the current loan portfolio. However, our determination of the appropriate allowance level is based upon a number of assumptions we make about future events, which we believe are reasonable, but which may or may not prove valid. Thus, there can be no assurance that our charge-offs in future periods will not exceed our allowance for loan losses or that we will not need to make additional increases in our allowance for loan losses. The changes in the allowance are presented in the following table:

	Six Months Ended June 30, 2007	2006
	(dollars in thousands)	
Allowance for loan losses, beginning of year	$ 12,399	$ 11,743
Loans charged off:		
Commercial	(67)	
Commercial/residential construction		
Commercial mortgages	(340)	
Residential construction consumer		(9)
Residential mortgages	(262)	
Consumer	(2,481)	(895)
Total loans charged off	(3,150)	(904)
Recoveries:		
Commercial		
Commercial/residential construction		
Commercial mortgages		
Residential construction consumer		22
Residential mortgages	29	
Consumer	219	206
Total recoveries	248	228
Net charge-offs	(2,902)	(676)
Provision for loan losses	3,053	1,045
Allowance for loan losses, end of period	$ 12,550	$ 12,112
Loans (net of premiums and discounts):		
Period-end balance	$ 826,325	$ 860,748
Average balance during period	851,855	854,757
Allowance as a percentage of period-end loan balance	1.52 %	1.41 %
Percent of average loans:		
Provision for loan losses (annualized)	0.72 %	0.25 %
Net charge-offs (annualized)	0.69 %	0.16 %

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

	June 30, 2007			December 31, 2006		
	Amount	Percent of Total	Percent of Loans to Total Loans	Amount	Percent of Total	Percent of Loans to Total Loans
	(dollars in thousands)					
Commercial	$ 515	4.1 %	8.5 %	$ 926	7.5 %	9.1