HARBOR BANKSHARES CORP
Form PRER14A
September 25, 2006

Appendix D
Form 10-KSB

FORM 10-KSB SECURITIES AND EXCHANGE COMMISSION WASHINGTON, D.C. 20549 ANNUAL REPORT PURSUANT TO SECTION 13 or 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934 For the fiscal year ended December 31, 2005 Commission File Number: 0-20990 HARBOR BANKSHARES CORPORATION (Exact name of registrant as specified in its charter) Maryland 52-1786341 (State or other jurisdiction of (IRS Employer Identification No.) incorporation or organization) 25 West Fayette Street 21201 Baltimore, Maryland (Zip Code) (Address of principal executive officer) Registrant's telephone number, including area code: (410) 528-1800 Securities registered pursuant to Section 12(b) of the Act: None. Securities registered pursuant to Section 12(g) of the Act: Common Stock, par value $0.01 per share (Title of Class) Check whether the issuer is not required to file reports pursuant to Section 13 or 15(d) of the Exchange Act. |_| Check whether the issuer (1 filed all reports required to be filed by Section 13 or 15(d) of the Exchange Act during the past 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes |X| No |_| Check if there is no disclosure of delinquent filers in response to Item 405 of Regulation S-B 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-KSB or any amendment to this Form 10-KSB. |_| Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes |_| No |X| Issuer's revenues for its most recent fiscal year: As of March 3, 2006, the registrant had 675,579 shares of Common Stock issued and outstanding, including 33,795 non-voting shares. The aggregate market value of shares held by nonaffiliates on such date was $12,060,050 based on the average of the bid and asked price of $25.00 per share of the Registrant's Common Stock on that date. For purposes of this calculation, it is assumed that the 193,177 shares held by directors and executive officers of the Registrant, are shares held by affiliates. Documents Incorporated by Reference: Portions of the Registrant's Annual Report to Stockholders for the year ended December 31, 2005. Transitional small business disclosure format (check one): Yes |_| No |X| HARBOR BANKSHARES CORPORATION ANNUAL REPORT PURSUANT TO SECTION 13 or 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934 SECURITIES AND EXCHANGE COMMISSION FORM 10-KSB TABLE OF CONTENTS ii PART I Forward Looking Statements Harbor Bankshares Corporation (the "Corporation") makes forward-looking statements in this Annual Report on Form 10-KSB that are subject to risks and uncertainties. These forward-looking statements include: statements of the Corporation's goals, intentions, and expectations; estimates of risks and of future costs and benefits; expectations regarding future financial performance of the Corporation; assessments of loan quality, probable loan losses, and the amount and timing of loan payoffs; liquidity, contractual obligations, off-balance sheet risk, and market or interest rate risk; and statements of the Corporation's ability to achieve financial and other goals. These forward-looking statements are subject to significant uncertainties because they are based upon: the amount and timing of future changes in interest rates, market behavior, and other economic conditions; future laws, regulations and accounting principles; and a variety of other matters. Because of these uncertainties, the actual future results may be materially different from the results indicated by these forward-looking statements. In addition, the Corporation's past growth and performance do not necessarily indicate its future results. Item 1. Description of Business Harbor Bankshares Corporation Harbor Bankshares Corporation (the "Corporation") is a bank holding company with one bank subsidiary and two Community Development financial subsidiaries, one for profit, The Harbor Bank of Baltimore LLC and a non-profit, The Harbor Bank CDC. Both were established during 2002. The Corporation has no investment in either subsidiary as of December 31, 2004. The Corporation was organized under the laws of the State of Maryland in 1992. On November 2, 1992, Harbor Bankshares Corporation acquired all outstanding stock of The Harbor Bank of Maryland (the "Bank"), headquartered in Baltimore, Maryland. The Harbor Bank of Maryland The Bank is a Maryland chartered commercial bank headquartered in Baltimore, Maryland. The Bank was opened on September 13, 1982. The deposits of the Bank are insured by the Federal Deposit Insurance Corporation. The Bank conducts general banking business in seven (7) locations and serves primarily the Baltimore Metropolitan area. It offers checking, savings and time deposits, commercial, real estate, personal, home improvement, automobile and other installment loans, credit cards and term loans. The Bank is also a member of a local and national ATM network. The retail nature of the Bank allows for diversification of deposits and borrowers so it is not dependent upon a single or a few customers. Harbor Financial Services, a company dealing with the sale of mutual funds, stocks, insurance, etc., was established as a subsidiary of the Bank during May 1997 in order to compete with that expanding market. Competition The Corporation's subsidiary, The Harbor Bank of Maryland, competes with virtually all banks and savings institutions that offer services in its market area. The Bank directly competes with branches of most of the State's largest banks, each of which has greater financial and other resources to conduct large advertising campaigns and to allocate their investment assets to regions of higher yield and demand. To attract business in this competitive environment, the Bank relies heavily on local promotional activities and personal contact by its officers and directors and by its ability to provide personalized services. Supervision and Regulation Following is a brief summary of certain statutes and regulations that significantly affect the Corporation and the Bank. A number of other statutes and regulations affect the Corporation and the Bank but are not summarized below. Bank Holding Company Regulation. The Corporation is registered as a bank holding company under the Holding Company Act and, as such, is subject to supervision and regulation by the Board of Governors of the Federal Reserve System (the "Federal Reserve"). As a bank holding company, the Corporation is required to furnish to the Federal Reserve regular reports of its operations and additional information and reports. The Corporation is also subject to regular examination by the Federal Reserve. 1 Under the Holding Company Act, a bank holding company must obtain the prior approval of the Federal Reserve before (1) acquiring direct or indirect ownership or control of any class of voting securities of any bank or bank holding company if, after the acquisition, the bank holding company would directly or indirectly own or control more than 5% of the class; (2) acquiring all or substantially all of the assets of another bank or bank holding company; or (3) merging or consolidating with another bank holding company. Under the Holding Company Act, any company must obtain approval of the Federal Reserve prior to acquiring control of the Corporation or the Bank. For purposes of the Holding Company Act, "control" is defined as ownership of 25% or more of any class of voting securities of the Corporation or the Bank, the ability to control the election of a majority of the directors, or the exercise of a controlling influence over management or policies of the Corporation or the Bank. The Change in Bank Control Act and the related regulations of the Federal Reserve require any person or persons acting in concert (except for companies required to make application under the Holding Company Act), to file a written notice with the Federal Reserve before the person or persons acquire control of the Corporation or the Bank. The Change in Bank Control Act defines "control" as the direct or indirect power to vote 25% or more of any class of voting securities or to direct the management or policies of a bank holding company or an insured bank. The Holding Company Act also limits the investments and activities of bank holding companies. In general, a bank holding company is prohibited from acquiring direct or indirect ownership or control of more than 5% of the voting shares of a company that is not a bank or a bank holding company or from engaging directly or indirectly in activities other than those of banking, managing or controlling banks, providing services for its subsidiaries, non-bank activities that are closely related to banking, and other financially related activities. The activities of the Corporation are subject to these legal and regulatory limitations under the Holding Company Act and Federal Reserve regulations. In general, bank holding companies that qualify as financial holding companies under federal banking law may engage in an expanded list of non-bank activities. Non-bank and financially related activities of bank holding companies, including companies that become financial holding companies, also may be subject to regulation and oversight by regulators other than the Federal Reserve. The Federal Reserve has the power to order a holding company or its subsidiaries to terminate any activity, or to terminate its ownership or control of any subsidiary, when it has reasonable cause to believe that the continuation of such activity or such ownership or control constitutes a serious risk to the financial safety, soundness, or stability of any bank subsidiary of that holding company. The Federal Reserve has adopted guidelines regarding the capital adequacy of bank holding companies, which require bank holding companies to maintain specified minimum ratios of capital to total assets and capital to risk-weighted assets. See "Regulatory Capital Requirements." The Federal Reserve has the power to prohibit dividends by bank holding companies if their actions constitute unsafe or unsound practices. The Federal Reserve has issued a policy statement on the payment of cash dividends by bank holding companies, which expresses the Federal Reserve's view that a bank holding company should pay cash dividends only to the extent that the company's net income for the past year is sufficient to cover both the cash dividends and a rate of earnings retention that is consistent with the company's capital needs, asset quality, and overall financial condition. Bank Regulation. The Bank is subject to supervision by the Federal Deposit Insurance Corporation (`FDIC") and the State of Maryland. Deposits of the Bank are insured by the FDIC to the legal maximum of $100,000 for each insured depositor. Deposits, reserves, investments, loans, consumer law compliance, issuance of securities, payment of dividends, establishment of branches, mergers and acquisitions, corporate activities, changes in control, electronic funds transfers, responsiveness to community needs, management practices, compensation policies, and other aspects of operations are subject to regulation by the appropriate federal and state supervisory authorities. In addition, the Bank is subject to numerous federal, state and local laws and regulations which set forth specific restrictions and procedural requirements with respect to extensions of credit (including to insiders), credit practices, disclosure of credit terms and discrimination in credit transactions. The FDIC regularly examines the operations and condition of the Bank, including, but not limited to, its capital adequacy, reserves, loans, investments, and management practices. These examinations are for the protection of the Bank's depositors and the FDIC's insurance fund. In addition, the Bank is required to furnish quarterly and annual reports to the FDIC. The FDIC's enforcement authority includes the power to remove officers and directors and the authority to issue cease-and-desist orders to prevent a bank from engaging in unsafe or unsound practices or violating laws or regulations governing its business. The FDIC has adopted regulations regarding the capital adequacy, which require FDIC supervised banks to maintain specified minimum ratios of capital to total assets and capital to risk-weighted assets. See "Regulatory Capital Requirements." Regulations limit the amount of dividends that the Bank may pay to the Corporation. See Note 15 "Regulatory Matters" on page 22 of the Audited Consolidated Financial Statements section of the Corporation's Annual Report to Shareholders. 2 The Bank is subject to restrictions under federal law which limit the transfer of funds by the Bank to the Corporation and its non-banking subsidiaries, whether in the form of loans, extensions of credit, investments, asset purchases, or otherwise. Such transfers by the Bank to the Corporation or any of the Corporation 's non-banking subsidiaries are limited in amount to 10% of the Bank's capital and surplus and, with respect to the Corporation and all such non-banking subsidiaries, to an aggregate of 20% of the Bank's capital and surplus. Furthermore, such loans and extensions of credit are required to be secured in specified amounts. The Bank is subject to restrictions imposed by federal law on extensions of credit to, and certain other transactions with, the Corporation and other affiliates, and on investments in their stock or other securities. These restrictions prevent the Corporation and the Bank's other affiliates from borrowing from the Bank unless the loans are secured by specified collateral, and require those transactions to have terms comparable to terms of arms-length transactions with third persons. In addition, secured loans and other transactions and investments by the Bank are generally limited in amount as to the Corporation and as to any other affiliate to 10% of the Bank's capital and surplus and as to the Corporation and all other affiliates together to an aggregate of 20% of the Bank's capital and surplus. Certain exemptions to these limitations apply to extensions of credit and other transactions between the Bank and its subsidiaries. These regulations and restrictions may limit the Corporation's ability to obtain funds from the Bank for its cash needs, including funds for acquisitions and for payment of dividends, interest, and operating expenses. Under Federal bank regulations, banks must adopt and maintain written policies that establish appropriate limits and standards for extensions of credit secured by liens or interests in real estate or are made for the purpose of financing permanent improvements to real estate. These policies must establish loan portfolio diversification standards; prudent underwriting standards, including loan-to-value limits, that are clear and measurable; loan administration procedures; and documentation, approval, and reporting requirements. A bank's real estate lending policy must reflect consideration of the Interagency Guidelines for Real Estate Lending Policies (the "Interagency Guidelines") adopted by the federal bank regulators. The Interagency Guidelines, among other things, call for internal loan-to-value limits for real estate loans that are not in excess of the limits specified in the Guidelines. The Interagency Guidelines state, however, that it may be appropriate in individual cases to originate or purchase loans with loan-to-value ratios in excess of the supervisory loan-to-value limits. The FDIC has established a risk-based deposit insurance premium assessment system for insured depository institutions. Under the system, the assessment rate for an insured depository institution depends on the assessment risk classification assigned to the institution by the FDIC, based upon the institution's capital level and supervisory evaluations. Institutions are assigned to one of three capital groups -- well-capitalized, adequately capitalized, or undercapitalized -- based on the data reported to regulators. Well-capitalized institutions are institutions satisfying the following capital ratio standards: (i) total risk-based capital ratio of 10% or greater; (ii) Tier 1 risk-based capital ratio of 6% or greater; and (iii) Tier 1 leverage ratio of 5% or greater. Adequately capitalized institutions are institutions that do not meet the standards for well-capitalized institutions but that satisfy the following capital ratio standards: (i) total risk-based capital ratio of 8% or greater; (ii) Tier 1 risk-based capital ratio of 4% or greater; and (iii) Tier 1 leverage ratio of 4% or greater. Institutions that do not qualify as either well-capitalized or adequately capitalized are deemed to be undercapitalized. Within each capital group, institutions are assigned to one of three subgroups on the basis of supervisory evaluations by the institution's primary supervisory authority and such other information as the FDIC determines to be relevant to the institution's financial condition and the risk it poses to the deposit insurance fund. Subgroup A consists of financially sound institutions with only a few minor weaknesses. Subgroup B consists of institutions with demonstrated weaknesses that, if not corrected, could result in significant deterioration of the institution and increased risk of loss to the deposit insurance fund. Subgroup C consists of institutions that pose a substantial probability of loss to the deposit insurance fund unless effective corrective action is taken. Deposit insurance rates may be increased during 2006 or later years. Regulatory Capital Requirements. The Federal bank regulators have established guidelines for maintenance of appropriate levels of capital by bank holding companies and banks. The regulations impose two sets of capital adequacy requirements: minimum leverage rules, which require bank holding companies and banks to maintain a specified minimum ratio of capital to total assets, and risk-based capital rules, which require the maintenance of specified minimum ratios of capital to "risk-weighted" assets. The regulations require bank holding companies and banks to maintain a minimum leverage ratio of "Tier 1 capital" (as defined in the risk-based capital guidelines discussed in the following paragraphs) to total assets of 3.0%. The capital regulations state, however, that only the strongest bank holding companies and banks, with composite examination ratings of 1 under the rating system used by the federal bank regulators, would be permitted to operate at or near this minimum level of capital. All other bank holding companies and banks are expected to maintain a leverage ratio of at least 1% to 2% above the minimum ratio, depending on the assessment of an individual organization's capital adequacy by its primary regulator. A bank or bank holding company experiencing or anticipating significant growth is expected to maintain capital well above the minimum levels. In addition, the bank regulators have indicated that they also may consider the level of an organization's ratio of tangible Tier 1 capital (after deducting all intangibles) to total assets in making an overall assessment of capital. 3 The risk-based capital rules require bank holding companies and member banks to maintain minimum regulatory capital levels based upon a weighting of their assets and off-balance sheet obligations according to risk. The risk-based capital rules have two basic components: a core capital (Tier 1) requirement and a supplementary capital (Tier 2) requirement. Core capital consists primarily of common stockholders' equity, certain perpetual preferred stock (noncumulative perpetual preferred stock with respect to banks), and minority interests in the equity accounts of consolidated subsidiaries; less all intangible assets, except for certain mortgage servicing rights and purchased credit card relationships. Supplementary capital elements include, subject to certain limitations, the allowance for losses on loans and leases; perpetual preferred stock that does not qualify as Tier 1 capital; long-term preferred stock with an original maturity of at least 20 years from issuance; hybrid capital instruments, including perpetual debt and mandatory convertible securities; subordinated debt, intermediate-term preferred stock, and up to

45% of pre-tax net unrealized gains on available-for-sale equity securities. In 2003, the Corporation, through its subsidiary, Harbor Bankshares Corporation Capital Trust, issued $7.2 million in trust preferred securities in a private placement. These securities are shown as junior subordinated debentures on the Consolidated Balance Sheets of the Corporation. These trust preferred securities issued are believed to meet the Federal Reserve's regulatory criteria for Tier 1 capital, subject to Federal Reserve guidelines that limit the amount of trust preferred securities (and any cumulative perpetual preferred stock) that may be included in Tier 1 capital to an aggregate of 25% of Tier 1 capital. Any excess may be included as supplementary capital. See Note 12 "Junior Subordinated Debentures" on page 20 of the Audited Consolidated Financial Statements section of the Corporation's Annual Report to Shareholders. The risk-based capital regulations assign balance sheet assets and credit equivalent amounts of off-balance sheet obligations to one of four broad risk categories based principally on the degree of credit risk associated with the obligor. The assets and off-balance sheet items in the four risk categories are weighted at 0%, 20%, 50% and 100%. These computations result in the total risk-weighted assets. The risk-based capital regulations require all commercial banks and bank holding companies to maintain a minimum ratio of total capital to total risk-weighted assets of 8%, with at least 4% as core capital. For the purpose of calculating these ratios: (i) supplementary capital is limited to no more than 100% of core capital; and (ii) the aggregate amount of certain types of supplementary capital is limited. In addition, the risk-based capital regulations limit the allowance for credit losses that may be included in capital to 1.25% of total risk-weighted assets. The federal bank regulatory agencies have established a joint policy regarding the evaluation of commercial banks' capital adequacy for interest rate risk. Under the policy, the Federal Reserve's assessment of a bank's capital adequacy includes an assessment of the bank's exposure to adverse changes in interest rates. The Federal Reserve has determined to rely on its examination process for such evaluations rather than on standardized measurement systems or formulas. The Federal Reserve may require banks that are found to have a high level of interest rate risk exposure or weak interest rate risk management systems to take corrective actions. Management believes its interest rate risk management systems and its capital relative to its interest rate risk are adequate. Federal banking regulations also require banks with significant trading assets or liabilities to maintain supplemental risk-based capital based upon their levels of market risk. The Bank did not have significant levels of trading assets or liabilities during 2004, and was not required to maintain such supplemental capital. Well-capitalized institutions are not subject to limitations on brokered deposits, while an adequately capitalized institution is able to accept, renew, or rollover brokered deposits only with a waiver from the FDIC and subject to certain restrictions on the yield paid on such deposits. Undercapitalized institutions are not permitted to accept brokered deposits. The Federal bank regulators have established regulations that classify banks by capital levels and provide for the Federal Reserve to take various "prompt corrective actions" to resolve the problems of any bank that fails to satisfy the capital standards. Under these regulations, a well-capitalized bank is one that is not subject to any regulatory order or directive to meet any specific capital level and that has a total risk-based capital ratio of 10% or more, a Tier 1 risk-based capital ratio of 6% or more, and a leverage ratio of 5% or more. An adequately capitalized bank is one that does not qualify as well-capitalized but meets or exceeds the following capital requirements: a total risk-based capital ratio of 8%, a Tier 1 risk-based capital ratio of 4%, and a leverage ratio of either (i) 4% or (ii) 3% if the bank has the highest composite examination rating. A bank that does not meet these standards is categorized as undercapitalized, significantly undercapitalized, or critically undercapitalized, depending on its capital levels. A bank that falls within any of the three undercapitalized categories established by the prompt corrective action regulation is subject to severe regulatory sanctions. As of December 31, 2005, the Bank was well-capitalized as defined in the regulations. 4 For information regarding the Corporation's and the Bank's compliance with their respective regulatory capital requirements, see note 16 "Regulatory Matters" on page 22 of the Audited Consolidated Financial Statements section of the Corporation's Annual Report to Shareholders. Community Reinvestment Under the Community Reinvestment Act ("CRA"), a financial institution has a continuing and affirmative obligation to help meet the credit needs of its entire community, including low- and moderate-income neighborhoods. The CRA does not establish specific lending requirements or programs for financial institutions, or limit an institution's discretion to develop the types of products and services that it believes are best suited to its particular community. However, institutions are rated on their performance in meeting the needs of their communities. Performance is tested in three areas: (a) lending, to evaluate the institution's record of making loans in its assessment areas; (b) investment, to evaluate the institution's record of investing in community development projects, affordable housing, and programs benefiting low or moderate income individuals and business; and (c) service, to evaluate the institution's delivery of services through its branches, ATMs and other offices. The CRA requires each federal banking agency, in connection with its examination of a financial institution, to assess and assign one of four ratings to the institution's record of meeting the credit needs of its community and to take such record into account in its evaluation of certain applications by the institution, including applications for charters, branches and other deposit facilities, relocations, mergers, consolidations, acquisitions of assets or assumptions of liabilities, and savings and loan holding company acquisitions. The CRA also requires that all institutions make public disclosure of their CRA ratings. The Bank was assigned an "outstanding" rating as a result of its last CRA examination. Bank Secrecy Act Under the Bank Secrecy Act ("BSA"), a financial institution is required to have systems in place to detect certain transactions, based on the size and nature of the transaction. Financial institutions are generally required to report cash transactions involving more than $10,000 to the United States Treasury. In addition, financial institutions are required to file suspicious activity reports for transactions that involve more than $5,000 and which the financial institution knows, suspects, or has reason to suspect involves illegal funds, is designed to evade the requirements of the BSA, or has no lawful purpose. The Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism Act, commonly referred to as the "USA Patriot Act" or the "Patriot Act", enacted in response to the September 11, 2001, terrorist attacks, enacted prohibitions against specified financial transactions and account relationships, as well as enhanced due diligence standards intended to prevent the use of the United States financial system for money laundering and terrorist financing activities. The Patriot Act requires banks and other depository institutions, brokers, dealers and certain other businesses involved in the transfer of money to establish anti-money laundering programs, including employee training and independent audit requirements meeting minimum standards specified by the act, to follow standards for customer identification and maintenance of customer identification records, and to compare customer lists against lists of suspected terrorists, terrorist organizations and money launderers. The Patriot Act also requires federal bank regulators to evaluate the effectiveness of an applicant in combating money laundering in determining whether to approve a proposed bank acquisition... On May 18, 2005, the Bank executed a memorandum of understanding with the FDIC and the Maryland Commissioner of Financial Regulation, in which it agreed to take certain steps to improve its Bank Secrecy Act and anti-money laundering compliance programs, including independent testing of compliance. Management believes that the Bank is fully in compliance with the terms of the memorandum. Sarbanes-Oxley Act of 2002 The Sarbanes-Oxley Act of 2002 ("Sarbanes-Oxley") established a broad range of corporate governance and accounting measures intended to increase corporate responsibility and protect investors by improving the accuracy and reliability of disclosures under federal securities laws. The Corporation is subject to Sarbanes-Oxley because it is required to file periodic reports with the SEC under the Securities and Exchange Act of 1934. Among other things, Sarbanes-Oxley, its implementing regulations have established new membership requirements and additional responsibilities for the Corporation's audit committee, imposed restrictions on the relationship between the Corporation and its outside auditors (including restrictions on the types of non-audit services our auditors may provide to us), imposed additional financial statement certification responsibilities for the Company's chief executive officer and chief financial officer, expanded the disclosure requirements for corporate insiders, and require management to evaluate the Corporation's disclosure controls and procedures and report material changes in the Corporation's internal control over financial reporting. Under current regulations, in future periods, Sarbanes-Oxley will require the management to evaluate the Corporation's internal control over financial reporting and will require Corporation's auditors to issue a report on the Corporation's internal control over financial reporting. 5 Other Laws and Regulations Some of the aspects of the lending and deposit business of the Bank that are subject to regulation by the FDIC include reserve requirements and disclosure requirements in connection with personal and mortgage loans and deposit accounts. In addition, the Bank is subject to numerous federal and state laws and regulations that include specific restrictions and procedural requirements with respect to the establishment of branches, investments, interest rates on loans, credit practices, the disclosure of credit terms, and discrimination in credit transactions. Enforcement Actions Federal statutes and regulations provide financial institution regulatory agencies with great flexibility to undertake an enforcement action against an institution that fails to comply with regulatory requirements. Possible enforcement actions range from the imposition of a capital plan and capital directive to civil money penalties, cease and desist orders, receivership, conservatorship, or the termination of deposit insurance. Governmental Monetary Policies and Economic Controls The earnings and growth of the banking industry and ultimately of The Harbor Bank of Maryland, Harbor Bankshares Corporation's sole subsidiary, are affected by the credit policies of monetary authorities including the Federal Reserve System. An important function of the Federal Reserve System is to regulate the national supply of bank credit in order to control recessionary and inflationary pressures. Among the instruments of monetary policy used by the Federal Reserve to implement these objectives are open market operations in U.S. Government securities, changes in the discount rate of member bank borrowings, and changes in reserve requirements against member bank deposits. These means are used in varying combinations to influence overall growth of bank loans and investments and deposits, and may also affect interest rates charged on loans or paid for deposits. The monetary policies of the Federal Reserve authorities have had a significant effect on the operating results of commercial banks in the past and are expected to continue to have such an effect in the future. In view of changing conditions in the national economy and in the money markets, as well as the effect of actions by monetary and fiscal authorities, including the Federal Reserve System, no prediction can be made as to possible future changes in interest rates, deposit levels, and loan demand, or their effect on the business and earnings of the Corporation and its subsidiary. 6 Employees At December 31, 2005, Harbor Bankshares Corporation and its subsidiaries employed 77 individuals, of which 27 were officers and 50 were full-time employees. Executive Officers Information concerning executive officers of the Corporation is listed below: Age Position Joseph Haskins, Jr. 58 Chairman, President and Chief Executive Officer of the Bank and Corporation John Paterakis 77 Chairman of the Executive Committee of the Corporation and the Bank Teodoro J. Hernandez 60 Treasurer of the Corporation and Senior Vice President and Cashier of the Bank Each of the executive officer has been employed in his current capacity for more than five years. 7 Tabular Information The information in this description of business should be read in conjunction with the information provided in the Management's Discussion and Analysis of Financial Condition and Operations, which is incorporated herein from the Annual Report... Consolidated Five-Years Selected Financial Data (In thousands, except per share data) Year ended December 31, 2005 2004 2003 2002 2001 ---- ---- ---- ---- ---- OPERATING DATA Interest Income $15,014 $12,648 $11,886 $11,647 $13,609 Interest Expense 3,787 2,283 2,411 3,402 5,973 ------- ------- ------- ------- ------- Net Interest Income 11,227 10,365 9,475 8,245 7,636 Provision for Loan Losses 410 360 755 340 400 Non-Interest Income 1,771 1,514 2,506 2,220 2,329 Non-Interest Expenses 9,638 9,295 8,610 8,575 8,526 ------- ------- ------- ------- ------- Income Before Taxes 2,950 2,224 2,616 1,550 1,039 Income Taxes 1,067 762 831 473 309 ------- ------- ------- ------- ------- Net Income $ 1,883 $ 1,462 $ 1,785 $ 1,077 $ 730 ======= ======= ======= ======= ======= PER SHARE DATA Net Income - Basic $2.73 $2.07 $2.46 $1.47 $1.02 Net Income - Diluted 2.55 1.93 2.36 1.43 0.99 Cash and Stock Dividends 0.40 0.35 0.25 0.25 -- Book Value $24.73 $23.04 $21.69 $19.23 $16.72 BALANCE SHEET DATA Total Assets $256,636 $235,464 $219,547 $210,234 $186,586 Deposits 229,845 210,224 195,901 193,294 171,531 Total Net Loans 188,936 172,205 149,729 120,523 105,847 Total Stockholder's Equity 16,954 16,240 15,274 14,149 12,241 Return on Average Assets 0.78% 0.63% 0.84% 0.54% 0.37% Return on Average Equity 11.57% 9.33% 12.23% 8.20% 6.20% Tier 1 Regulatory Capital to Average Assets 7.31% 7.36% 7.46% 5.20% 5.40% Average Equity to Average Assets 6.74% 7.27% 6.48% 5.24% 4.77% Dividend Paid to Diluted Net Income 15.69% 18.13% 10.59% 17.48% -- 8 Average Balances, Yields/Rates and Income/Expense Years ended December 31, 2005 2004 2003 Average Yields/ Income Average Yields/ Income Average Yields/ Income Balances Rates Expense Balances Rates Expense Balances Rates Expense -------- ----- ------- -------- ---- ------- -------- ---- ------- ASSETS U. S. Treasury Securities $ -- --% $ -- $ 836 3.11% $ 26 $ 3,048 2.79% $ 85 U.S. Government Agencies 27,230 3.11 848 35,824 3.08 1,104 39,878 3.39 1,354 Interest-Bearing Deposits with Other Banks 562 3.20 18 1,510 2.91 44 2,100 3.24 68 FHLB Stock and Other Securities 507 4.14 21 550 3.82 21 1,051 3.61 38 Federal Funds Sold 6,440 3.35 216 7,776 1.21 94 9,397 1.03 97 -------- ------- -------- ------- ------- ------- 34,739 3.18% 1,103 46,496 2.77% 1,289 55,474 2.96% 1,642 -------- ------- -------- ------- ------- ------- Loans Commercial Loans 75,390 8.70 6,556 64,090 7.37 4,725 44,887 7.03 3,156 Real Estate Loans 102,932 6.67 6,863 91,544 6.68 6,113 85,226 7.16 6,102 Consumer Loans 6,052 8.11 491 8,032 6.49 521 10,263 9.61 986 -------- ------- -------- ------- -------- ------- Loans Net of Unearned Income 184,374 7.54 13,910 163,666 6.94 11,359 140,376 7.30 10,244 ------- -------- ------- -------- ------- Total Earning Assets 219,113 6.85% $15,013 210,162 6.02% $12,648 195,850 6.07% $11,886 ======= ======= ======= Allowance for Possible Losses (2,059) (1,543) (1,488) Other Assets 24,183 23,461 18,909 -------- -------- -------- TOTAL ASSETS $241,237 $232,080 $213,271 ======== ======== ======== LIABILITIES AND STOCKHOLDERS' EQUITY Non-Interest Bearing Deposits $ 47,933 --% $ -- $ 40,646 --% $ -- $ 31,641 --% $ -- Interest-Bearing Transaction Accounts 26,020 .22 57 24,370 .18 43 23,515 .16 38 Savings 81,048 1.74 1,409 85,059 .79 670 84,715 .82 696 Time - $100,000 or more 28,268 2.35 664 22,627 2.02 456 25,172 2.63 662 Other Time 32,208 3.70 1,192 34,968 2.24 782 29,831 2.81 840 -------- ------- -------- ------- -------- ------- Savings and Time Deposits 167,544 1.98% 3,322 167,024 1.17% 1,951 163,233 1.37% 2,236 -------- -------- -------- TOTAL Deposits 215,477 207,670 194,874 Junior

Subordinated Debentures 7,217 6.15% 444 7,217 4.41% 318 1,611 4.40% 71 Other Borrowed Money 611 3.44 21 720 1.94 14 -- -- -- Notes payable -- -- -- -- -- -- 1,310 7.00 104 Other Liabilities 1,661 795 871 -------- -------- -------- TOTAL Liabilities 224,966 2.15% $ 3,787 216,402 1.30% $ 2,283 198,666 1.45% $ 2,411 ======= ======= ======= STOCKHOLDERS' EQUITY 16,271 15,678 14,605 -------- -------- -------- TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY $241,237 $232,080 $213,271 ======== ======== ======== Net Yield on Interest Earning Assets 4.70% 4.72% 4.62% Benefit of Non-Interest Bearing Funds .45% .25% .22% Net Interest Margin 5.15% 4.97% 4.84% Nonaccrual loans are included in the appropriate loan categories, above. 9 Interest Variance Analysis (dollars in thousands) 2005 Compared to 2004 2004 Compared to 2003 Increase (Decrease) Due to: Increase (Decrease) Due to: ------------------------------ ------------------------------ Volume Rate Net Volume Rate Net ------ ---- --- ------ ---- --- INTEREST INCOME Loans $ 1,437 $ 1,114 $ 2,551 $ 1,700 $ (585) $ 1,115 Investment Securities (266) (16) (282) (227) (99) (326) Federal Funds Sold (16) 138 122 (17) 14 (3) Other Interest Bearing Assets (1) (25) -- (25) (21) (3) (24) ------- ------- ------- ------- ------- ------- TOTAL Interest Income $ 1,130 $ 1,236 $ 2,366 $ 1,435 $ (673) $ 762 ======= ======= ======= ======= ======= ======= INTEREST EXPENSE Interest-Bearing Transaction Accounts $ 3 $ 11 $ 14 $ 1 $ 4 $ 5 Savings (32) 771 739 3 (29) (26) Time - $100,000 or more 114 94 208 (67) (139) (206) Other Time (62) 472 410 144 (202) (58) Other Borrowed Money (2) 9 7 14 -- 14 Subordinate Debentures -- 126 126 246 2 248 Notes Payable -- -- -- (104) -- (104) ------- ------- ------- ------- ------- ------- TOTAL Interest Expense $ 21 $ 1,483 $ 1,504 $ 237 $ (364) $ (127) ======= ======= ======= ======= ======= ======= NET INTEREST INCOME $ 1,108 $ (247) $ 862 $ 1,198 $ (309) $ 889 ======= ======= ======= ======= ======= ======= Note: Loan fees, which were included in interest income, were $981 in 2005, $1,024 in 2004, and $814 in 2003. A change in Rate/Volume has been allocated to the change in rate. (1) Certificates of Deposit with other financial institutions. Maturity Distribution of Investment Securities (dollars in thousands) -- U.S Treasuries U.S Agencies Other Securities TOTAL ------------- ----------- --------------- ----- Maturing Within One Year $ -- $ 2,438 $ -- $ 2,438 Maturing After One But Within Five Years -- 23,544 -- 23,544 Maturing After Five But Within Ten Years -- -- -- -- Maturing After Ten Years -- 135 30 165 ------- ------- ------- ------- TOTAL $ -- $26,117 $ 30 $26,147 ======= ======= ======= ======= 10 Weighted Average Interest Rates of Investment Securities at December 31, 2005 -- U.S Government Other U.S Treasuries Agencies Securities TOTAL ------------- -------- --------- ----- Maturing Within One Year --% 2.22% --% 2.22% Maturing After One But Within Five Years --% 3.07% --% 3.07% Maturing After Five But Within Ten Years --% --% --% --% Maturing After Ten Years --% 5.15% 7.25% 6.20% TOTAL --% 3.48% 7.25% 3.83% Amortized cost and the fair value of Investment Securities at 2005 , 2004 and 2003 (dollars in thousands) ------------------------------ 2005 2004 2003 ------------------- ------------------- ------------------- Amortized Fair Amortized Fair Amortized Fair Cost Value Cost Value Cost Value ---- ----- ---- ----- ---- ----- U.S. Treasuries, Government Agencies and Mortgage Backed Securities $26,979 $26,117 $28,988 $28,606 $37,258 $37,369 Other Securities 30 30 36 36 548 549 ------- ------- ------- ------- ------- ------- TOTAL $27,009 $26,147 $29,024 $28,642 $37,806 $37,918 ======= ======= ======= ======= ======= ======= 11 Loan Distribution Five-Year Loan Distribution at December 31, 2005 (dollars in thousands) 2005 2004 2003 2002 2001 ---- ---- ---- ---- ---- Commercial Loans $ 82,845 $ 72,414 $ 55,184 $ 30,964 $ 23,126 Real Estate Loans 102,404 94,204 87,228 78,856 71,962 Consumer Loans 5,746 7,198 8,806 11,751 11,718 --- --------------------------------- TOTAL $190,995 $173,816 $151,218 $121,571 $106,806 === ================================== Five-Year Loan Distribution at December 31 (expressed as percentages) 2005 2004 2003 2002 2001 ---- ---- ---- ---- ---- Commercial Loans 43.37% 38.87% 36.49% 25.47% 21.65% Real Estate Loans 53.62% 56.90% 57.69% 64.86% 67.38% Consumer Loans 3.01% 4.23% 5.82% 9.67% 10.97% -- ---------------------------------- TOTAL 100.00% 100.00% 100.00% 100.00% 100.00% === ================================== Maturity and Repricing of Loans at December 31, 2005 (dollars in thousands) -- Commercial Real Estate Consumer Loans Loans Loans TOTAL ----- ----- ----- ----- Within One Year $44,970 $23,325 $1,043 $69,338 After One Year But Within Five Years 37,131 22,516 3,068 $62,715 After Five Years 744 56,563 1,635 $58,942 ------------- ------------- ------------- ------------ TOTAL $82,845 $102,404 $5,746 $190,995 ============= ============= ============= ============ Loans Classified by Sensitivity to Changes in Interest Rates (dollars in thousands)

--------------------- Adjustable Fixed Rate Interest Rate Loans Loans TOTAL ----- ----- ----- Within One Year $18,221 $51,742 $69,963 After One Year But Within Five Years 62,719 -- $62,719 After Five Years 58,313 -- $58,313 ----------------- ------------------ ------------- TOTAL $139,253 $51,742 $190,995 ================== ================== ============= The total amount of Real Estate Construction and Mortgage loans due after one year included above are $2,600 and $2,441 respectively. Asset Quality One of the Corporation's main objectives has been and continues to be the achievement of a high level of asset quality. We maintain a large portion of loans secured by residential one-to four- family properties and commercial properties. As of December 31, 2005, those loans totaled $89 million or 46.35 percent of total outstanding loans. We set sound credit standards for new loan originations, and follow careful loan administration procedures. We strengthened our focus on credit risk by having independent reviews of all major credits with detailed reports to management. Delinquent Loans and Foreclosed Assets: The Corporation policies require that management continuously monitor the status of the loan portfolio and report to the Board of Directors on a monthly basis. These reports include information on delinquent loans and foreclosed real estate, and actions and plans to cure the delinquent status of the loans and to dispose of the foreclosed properties. 12 Interest on Non-accrual Loans. (dollars in thousands) --- 2005 2004 ---- ---- Interest Income that Would Have Been Recorded Under Original Terms $ 27 $ 52 --------- ------- Interest Income Recorded during the Period $ -- $ -- --------- ------- It is the policy of the Corporation to place a loan on non-accrual status whenever there is substantial doubt about the ability of a borrower to pay principal or interest on any outstanding credit. Management considers such factors as payment history, the nature of the collateral securing the loan, and the overall economic situation of the borrower when making a non-accrual decision. Non-accrual loans are closely monitored by management. A non-accruing loan is restored to accrual status when principal and interest payments have been brought current or it becomes well-secured or is in the process of collection and the prospects of future contractual payments are no longer in doubt. We generally stop accruing income when interest or principal payments are 90 days in arrears. We may stop accruing income on such loans earlier than 90 days when we consider the timely collectibility of interest or principal payment to be doubtful. When we designate non-accrual loans, we reverse all outstanding interest that we had previously credited. If we receive a payment on a non-accrual loan, we may recognize a portion of that payment as interest income if we determine that the ultimate collectibility of principal is no longer in doubt. However, such loans may remain in non-accrual status. Impaired Loans At December 31, 2005, the Corporation had $576 thousand of impaired loans for which the borrowers were experiencing financial difficulties. Those loans are subject to constant management attention and their classification is reviewed monthly. Impaired loans are individually assessed to determine whether the carrying value exceeds the fair value of the collateral. Foreclosed Real Estate Foreclosed real estate consists of property we have acquired through foreclosed or deed in lieu of foreclosure. Foreclosed real estate properties are initially recorded at the lower of the recorded investment in the loan or fair value. At December 31, 2005 and 2004 we had no foreclosed real estate. Potential Nonperforming Loans Those performing loans considered potential nonperforming loans, loans which are not included in the past due, nonaccrual or restructured categories, but for which known information about possible credit problems cause management to be uncertain as to the ability of the borrowers to comply with the present loan repayment terms over the next six months, amounted to approximately $7,149 thousand at December 31, 2005, compared to $3,716 thousand at December 31, 2004, and $3,502 thousand at December 31, 2003. These loans are subject to continuing management attention and are considered by management in determining the level of the allowance for loan losses. 13 Allowance for Loan Losses The Corporation's allowance for loan loss methodology is a loan classification-based system, based on the required allowance on a percentage of the loan balance for each type of loan and classification level. Allowance percentages are 3.0% and 5.0% for watch loans, 10.0% for special mention, 15.0% and 20.0% for substandard and 50.0% for doubtful loans. Allowance percentages are based on each individual lending program, its loss history and underwriting characteristics such as: loan to value, credit score, debt coverage, collateral, and capacity to service debt. This analysis is used to validate the loan loss allowance matrix as well as to assist in establishing overall lending direction. While management considers the Corporation's allowance for loan losses to be adequate based on information currently available, future adjustments to the allowance may be necessary due to changes in economic conditions, management's assumptions as to future delinquencies or loss rates, and management's intent with regard to asset disposition options. In addition, the Corporation's allowance for loan losses is periodically reviewed by the bank regulatory agencies and an independent external loan review as an integral part of their examination process. Based on their reviews, the agencies may require the Corporation to adjust the allowance. 14 Allowance for Loan Losses (dollars in thousands) Year ended December 31, 2005 2004 2003 2002 2001 ---- ---- ---- ---- ---- Balance at Beginning of Period $ 1,612 $ 1,488 $ 1,049 $ 959 $ 732 Loans Charged Off: Commercial Loans -- 108 71 109 65 Real Estate Loans -- 10 11 26 70 Consumer Loans 91 295 341 178 111 --------- --------- --------- --------- --------- TOTAL Loans Charged Off 91 413 423 313 246 --------- --------- --------- --------- --------- Recoveries of Loans: Commercial Loans 45 13 22 42 39 Real Estate Loans -- 1 22 11 22 Consumer Loans 83 163 63 10 12 --------- --------- --------- --------- TOTAL Loans Recovered 128 177 107 63 73 --------- --------- --------- --------- --------- Net Loans Charged Off (Recovered) (37) 236 316 250 173 --------- --------- --------- --------- --------- Provisions Charged to Operations 410 360 755 340 400 --------- --------- --------- --------- --------- Balance at End of Period $ 2,059 $ 1,612 $ 1,488 $ 1,049 $ 959 ========= ========= ========= ========= ========= Daily Average Amount of Loans $ 184,374 $ 163,656 $ 140,376 $ 110,293 $ 105,067 ========= ========= ========= ========= ========= Allowance for Possible Loan Losses to Loans Outstanding 1.08% .93% .98% .86% .90% ========= ========= ========= ========= ========= Net Charge Offs (Recoveries) to Average Loans Outstanding (.02%) .14% .22% .22% .16% ========= ========= ========= ========= ========= A breakdown of the Allowance is provided in the table below; however, management does not believe that the Allowance can be segregated y category with precision. The breakdown of the Allowance is based primarily on hose factors discussed previously in evaluating the Allowance as a whole. Since all of those factors are subject to change, the breakdown is not necessarily indicative of the category of actual or realized credit losses. The following table presents the allocation of the Allowance among the various loan categories at December 31: Allocation of Allowance for Loan Losses (dollars in thousands) As of December 31, 2005 % 2004 % 2003 % 2002 % 2001 % ---- - ---- - ---- - ---- - ---- - Commercial Loans $573 45.1% 44.7% $825 36.9% $555 25.4% $557 21.7% $406 Real Estate Loans 702 52.8 746 54.1 151 57.3 138 64.9 110 67.4 Consumer Loans 65 2.2 83 3.7 35 5.2 76 8.9 80 9.9 Credit Cards 38 .4 41 .5 47 .6 46 .8 55 1.0 Unallocated 681 -- 336 -- 430 -- 234 -- 157 -- ------- ---- ------- ---- ------- ---- ------ ---- ----- ---- TOTAL Allowance for Loan Losses $ 2,059 100% $ 1,612 100% $ 1,488 100% $1,049 100% $ 959 100% ======= ==== ======= ==== ======= ==== ====== ==== ===== ==== 15 Maturities of Time Certificates of Deposit of $100,000 or More Outstanding at December 31, 2005 and 2004 (dollars in thousands) 2005 2004 ---- ---- Three months or less $7,145 $5,804 Three to six months 2,111 2,746 Six to twelve months 13,315 8,187 Over twelve months 10,239 8,662 -------- ---------- TOTAL $32,810 $25,399 ======== ========== Long And Short Term Borrowings Junior Subordinated Debt Security On October 9, 2003, Harbor Bankshares Corporation issued a Floating Rate Junior Subordinated Debt Securities due 2033 in the amount of $7.2 million. The Debt Security was issued by the Corporation pursuant to an Indenture, dated as of October 9, 2003, between the Corporation and Wilmington Trust Company. The Capital Securities were issued by Harbor Bankshares Corporation Capital Trust pursuant to a Purchase Agreement dated September 18, 2003, among the Corporation, the Trust and Citigroup Global Markets Inc. Upon receipt of the funds, the corporation paid off its long-term debt to the National Community Investment Fund ("NCIF") in the amount of $1.8 million and placed the remaining funds in its subsidiary, The Harbor Bank of Maryland, increasing the Bank's Tier One capital. This capital infusion increased the Bank's lending limit and allowed for future growth. 16 Borrowings for the Years Ended December 31, 2005 and 2004 (dollars in thousands) 2005 2004 ---- ---- Amount outstanding at period-end: Subordinated Debt Securities 7,217 7,217 Average outstanding: Subordinated Debt Securities 7,217 7,217 Weighted average interest rate during the period: Subordinated Debt Securities 6.15% 4.41% Off-Balance Sheet Arrangements Standby letters of credit are conditional commitments issued by the Bank to guarantee the performance of a customer to a third party. The credit risk involved in issuing letters of credit is essentially the same as that involved in extending loan facilities to customers. The Bank holds collateral supporting those commitments for which collateral is deemed necessary. The Harbor Bank of Maryland has not been required to perform on any financial guarantees and has not incurred any losses on its commitments. The issuance of letters of credit is not a significant activity of the Bank. Commitments to extend credit are agreements to lend funds to customers as long as there are no violations of any condition established in the loan contracts. Commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. Since many of the commitments are expected to expire without being drawn upon, the total commitment amounts do not necessarily represent future cash requirements. The Bank evaluates each customer's credit worthiness on a case-by-case basis. The amount of collateral obtained, if it is deemed necessary by the Bank upon extension of credit, is based on credit evaluation by management. Collateral held varies but may include accounts receivable, inventory, property, plant and equipment as well as income producing properties. We believe that we have adequate resources to fund all loan commitments. The Bank has entered into leases for some of its branches, most of which contain renewal options. For additional information regarding off-balance sheet arrangements, please see Notes 7 and 17 to the Consolidated Financial Statements and the discussion of the Debt Security in "Long and Short Term Borrowings," above. Critical Accounting Policies The Corporation's consolidated financial statements are prepared in accordance with accounting principles generally accepted in the United States and follow general practices within the industries 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. The fair values and the information used to record valuation adjustments for certain assets and liabilities are based either on quoted market prices or are provided by other third-party sources, when available. 17 The most significant accounting policies followed by the Corporation are presented in Note 2 to the consolidated financial statements. These policies, along with the disclosures presented in the other financial statement notes and in this discussion, provide information on how significant assets and liabilities are valued in the financial statements and how those values are determined. Based on the valuation techniques used and the sensitivity of financial statement amounts to the methods, assumptions and estimates underlying those amounts, management has identified the determination of the allowance for loan losses as the accounting area that requires the most subjective or complex judgments, and as such could be most subject to revision as new information becomes available. The Corporation believes it has developed appropriate policies and procedures for assessing the adequacy of the allowance for loan losses, recognizing that this process requires a number of assumptions and estimates with respect to its loan portfolio. The Corporation's assessments may be affected in future periods by changes in economic conditions, the impact of regulatory examinations, and the discovery of information with respect to borrowers which is not known to management at the time of the issuance of the consolidated financial statements. For additional discussion concerning the Corporation's allowance for loan losses and related matters, see "Provision for Loan Losses and Asset Quality" above and Note 2 to the Consolidated Financial Statements. Item 2. Description of Property The Corporation's Headquarters is located at 25 West Fayette Street, Baltimore, Maryland 21201. This location is approximately 60,000 square feet and was bought by the Corporation during September 2003 for $2.9 million. The renovation of the building is completed. The Bank also maintains another six (6) branch offices, five (5) are leased; three (3) located in Baltimore City, 1000 Lancaster Street Baltimore, Maryland 21202, 5000 Park Heights Avenue Baltimore, Maryland 21215 and 800 West Baltimore Street, Baltimore, Maryland 21201, one (1) located in Prince George's County, Maryland at 6820 Riverdale Road Riverdale, Maryland 20737 and one (1) located in Baltimore County, Maryland at 3825 Liberty Plaza Randallstown, Maryland 21133. The Bank owns another branch facility in Baltimore City located at 3240 Belair Road Baltimore, Maryland 21213. Item 3. Legal Proceedings In the normal course of business, the Corporation is at all times subject to various pending and threatened legal actions. The relief or damages sought in some of these actions may be substantial. After reviewing pending and threatened actions with counsel, management considers that the outcome of such actions will not have a material adverse effect on the Corporation's financial position; however, the Corporation is not able to predict whether the outcome of such actions may or may not have a material adverse effect on results of operations in a particular future period as the timing and amount of any resolution of such actions and relationship to the future results of operations are not known. Item 4. Submission of Matters to a Vote of Security Holders None 18 PART II Item 5. Market for Common Equity and Related Stockholder Matters. Harbor Bankshares Corporation is traded privately and is not listed on any exchange. During 2005 and 2004, there was little trading activity in the stock. The bid and ask price during 2005 and 2004 was $25.00 per share. On December 31, 2005 the Corporation had 626 common stockholders of record. A cash dividend of $.40 per share was paid during the first quarter of 2005. The following table presents disclosure regarding equity compensation plans in existence at December 31, 2005, consisting only of the stock option plan arrangements described further under the caption "Stock Options" in Note 14 to the consolidated financial statements. Equity Compensation Plan Information

------------------------------ -------------------------- -------------------------- --------------------------- Plan Category Number of securities to be Weighted average exercise Number of securities issued upon exercise of price of outstanding remaining available for outstanding options, options, warrants and future issuance under warrants and rights rights equity compensation plans (a) (b) excluding securities reflected in column (a) (c) ------------------------------ -------------------------- -------------------------- --------------------------- Equity compensation plans -- -- -- approved by security holders ------------------------------ --------------------------- -------------------------- --------------------------- Equity compensation plans not 132,741 $18.80 94,145 approved by security holders ------------------------------ -------------------------- -------------------------- --------------------------- Total 132,741 $18.80 94,145 ------------------------------ -------------------------- --------------------------- --------------------------- 19 Item 6. Management's Discussion and Analysis of Financial Condition and Results of Operations This Management's Discussion and Analysis of Financial Condition and Results of Operations should be read in conjunction with Item 1. Business, and Item 7, Financial Statements, of this Report. OVERVIEW - 2005 COMPARED TO 2004 All references to Harbor Bankshares Corporation (the "Corporation") should be interpreted to include The Harbor Bank of Maryland (the "Bank") whenever appropriate, except when specifically noted otherwise. The Corporation earnings increased for the year 2005 when compared to the prior year. Earnings for the year were $1.9 million in comparison to $1.5 million earned during 2004, an increase of $421 thousand or 28.8 %. The 2005 earnings did not include any securities gains or Federal agency awards. The earnings for 2004 reflected only $17 thousand of securities gains and no awards. The Harbor Bank of Maryland, the Corporation's subsidiary, achieved earnings of $2.5 million in comparison to $1.9 million for the prior year, an increase of $564 thousand or 29.0%. Returns on average assets (ROAA) and average equity (ROAE) for the Corporation in 2005 were .78% and 11.57%, respectively, compared to the .63% and 9.33% achieved during the prior year. The return on average assets for the Bank in 2005 was 1.04%, compared to .84% for the prior year. NET-INTEREST INCOME Net interest income is the difference between interest income and related fees on earning assets and the interest expense incurred on deposits and other borrowings. Net interest income continues to be the Corporation's main source of earnings. Net interest income for 2005 increased by $862 thousand or 8.3 %. The increase reflects the growth of the loan portfolio during 2005, mainly in the commercial and commercial real estate categories. Total interest income increased by $2.4 million or 18.7% to $15.0 million for 2005 in comparison to the $12.7 million earned during 2004. As stated above, the growth of the loan portfolio combined with higher rates were the main reasons for the increase. Total interest expense increased by $1.5 million or 6.6 % to $3.8 million in 2005 from $2.3 million in 2004. Higher interest rates combined with interest bearing deposit increases resulted in the increase. Net interest margin for 2005 was 5.15% compared to 4.97% for 2004. PROVISION FOR LOAN LOSSES AND ASSET QUALITY For the year 2005, the Corporation recorded a $410 thousand provision for loan losses, compared to $360 for the year 2004. Gross charge-offs totaled $91 thousand for the year ended December 31, 2005, compared to the prior year total of $413 thousand. These charge-offs in 2004 primarily relate to credit card, consumer and commercial loans. The allowance for loan losses as of December 31, 2005, was 1.08% of total loans and .93% at the end of the comparable 2004 period. Future provisions for loan losses will continue to be based upon our assessment of the overall loan portfolio and its underlying collateral, the mix of loans within the portfolio, delinquency trends, economic conditions, current and prospective trends in real estate values, and other relevant factors. 20 The table below shows the non-performing assets for a five-year period: Non-Performing Assets (in thousands except percentages) 2005 2004 2003 2002 2001 ---- ---- ---- ---- ---- Non-accrual Loans $558 $799 $ 220 $409 $620 Accruing Loans past due 90 days or more 18 9 506 746 135 Foreclosed Real Estate - - - 70 14 Total Non-performing Assets and ---- ---- ---- ------ ---- past due Loans $576 $808 $726 $1,225 $769 ==== ==== ==== ====== ==== Total Non-performing Assets and past due Loans to year-end Assets .22% .34% .33% .58% .41% Total Non-performing Loans to year-end Loans .30% .46% .48% 1.01% .72% The Corporation's allowance for loan loss methodology is a loan classification-based system, based on the required allowance on a percentage of the loan balance for each type of loan and classification level. Allowance percentages are 3.0% and 5.0% for watch loans, 10.0% for special mention, 15.0% and 20.0% for substandard and 50.0% for doubtful loans. Allowance percentages are based on each individual lending program, its loss history and underwriting characteristics such as: loan to value, credit score, debt coverage, collateral, and capacity to service debt. This analysis is used to validate the loan loss allowance matrix as well as to assist in establishing overall lending direction. While management considers the Corporation's allowance for loan losses to be adequate based on information currently available, future adjustments to the allowance may be necessary due to changes in economic conditions, management's assumptions as to future delinquencies or loss rates, and management's intent with regard to asset disposition options. In addition, the Corporation's allowance for loan losses is periodically reviewed by the bank regulatory agencies and an independent external loan review as an integral part of their examination process. Based on their reviews, the agencies may require the Corporation to adjust the allowance. NON-INTEREST INCOME Non-interest income increased by $257 thousand or 17.0% to $1.8 million in 2005. Included in the 2004 non-interest income were $6 thousand in gain on sale of loans, $17 thousand in securities gains and no Community Development Financial Institution Fund ("CDFI") awards. In 2005, there were no gains on the sale of securities or loans, and no CDFI awards. Service charges on deposit accounts increased by $98 thousand or 12.2% and other non-interest income by $152 thousand or 31.9%. Included in other non-interest income are fees in the amount of $82 thousand for reimbursement for services and expenses incurred by the Bank in the formation of one of the Holding Company unconsolidated subsidiaries in 2002. Non-Interest Income Summary (in thousands) 2005 2004 2003 2002 2001 ---- ---- ---- ---- ---- Service charges on deposit accounts $900 $802 $855 $910 $965 ATM fees 224 195 216 274 166 Awards & Grants -- -- 664 214 229 Gain on sale of real estate -- -- -- -- -- Gain on sale of loans -- 6 51 54 45 Gain on sale of securities -- 17 225 226 197 Servicing fees 18 17 16 26 27 Other non-interest income 629 477 479 517 700 ------ ------ ------ ------ ------ Total non-interest income $1,771 $1,514 $2,506 $2,221 $2,329 ====== ====== ====== ====== ====== 21 NON-INTEREST EXPENSES Non-interest expenses of $9.6 million in 2005 increased by $343 thousand or 3.7 % when compared to the prior year. Salaries and benefits of $4.4 million in 2005 reflected a decrease of $85 thousand or 1.9% when compared to the prior year salaries and benefits cost. Advertising expenses increased by $69 thousand or 23.0%. Occupancy expense increased by $414 thousand or 61.0% due to the renovation of the Corporation's Headquarters building and the opening of a new branch facility. Equipment expense decreased by $32 thousand or 9.0% due to lower depreciation. Professional fees, which include legal expenses, decreased by $98 thousand or 19.0%. In 2005, the Bank settled its claims against third parties in connection with a 2004 ATM cash shortage upon payment to the Bank of $575,000. The Bank recorded losses of $225,000 in 2005 and $275,000 in 2004 relating to this cash shortage. The amortization expense in 2002 through 2005 includes amortization of core deposit intangibles recorded in the purchase of a branch facility during 2002. Amortization in 2001 and 2002 reflects amortization of goodwill. Other non-interest expenses increased by $46 thousand or 3.0 %. Non-Interest Expenses Summary (In thousands) 2005 2004 2003 2002 2001 ---- ---- ---- ---- ---- Salaries and Employee Benefits $4,425 $4,510 $4,368 $ 4,230 $ 3,989 Occupancy Expense, net 1,093 679 720 785 778 Advertising 369 300 344 287 115 Equipment Expenses 324 356 386 478 654 Data Processing Fees 1,110 1,031 973 976 918 Professional Fees 420 518 303 399 327 Amortization of Intangible Assets 81 81 81 47 331 Amo