

SANDY SPRING BANCORP INC  
Form 10-Q  
November 08, 2013

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

**FORM 10-Q**

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

**For the Quarterly Period Ended September 30, 2013**

OR

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

For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission File Number: 0-19065

**SANDY SPRING BANCORP, INC.**

(Exact name of registrant as specified in its charter)

**Maryland**

(State of incorporation)

**52-1532952**

(I.R.S. Employer Identification Number)

**17801 Georgia Avenue, Olney, Maryland**

(Address of principal executive office)

**20832**

(Zip Code)

**301-774-6400**

(Registrant's telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to filing requirements for the past 90 days.

Yes  No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).

Yes  No

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

Edgar Filing: SANDY SPRING BANCORP INC - Form 10-Q

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

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

The number of outstanding shares of common stock outstanding as of November 8, 2013.

**Common stock, \$1.00 par value 24,986,939 shares**

**SANDY SPRING BANCORP, INC.****TABLE OF CONTENTS**

	<b>Page</b>	
<b>PART I - FINANCIAL INFORMATION</b>		
Item 1.	FINANCIAL STATEMENTS	
	Condensed Consolidated Statements of Condition at September 30, 2013 (Unaudited) and December 31, 2012	4
	Condensed Consolidated Statements of Income - Unaudited for the Three and Nine Months Ended September 30, 2013 and 2012	5
	Condensed Consolidated Statements of Comprehensive Income Unaudited for the Three and Nine Months Ended September 30, 2013 and 2012	6
	Condensed Consolidated Statements of Cash Flows Unaudited for the Nine Months Ended September 30, 2013 and 2012	7
	Condensed Consolidated Statements of Changes in Stockholders' Equity Unaudited for the Nine Months Ended September 30, 2013 and 2012	8
	Notes to Condensed Consolidated Financial Statements	9
Item 2.	MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS	34
Item 3.	QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK	59
Item 4.	CONTROLS AND PROCEDURES	59
<b>PART II - OTHER INFORMATION</b>		
Item 1.	LEGAL PROCEEDINGS	59
Item 1A.	RISK FACTORS	59
Item 2.	UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS	59
Item 3.	DEFAULTS UPON SENIOR SECURITIES	59

Item 4.	MINE SAFETY DISCLOSURES	59
Item 5.	OTHER INFORMATION	59
Item 6.	EXHIBITS	60
SIGNATURES		61

## Forward-Looking Statements

This Quarterly Report on Form 10-Q, as well as other periodic reports filed with the Securities and Exchange Commission, and written or oral communications made from time to time by or on behalf of Sandy Spring Bancorp and its subsidiaries (the “Company”), may contain statements relating to future events or future results of the Company that are considered “forward-looking statements” under the Private Securities Litigation Reform Act of 1995. These forward-looking statements may be identified by the use of words such as “believe,” “expect,” “anticipate,” “plan,” “estimate,” “intend” and “potential,” or words of similar meaning, or future or conditional verbs such as “should,” “could,” or “may.” Forward-looking statements include statements of Company goals, intentions and expectations; statements regarding our business plans, prospects, growth and operating strategies; statements regarding the quality of our loan and investment portfolios; and estimates of our risks and future costs and benefits.

Forward-looking statements reflect the Company’s expectation or prediction of future conditions, events or results based on information currently available. These forward-looking statements are subject to significant risks and uncertainties that may cause actual results to differ materially from those in such statements. These risk and uncertainties include, but are not limited to, the risks identified in Item 1A of the Company’s 2012 Annual Report on Form 10-K, Item 1A of Part II of this report and the following:

- general business and economic conditions nationally or in the markets that the Company serves could adversely affect, among other things, real estate prices, unemployment levels, and consumer and business confidence, which could lead to decreases in the demand for loans, deposits and other financial services that we provide and increases in loan delinquencies and defaults;
- changes or volatility in the capital markets and interest rates may adversely impact the value of securities, loans, deposits and other financial instruments and the interest rate sensitivity of our balance sheet as well as the Company’s liquidity;
- the Company’s liquidity requirements could be adversely affected by changes in our assets and liabilities;
- the Company’s investment securities portfolio is subject to credit risk, market risk, and liquidity risk as well as changes in the estimates the Company uses to value certain of the securities in the portfolio;
- the effect of legislative or regulatory developments including changes in laws concerning taxes, banking, securities, insurance and other aspects of the financial services industry;
- competitive factors among financial services companies, including product and pricing pressures and the Company’s ability to attract, develop and retain qualified banking professionals;
- the effect of changes in accounting policies and practices, as may be adopted by the Financial Accounting Standards Board, the Securities and Exchange Commission, the Public Company Accounting Oversight Board and other regulatory agencies; and
- the effect of fiscal and governmental policies of the United States federal government.

Forward-looking statements speak only as of the date of this report. The Company does not undertake to update forward-looking statements to reflect circumstances or events that occur after the date of this report or to reflect the occurrence of unanticipated events except as required by federal securities laws.



**PART I****Item 1. FINANCIAL STATEMENTS****Sandy spring bancorp, inc. and subsidiaries****CONDENSED Consolidated STATEMENTS OF CONDITION**

(Dollars in thousands)	(Unaudited) September 30, 2013	December 31, 2012
<b>Assets</b>		
Cash and due from banks	\$ 58,746	\$ 59,540
Federal funds sold	475	466
Interest-bearing deposits with banks	20,847	26,400
Cash and cash equivalents	80,068	86,406
Residential mortgage loans held for sale (at fair value)	10,542	36,149
Investments available-for-sale (at fair value)	815,545	825,582
Investments held-to-maturity fair value of \$220,054 and \$222,024 at September 30, 2013 and December 31, 2012, respectively	225,994	215,814
Other equity securities	36,412	33,636
Total loans and leases	2,662,010	2,531,128
Less: allowance for loan and lease losses	(39,422)	(42,957)
Net loans and leases	2,622,588	2,488,171
Premises and equipment, net	46,655	48,326
Other real estate owned	1,662	5,926
Accrued interest receivable	12,464	12,392
Goodwill	84,171	84,808
Other intangible assets, net	1,792	3,163
Other assets	115,076	114,833
Total assets	\$ 4,052,969	\$ 3,955,206
<b>Liabilities</b>		
Noninterest-bearing deposits	\$ 890,319	\$ 847,415
Interest-bearing deposits	2,026,147	2,065,619
Total deposits	2,916,466	2,913,034
Securities sold under retail repurchase agreements and federal funds purchased	53,177	86,929
Advances from FHLB	520,000	405,058
Subordinated debentures	35,000	35,000
Accrued interest payable and other liabilities	34,444	31,673
Total liabilities	3,559,087	3,471,694
<b>Stockholders' Equity</b>		
Common stock par value \$1.00; shares authorized 50,000,000; shares issued and outstanding 24,985,146 and 24,905,392 at September 30, 2013 and December 31, 2012, respectively	24,985	24,905
Additional paid in capital	192,964	191,689

Edgar Filing: SANDY SPRING BANCORP INC - Form 10-Q

Retained earnings	278,825	255,606
Accumulated other comprehensive income (loss)	(2,892)	11,312
Total stockholders' equity	493,882	483,512
Total liabilities and stockholders' equity	\$ 4,052,969	\$ 3,955,206

The accompanying notes are an integral part of these statements



**Sandy Spring Bancorp, Inc. and Subsidiaries**  
**CONDENSED Consolidated Statements of IncomeE UNAUDITED**

(Dollars in thousands, except per share data)	Three Months Ended		Nine Months Ended	
	September 30,		September 30,	
	2013	2012	2013	2012
<b>Interest Income:</b>				
Interest and fees on loans and leases	\$ 33,079	\$ 30,697	\$ 91,937	\$ 86,164
Interest on loans held for sale	176	248	838	587
Interest on deposits with banks	22	38	65	83
<b>Interest and dividends on investment securities:</b>				
Taxable	4,558	4,204	12,411	13,809
Exempt from federal income taxes	2,345	2,308	6,987	7,024
Interest on federal funds sold	-	-	-	1
<b>Total interest income</b>	<b>40,180</b>	<b>37,495</b>	<b>112,238</b>	<b>107,668</b>
<b>Interest Expense:</b>				
Interest on deposits	1,358	1,823	4,209	5,707
Interest on retail repurchase agreements and federal funds purchased	39	46	126	158
Interest on advances from FHLB	3,255	3,599	9,667	10,772
Interest on subordinated debt	222	242	672	732
<b>Total interest expense</b>	<b>4,874</b>	<b>5,710</b>	<b>14,674</b>	<b>17,369</b>
<b>Net interest income</b>	<b>35,306</b>	<b>31,785</b>	<b>97,564</b>	<b>90,299</b>
Provision for loan and lease losses	1,128	232	(1,670)	2,481
<b>Net interest income after provision for loan and lease losses</b>	<b>34,178</b>	<b>31,553</b>	<b>99,234</b>	<b>87,818</b>
<b>Non-interest Income:</b>				
Investment securities gains	-	296	118	459
Total other-than-temporary impairment ("OTTI") losses	-	(23)	-	(95)
Portion of OTTI losses recognized in other comprehensive income, before taxes	-	-	-	-
<b>Net OTTI recognized in earnings</b>	<b>-</b>	<b>(23)</b>	<b>-</b>	<b>(95)</b>
Service charges on deposit accounts	2,171	2,230	6,390	6,713
Mortgage banking activities	(26)	1,981	2,738	4,294
Wealth management income	4,503	3,858	13,077	11,949
Insurance agency commissions	1,193	1,020	3,578	3,156
Income from bank owned life insurance	629	660	1,864	1,954
Visa check fees	1,077	984	3,113	2,844
Other income	1,676	1,236	4,979	3,435
<b>Total non-interest income</b>	<b>11,223</b>	<b>12,242</b>	<b>35,857</b>	<b>34,709</b>
<b>Non-interest Expenses:</b>				
Salaries and employee benefits	16,382	15,476	48,891	47,104
Occupancy expense of premises	3,149	3,106	9,327	8,895
Equipment expenses	1,200	1,237	3,676	3,682
Marketing	713	764	1,983	1,824
Outside data services	1,152	1,076	3,418	4,183

Edgar Filing: SANDY SPRING BANCORP INC - Form 10-Q

FDIC insurance	678	667	1,855	1,972
Amortization of intangible assets	462	476	1,384	1,403
Other expenses	3,157	4,365	11,690	13,645
Total non-interest expenses	26,893	27,167	82,224	82,708
Income before income taxes	18,508	16,628	52,867	39,819
Income tax expense	6,419	5,638	18,058	13,146
Net income	\$ 12,089	\$ 10,990	\$ 34,809	\$ 26,673
Net Income Per Share Amounts:				
Basic net income per share	\$ 0.48	\$ 0.44	\$ 1.40	\$ 1.09
Diluted net income per share	\$ 0.48	\$ 0.44	\$ 1.39	\$ 1.09
Dividends declared per share	\$ 0.16	\$ 0.12	\$ 0.46	\$ 0.34

The accompanying notes are an integral part of these statements

**Sandy Spring Bancorp, Inc. and Subsidiaries****CONDENSED Consolidated Statements of COMPREHENSIVE INCOME - UNAUDITED**

(In thousands)	Three Months Ended September 30,		Nine Months Ended September 30,	
	2013	2012	2013	2012
Net income	\$ 12,089	\$ 10,990	\$ 34,809	\$ 26,673
Other comprehensive income:				
Investments available-for-sale:				
Net change in unrealized gains (losses) on investments available-for-sale	(1,032)	2,594	(24,925)	3,943
Related income tax (expense) benefit	407	(1,035)	9,935	(1,573)
Net investment gains reclassified into earnings	-	296	118	459
Related income tax expense	-	(118)	(47)	(183)
Net effect on other comprehensive income (loss) for the period	(625)	1,737	(14,919)	2,646
Defined benefit pension plan:				
Recognition of unrealized gain	249	197	1,176	896
Related income tax expense	(91)	(78)	(461)	(357)
Net effect on other comprehensive income for the period	158	119	715	539
Total other comprehensive income (loss)	(467)	1,856	(14,204)	3,185
Comprehensive income	\$ 11,622	\$ 12,846	\$ 20,605	\$ 29,858

The accompanying notes are an integral part of these statements

**Sandy Spring Bancorp, Inc. and Subsidiaries**  
**CONDENSED Consolidated Statements of Cash Flows    UNAUDITED**

(Dollars in thousands)	Nine Months Ended September 30,	
	2013	2012
Operating activities:		
Net income	\$ 34,809	\$ 26,673
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	6,033	5,844
Net OTTI recognized in earnings	-	95
Provision (credit) for loan and lease losses	(1,670)	2,481
Share based compensation expense	1,307	1,132
Deferred income tax expense	2,945	2,315
Origination of loans held for sale	(219,153)	(221,288)
Proceeds from sales of loans held for sale	248,907	210,085
Gains on sales of loans held for sale	(4,147)	(3,340)
Loss on sales of other real estate owned	1,072	861
Investment securities gains	(118)	(459)
Gains on sales of premises and equipment	-	(93)
Net (increase) decrease in accrued interest receivable	(72)	85
Net (increase) decrease in other assets	6,441	(1,681)
Net increase in accrued expenses and other liabilities	2,010	2,505
Other net	3,706	7,315
Net cash provided by operating activities	82,070	32,530
Investing activities:		
Purchases of other equity securities	(2,776)	(2,956)
Purchases of investments held-to-maturity	(20,666)	(132,097)
Purchases of investments available-for-sale	(161,379)	(198,123)
Net proceeds from redemption of Federal Home Loan Bank of Atlanta stock	-	4,174
Proceeds from sales of investment available-for-sale	-	28,519
Proceeds from maturities, calls and principal payments of investments held-to-maturity	9,959	103,789
Proceeds from maturities, calls and principal payments of investments available-for-sale	143,220	286,607
Net increase in loans and leases	(135,100)	(74,008)
Proceeds from the sales of other real estate owned	7,137	3,102
Acquisition of business activity, net of cash acquired	-	(849)
Expenditures for premises and equipment	(1,883)	(3,675)
Net cash used in investing activities	(161,488)	14,483
Financing activities:		
Net increase in deposits	3,432	53,821
Net decrease in retail repurchase agreements and federal funds purchased	(33,752)	(85,307)
Proceeds from advances from FHLB	745,000	40,000
Repayment of advances from FHLB	(630,058)	(40,262)
Proceeds from issuance of common stock	48	(21)

Edgar Filing: SANDY SPRING BANCORP INC - Form 10-Q

Remittances due to vesting of restricted stock	-	-
Tax benefits associated with shared based compensation	-	80
Dividends paid	(11,590)	(8,371)
Net cash provided by financing activities	73,080	(40,060)
Net increase (decrease) in cash and cash equivalents	(6,338)	6,953
Cash and cash equivalents at beginning of period	86,406	72,314
Cash and cash equivalents at end of period	\$ 80,068	\$ 79,267
Supplemental Disclosures:		
Interest payments	\$ 15,031	\$ 17,319
Income tax payments	12,470	8,326
Transfers from loans to other real estate owned	2,353	4,410

The accompanying notes are an integral part of these statements.

**Sandy Spring Bancorp, Inc. and Subsidiaries**  
**CONDENSED Consolidated Statements of changes in stockholders' equity - UNAUDITED**

(Dollars in thousands, except per share data)	Common Stock	Additional Paid-In Capital	Retained Earnings	Accumulated Other Comprehensive Income	Total Stockholders' Equity
Balances at January 1, 2013	\$ 24,905	\$ 191,689	\$ 255,606	\$ 11,312	\$ 483,512
Net income	-	-	34,809	-	34,809
Other comprehensive loss, net of tax	-	-	-	(14,204)	(14,204)
Common stock dividends - \$0.46 per share	-	-	(11,590)	-	(11,590)
Stock compensation expense	-	1,307	-	-	1,307
Common stock issued pursuant to:					-
Stock option plan - 10,964 shares	11	128	-	-	139
Employee stock purchase plan - 19,971 shares	20	336	-	-	356
Restricted stock - 48,819 shares	49	(496)	-	-	(447)
Balances at September 30, 2013	\$ 24,985	\$ 192,964	\$ 278,825	\$ (2,892)	\$ 493,882
Balances at January 1, 2012	\$ 24,091	\$ 177,828	\$ 230,942	\$ 13,248	\$ 446,109
Net income	-	-	26,673	-	26,673
Other comprehensive income, net of tax	-	-	-	3,185	3,185
Common stock dividends - \$0.34 per share	-	-	(8,371)	-	(8,371)
Stock compensation expense	-	1,132	-	-	1,132
Common stock issued pursuant to:					
Acquisition of CommerceFirst Bancorp, Inc. - 732,054 shares	732	12,291	-	-	13,023
Stock option plan - 1,217 shares	1	14	-	-	15
Employee stock purchase plan - 24,295 shares	24	348	-	-	372
Director stock purchase plan - 1,083 shares	1	18	-	-	19
Restricted stock - 46,445 shares	47	(394)	-	-	(347)
Balances at September 30, 2012	\$ 24,896	\$ 191,237	\$ 249,244	\$ 16,433	\$ 481,810

The accompanying notes are an integral part of these statements

**Sandy Spring Bancorp, Inc. and Subsidiaries**  
**Notes to the CONDENSED Consolidated Financial Statements - UNAUDITED**

**Note 1 Significant Accounting Policies**

**Nature of Operations**

Sandy Spring Bancorp (the “Company”), a Maryland corporation, is the bank holding company for Sandy Spring Bank (the “Bank”), which conducts a full-service commercial banking, mortgage banking and trust business. Services to individuals and businesses include accepting deposits, extending real estate, consumer and commercial loans and lines of credit, equipment leasing, general insurance, personal trust, and investment and wealth management services. The Company operates in the six Maryland counties of Anne Arundel, Carroll, Frederick, Howard, Montgomery, and Prince George's, and in Arlington, Fairfax and Loudoun counties in Virginia. The Company offers investment and wealth management services through the Bank's subsidiary, West Financial Services. Insurance products are available to clients through Sandy Spring Insurance, and Neff & Associates, which are agencies of Sandy Spring Insurance Corporation.

**Basis of Presentation**

The accounting and reporting policies of the Company conform to accounting principles generally accepted in the United States of America (“GAAP”) and prevailing practices within the financial services industry for interim financial information and Rule 10-01 of Regulation S-X. Accordingly, they do not include all of the information and notes required for complete financial statements. The following summary of significant accounting policies of the Company is presented to assist the reader in understanding the financial and other data presented in this report. Operating results for the three and nine months ended September 30, 2013 are not necessarily indicative of the results that may be expected for any future periods or for the year ending December 31, 2013. In the opinion of management, all adjustments (comprising only normal recurring accruals) necessary for a fair presentation of the results of the interim periods have been included. Certain reclassifications have been made to prior period amounts, as necessary, to conform to the current period presentation. The Company has evaluated subsequent events through the date of the issuance of its financial statements.

These statements should be read in conjunction with the financial statements and accompanying notes included in the Company's 2012 Annual Report on Form 10-K as filed with the Securities and Exchange Commission (“SEC”) on March 18, 2013. There have been no significant changes to the Company's accounting policies as disclosed in the 2012 Annual Report on Form 10-K.

**Principles of Consolidation**

The unaudited condensed consolidated financial statements include the accounts of the Company and its wholly owned subsidiary, Sandy Spring Bank and its subsidiaries, Sandy Spring Insurance Corporation and West Financial Services, Inc. Consolidation has resulted in the elimination of all intercompany accounts and transactions.

**Use of Estimates**

The preparation of financial statements requires management to make estimates and assumptions 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 affect the reported amounts of revenues earned and expenses incurred during the reporting period. Actual results could differ from those estimates. Estimates that could change significantly relate to the provision for loan and lease losses and the related allowance, determination of impaired loans and the related measurement of impairment, potential impairment of goodwill or other intangible assets, valuation of investment securities and the determination of whether impaired securities are other-than-temporarily impaired, valuation of other real estate owned, prepayment rates, valuation of share-based compensation, the assessment that a liability should be recognized with respect to any matters under litigation, the calculation of current and deferred income taxes and the actuarial projections related to pension expense and the related liability.

**Cash Flows**

For purposes of reporting cash flows, cash and cash equivalents include cash and due from banks, federal funds sold and interest-bearing deposits with banks (items with stated original maturity of three months or less).



**Loans Acquired with Deteriorated Credit Quality**

Acquired loans are evaluated for evidence of credit deterioration since their origination as of the date of the acquisition are recorded at their initial fair value. Credit deterioration is determined based on the probability of collection of all contractually required principal and interest payments. The historical allowance for loan and lease losses related to the purchased loans is not carried over to the Company. The determination of credit quality deterioration as of the purchase date may include parameters such as past due and non-accrual status, commercial risk ratings, cash flow projections, type of loan and collateral, collateral value and recent loan-to-value ratios or appraised values. For loans acquired with no evidence of credit deterioration, the fair value discount or premium is amortized over the contractual life of the loan as an adjustment to yield. For loans acquired with evidence of credit deterioration, the Company determines at the acquisition date the excess of the loan's contractually required payments over all cash flows expected to be collected as an amount that should not be accreted into interest income (nonaccretable difference). The remaining amount representing the difference in the expected cash flows of acquired loans and the initial investment in the acquired loans is accreted into interest income over the remaining life of the loan or pool of loans (accretable yield). Subsequent to the purchase date, increases in expected cash flows over those expected at the purchase date are recognized prospectively as interest income over the remaining life of the loan. The present value of any decreases in expected cash flows after the purchase date is recognized as an impairment through a charge to the provision for loan losses. Increases in the present value of expected cash flows after the purchase date are recognized as an adjustment to the accretable yield. Subsequent to the purchase date, the methods utilized to estimate the required allowance for loan and lease losses ("ALLL") are similar to originated loans. Loans carried at fair value, mortgage loans held for sale and loans under revolving credit agreements are excluded from the scope of this guidance on loans acquired with deteriorated credit quality.

**Adopted Accounting Pronouncements**

In February 2013, the FASB issued a standard on the reporting of reclassifications out of accumulated other comprehensive income ("AOCI"). The guidance sets requirements for presentation for significant items reclassified to net income in their entirety during the period and for items not reclassified to net income in their entirety during the period. Information about the reclassifications out of AOCI must be contained in single location in the financial statements. The reclassifications must also be presented by each component as part of the reporting on the changes in the AOCI balances. This guidance is effective prospectively for fiscal years, and interim periods within those years, beginning after December 15, 2012. This guidance did not have any impact on the financial position, results of operations or cash flows of the Company, as it only affects the presentation of the information in the financial statements.

**NOTE 2 ACQUISITION**

On May 31, 2012, the Company completed the acquisition of CommerceFirst Bancorp, Inc. and its wholly-owned subsidiary. Under the terms of the acquisition the Company acquired 100% of the shares of CommerceFirst common stock for a combination of 50% Sandy Spring Bancorp common stock and 50% cash. The results of operations acquired in this transaction have been included in the Company's financial results from the date of the acquisition. Stock consideration was exchanged at a ratio of 0.8043 of the Company's shares for each CommerceFirst share resulting in the issuance of 732,054 of the Company's common stock. Total cash consideration amounted to \$12.4 million or \$13.60 per share.

**Note 3 Investments**Investments available-for-sale

The amortized cost and estimated fair values of investments available-for-sale at the dates indicated are presented in the following table:

At September 30, 2013				At December 31, 2012			
Amortized	Gross Unrealized	Gross Unrealized	Estimated Fair	Amortized	Gross Unrealized	Gross Unrealized	Estimated Fair

Edgar Filing: SANDY SPRING BANCORP INC - Form 10-Q

(In thousands)	Cost	Gains	Losses	Value	Cost	Gains	Losses	Value
U.S. government agencies	\$177,979	\$126	\$(5,862)	\$172,243	\$155,442	\$1,084	\$(98)	\$156,428
State and municipal	159,772	7,164	(70)	166,866	160,496	13,996	(1)	174,491
Mortgage-backed	464,483	12,523	(4,737)	472,269	471,527	19,080	(128)	490,479
Corporate debt	2,000	5	-	2,005	2,000	-	(4)	1,996
Trust preferred	1,701	-	(262)	1,439	1,701	-	(236)	1,465
Total debt securities	805,935	19,818	(10,931)	814,822	791,166	34,160	(467)	824,859
Marketable equity securities	723	-	-	723	723	-	-	723
Total investments available-for-sale	\$806,658	\$19,818	\$(10,931)	\$815,545	\$791,889	\$34,160	\$(467)	\$825,582

Any unrealized losses in the U.S. government agencies, state and municipal, mortgage-backed or corporate debt investment securities at September 30, 2013 are not the result of credit related events but due to changes in interest rates. These declines are considered temporary in nature and are expected to decline over time and recover as these securities approach maturity.

The mortgage-backed securities portfolio at September 30, 2013 is composed entirely of either the most senior tranches of GNMA collateralized mortgage obligations (\$219.1 million), or GNMA, FNMA or FHLMC mortgage-backed securities (\$253.2 million). The Company does not intend to sell these securities and has sufficient liquidity to hold these securities for an adequate period of time, which may be maturity, to allow for any anticipated recovery in fair value.

At September 30, 2013, the trust preferred portfolio consisted of one pooled trust preferred security. The pooled trust preferred security, which is backed by debt issued by banks and thrifts, totals \$1.7 million with a fair value of \$1.4 million. The fair value of this security was determined by management through the use of a third party valuation specialist due to the limited trading activity for this security.

The income valuation approach technique (present value) was used that maximizes the use of relevant observable inputs and minimizes the use of unobservable inputs. The methodology and significant assumptions employed to determine fair value included:

- Evaluation of the structural terms as established in the indenture;
- Detailed credit and structural evaluation for each piece of issuer collateral in the pool;
- Overall default (.48%), recovery and prepayment (2%)/amortization probabilities by issuers in the pool;
- Identification of adverse conditions specifically related to the security, industry and geographical area;
- Projection of estimated cash flows that incorporate default expectations and loss severities;
- Review of historical and implied volatility of the fair value of the security;
- Evaluation of credit risk concentrations;
- Evaluation of the length of time and the extent to which the fair value has been less than the amortized cost; and
- A discount rate of 12.7% was established using credit adjusted financial institution spreads for comparably rated institutions and a liquidity adjustment that considered the previously noted characteristics.

As a result of this evaluation, it was determined that the pooled trust preferred security had not incurred any credit-related other-than-temporary impairment (“OTTI”) for the quarter ended September 30, 2013. Non-credit related OTTI on this security, which is not expected to be sold and which the Company has the ability to hold until maturity, was \$0.3 million at September 30, 2013. This non-credit related OTTI was recognized in other comprehensive income (“OCI”) at September 30, 2013.

The methodology and significant inputs used to measure the amount related to credit loss consisted of the following:

- Default rates were developed based on the financial condition of the trust preferred issuers in the pool and the payment or deferral status. Conditional default rates were estimated based on the payment characteristics of the security and the financial condition of the issuers in the pool. Near term and future defaults are estimated using third party industry data in addition to a review of key financial ratios and other pertinent data on the financial stability of the underlying issuer;
- Loss severity is forecasted based on the type of impairment using research performed by third parties;
- The security contains one level of subordination below the senior tranche, with the senior tranche receiving the spread from the subordinate bonds;
- Credit ratings of the underlying issuers are reviewed in conjunction with the development of the default rates applied to determine the credit amounts related to the credit loss; and
- Potential prepayments are estimated based on terms and rates of the underlying trust preferred securities to determine the impact of excess spread on the credit enhancement, the removal of the strongest institutions from the underlying pool and any impact that prepayments might have on diversity and concentration.

The following table provides the activity of OTTI on investment securities due to credit losses recognized in earnings for the period indicated:

(In thousands)	OTTI Losses
Cumulative credit losses on investment securities, through December 31, 2012	\$ 531
Additions for credit losses not previously recognized	-
Cumulative credit losses on investment securities, through September 30, 2013	\$ 531

Gross unrealized losses and fair value by length of time that the individual available-for-sale securities have been in an unrealized loss position at the dates indicated are presented in the following table:

At September 30, 2013					
(Dollars in thousands)	Number of securities	Fair Value	Continuous Unrealized Losses Existing for:		Total Unrealized Losses
			Less than 12 months	More than 12 months	
U.S. government agencies	14	\$ 138,520	\$ 5,862	\$ -	\$ 5,862
State and municipal	7	5,758	70	-	70
Mortgage-backed	24	150,173	4,737	-	4,737
Trust preferred	1	1,439	-	262	262
Total	46	\$ 295,890	\$ 10,669	\$ 262	\$ 10,931

At December 31, 2012					
(Dollars in thousands)	Number of securities	Fair Value	Continuous Unrealized Losses Existing for:		Total Unrealized Losses
			Less than 12 months	More than 12 months	
U.S. government agencies	2	\$ 29,900	\$ 98	\$ -	\$ 98
State and municipal	1	390	1	-	1
Mortgage-backed	2	12,653	128	-	128
Corporate debt	1	1,996	4	-	4
Trust preferred	1	1,465	-	236	236
Total	7	\$ 46,404	\$ 231	\$ 236	\$ 467

The amortized cost and estimated fair values of debt securities available-for-sale by contractual maturity at the dates indicated are provided in the following table. The Company has allocated mortgage-backed securities into the four maturity groupings reflected in the following table using the expected average life of the individual securities based on statistics provided by independent third party industry sources. Expected maturities will differ from contractual maturities as borrowers may have the right to prepay obligations with or without prepayment penalties.

(In thousands)	At September 30, 2013		At December 31, 2012	
	Amortized Cost	Estimated Fair Value	Amortized Cost	Estimated Fair Value
Due in one year or less	\$ 30,314	\$ 30,439	\$ 35,544	\$ 36,349
Due after one year through five years	11,953	12,301	3,957	3,994
Due after five years through ten years	394,079	398,163	382,957	399,180
Due after ten years	369,589	373,919	368,708	385,336
Total debt securities available for sale	\$ 805,935	\$ 814,822	\$ 791,166	\$ 824,859

At September 30, 2013 and December 31, 2012, investments available-for-sale with a book value of \$189.2 million and \$195.4 million, respectively, were pledged as collateral for certain government deposits and for other purposes as required or permitted by law. The outstanding balance of no single issuer, except for U.S. Agencies securities, exceeded ten percent of stockholders' equity at September 30, 2013 and December 31, 2012.

Investments held-to-maturity

The amortized cost and estimated fair values of investments held-to-maturity at the dates indicated are presented in the following table:

(In thousands)	At September 30, 2013				At December 31, 2012			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
U.S. government agencies	\$ 64,503	\$ -	\$ (3,381)	\$ 61,122	\$ 64,498	\$ 125	\$ (29)	\$ 64,594
State and municipal	161,231	2,219	(4,813)	158,637	150,995	6,194	(123)	157,066
Mortgage-backed	260	35	-	295	321	43	-	364
Total investments held-to-maturity	\$ 225,994	\$ 2,254	\$ (8,194)	\$ 220,054	\$ 215,814	\$ 6,362	\$ (152)	\$ 222,024

Gross unrealized losses and fair value by length of time that the individual held-to-maturity securities have been in a continuous unrealized loss position at the dates indicated are presented in the following tables:

(Dollars in thousands)	At September 30, 2013		Continuous Unrealized Losses Existing for:		
	Number of securities	Fair Value	Less than	More than	Total Unrealized Losses
			12 months	12 months	
U.S. government agencies	8	\$ 61,122	\$ 3,381	\$ -	\$ 3,381
State and municipal	100	85,882	4,813	-	4,813
Total	108	\$ 147,004	\$ 8,194	\$ -	\$ 8,194

(Dollars in thousands)	At December 31, 2012		Continuous Unrealized Losses Existing for:		
	Number of securities	Fair Value	Less than	More than	Total Unrealized Losses
			12 months	12 months	

Edgar Filing: SANDY SPRING BANCORP INC - Form 10-Q

U.S. government agencies	1	\$ 9,961	\$ 29	\$ -	\$ 29
State and municipal	13	16,868	123	-	123
Total	14	\$ 26,829	\$ 152	\$ -	\$ 152

The Company intends to hold these securities until they reach maturity.

The amortized cost and estimated fair values of debt securities held-to-maturity by contractual maturity at the dates indicated are reflected in the following table. Expected maturities will differ from contractual maturities as borrowers may have the right to prepay obligations with or without prepayment penalties.

(In thousands)	At September 30, 2013		At December 31, 2012	
	Amortized Cost	Estimated Fair Value	Amortized Cost	Estimated Fair Value
Due in one year or less	\$ 2,765	\$ 2,787	\$ 7,431	\$ 7,523
Due after one year through five years	3,253	3,264	4,653	4,725
Due after five years through ten years	132,577	130,588	116,735	120,074
Due after ten years	87,399	83,415	86,995	89,702
Total debt securities held-to-maturity	\$ 225,994	\$ 220,054	\$ 215,814	\$ 222,024

At September 30, 2013 and December 31, 2012, investments held-to-maturity with a book value of \$168.9 million and \$155.5 million, respectively, were pledged as collateral for certain government deposits and for other purposes as required or permitted by law. The outstanding balance of no single issuer, except for U.S. Agency securities, exceeded ten percent of stockholders' equity at September 30, 2013 and December 31, 2012.

#### Equity securities

Other equity securities at the dates indicated are presented in the following table:

(In thousands)	September 30, 2013	December 31, 2012
Federal Reserve Bank stock	\$ 8,269	\$ 8,269
Federal Home Loan Bank of Atlanta stock	28,143	25,367
Total equity securities	\$ 36,412	\$ 33,636

#### **Note 4 Loans and Leases**

Outstanding loan balances at September 30, 2013 and December 31, 2012 are net of unearned income including net deferred loan costs of \$0.8 million and \$1.4 million, respectively. The loan portfolio segment balances at the dates indicated are presented in the following table:

(In thousands)	September 30, 2013	December 31, 2012
Residential real estate:		
Residential mortgage	\$ 595,180	\$ 523,364
Residential construction	118,316	120,314
Commercial real estate:		
Commercial owner occupied real estate	569,350	571,510
Commercial investor real estate	518,029	456,888
Commercial acquisition, development and construction	158,739	151,933
Commercial Business	332,670	346,708
Leases	962	3,421
Consumer	368,764	356,990
Total loans and leases	\$ 2,662,010	\$ 2,531,128

#### **Note 5 CREDIT QUALITY ASSESSMENT**

##### **Allowance for Loan and Lease Losses**

Summary information on the allowance for loan and lease loss activity for the period indicated is provided in the following table:

Edgar Filing: SANDY SPRING BANCORP INC - Form 10-Q

(In thousands)	Nine Months Ended September 30,	
	2013	2012
Balance at beginning of year	\$ 42,957	\$ 49,426
Provision (credit) for loan and lease losses	(1,670)	2,481
Loan and lease charge-offs	(9,639)	(11,456)
Loan and lease recoveries	7,774	2,167
Net charge-offs	(1,865)	(9,289)
Balance at period end	\$ 39,422	\$ 42,618



Edgar Filing: SANDY SPRING BANCORP INC - Form 10-Q

The following tables provide information on the activity in the allowance for loan and lease losses by the respective loan portfolio segment for the period indicated:

(Dollars in thousands)	For the Nine Months Ended September 30, 2013														
	Commercial Real Estate										Residential Real Estate				
	Commercial	Commercial	Commercial	Commercial	Commercial	Commercial	Commercial	Commercial	Commercial	Commercial	Residential	Residential	Residential	Residential	Residential
Business	AD&C	Investor	R/E	Occupied	R/E	Leasing	Consumer	Mortgage	Construction	Total					
Balance at beginning of year	\$6,495	\$4,737	\$9,583	\$6,997	\$332	\$3,846	\$8,522	\$2,445	\$42,957						
Provision (credit)	1,332	(4,037)	1,026	(642)	(321)	1,204	231	(463)	(1,670)						
Charge-offs	(2,405)	-	(4,744)	(229)	-	(1,327)	(829)	(105)	(9,639)						
Recoveries	692	3,080	3,347	332	10	160	144	9	7,774						
Net charge-offs	(1,713)	3,080	(1,397)	103	10	(1,167)	(685)	(96)	(1,865)						
Balance at end of period	\$6,114	\$3,780	\$9,212	\$6,458	\$21	\$3,883	\$8,068	\$1,886	\$39,422						
Total loans and leases	\$332,670	\$158,739	\$518,029	\$569,350	\$962	\$368,764	\$595,180	\$118,316	\$2,662,010						
Allowance for loans and leases to total loans and leases ratio	1.84 %	2.38 %	1.78 %	1.13 %	2.18 %	1.05 %	1.36 %	1.59 %	1.48 %						
Balance of loans specifically evaluated for impairment	\$6,562	\$5,086	\$7,729	\$5,385	na.	\$29	\$4,438	\$1,860	\$31,089						
Allowance for loans specifically evaluated for impairment	\$1,550	\$946	\$146	\$391	na.	na.	\$650	\$547	\$4,230						
Specific allowance to specific loans ratio	23.62 %	18.60 %	1.89 %	7.26 %	na.	na.	14.65 %	29.41 %	13.61 %						
Balance of loans	\$326,108	\$153,653	\$510,300	\$563,965	\$962	\$368,735	\$590,742	\$116,456	\$2,630,921						

Edgar Filing: SANDY SPRING BANCORP INC - Form 10-Q

collectively evaluated Allowance for loans collectively evaluated	\$4,564	\$2,834	\$9,066	\$6,067	\$21	\$3,883	\$7,418	\$1,339	\$35,192
Collective allowance to collective loans ratio	1.40	% 1.84	% 1.78	% 1.08	% 2.18	% 1.05	% 1.26	% 1.15	% 1.34

For the Year Ended December 31, 2012

(Dollars in thousands)	Commercial Real Estate						Residential Real Estate		
	Commercial Business	Commercial AD&C	Commercial			Consumer	Residential Mortgage	Residential Construction	Total
			Investor R/E	Occupied R/E	Leasing				
Balance at beginning of year	\$6,727	\$6,664	\$8,248	\$7,329	\$795	\$4,873	\$10,583	\$4,207	\$49,426
Provision (credit)	(758)	826	4,928	804	(478)	44	(167)	(1,550)	3,649
Charge-offs	(1,022)	(3,281)	(3,690)	(1,174)	(8)	(1,298)	(2,107)	(224)	(12,804)
Recoveries	1,548	528	97	38	23	227	213	12	2,686
Net charge-offs	526	(2,753)	(3,593)	(1,136)	15	(1,071)	(1,894)	(212)	(10,118)
Balance at end of period	\$6,495	\$4,737	\$9,583	\$6,997	\$332	\$3,846	\$8,522	\$2,445	\$42,957
Total loans and leases	\$346,708	\$151,933	\$456,888	\$571,510	\$3,421	\$356,990	\$523,364	\$120,314	\$2,531,128
Allowance for loans and leases to total loans and leases ratio	1.87	% 3.12	% 2.10	% 1.22	% 9.70	% 1.08	% 1.63	% 2.03	% 1.70

Balance of loans specifically evaluated for impairment	\$8,984	\$6,332	\$11,843	\$15,184	na.	\$31	\$4,528	\$1,871	\$48,773
Allowance for loans specifically evaluated for impairment	\$2,597	\$-	\$774	\$598	na.	na.	\$713	\$467	\$5,149

Specific allowance to specific loans ratio

28.91 % - 6.54 % 3.94 % na. na. 15.75 % 24.96 % 10.56 %

Balance of loans collectively evaluated

\$337,724 \$145,601 \$445,045 \$556,326 \$3,421 \$356,959 \$518,836 \$118,443 \$2,482,355

Allowance for loans collectively evaluated

\$3,898 \$4,737 \$8,809 \$6,399 \$332 \$3,846 \$7,809 \$1,978 \$37,808

Collective allowance to collective loans ratio

1.15 % 3.25 % 1.98 % 1.15 % 9.70 % 1.08 % 1.51 % 1.67 % 1.52 %

The following table provides summary information regarding impaired loans at the dates indicated and for the periods then ended:

(In thousands)	September 30, 2013	December 31, 2012
Impaired loans with a specific allowance	\$ 15,142	\$ 27,526
Impaired loans without a specific allowance	15,947	21,247
Total impaired loans	\$ 31,089	\$ 48,773
Allowance for loan and lease losses related to impaired loans	\$ 4,230	\$ 5,149
Allowance for loan and lease losses related to loans collectively evaluated	35,192	37,808
Total allowance for loan and lease losses	\$ 39,422	\$ 42,957
Average impaired loans for the period	\$ 39,843	\$ 57,438
Contractual interest income due on impaired loans during the period	\$ 2,292	\$ 4,433
Interest income on impaired loans recognized on a cash basis	\$ 1,694	\$ 1,121
Interest income on impaired loans recognized on an accrual basis	\$ 332	\$ 560

The following tables present the recorded investment with respect to impaired loans, the associated allowance by the applicable portfolio segment and the principal balance of the impaired loans prior to amounts charged-off at the dates indicated:

(In thousands)	September 30, 2013					Total Recorded Investment in Impaired Loans
	Commercial	Commercial AD&C	Commercial Investor	Commercial Owner Occupied R/E	All Other R/ELoans	
Impaired loans with a specific allowance						
Non-accruing	\$ 1,189	\$ 1,379	\$ 770	\$ 207	\$ -	\$ 3,545
Restructured accruing	905	-	-	995	2,379	4,279
Restructured non-accruing	266	2,439	-	2,581	2,032	7,318
Balance	\$ 2,360	\$ 3,818	\$ 770	\$ 3,783	\$ 4,411	\$ 15,142
Allowance	\$ 1,550	\$ 946	\$ 146	\$ 391	\$ 1,197	\$ 4,230
Impaired loans without a specific allowance						
Non-accruing	\$ 1,079	\$ 1,268	\$ 5,483	\$ 675	\$ -	\$ 8,505
Restructured accruing	1,607	-	852	188	1,128	3,775
Restructured non-accruing	1,516	-	624	739	788	3,667
Balance	\$ 4,202	\$ 1,268	\$ 6,959	\$ 1,602	\$ 1,916	\$ 15,947
Total impaired loans						
Non-accruing	\$ 2,268	\$ 2,647	\$ 6,253	\$ 882	\$ -	\$ 12,050
Restructured accruing	2,512	-	852	1,183	3,507	8,054
Restructured non-accruing	1,782	2,439	624	3,320	2,820	10,985
Balance	\$ 6,562	\$ 5,086	\$ 7,729	\$ 5,385	\$ 6,327	\$ 31,089

Unpaid principal balance in total impaired loans	\$ 8,645	\$ 13,448	\$ 12,585	\$ 7,028	\$ 6,944	\$ 48,650
---	----------	-----------	-----------	----------	----------	-----------

Edgar Filing: SANDY SPRING BANCORP INC - Form 10-Q

September 30, 2013						
(In thousands)	Commercial Real Estate					Total Recorded Investment in Impaired Loans
	Commercial	Commercial AD&C	Commercial Investor R/E	Commercial Owner Occupied R/E	All Other Loans	
Average impaired loans for the period	\$ 7,539	\$ 5,782	\$ 11,343	\$ 8,705	\$ 6,474	\$ 39,843
Contractual interest income due on impaired loans during the period	\$ 481	\$ 590	\$ 430	\$ 578	\$ 213	
Interest income on impaired loans recognized on a cash basis	\$ 250	\$ 269	\$ 74	\$ 1,010	\$ 91	
Interest income on impaired loans recognized on an accrual basis	\$ 117	\$ -	\$ 23	\$ 58	\$ 134	
December 31, 2012						
(In thousands)	Commercial Real Estate					Total Recorded Investment in Impaired Loans
	Commercial	Commercial AD&C	Commercial Investor R/E	Commercial Owner Occupied R/E	All Other Loans	
Impaired loans with a specific allowance						
Non-accruing	\$ 2,514	\$ -	\$ 10,219	\$ 4,319	\$ -	\$ 17,052
Restructured accruing	2,981	-	-	1,503	3,419	7,903
Restructured non-accruing	228	-	-	1,039	1,304	2,571
Balance	\$ 5,723	\$ -	\$ 10,219	\$ 6,861	\$ 4,723	\$ 27,526
Allowance	\$ 2,597	\$ -	\$ 774	\$ 598	\$ 1,180	\$ 5,149
Impaired loans without a specific allowance						
Non-accruing	\$ 1,846	\$ 3,033	\$ 577	\$ 6,191	\$ -	\$ 11,647
Restructured accruing	1,392	-	-	-	815	2,207
Restructured non-accruing	23	3,299	1,047	2,132	892	7,393
Balance	\$ 3,261	\$ 6,332	\$ 1,624	\$ 8,323	\$ 1,707	\$ 21,247
Total impaired loans						
Non-accruing	\$ 4,360	\$ 3,033	\$ 10,796	\$ 10,510	\$ -	\$ 28,699
Restructured accruing	4,373	-	-	1,503	4,234	10,110
Restructured non-accruing	251	3,299	1,047	3,171	2,196	9,964
Balance	\$ 8,984	\$ 6,332	\$ 11,843	\$ 15,184	\$ 6,430	\$ 48,773
Unpaid principal balance in total impaired loans	\$ 11,506	\$ 21,590	\$ 15,405	\$ 17,928	\$ 6,904	\$ 73,333

December 31, 2012

Commercial Real Estate

Total Recorded

Edgar Filing: SANDY SPRING BANCORP INC - Form 10-Q

(In thousands)	Commercial	Commercial AD&C	Commercial Investor R/E	Commercial Owner Occupied R/E	All Other Loans	Investment in Impaired Loans
Average impaired loans for the period	\$ 8,659	\$ 12,270	\$ 13,838	\$ 16,172	\$ 6,499	\$ 57,438
Contractual interest income due on impaired loans during the period	\$ 527	\$ 1,222	\$ 1,181	\$ 1,391	\$ 112	
Interest income on impaired loans recognized on a cash basis	\$ 121	\$ 323	\$ 175	\$ 420	\$ 82	
Interest income on impaired loans recognized on an accrual basis	\$ 257	\$ -	\$ -	\$ 102	\$ 201	

**Credit Quality**

The following tables provide information on the credit quality of the loan portfolio by segment at the dates indicated:

(In thousands)	September 30, 2013								
	Commercial Real Estate					Residential Real Estate			
	Commercial					Residential			
	Commercial	Commercial AD&C	Commercial Investor R/E	Commercial Owner Occupied R/E	Commercial Leasing	Residential Consumer Mortgage	Residential Construction	Total	
Non-performing loans and assets:									
Non-accrual loans and leases	\$ 4,050	\$ 5,086	\$ 6,877	\$ 4,202	\$ -	\$ 2,004	\$ 5,643	\$ 2,327	\$ 30,189
Loans and leases 90 days past due	-	-	-	-	-	10	-	-	10
Restructured loans and leases	2,512	-	852	1,183	-	29	3,478	-	8,054
Total non-performing loans and leases	6,562	5,086	7,729	5,385	-	2,043	9,121	2,327	38,253
Other real estate owned	408	-	-	-	-	-	1,254	-	1,662
Total non-performing assets	\$ 6,970	\$ 5,086	\$ 7,729	\$ 5,385	\$ -	\$ 2,043	\$ 10,375	\$ 2,327	\$ 39,915

(In thousands)	December 31, 2012								
	Commercial Real Estate					Residential Real Estate			
	Commercial					Residential			
	Commercial	Commercial AD&C	Commercial Investor R/E	Commercial Owner Occupied R/E	Commercial Leasing	Residential Consumer Mortgage	Residential Construction	Total	
Non-performing loans and assets:									
Non-accrual loans and leases	\$ 4,611	\$ 6,332	\$ 11,843	\$ 13,681	\$ 865	\$ 2,410	\$ 4,681	\$ 3,125	\$ 47,548
Loans and leases 90 days past due	24	-	-	209	-	14	-	-	247
Restructured loans and leases	4,373	-	-	1,503	-	31	4,203	-	10,110
Total non-performing loans and leases	9,008	6,332	11,843	15,393	865	2,455	8,884	3,125	57,905
Other real estate owned	1,829	-	220	2,396	-	-	1,401	80	5,926
Total non-performing assets	\$ 10,837	\$ 6,332	\$ 12,063	\$ 17,789	\$ 865	\$ 2,455	\$ 10,285	\$ 3,205	\$ 63,831

(In thousands)	September 30, 2013								
	Commercial Real Estate					Residential Real Estate			
	Commercial					Residential			
	Commercial	Commercial AD&C	Commercial Investor R/E	Commercial Owner Occupied R/E	Commercial Leasing	Residential Consumer Mortgage	Residential Construction	Total	
Past due loans and leases									
31-60 days	\$ 4,989	\$ -	\$ 5,901	\$ 3,540	\$ -	\$ 713	\$ 5,985	\$ -	\$ 21,128



Edgar Filing: SANDY SPRING BANCORP INC - Form 10-Q

61-90 days	984	382	78	5,022	-	596	-	-	7,062
> 90 days	-	-	-	-	-	10	-	-	10
Total past due	5,973	382	5,979	8,562	-	1,319	5,985	-	28,200
Non-accrual loans and leases	4,050	5,086	6,877	4,202	-	2,004	5,643	2,327	30,189
Loans acquired with deteriorated credit quality	1,655	-	1,598	2,635	-	-	-	-	5,888
Current loans	320,992	153,271	503,575	553,951	962	365,441	583,552	115,989	2,597,733
Total loans and leases	\$ 332,670	\$ 158,739	\$ 518,029	\$ 569,350	\$ 962	\$ 368,764	\$ 595,180	\$ 118,316	\$ 2,662,010

December 31, 2012

(In thousands)	Commercial Real Estate					Residential Real Estate			
	Commercial	Commercial			Leasing	Consumer	Residential Mortgage	Residential Construction	Total
		AD&C	Investor R/O	Commercial Owner/ Occupied R/O					
Past due loans and leases									
31-60 days	\$ 2,138	\$ -	\$ 2,020	\$ 1,556	\$ 7	\$ 496	\$ 5,443	\$ -	\$ 11,660
61-90 days	212	-	-	1,809	68	101	1,603	-	3,793
> 90 days	24	-	-	209	-	14	-	-	247
Total past due	2,374	-	2,020	3,574	75	611	7,046	-	15,700
Non-accrual loans and leases	4,611	6,332	11,843	13,681	865	2,410	4,681	3,125	47,548
Loans acquired with deteriorated credit quality	1,978	332	949	3,941	-	-	-	-	7,200
Current loans	337,745	145,269	442,076	550,314	2,481	353,969	511,637	117,189	2,460,680
Total loans and leases	\$ 346,708	\$ 151,933	\$ 456,888	\$ 571,510	\$ 3,421	\$ 356,990	\$ 523,364	\$ 120,314	\$ 2,531,128

Edgar Filing: SANDY SPRING BANCORP INC - Form 10-Q

The following tables provide information by credit risk rating indicators for each segment of the commercial loan portfolio for the dates indicated:

September 30, 2013

(In thousands)	Commercial Real Estate				Total
	Commercial	Commercial AD&C	Commercial Investor R/E	Commercial Owner Occupied R/E	
Pass	\$ 292,973	\$ 151,546	\$ 493,523	\$ 528,610	\$ 1,466,652
Special Mention	19,345	109	1,713	17,300	38,467
Substandard	20,063	7,084	22,750	23,440	73,337
Doubtful	289	-	43	-	332
Total	\$ 332,670	\$ 158,739	\$ 518,029	\$ 569,350	\$ 1,578,788

December 31, 2012

(In thousands)	Commercial Real Estate				Total
	Commercial	Commercial AD&C	Commercial Investor R/E	Commercial Owner Occupied R/E	
Pass	\$ 305,348	\$ 141,802	\$ 405,448	\$ 520,844	\$ 1,373,442
Special Mention	13,603	1,793	21,963	17,262	54,621
Substandard	26,091	8,338	28,885	32,613	95,927
Doubtful	1,666	-	592	791	3,049
Total	\$ 346,708	\$ 151,933	\$ 456,888	\$ 571,510	\$ 1,527,039

Homogeneous loan pools do not have individual loans subjected to internal risk ratings therefore, the credit indicator applied to these pools is based on their delinquency status. The following tables provide information by credit risk rating indicators for those remaining segments of the loan portfolio at the dates indicated:

September 30, 2013

(In thousands)	Residential Real Estate				Total
	Leasing	Consumer	Residential Mortgage	Residential Construction	
Performing	\$ 962	\$ 366,721	\$ 586,059	\$ 115,989	\$ 1,069,731
Non-performing:					
90 days past due	-	10	-	-	10
Non-accruing	-	2,004	5,643	2,327	9,974
Restructured loans and leases	-	29	3,478	-	3,507
Total	\$ 962	\$ 368,764	\$ 595,180	\$ 118,316	\$ 1,083,222

December 31, 2012

(In thousands)	Residential Real Estate				Total
	Leasing	Consumer	Residential Mortgage	Residential Construction	
Performing	\$ 2,556	\$ 354,535	\$ 514,480	\$ 117,189	\$ 988,760
Non-performing:					
90 days past due	-	14	-	-	14
Non-accruing	865	2,410	4,681	3,125	11,081
Restructured loans and leases	-	31	4,203	-	4,234
Total	\$ 3,421	\$ 356,990	\$ 523,364	\$ 120,314	\$ 1,004,089



During the nine months ended September 30, 2013, the Company restructured \$1.6 million in loans. Modifications consisted principally of interest rate concessions. No modifications resulted in the reduction of the principal in the associated loan balances. Restructured loans are subject to periodic credit reviews to determine the necessity and adequacy of a specific loan loss allowance based on the collectability of the recorded investment in the restructured loan. Loans restructured during 2013 did not require significant specific reserves at September 30, 2013. For the year ended December 31, 2012, the Company restructured \$4.9 million in loans. Modifications consisted principally of interest rate concessions and no modifications resulted in the reduction of the recorded investment in the associated loan balances. Loans restructured during 2012 had specific reserves of \$1.2 million at December 31, 2012. Commitments to lend additional funds on loans that have been restructured at September 30, 2013 and December 31, 2012 amounted to \$5.3 million and \$5.1 million, respectively.

The following table provides the amounts of the restructured loans at the date of restructuring for specific segments of the loan portfolio during the period indicated:

(In thousands)	For the Nine Months Ended September 30, 2013					Total
	Commercial Real Estate					
	Commercial	Commercial AD&C	Commercial Investor	Commercial Owner Occupied	All Other R/Loans	
Troubled debt restructurings						
Restructured accruing	\$ 483	\$ -	\$ 852	\$ -	\$ -	\$ 1,335
Restructured non-accruing	221	-	-	-	-	221
Balance	\$ 704	\$ -	\$ 852	\$ -	\$ -	\$ 1,556
Specific allowance	\$ 22	\$ -	\$ -	\$ -	\$ -	\$ 22
Restructured and subsequently defaulted	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -
	For the Year Ended December 31, 2012					
	Commercial Real Estate					
	Commercial	Commercial AD&C	Commercial Investor	Commercial Owner Occupied	All Other R/Loans	Total
Troubled debt restructurings						
Restructured accruing	\$ 2,600	\$ -	\$ -	\$ 1,014	\$ -	\$ 3,614
Restructured non-accruing	-	-	-	-	1,304	1,304
Balance	\$ 2,600	\$ -	\$ -	\$ 1,014	\$ 1,304	\$ 4,918
Specific allowance	\$ 552	\$ -	\$ -	\$ 204	\$ 467	\$ 1,223
Restructured and subsequently defaulted	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -

Changes in the accretable yield related to loans acquired with evidence of deteriorated credit quality are as follows:

(In thousands)	Amount
Balance at January 1, 2013	\$ 693
Accretion recognized to date	(333)
Net reclassification from accretable to non-accretable	-

Balance at September 30, 2013 \$ 360

**Other Real Estate Owned**

Other real estate owned totaled \$1.7 million and \$5.9 million at September 30, 2013 and December 31, 2012.

**Note 6 Goodwill and Other Intangible Assets**

The gross carrying amounts and accumulated amortization of intangible assets and goodwill are presented at the dates indicated in the following table:

	At September 30, 2013			Weighted Average Remaining Life	At December 31, 2012			Weighted Average Remaining Life
	Gross Carrying Amount	Accumulated Amortization	Net Carrying Amount		Gross Carrying Amount	Accumulated Amortization	Net Carrying Amount	
(Dollars in thousands)								
Amortizing intangible assets:								
Core deposit intangibles	\$ 9,716	\$ (9,004)	\$ 712	0.5 years	\$ 9,716	\$ (7,964)	\$ 1,752	1.3 years
Other identifiable intangibles	8,623	(7,543)	1,080	2.3 years	8,611	(7,200)	1,411	3.1 years
Total amortizing intangible assets	\$ 18,339	\$ (16,547)	\$ 1,792		\$ 18,327	\$ (15,164)	\$ 3,163	
Goodwill	\$ 84,171		\$ 84,171		\$ 84,808		\$ 84,808	

During the second quarter of 2013 goodwill associated with the 2012 acquisition of CommerceFirst Bancorp, Inc. was reduced by \$0.6 million relating to a reduction in the liabilities which existed as of the acquisition date.

The following table presents the estimated future amortization expense for amortizing intangible assets within the years ending December 31:

(In thousands)	Amount
2014	\$ 821
2015	372
2016	94
2017	16
Thereafter	27
Total amortizing intangible assets	\$ 1,330

**Note 7 Deposits**

The following table presents the composition of deposits at the dates indicated:

(In thousands)	September 30, 2013	December 31, 2012
Noninterest-bearing deposits	\$ 890,319	\$ 847,415
Interest-bearing deposits:		
Demand	435,458	428,048
Money market savings	871,360	884,367
Regular savings	240,210	228,384
Time deposits of less than \$100,000	272,101	307,445
Time deposits of \$100,000 or more	207,018	217,375
Total interest-bearing deposits	2,026,147	2,065,619
Total deposits	\$ 2,916,466	\$ 2,913,034

**Note 8 Stockholders' Equity**

The Company re-approved the stock repurchase program in August 2013. The current program permits the repurchase of up to 5% of the Company's outstanding shares of common stock or approximately 1,250,000 shares. Repurchases, which will be conducted through open market purchases or privately negotiated transactions, will be made depending on market conditions and other factors. No shares were repurchased during the first nine months of 2013.

**Note 9 Share Based Compensation**

At September 30, 2013, the Company had two share based compensation plans in existence, the 1999 Stock Option Plan (expired but having outstanding options that may still be exercised) and the 2005 Omnibus Stock Plan, which is described below.

The Company's 2005 Omnibus Stock Plan ("Omnibus Plan") provides for the granting of non-qualifying stock options to the Company's directors, and incentive and non-qualifying stock options, stock appreciation rights and restricted stock grants to selected key employees on a periodic basis at the discretion of the board. The Omnibus Plan authorizes the issuance of up to 1,800,000 shares of common stock of which 998,375 are available for issuance at September 30, 2013, has a term of ten years, and is administered by a committee of at least three directors appointed by the board of directors. Options granted under the plan have an exercise price which may not be less than 100% of the fair market value of the common stock on the date of the grant and must be exercised within seven to ten years from the date of grant. The exercise price of stock options must be paid for in full in cash or shares of common stock, or a combination of both. The Stock Option Committee has the discretion when making a grant of stock options to impose restrictions on the shares to be purchased upon the exercise of such options. Options granted under the expired 1999 Stock Option Plan remain outstanding until exercised or they expire. The Company generally issues authorized but previously unissued shares to satisfy option exercises.

The fair values of all of the options granted for the periods indicated have been estimated using a binomial option-pricing model with the weighted-average assumptions for the periods shown are presented in the following table:

	Nine Months Ended September 30,			
	2013		2012	
Dividend yield	2.80	%	2.17	%
Weighted average expected volatility	53.87	%	50.90	%
Weighted average risk-free interest rate	0.83	%	1.14	%
Weighted average expected lives (in years)	5.34		5.35	
Weighted average grant-date fair value	\$ 7.99		\$ 7.85	

The dividend yield is based on estimated future dividend yields. The risk-free rate for periods within the contractual term of the share option is based on the U.S. Treasury yield curve in effect at the time of the grant. Expected volatilities are generally based on historical volatilities. The expected term of share options granted is generally derived from historical experience.

Compensation expense is recognized on a straight-line basis over the vesting period of the respective stock option or restricted stock grant. The Company recognized compensation expense of \$0.4 million and \$0.4 million for the three months ended September 30, 2013 and 2012, respectively, related to the awards of stock options and restricted stock grants. Compensation expense of \$1.2 million and \$1.0 million was recognized for the nine months ended September 30, 2013 and 2012, respectively. Stock options exercised were 10,964 and 1,217 for the nine months ended September 30, 2013 and 2012, respectively. The intrinsic value for any exercised stock options in 2013 and 2012 was not significant. The total of unrecognized compensation cost related to stock options was approximately \$0.3 million as of September 30, 2013. That cost is expected to be recognized over a weighted average period of approximately 1.7 years. The total of unrecognized compensation cost related to restricted stock was approximately \$3.6 million as of September 30, 2013. That cost is expected to be recognized over a weighted average period of approximately 3.1 years. The fair value of the options vested during the three months ended September 30, 2013 and 2012, was \$0.2 million and \$0.2 million, respectively.

In the first quarter of 2013, 20,229 stock options were granted, subject to a three year vesting schedule with one third of the options vesting each year on the anniversary date of the grant. Additionally, 93,770 shares of restricted stock



were granted, subject to a five year vesting schedule with one fifth of the shares vesting each year on the grant date anniversary.

A summary of share option activity for the period indicated is reflected in the following table:

	Number of Common Shares	Weighted Average Exercise Share Price	Weighted Average Contractual Remaining Life(Years)	Aggregate Intrinsic Value (in thousands)
Balance at January 1, 2013	440,453	\$ 29.17		\$ 557
Granted	20,229	\$ 20.26		\$ -
Exercised	(10,964)	\$ 12.70		\$ -
Forfeited or expired	(4,962)	\$ 34.29		\$ -
Balance at September 30, 2013	444,756	\$ 29.11	1.9	\$ 1,032
Exercisable at September 30, 2013	399,221	\$ 30.21	1.5	\$ 861
Weighted average fair value of options granted during the year		\$ 7.99		

A summary of the activity for the Company's non-vested options for the period indicated is presented in the following table:

(In dollars, except share data):	Number of Shares	Weighted Average Grant-Date Fair Value
Non-vested options at January 1, 2013	54,416	\$7.56
Granted	20,229	\$ 7.99
Vested	(29,110)	\$ 7.34
Forfeited or expired	-	-
Non-vested options at September 30, 2013	45,535	\$ 7.89

A summary of the activity for the Company's restricted stock for the period indicated is presented in the following table:

(In dollars, except share data):	Number of Shares	Weighted Average Grant-Date Fair Value
Restricted stock at January 1, 2013	224,005	\$ 17.40
Granted	93,770	\$ 20.26
Vested	(71,455)	\$ 17.06
Forfeited	(17,187)	\$ 18.24
Restricted stock at September 30, 2013	229,133	\$ 18.61

#### **Note 10 Pension, Profit Sharing, and Other Employee Benefit Plans**

##### **Defined Benefit Pension Plan**

The Company has a qualified, noncontributory, defined benefit pension plan (the "Plan") covering substantially all employees. Benefits after January 1, 2005, are based on the benefit earned as of December 31, 2004, plus benefits earned in future years of service based on the employee's compensation during each such year. All benefit accruals for employees were frozen as of December 31, 2007 based on past service and thus future salary increases and additional

years of service will no longer affect the defined benefit provided by the plan although additional vesting may continue to occur.

The Company's funding policy is to contribute amounts to the plan sufficient to meet the minimum funding requirements of the Employee Retirement Income Security Act of 1974 (“ERISA”), as amended. In addition, the Company contributes additional amounts as it deems appropriate based on benefits attributed to service prior to the date of the plan freeze. The Plan invests primarily in a diversified portfolio of managed fixed income and equity funds.

The components of net periodic benefit cost for the periods indicated are presented in the following table:

(In thousands)	Three Months Ended September 30,		Nine Months Ended September 30,	
	2013	2012	2013	2012
Interest cost on projected benefit obligation	\$ 390	\$ 374	\$ 1,163	\$ 1,151
Expected return on plan assets	(425)	(220)	(1,259)	(874)
Recognized net actuarial loss	249	197	1,176	896
Net periodic benefit cost	\$ 214	\$ 351	\$ 1,080	\$ 1,173

### Contributions

The decision as to whether or not to make a plan contribution and the amount of any such contribution is dependent on a number of factors. Such factors include the investment performance of the plan assets in the current economy and, since the plan is currently frozen, the remaining investment horizon of the plan. Given these uncertainties, management continues to monitor the funding level of the pension plan and may make contributions as necessary during 2013.

### Note 11 Net Income per Common Share

The calculation of net income per common share for the periods indicated is presented in the following table:

(Dollars and amounts in thousands, except per share data)	Three Months Ended September 30,		Nine Months Ended September 30,	
	2013	2012	2013	2012
Net income	\$ 12,089	\$ 10,990	\$ 34,809	\$ 26,673
Basic:				
Basic weighted average EPS shares	24,979	24,893	24,952	24,463
Basic net income per share	\$ 0.48	\$ 0.44	\$ 1.40	\$ 1.09
Diluted:				
Basic weighted average EPS shares	24,979	24,893	24,952	24,463
Dilutive common stock equivalents	92	56	97	72
Dilutive EPS shares	25,071	24,949	25,049	24,535
Diluted net income per share	\$ 0.48	\$ 0.44	\$ 1.39	\$ 1.09
Anti-dilutive shares	146	459	195	489

**NOTE 12 OTHER COMPREHENSIVE INCOME (LOSS)**

Comprehensive income (loss) is defined as net income plus transactions and other occurrences that are the result of non-owner changes in equity. For condensed financial statements presented for the Company, non-equity changes are comprised of unrealized gains or losses on available-for-sale debt securities and any minimum pension liability adjustments. These do not have an impact on the Company's net income. The following table presents the activity in net accumulated other comprehensive income (loss) and the components of the activity for the periods indicated:

(In thousands)	Unrealized Gains (Losses) on		Total
	Investments Available-for-Sale	Defined Benefit Pension Plan	
Balance at January 1, 2013	\$ 20,258	\$ (8,946)	\$ 11,312
Other comprehensive income before reclassification, net of tax	(14,990)	-	(14,990)
Reclassifications from accumulated other comprehensive income, net of tax	71	715	786
Current period change in other comprehensive income, net of tax	(14,919)	715	(14,204)
Balance at September 30, 2013	\$ 5,339	\$ (8,231)	\$ (2,892)

(In thousands)	Unrealized Gains (Losses) on		Total
	Investments Available-for-Sale	Defined Benefit Pension Plan	
Balance at January 1, 2012	\$ 20,006	\$ (6,758)	\$ 13,248
Other comprehensive income before reclassification, net of tax	2,370	-	2,370
Reclassifications from accumulated other comprehensive income, net of tax	276	539	815
Current period change in other comprehensive income, net of tax	2,646	539	3,185
Balance at September 30, 2012	\$ 22,652	\$ (6,219)	\$ 16,433

The following table provides the information on the reclassification adjustments out of accumulated other comprehensive income (loss) for the periods indicated:

(In thousands)	Nine Months Ended September 30,	
	2013	2012
Unrealized gains/(losses) on investments available-for-sale		
Affected line item in the Statements of Income:		
Investment securities gains	\$ 118	\$ 459
Income before taxes	118	459
Tax expense	47	183
Net income	\$ 71	\$ 276
Amortization of defined benefit pension plan items		
Affected line item in the Statements of Income:		
Recognized actuarial loss 1	\$ 1,176	\$ 896
Income before taxes	1,176	896
Tax expense	461	357
Net income	\$ 715	\$ 539

1 This amount is included in the computation of net periodic benefit cost, see Note 10

25

**Note 13 Financial Instruments with Off-balance Sheet Risk and Derivatives**

The Company is a party to interest rate derivatives that are not designated as hedging instruments. The Company has entered into these interest rate derivatives to facilitate customer transactions and meet their financing needs. These derivatives are interest rate swaps that the Company entered into with loan customers to allow the customers to convert variable rate loans to a fixed rate. Interest is paid to the customer at a floating rate based on the notional amount and the Company receives interest from the customer at a fixed rate for the same notional amount. Concurrent with the customer transaction, the Company enters into an offsetting interest rate swap with another financial institution. The Company pays the other financial institution at the same fixed rate on the same notional amount as the swap entered into with the customer, and receives interest from the financial institution for the same floating rate on the same notional amount. The changes in the fair value of the swaps offset each other. When the fair value of a derivative instrument contract is positive, this generally indicates that the counterparty or customer owes the Company, and results in credit risk to the Company. When the fair value of a derivative instrument contract is negative, the Company owes the customer or counterparty and therefore, has no credit risk to the Company. The notional value of commercial loan interest rate swaps outstanding was \$46.8 million with a fair value of \$1.9 million as of September 30, 2013 compared to \$35.9 million with a fair value of \$1.3 million as of December 31, 2012. The offsetting nature of the interest rate swaps results in a neutral effect on the Company's operations. Fair values of the interest rate swaps are carried as both gross assets and gross liabilities in the condensed consolidated statements of condition. The associated net gains and losses on the interest rate swaps are recorded in other non-interest income.

**Note 14 Fair Value**

Generally accepted accounting principles provide entities the option to measure eligible financial assets, financial liabilities and commitments at fair value (i.e. the fair value option), on an instrument-by-instrument basis, that are otherwise not permitted to be accounted for at fair value under other accounting standards. The election to use the fair value option is available when an entity first recognizes a financial asset or financial liability or upon entering into a commitment. Subsequent changes in fair value must be recorded in earnings. The Company applies the fair value option on residential mortgage loans held for sale. The fair value option on residential mortgage loans allows the recognition of gains on sale of mortgage loans to more accurately reflect the timing and economics of the transaction.

The standard for fair value measurement establishes a fair value hierarchy that prioritizes the inputs to valuation techniques used to measure fair value. The hierarchy gives the highest priority to unadjusted quoted prices in active markets for identical assets or liabilities (Level 1 measurements) and the lowest priority to unobservable inputs (Level 3 measurements). The three levels of the fair value hierarchy are described below.

**Basis of Fair Value Measurement:**

Level 1- Unadjusted quoted prices in active markets that are accessible at the measurement date for identical, unrestricted assets or liabilities;

Level 2- Quoted prices in markets that are not active, or inputs that are observable, either directly or indirectly, for substantially the full term of the asset or liability;

Level 3- Prices or valuation techniques that require inputs that are both significant to the fair value measurement and unobservable (i.e. supported by little or no market activity).

Changes to interest rates may result in changes in the cash flows due to prepayments or extinguishments. Accordingly, this could result in higher or lower measurements of the fair values.

A financial instrument's level within the fair value hierarchy is based on the lowest level of input that is significant to the fair value measurement.

**Assets and Liabilities**

*Mortgage loans held for sale*

Mortgage loans held for sale are valued based on quotations from the secondary market for similar instruments and are classified as Level 2 of the fair value hierarchy.

*Investments available-for-sale*

U.S. government agencies, mortgage-backed securities and corporate debt

Valuations are based on active market data and use of evaluated broker pricing models that vary based by asset class and includes available trade, bid, and other market information. Generally, the methodology includes broker quotes, proprietary models, descriptive terms and conditions databases coupled with extensive quality control programs. Multiple quality control evaluation processes review available market, credit and deal level information to support the evaluation of the security. If there is a lack of objectively verifiable information available to support the valuation, the evaluation of the security is discontinued. Additionally, proprietary models and pricing systems, mathematical tools, actual transacted prices, integration of market developments and experienced evaluators are used to determine the value of a security based on a hierarchy of market information regarding a security or securities with similar characteristics. The Company does not adjust the quoted price for such securities. Such instruments are generally classified within Level 2 of the fair value hierarchy.



State and municipal securities

Proprietary valuation matrices are used for valuing all tax-exempt municipals that can incorporate changes in the municipal market as they occur. Market evaluation models include the ability to value bank qualified municipals and general market municipals that can be broken down further according to insurer, credit support, state of issuance and rating to incorporate additional spreads and municipal curves. Taxable municipals are valued using a third party model that incorporates a methodology that captures the trading nuances associated with these bonds. Such instruments are generally classified within Level 2 of the fair value hierarchy.

Trust preferred securities

In active markets, these types of instruments are valued based on quoted market prices that are readily accessible at the measurement date and are classified within Level 1 of the fair value hierarchy. Positions that are not traded in active markets or are subject to transfer restrictions are valued or adjusted to reflect illiquidity and/or non-transferability, and such adjustments are generally based on available market evidence. In the absence of such evidence, management uses a process that employs certain assumptions to determine the present value. For further information, refer to Note 3 Investments. Positions that are not traded in active markets or are subject to transfer restrictions are classified within Level 3 of the fair value hierarchy.

*Interest rate swap agreements*

Interest rate derivatives are reported at estimated fair value utilizing Level 2 inputs and are included in Other assets and Other liabilities. Based on the complex nature of interest rate swap agreements, the markets these instruments trade in are not as efficient and are less liquid than that of the more mature Level 1 markets. These markets do however have comparable, observable inputs in which an alternative pricing source values these assets in order to arrive at a fair market value. Interest rate swap agreements are valued using the LIBOR yield curve for an appropriate set of instruments. Interest rate derivatives are further described in Note 13.

**Assets Measured at Fair Value on a Recurring Basis**

The following tables set forth the Company's financial assets and liabilities at the dates indicated that were accounted for at fair value. Assets and liabilities are classified in their entirety based on the lowest level of input that is significant to the fair value measurement:

(In thousands)	At September 30, 2013			Total
	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	
<b>Assets</b>				
Residential mortgage loans held for sale	\$ -	\$ 10,542	\$ -	\$ 10,542
Investments available-for-sale:				
U.S. government agencies	-	172,243	-	172,243
State and municipal	-	166,866	-	166,866
Mortgage-backed	-	472,269	-	472,269
Corporate debt	-	2,005	-	2,005
Trust preferred	-	-	1,439	1,439
Marketable equity securities	-	723	-	723
Interest rate swap agreements	-	1,855	-	1,855
<b>Liabilities</b>				
Interest rate swap agreements	\$ -	\$ (1,855)	\$ -	\$ (1,855)
(In thousands)	At December 31, 2012			Total
	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	
<b>Assets</b>				
Residential mortgage loans held for sale	\$ -	\$ 36,149	\$ -	\$ 36,149
Investments available-for-sale:				
U.S. government agencies	-	156,428	-	156,428
State and municipal	-	174,491	-	174,491
Mortgage-backed	-	490,479	-	490,479
Corporate debt	-	1,996	-	1,996
Trust preferred	-	-	1,465	1,465
Marketable equity securities	-	723	-	723
Interest rate swap agreements	-	1,280	-	1,280
<b>Liabilities</b>				
Interest rate swap agreements	\$ -	\$ (1,280)	\$ -	\$ (1,280)

The following table provides unrealized losses included in assets measured in the Condensed Consolidated Statements of Condition at fair value on a recurring basis for the period indicated:

(In thousands)	Significant Unobservable Inputs (Level 3)
Investments available-for-sale:	
Balance at January 1, 2013	\$ 1,465
Total OTTI included in earnings	-
Principal redemption	-
Total unrealized losses included in other comprehensive income (loss)	(26)
Balance at September 30, 2013	\$ 1,439

### Assets Measured at Fair Value on a Nonrecurring Basis

The following table sets forth the Company's financial assets subject to fair value adjustments (impairment) on a nonrecurring basis at the date indicated that are valued at the lower of cost or market. Assets are classified in their entirety based on the lowest level of input that is significant to the fair value measurement:

(In thousands)	At September 30, 2013			Total	Total Losses
	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)		
Impaired loans (1)	\$ -	\$ -	\$ 26,859	\$ 26,859	\$ (5,891)
Other real estate owned	-	-	1,662	1,662	209
Total	\$ -	\$ -	\$ 28,521	\$ 28,521	\$ (5,682)

(1) Amounts represent the fair value of collateral for impaired loans allocated to the allowance for loan and lease losses. Fair values are determined using actual market prices (Level 2), independent third party valuations and borrower records, discounted as appropriate (Level 3).

(In thousands)	At December 31, 2012			Total	Total Losses
	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)		
Impaired loans (1)	\$ -	\$ -	\$ 43,624	\$ 43,624	\$ (6,730)
Other real estate owned	-	-	5,926	5,926	(188)
Total	\$ -	\$ -	\$ 49,550	\$ 49,550	\$ (6,918)

(1) Amounts represent the fair value of collateral for impaired loans allocated to the allowance for loan and lease losses. Fair values are determined using actual market prices (Level 2), independent third party valuations and borrower records, discounted as appropriate (Level 3).

At September 30, 2013, impaired loans totaling \$31.1 million were written down to fair value of \$26.9 million as a result of specific loan loss allowances of \$4.2 million associated with the impaired loans which was included in the allowance for loan losses. Impaired loans totaling \$48.8 million were written down to fair value of \$43.6 million at December 31, 2012 as a result of specific loan loss allowances of \$5.2 million associated with the impaired loans.

Loan impairment is measured using the present value of expected cash flows, the loan's observable market price or the fair value of the collateral (less selling costs) if the loans are collateral dependent. Collateral may be real estate and/or business assets including equipment, inventory and/or accounts receivable. The value of business equipment, inventory and accounts receivable collateral is based on net book value on the business' financial statements and, if necessary, discounted based on management's review and analysis. Appraised and reported values may be discounted based on management's historical knowledge, changes in market conditions from the time of valuation, and/or management's expertise and knowledge of the client and client's business. Impaired loans are reviewed and evaluated on at least a quarterly basis for additional impairment and adjusted accordingly, based on the factors identified above. Valuation techniques are consistent with those techniques applied in prior periods.

Other real estate owned (“OREO”) is adjusted to fair value upon transfer of the loans to OREO. Subsequently, OREO is carried at the lower of carrying value or fair value. The estimated fair value for other real estate owned included in Level 3 is determined by independent market based appraisals and other available market information, less cost to sell, that may be reduced further based on market expectations or an executed sales agreement. If the fair value of the collateral deteriorates subsequent to initial recognition, the Company records the OREO as a non-recurring Level 3 adjustment. Valuation techniques are consistent with those techniques applied in prior periods.

### **Fair Value of Financial Instruments**

The Company discloses fair value information about financial instruments for which it is practicable to estimate the value, whether or not such financial instruments are recognized on the balance sheet. Fair value is the amount at which a financial instrument could be exchanged in a current transaction between willing parties, other than in a forced sale or liquidation, and is best evidenced by a quoted market price, if one exists.

Quoted market prices, where available, are shown as estimates of fair market values. Because no quoted market prices are available for a significant portion of the Company's financial instruments, the fair value of such instruments has been derived based on the amount and timing of future cash flows and estimated discount rates.

Present value techniques used in estimating the fair value of many of the Company's financial instruments are significantly affected by the assumptions used. In that regard, the derived fair value estimates cannot be substantiated by comparison to independent markets and, in many cases, could not be realized in immediate cash settlement of the instrument. Additionally, the accompanying estimates of fair values are only representative of the fair values of the individual financial assets and liabilities, and should not be considered an indication of the fair value of the Company.

The carrying amounts and fair values of the Company's financial instruments at the dates indicated are presented in the following table:

(In thousands)	September 30, 2013		Fair Value Measurements		
	Carrying Amount	Estimated Fair Value	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Observable Inputs (Level 2)	Other Significant Unobservable Inputs (Level 3)
<b>Financial Assets</b>					
Investments held-to-maturity	\$ 225,994	\$ 220,054	\$ -	\$ 220,054	\$ -
Other equity securities	36,412	36,412	-	36,412	-
Loans, net of allowance	2,622,588	2,587,170	-	-	2,587,170
Other assets	85,578	85,578	-	85,578	-
<b>Financial Liabilities</b>					
Time Deposits	\$ 479,119	\$ 479,780	\$ -	\$ 479,780	\$ -
Securities sold under retail repurchase agreements and federal funds purchased	53,177	53,177	-	53,177	-
Advances from FHLB	520,000	550,662	-	550,662	-
Subordinated debentures	35,000	8,669	-	-	8,669
<b>December 31, 2012</b>					
(In thousands)	Carrying Amount	Estimated Fair Value	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Observable Inputs (Level 2)	Other Significant Unobservable Inputs (Level 3)
<b>Financial Assets</b>					
Investments held-to-maturity	\$ 215,814	\$ 222,024	\$ -	\$ 222,024	\$ -
Other equity securities	33,636	33,636	-	33,636	-
Loans, net of allowance	2,488,171	2,453,314	-	-	2,453,314
Other assets	83,714	83,714	-	83,714	-
<b>Financial Liabilities</b>					
Time Deposits	\$ 524,820	\$ 528,074	\$ -	\$ 528,074	\$ -
Securities sold under retail repurchase agreements and federal funds purchased	86,929	86,929	-	86,929	-
Advances from FHLB	405,058	451,408	-	451,408	-
Subordinated debentures	35,000	9,919	-	-	9,919

The following methods and assumptions were used to estimate the fair value of each category of financial instruments for which it is practicable to estimate that value:

**Cash and Temporary Investments:** The carrying amounts of cash and cash equivalents approximate their fair value and have been excluded from the table above.

**Investments:** The fair value of marketable securities is based on quoted market prices, prices quoted for similar instruments, and prices obtained from independent pricing services.

**Loans:**For certain categories of loans, such as mortgage, installment and commercial loans, the fair value is estimated by discounting the expected future cash flows using the current rates at which similar loans would be made to borrowers with similar credit ratings and similar remaining maturities. Expected cash flows were projected based on contractual cash flows, adjusted for estimated prepayments.

**Accrued interest receivable:** The carrying value of accrued interest receivable approximates fair value due to the short-term duration and has been excluded from the table above.

**Other assets:** The investment in bank-owned life insurance represents the cash surrender value of the policies at September 30, 2013 and December 31, 2012 as determined by the each insurance carrier. The carrying value of accrued interest receivable approximates fair values due to the short-term duration.

**Deposits:** The fair value of demand, money market savings and regular savings deposits, which have no stated maturity, were considered equal to their carrying amount, representing the amount payable on demand. While management believes that the Bank's core deposit relationships provide a relatively stable, low-cost funding source that has a substantial intangible value separate from the value of the deposit balances, these estimated fair values do not include the intangible value of core deposit relationships, which comprise a significant portion of the Bank's deposit base.

**Short-term borrowings:** The carrying values of short-term borrowings, including overnight, securities sold under agreements to repurchase and federal funds purchased approximates the fair values due to the short maturities of those instruments.

**Long-term borrowings:** The fair value of the Federal Home Loan Bank of Atlanta ("FHLB") advances and subordinated debentures was estimated by computing the discounted value of contractual cash flows payable at current interest rates for obligations with similar remaining terms. The Company's credit risk is not material to calculation of fair value because the FHLB borrowings are collateralized. The Company classifies advances from the Federal Home Loan Bank of Atlanta within Level 2 of the fair value hierarchy since the fair value of such borrowings is based on rates currently available for borrowings with similar terms and remaining maturities. Subordinated debentures are classified as Level 3 in the fair value hierarchy due to the lack of market activity of such instruments.

**Accrued interest payable:** The carrying value of accrued interest payable approximates fair value due to the short-term duration and has been excluded from the table above.

#### **Note 15 - Segment Reporting**

Currently, the Company conducts business in three operating segments Community Banking, Insurance and Investment Management. Each of the operating segments is a strategic business unit that offers different products and services. The Insurance and Investment Management segments were businesses that were acquired in separate transactions where management of acquisition was retained. The accounting policies of the segments are the same as those of the Company. However, the segment data reflect inter-segment transactions and balances.

The Community Banking segment is conducted through Sandy Spring Bank and involves delivering a broad range of financial products and services, including various loan and deposit products to both individuals and businesses. Parent company income is included in the Community Banking segment, as the majority of effort of these functions is related to this segment. Major revenue sources include net interest income, gains on sales of mortgage loans, trust income, fees on sales of investment products and service charges on deposit accounts. Expenses include personnel, occupancy, marketing, equipment and other expenses. Non-cash charges associated with amortization of intangibles related to the acquired entities amounted to \$0.3 million and \$0.4 million in for the three months ended September 30, 2013 and 2012, respectively. These non-cash charges amounted to \$1.1 million for the nine months ended September 30, 2013 and 2012.

The Insurance segment is conducted through Sandy Spring Insurance Corporation, a subsidiary of the Bank, and offers annuities as an alternative to traditional deposit accounts. Sandy Spring Insurance Corporation operates Sandy Spring Insurance, a general insurance agency located in Annapolis, Maryland, and Neff and Associates, located in Ocean City, Maryland. Major sources of revenue are insurance commissions from commercial lines, personal lines, and medical liability lines. Expenses include personnel and support charges. Non-cash charges associated with amortization of intangibles related to the acquired entities was not significant for the three and nine months ended September 30, 2013 and 2012, respectively.



The Investment Management segment is conducted through West Financial Services, Inc., a subsidiary of the Bank. This asset management and financial planning firm, located in McLean, Virginia, provides comprehensive investment management and financial planning to individuals, families, small businesses and associations including cash flow analysis, investment review, tax planning, retirement planning, insurance analysis and estate planning. West Financial currently has approximately \$880 million in assets under management. Major revenue sources include non-interest income earned on the above services. Expenses include personnel and support charges. Non-cash charges associated with amortization of intangibles related to the acquired entities was not significant for the three and nine months ended September 30, 2013 and 2012, respectively.



(In thousands)	Nine Months Ended September 30, 2012				Total
	Community Banking	Insurance	Investment Mgmt.	Inter-Segment Elimination	
Interest income	\$ 107,668	\$ 5	\$ 9	\$ (14)	\$ 107,668
Interest expense	17,383	-	-	(14)	17,369
Provision for loan and lease losses	2,481	-	-	-	2,481
Non-interest income	27,742	3,388	4,188	(609)	34,709
Non-interest expenses	77,736	3,204	2,377	(609)	82,708
Income before income taxes	37,810	189	1,820	-	39,819
Income tax expense	12,363	77	706	-	13,146
Net income	\$ 25,447	\$ 112	\$ 1,114	\$ -	\$ 26,673
Assets	\$ 3,901,588	\$ 13,058	\$ 16,579	\$ (43,798)	\$ 3,887,427

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

### The Company

Sandy Spring Bancorp, Inc. (the "Company") is the bank holding company for Sandy Spring Bank (the "Bank"). The Company is registered as a bank holding company pursuant to the Bank Holding Company Act of 1956, as amended (the "Holding Company Act"). As such, the Company is subject to supervision and regulation by the Board of Governors of the Federal Reserve System (the "Federal Reserve"). The Company began operating in 1988. The Bank was founded in 1868 and is the oldest banking business based in Maryland. The Bank is independent, community oriented, and conducts a full-service commercial banking business through 49 community offices located in Anne Arundel, Carroll, Frederick, Howard, Montgomery and Prince George's counties in Maryland, and Arlington, Fairfax and Loudoun counties in Virginia. The Bank is a state chartered bank subject to supervision and regulation by the Federal Reserve and the State of Maryland. The Bank's deposit accounts are insured by the Deposit Insurance Fund administered by the Federal Deposit Insurance Corporation (the "FDIC") to the maximum permitted by law. The Bank is a member of the Federal Reserve System and is an Equal Housing Lender. The Company, the Bank, and its other subsidiaries are Affirmative Action/Equal Opportunity Employers.

### Overview

Net income for the Company for the third quarter of 2013 totaled \$12.1 million (\$0.48 per diluted share) as compared to net income of \$11.0 million (\$0.44 per diluted share) for the third quarter of 2012. For the first nine months of 2013, net income totaled \$34.8 million (\$1.39 per diluted share), compared to net income of \$26.7 million (\$1.09 per diluted share) for the first nine months of 2012. These results reflect the following events:

- During the third quarter of 2013 the Company experienced significant activity in recoveries realized from the resolution of two previously non-performing commercial real estate loans. The impact of these recoveries can be summarized as follows:

Interest income	\$ 3.7 million
Non-interest income	\$ 0.4 million
Non-interest expense	\$ 0.5 million
Loan loss recoveries	\$ 3.2 million
Reduction of non-performing loans	\$10.4 million

- Net interest income increased 11% for the third quarter of 2013 compared to the third quarter of 2012. For the year-to-date, net interest income increased 8% for 2013 compared to the first nine months of 2012. These increases were due primarily to the recovery of interest income mentioned above together with growth in average interest-earning assets. Excluding the interest recoveries, net interest income for the third quarter of 2013 remained level with the same quarter of the prior year and increased 4% from the prior year-to-date.
- The provision for loan and lease losses was a charge of \$1.1 million for the third quarter of 2013 compared to a charge of \$0.2 million for the third quarter of 2012 and a credit of \$2.9 million for the second quarter of 2013. The increase in the provision for the third quarter of 2013 compared to the third quarter of 2012 was due primarily to loan growth during the quarter.
- Non-performing loans decreased to \$38.3 million at September 30, 2013 compared to \$58.9 million at September 30, 2012. The coverage ratio of the allowance for loan and lease losses to non-performing loans was 103% at September 30, 2013 compared to a coverage ratio of 72% at September 30, 2012.
- Non-interest income decreased \$1.0 million or 8% for the third quarter of 2013 compared to the third quarter of 2012 due largely to a significant decline in income from mortgage banking which was somewhat offset by increases in insurance agency commissions and other non-interest income.
- Average total loans for the third quarter of 2013 increased 5% compared to the third quarter of 2012 due primarily to organic growth in the commercial investor real estate, residential mortgage and consumer

portfolios.

In the third quarter of 2013, the region in which the Company operates continued to show slow but steady economic improvement. The initial effects of the payroll tax increases and federal government spending cuts (sequestration) were offset by positive trends in housing and consumer spending. These trends have been somewhat offset by a contraction in manufacturing and continued relatively high unemployment, together with uncertainty over implementation of the new health care law, all of which have caused uncertainty on the part of both large and small businesses and limited economic expansion. The financial stability of the European Union also continues to be an underlying volatility factor. Together with state and municipal budget challenges across the country, these factors have caused enough economic uncertainty, particularly among individual consumers and small and medium-sized businesses, to limit confidence and thus constrain the pace of economic expansion and lending. Despite this challenging business environment, the Company has emphasized the fundamentals of community banking as it has maintained strong levels of liquidity and capital while overall credit quality has continued to improve.

The net interest margin increased to 3.88% in the third quarter of 2013 compared to 3.67% for the third quarter of 2012 and 3.51% for the second quarter of 2013. Excluding the effect of the commercial loan recoveries mentioned above, the net interest margin was 3.49% for the third quarter of 2013. The decrease in the margin without the recoveries was due primarily to the decline in the yield on a higher level of interest-earning assets which more than offset the lower cost of borrowings and deposits. Average borrowings increased 22% and average total deposits increased 2% for the quarter compared with the prior year period, while average loans increased 5% compared to 2012. Net interest income remained virtually level compared to the prior year quarter as the effects of a 15 basis point decrease in the cost of interest-bearing liabilities, growth of 5% in average interest-earning assets and a 41% decrease in non-performing assets were offset by a decline of 9 basis points in the yield on average interest-earning assets.

Liquidity remained strong due to the availability of borrowing lines with the Federal Home Loan Bank of Atlanta and the Federal Reserve and the size and composition of the investment portfolio.

The Company's credit quality continued to improve as non-performing assets decreased to \$39.9 million at September 30, 2013 from \$68.2 million at September 30, 2012. This decrease was primarily the result of the resolution of the two previously mentioned commercial real estate credits, the orderly disposition of other real estate owned, loan pay-offs and the reduced migration of commercial loans into nonperforming status. Non-performing assets represented 0.98% of total assets at September 30, 2013 compared to 1.75% at September 30, 2012. The Bank had net charge-offs of \$0.7 million for the third quarter of 2013 as compared to net charge-offs of \$2.9 million for the prior year period.

Non-interest income decreased 8% in the third quarter of 2013 compared to the third quarter of 2012. This decrease was driven by a significant decrease in mortgage banking income due primarily to lower mortgage origination volumes. This decrease was somewhat offset by a 17% increase in wealth management income due to growth in assets under management and insurance agency commissions, which increased 17% due to higher revenues on commercial and physicians' liability lines. Other non-interest income increased 36% over the prior year quarter due to gains on sales and dispositions of loans and loan fee recoveries on non-performing commercial loans. These increases were somewhat offset by a decrease of 3% in service charges on deposits due to lower overdraft fees.

Non-interest expenses decreased 1% in the third quarter of 2013 compared to the prior year period. This decrease was driven primarily by a decline in other non-interest expenses related to the recovery of expenses related to the resolution of problem loan credits. Excluding the effect of the recovery of these expenses, non-interest expenses would have increased 1% for the quarter due to a 6% increase in salaries and benefits expenses primarily associated with increased staffing.

Total assets at September 30, 2013 increased 2% compared to December 31, 2012 primarily due to loan growth which was temporarily funded by increased borrowings to take advantage of low existing borrowing rates. The increase in loan balances compared to the prior year-end was due primarily to increases of 11% in residential mortgage and construction loans and 3% in both commercial and consumer loans. The increase in commercial loans was due to organic loan growth during the first nine months of the year, particularly in the investor real estate segment of the portfolio. The increase in residential mortgage loans was due to a 14% increase in permanent residential mortgages due to growth in adjustable rate mortgages, which the Company maintains in portfolio, and a decrease in loan prepayments. Customer funding sources, which include deposits plus other short-term borrowings from core customers, remained virtually level compared to balances at December 31, 2012. Customer funding sources reflected increases of 5% in regular savings accounts and 4% in combined non-interest-bearing and interest-bearing checking accounts. These increases were somewhat offset by a decrease of 9% in certificates of deposit while money market accounts remained relatively level for the nine month period. The Company continued to manage its net interest margin primarily by reducing rates on certificates of deposit and borrowings during this extended period of historically low interest rates. During 2013 stockholders' equity increased to \$494 million due to net income during the first nine months of the year. Tangible book value per common share increased 8% to \$16.44 at September 30, 2013 from \$15.26 at September 30, 2012.



**Critical Accounting Policies**

The Company's critical accounting policies involving the significant judgments and assumptions used in the preparation of the Condensed Consolidated Financial Statements as of September 30, 2013 have remained unchanged from the disclosures presented in the Company's Annual Report on Form 10-K for the year ended December 31, 2012 under the section "Management's Discussion and Analysis of Financial Condition and Results of Operations."



**Consolidated Average Balances, Yields and Rates**

(Dollars in thousands and tax-equivalent)	Nine Months Ended September 30,					
	2013			2012		
	Average Balances	(1) Interest	Annualized Average Yield/Rate	Average Balances	(1) Interest	Annualized Average Yield/Rate
<b>Assets</b>						
Residential mortgage loans (2)	\$ 583,105	\$ 16,001	3.66 %	\$ 491,160	\$ 16,003	4.37 %
Residential construction loans	120,053	3,142	3.50	125,179	3,505	3.74
Commercial ADC loans	155,965	7,540	6.46	151,307	5,855	5.17
Commercial investor real estate loans	486,624	20,927	5.75	410,905	16,925	5.50
Commercial owner occupied real estate loans	565,108	22,464	5.45	546,575	22,722	5.64
Commercial business loans	338,869	13,288	5.10	291,727	11,988	5.33
Leasing	1,764	88	6.67	5,568	272	6.52
Consumer loans	361,624	9,325	3.47	358,304	9,481	3.56
Total loans and leases (3)	2,613,112	92,775	4.77	2,380,725	86,751	4.88
Taxable securities	765,054	13,536	2.36	775,916	14,761	2.54
Tax-exempt securities (4)	300,826	9,829	4.36	283,137	10,112	4.76
Interest-bearing deposits with banks	34,379	65	0.25	40,892	83	0.27
Federal funds sold	475	-	0.22	811	1	0.17
Total interest-earning assets	3,713,846	116,205	4.19	3,481,481	111,708	4.28
Less: allowance for loan and lease losses	(42,223)			(47,442)		
Cash and due from banks	45,932			45,844		
Premises and equipment, net	47,479			48,959		
Other assets	216,958			208,371		
Total assets	\$ 3,981,992			\$ 3,737,213		
<b>Liabilities and Stockholders' Equity</b>						
Interest-bearing demand deposits	\$ 436,236	280	0.09 %	\$ 379,910	256	0.09 %
Regular savings deposits	238,627	159	0.09	209,920	155	0.10
Money market savings deposits	880,794	1,131	0.17	869,675	1,471	0.23
Time deposits	497,136	2,639	0.71	573,946	3,825	0.89
Total interest-bearing deposits	2,052,793	4,209	0.27	2,033,451	5,707	0.37
Other borrowings	59,734	126	0.28	72,347	158	0.29
Advances from FHLB	482,679	9,667	2.68	405,271	10,772	3.55
Subordinated debentures	35,000	672	2.56	35,000	732	2.79
Total interest-bearing liabilities	2,630,206	14,674	0.75	2,546,069	17,369	0.91
Noninterest-bearing demand deposits	833,059			705,362		
Other liabilities	33,230			25,738		
Stockholders' equity	485,497			460,044		
Total liabilities and stockholders' equity	\$ 3,981,992			\$ 3,737,213		
Net interest income and spread		\$ 101,531	3.44 %		\$ 94,339	3.37 %
Less: tax-equivalent adjustment		3,967			4,040	
Net interest income		\$ 97,564			\$ 90,299	

Edgar Filing: SANDY SPRING BANCORP INC - Form 10-Q

Interest income/earning assets	4.19 %	4.28 %
Interest expense/earning assets	0.53	0.66
Net interest margin	3.66 %	3.62 %

(1) Tax-equivalent income has been adjusted using the combined marginal federal and state rate of 39.88% for 2013 and 2012. The annualized taxable-equivalent adjustments utilized in the above table to compute yields aggregated to \$4.0 million and \$4.0 million in 2013 and 2012, respectively.

(2) Includes residential mortgage loans held for sale. Home equity loans and lines are classified as consumer loans.

(3) Non-accrual loans are included in the average balances.

(4) Includes only investments that are exempt from federal taxes.

**Results of Operations****For the Nine Months Ended September 30, 2013 Compared to the Nine Months Ended September 30, 2012**

Net income for the Company for the first nine months of 2013 totaled \$34.8 million (\$1.39 per diluted share) compared to net income of \$26.7 million (\$1.09 per diluted share) for the first nine months of 2012.

**Net Interest Income**

The largest source of the Company's operating revenue is net interest income, which is the difference between the interest earned on interest-earning assets and the interest paid on interest-bearing liabilities. For purposes of this discussion and analysis, the interest earned on tax-exempt investment securities has been adjusted to an amount comparable to interest subject to normal income taxes. The result is referred to as tax-equivalent interest income and tax-equivalent net interest income. The following discussion of net interest income should be considered in conjunction with the review of the information provided in the preceding table.

Net interest income for the first nine months of 2013 was \$97.6 million compared to \$90.3 million for the same period of 2012, an increase of 8%. On a tax-equivalent basis, net interest income increased by 8% for the nine months ended September 30, 2013 to \$101.5 million from \$94.3 million for the prior year period. Excluding interest recoveries due to the resolution of previously non-performing commercial real estate loans, net interest income was \$93.9 million, an increase of 4% on a tax-equivalent basis. Average interest-earning assets increased by 7% while average interest-bearing liabilities increased 3% in 2013. Average non-interest-bearing deposits increased 18% in the first nine months of 2013 compared to the first nine months of 2012 while the percentage of average non-interest-bearing deposits to total deposits also increased to 29% for the first nine months of 2013 compared to 28% for the same period in 2012.

**Interest Rate Performance**

The Company's net interest margin increased to 3.66% for the first nine months of 2013 compared to 3.62% for the first nine months of 2012 while the net interest spread increased to 3.44% in 2013 compared to 3.37% in 2012. The increase in both the net interest margin and net interest spread was due to the interest recoveries previously mentioned. Excluding these recoveries, the net interest margin and net interest spread were 3.53% and 3.31%, respectively. Excluding the interest recoveries, the decrease in the net interest margin was caused by the effect of lower rates on interest-earning assets exceeding the benefit of the decline in rates on interest-bearing deposits and borrowings.

**Effect of Volume and Rate Changes on Net Interest Income**

The following table analyzes the reasons for the changes from year-to-year in the principal elements that comprise net interest income:

	2013 vs. 2012			2012 vs. 2011		
	Or (Decrease)	Due to Change In Volume	Average Rate	Or (Decrease)	Due to Change In Volume	Average Rate
(Dollars in thousands and tax equivalent)						
Interest income from earning assets:						
Loans and leases	\$ 6,024	\$ 8,054	\$ (2,030)	\$ 5,766	\$ 8,337	\$ (2,571)
Securities	(1,508)	160	(1,668)	(2,995)	(1,370)	(1,625)
Other earning assets	(19)	(14)	(5)	21	15	6
Total interest income	4,497	8,200	(3,703)	2,792	6,982	(4,190)
Interest expense on funding of earning assets:						
Interest-bearing demand deposits	24	28	(4)	(22)	33	(55)
Regular savings deposits	4	21	(17)	13	15	(2)

Edgar Filing: SANDY SPRING BANCORP INC - Form 10-Q

Money market savings deposits	(340)	20	(360)	(1,394)	48	(1,442)
Time deposits	(1,186)	(472)	(714)	(1,563)	(360)	(1,203)
Total borrowings	(1,197)	1,353	(2,550)	67	(112)	179
Total interest expense	(2,695)	950	(3,645)	(2,899)	(376)	(2,523)
Net interest income	\$ 7,192	\$ 7,250	\$ (58)	\$ 5,691	\$ 7,358	\$ (1,667)

\* Variances that are the combined effect of volume and rate, but cannot be separately identified, are allocated to the volume and rate variances based on their respective relative amounts.

### **Interest Income**

The Company's total tax-equivalent interest income increased 4%, or 1% exclusive of the interest recoveries for the first nine months of 2013 compared to the prior year period. The previous table shows that, in 2013, the increase in average loans and leases more than offset a continued decline in earning asset yields with respect to the loan portfolio which resulted in an increase in total tax-equivalent interest income.

In the first nine months of 2013, the average balance of the loan portfolio, including residential mortgage loans held for sale, increased 10% compared to the prior year period. This growth was primarily in the owner occupied and investor real estate, commercial business and residential mortgage portfolios. These increases were driven by loans added from the CommerceFirst acquisition in the second quarter of 2012 and organic loan growth as the regional economy slowly improved. The yield on average loans and leases decreased by 9 basis points due to the continued prevailing low interest rate environment as relatively higher rate loans were paid off and new loans were originated at comparatively lower rates. Excluding the effect of the interest recoveries on charged-off loans mentioned previously, the yield on average loans and leases decreased 30 basis points compared to the prior year period. After excluding the effect of the interest recoveries, the decline in the portfolio yield was driven primarily by a decrease of 60 basis points in the yield in the combined residential mortgage and construction portfolio and a decrease of 23 basis points in the yield in the overall commercial loan portfolio. The decrease in the yield on the mortgage loan portfolio was due to declining rates on both new and existing adjustable rate mortgage loans, which the Company does not sell but maintains in the portfolio.

The average yield on total investment securities decreased 21 basis points while the average balance of the portfolio remained virtually level in the first nine months of 2013 compared to the first nine months of 2012. The decrease in the yield on investments was due primarily to calls of securities and principal payments on mortgage-backed securities that were replaced by lower yielding investments as a result of lower overall market rates.

### **Interest Expense**

Interest expense decreased by \$2.7 million or 16% in the first nine months of 2013 compared to the first nine months of 2012, primarily as a result of a 16 basis point decrease in the average rate paid on interest-bearing liabilities. Deposit average balances during the first nine months of 2013 compared to the prior year period were driven by the CommerceFirst acquisition in the second quarter of 2012 and by clients' continued emphasis on safety and liquidity as average total deposits increased 16% for the first nine months of 2013 compared to the prior year period. The increase in deposits was driven by increases of \$184 million or 17% in average non-interest-bearing and interest-bearing checking accounts together with increases of \$29 million or 14% in regular savings accounts and \$11 million or 1% in money market accounts as clients kept funds in short-term instruments to preserve liquidity. This growth was partially offset by a decrease in average certificates of deposit of \$77 million or 13% in the first nine months of 2013 compared to 2012. This decrease was primarily due to a decline in the rates offered on certificates and the run-off of brokered certificates of deposit acquired from the CommerceFirst acquisition in an effort to preserve the Company's net interest margin during this extended period of historically low interest rates. In addition, the average rate paid on advances from the Federal Home Loan Bank of Atlanta decreased 87 basis points for the first nine months of 2013 compared to the prior year period due primarily to an increase in short-term borrowings at very favorable rates and the restructuring of \$170 million of such advances into longer term lower rate instruments during the fourth quarter of 2012 and in the first six months of 2013.

**Non-interest Income**

Non-interest income amounts and trends are presented in the following table for the periods indicated:

(Dollars in thousands)	Nine Months Ended September 30,				
	2013	2012	\$ Change	% Change	
Securities gains	\$ 118	\$ 459	\$ (341)	(74.3)	%
Total other-than-temporary impairment ("OTTI") losses	-	(95)	95	(100.0)	
Portion of OTTI losses recognized in other comprehensive income before taxes	-	-	-	-	
Net OTTI recognized in earnings	-	(95)	95	(100.0)	
Service charges on deposit accounts	6,390	6,713	(323)	(4.8)	
Mortgage banking activities	2,738	4,294	(1,556)	(36.2)	
Wealth management income	13,077	11,949	1,128	9.4	
Insurance agency commissions	3,578	3,156	422	13.4	
Income from bank owned life insurance	1,864	1,954	(90)	(4.6)	
Visa check fees	3,113	2,844	269	9.5	
Other income	4,979	3,435	1,544	44.9	
Total non-interest income	\$ 35,857	\$ 34,709	\$ 1,148	3.3	

Total non-interest income was \$35.9 million for the first nine months of 2013 compared to \$34.7 million for the first nine months of 2012. The primary drivers of non-interest income for the first nine months of 2013 were a decrease in mortgage banking income, which largely offset increases in wealth management income, income from insurance agency commissions and other non-interest income.

Income from mortgage banking activities decreased in the first nine months of 2013 compared to the first nine months of 2012 due primarily to the increase in interest rates during the second and third quarter of 2013, which significantly reduced loan origination volumes from refinancing activity.

Wealth management income is comprised of income from trust and estate services, investment management fees earned by West Financial Services, the Company's investment management subsidiary, and fees on sales on investment products and services. Trust services fees increased 6% compared to the prior year period, due to an increase in assets under management. Investment management fees in West Financial Services increased 10% for the first nine months of 2013 compared to 2012, due to higher assets under management. Fees on sales of investment products and services increased 14% for the year-to-date, also due to an increase in assets under management. Overall total assets under management increased to \$2.5 billion at September 30, 2013 compared to \$2.2 billion at September 30, 2012 from positive market movements and additions from new and existing clients.

Insurance agency commissions increased 13% in the first nine months of 2013 compared to the first nine months of 2012 due primarily to higher revenues on commercial and physicians' liability lines.

Other non-interest income increased during the first nine months compared to the prior year period due mainly to gains on sales and dispositions of loans, a non-recurring legal settlement and recovery of fees on non-performing loans mentioned previously.

Service charges on deposits decreased in the first nine months of 2013 compared to the first nine months of 2012 due primarily to a decline in overdraft fees.

Income from bank owned life insurance decreased in the first nine months of 2013 compared to the prior year period due to the decline in interest rates paid on such policies. The Company invests in bank owned life insurance products

in order to better manage the cost of employee benefit plans. Investments totaled \$85.6 million at September 30, 2013 and \$83.1 million at September 30, 2012 and were well diversified by carrier in accordance with defined policies and practices. The average tax-equivalent yield on these insurance contract assets was 4.90% for the first nine months of 2013 compared to 5.30% for the prior year period.

No net OTTI losses were recognized in earnings in the first nine months of 2013 compared to \$95 thousand for the prior year period. The Company recognized net securities gains, exclusive of net OTTI losses which resulted primarily from securities calls during the period.

**Non-interest Expense**

Non-interest expense amounts and trends are presented in the following table for the years indicated:

(Dollars in thousands)	Nine Months Ended September 30,				
	2013	2012	\$ Change	% Change	
Salaries and employee benefits	\$ 48,891	\$ 47,104	\$ 1,787	3.8	%
Occupancy expense of premises	9,327	8,895	432	4.9	
Equipment expenses	3,676	3,682	(6)	(0.2)	
Marketing	1,983	1,824	159	8.7	
Outside data services	3,418	4,183	(765)	(18.3)	
FDIC insurance	1,855	1,972	(117)	(5.9)	
Amortization of intangible assets	1,384	1,403	(19)	(1.4)	
Professional fees	3,093	4,725	(1,632)	(34.5)	
Other real estate owned	(394)	589	(983)	(166.9)	
Other expenses	8,991	8,331	660	7.9	
Total non-interest expense	\$ 82,224	\$ 82,708	\$ (484)	(0.6)	

Non-interest expenses totaled \$82.2 million in the first nine months of 2013 compared to \$82.7 million in the first nine months of 2012. This decrease in expenses was driven primarily by merger expenses of \$2.7 million from the CommerceFirst acquisition in 2012 and the benefit of the recovery of expenses related to the resolution of problem loans.

Salaries and employee benefits, the largest component of non-interest expenses, increased in the first nine months of 2013 due primarily to higher compensation expenses as a result of a larger staff, merit increases and higher incentive compensation. The average number of full-time equivalent employees was 712 in the first nine months of 2013 compared to 680 for the first nine months of 2012.

Occupancy expenses increased for the first nine months of 2013 compared to 2012 due to higher rental expenses from a larger branch network. In addition, grounds maintenance expenses increased in the first nine months of 2013 compared to the first nine months of 2012 due to weather related expenses. Equipment expenses remained level for the first nine months of 2013 compared to the first nine months of 2012.

Marketing expenses increased in 2013 compared to 2012 due to higher advertising expenses.

Outside data services expenses and professional fees decreased in the first nine months of 2013 compared to the prior year period due primarily to merger expenses recognized in the first nine months of 2012 and due to the recovery of legal and other expenses incurred with respect to loan recoveries.

FDIC insurance expense decreased in the first nine months of 2013 compared to the first nine months of 2012 as the Company's growth in assets was more than offset by a lower assessment rate due to improving financial ratios.

Other real estate owned expenses decreased compared to the prior year period due to the decline in the number of real estate owned properties and gains on the sales of several properties.

Other non-interest expenses increased in the first nine months of 2013 compared to the prior year period due mainly to increases in various categories of operating expenses.

**Income Taxes**

The Company had income tax expense of \$18.1 million in the first nine months of 2013, compared to \$13.1 million in the first nine months of 2012. The resulting effective rates were 34% for the first nine months of 2013 and 33% for the



first nine months of 2012. The increase in the effective tax rate in the first nine months of 2013 was due primarily to a higher proportion of income before taxes that was taxed at the full statutory rate compared to tax exempt income.

## **Results of Operations**

### **For the Quarter Ended September 30, 2013 Compared to the Quarter Ended September 30, 2012**

Net income for the Company for the third quarter of 2013 totaled \$12.1 million (\$0.48 per diluted share) compared to net income of \$11.0 million (\$0.44 per diluted share) for the third quarter of 2012.

#### **Net Interest Income**

Net interest income for the third quarter of 2013 was \$35.3 million compared to \$31.8 million for the same period of 2012, an increase of 11%. On a tax-equivalent basis, net interest income increased by 11% for the quarter ended September 30, 2013 to \$36.7 million from \$33.1 million for the prior year period. Excluding interest recoveries of \$3.7 million due to the resolution of previously non-performing commercial real estate loans, net interest income was \$31.7 million. Average interest-earning assets increased by 5% while average interest-bearing liabilities increased 3% in 2013. Average non-interest-bearing deposits increased 11% in the third quarter of 2013 compared to the third quarter of 2012 while the percentage of average non-interest-bearing deposits to total deposits also increased to 30% for the third quarter of 2013 compared to 27% for the same period in 2012.

#### **Interest Rate Performance**

The Company's net interest margin increased to 3.88% for the third quarter of 2013 compared to 3.67% for the third quarter of 2012 while the net interest spread increased to 3.66% in 2013 compared to 3.42% in 2012. The increase in both the net interest margin and net interest spread was due to the interest recoveries mentioned above. Excluding these recoveries, the net interest margin and net interest spread were 3.49% and 3.28%, respectively. After excluding the interest recoveries, the decrease in the net interest margin was due primarily to the decline in the yield on the higher average balance of interest-earning assets, which more than offset lower rates on interest-bearing deposits and borrowings and higher balances of non-interest-bearing deposits.

#### **Interest Income**

The Company's total tax-equivalent interest income increased 7% for the third quarter of 2013 compared to the prior year quarter. Exclusive of the interest recoveries described above, tax-equivalent interest income remained level for the third quarter of 2013 compared to the prior year quarter. In the third quarter of 2013, the average balance of the loan portfolio, including residential mortgage loans held for sale, increased 5% compared to the prior year period. This growth was primarily in the residential mortgage, commercial investor real estate and commercial ADC portfolios. These increases were driven by organic loan growth as the regional economy slowly improved. The yield on average loans and leases increased by 10 basis points due primarily to the interest recoveries mentioned previously. Excluding the effect of the interest recoveries, the yield on average loans and leases decreased 46 basis points. This decline in the portfolio yield was driven primarily by a decrease of 46 basis points in the yield in the combined residential mortgage and construction portfolio together with a decline of 51 basis points in the overall commercial loan portfolio. The decrease in the yield on the mortgage loan portfolio was due to declining rates on both new and existing adjustable rate mortgage loans, which the Company does not sell but maintains in the portfolio. The decrease in yield on the commercial loan portfolio was due to intense competition for quality loans in the prevailing low interest rate environment.

The average yield on total investment securities decreased 2 basis points while the average balance of the portfolio increased 5% for the third quarter of 2013 compared to the third quarter of 2012. The decrease in the yield on investments was due primarily to calls of securities and principal payments on mortgage-backed securities that were replaced by lower yielding investments as a result of lower overall market rates.

#### **Interest Expense**

Interest expense decreased by \$0.8 million or 15% in the third quarter of 2013 compared to the third quarter of 2012, primarily as a result of a 15 basis point decrease in the average rate paid on interest-bearing liabilities. Deposit average balances during the third quarter of 2013 compared to the prior year quarter were driven by clients' continued emphasis

on safety and liquidity as average total deposits increased 2% for the quarter compared to the prior year quarter. This increase was driven by an increase of \$138 million or 12% in average non-interest-bearing and interest-bearing checking accounts together with increases of \$25 million or 11% in regular savings accounts as clients kept funds in short-term instruments to preserve liquidity. This growth was partially offset by a decrease in average certificates of deposit of \$96 million or 17% in the third quarter of 2013 compared to 2012. This decrease was primarily due to a decline in the rates offered on certificates and the run-off of brokered certificates of deposit acquired in the CommerceFirst acquisition in an effort to preserve the Company's net interest margin during this extended period of historically low interest rates. In addition, average money market accounts decreased \$20 million or 2% for the quarter compared to the third quarter of 2012. The average balance of advances from the Federal Home Loan Bank of Atlanta ("FHLB") increased \$120 million or 30% for the third quarter of 2013 compared to the prior year quarter as the Company took advantage of prevailing low rates on short-term advances. The average rate paid on advances from the Federal Home Loan Bank of Atlanta decreased 107 basis points for the third quarter of 2013 compared to the prior year period. This decrease was due to the restructuring of \$170 million of such advances into longer term lower rate instruments during the fourth quarter of 2012 and in the first six months of 2013 together with the short-term borrowings at comparatively low rates mentioned above.

**Non-interest Income**

Non-interest income amounts and trends are presented in the following table for the periods indicated:

(Dollars in thousands)	Three Months Ended September 30,				
	2013	2012	\$ Change	% Change	
Securities gains	\$ -	\$ 296	\$ (296)	100.0	%
Total other-than-temporary impairment ("OTTI") losses	-	(23)	23	(100.0)	
Portion of OTTI losses recognized in other comprehensive income before taxes	-	-	-	-	
Net OTTI recognized in earnings	-	(23)	23	(100.0)	
Service charges on deposit accounts	2,171	2,230	(59)	(2.6)	
Mortgage banking activities	(26)	1,981	(2,007)	(101.3)	
Wealth management income	4,503	3,858	645	16.7	
Insurance agency commissions	1,193	1,020	173	17.0	
Income from bank owned life insurance	629	660	(31)	(4.7)	
Visa check fees	1,077	984	93	9.5	
Other income	1,676	1,236	440	35.6	
Total non-interest income	\$ 11,223	\$ 12,242	\$ (1,019)	(8.3)	

Total non-interest income was \$11.2 million for the third quarter of 2013 compared to \$12.2 million for the third quarter of 2012. As shown in the table above, the primary drivers of non-interest income for the third quarter of 2013 were a decrease in income from mortgage banking, which was somewhat offset by increases in wealth management income, insurance agency commissions and other non-interest income.

Income from mortgage banking activities decreased in the third quarter of 2013 compared to the third quarter of 2012 due primarily to lower loan origination volumes, reduced average gains on sales and a decline in accrued gains on mortgage commitments as a result of rising interest rates during the second and third quarter of 2013.

Wealth management income is comprised of income from trust and estate services, investment management fees earned by West Financial Services, the Company's investment management subsidiary, and fees on sales on investment products and services. During the third quarter of 2013, wealth management income increased compared to the prior year quarter due to growth in assets under management. Fees on sales of investment products and services increased for the third quarter of 2013 due to a 12% increase in assets under management and fees on sales of life insurance products. Investment management fees in West Financial Services increased 10% while trust services fees increased 9% compared to the prior year quarter, both of which were due to positive market movements and client additions. Overall total assets under management increased to \$2.5 billion at September 30, 2013 compared to \$2.2 billion at September 30, 2012.

Insurance agency commissions increased 17% in the third quarter of 2013 compared to the third quarter of 2012 due primarily to higher revenues on commercial and physicians' liability lines. Other non-interest income increased during the quarter compared to the prior year period due mainly to gains on sales and dispositions of loans.

Service charges on deposits decreased in the third quarter of 2013 compared to the third quarter of 2012 due primarily to a decline in overdraft fees.

Income from bank owned life insurance decreased in the third quarter of 2013 compared to the prior year period due to the decline in interest rates paid on such policies.



No net OTTI losses were recognized in earnings in the third quarter of 2013 compared to \$23 thousand for the third quarter of 2012. The Company recognized net securities gains, exclusive of net OTTI losses which resulted primarily from securities calls during the period.

### Non-interest Expense

Non-interest expense amounts and trends are presented in the following table for the years indicated:

(Dollars in thousands)	Three Months Ended September 30,				
	2013	2012	\$ Change	% Change	
Salaries and employee benefits	\$ 16,382	\$ 15,476	\$ 906	5.9	%
Occupancy expense of premises	3,149	3,106	43	1.4	
Equipment expenses	1,200	1,237	(37)	(3.0)	
Marketing	713	764	(51)	(6.7)	
Outside data services	1,152	1,076	76	7.1	
FDIC insurance	678	667	11	1.6	
Amortization of intangible assets	462	476	(14)	(2.9)	
Professional fees	511	1,282	(771)	(60.1)	
Other real estate owned	(150)	174	(324)	(186.2)	
Other expenses	2,796	2,909	(113)	(3.9)	
Total non-interest expense	\$ 26,893	\$ 27,167	\$ (274)	(1.0)	

Non-interest expenses totaled \$26.9 million in the third quarter of 2013 compared to \$27.2 million in the third quarter of 2012, a decrease of 1%.

Salaries and employee benefits, the largest component of non-interest expenses, increased in the third quarter of 2013 due primarily to higher compensation expenses as a result of a larger staff, merit increases and increased incentive compensation. The average number of full-time equivalent employees was 722 in the third quarter of 2013 compared to 686 for the third quarter of 2012.

Occupancy, equipment and marketing expenses remained level for the third quarter compared to the prior year quarter.

Outside data services increased compared to the prior year quarter due to an increase in provider costs.

Professional fees decreased in the third quarter of 2013 compared to the prior year period due primarily to the recovery of expenses from the resolution of the problem loan credits mentioned previously.

FDIC insurance expense remained virtually level for the third quarter of 2013 compared to the third quarter of 2012 as the Company's growth in assets was offset by a lower assessment rate due to improving financial ratios.

Real estate owned expenses decreased compared to the prior year period due the decline in the number of real estate owned properties and due to gains on the sale of properties. Other non-interest expenses also decreased in the third quarter of 2013 due to decreases in several categories other expenses.

### Income Taxes

The Company had income tax expense of \$6.4 million in the third quarter of 2013, compared to \$5.6 million in the third quarter of 2012. The resulting effective rates were 35% for the third quarter of 2013 compared to 34% for the third quarter of 2012. The increase in the effective tax rate for the third quarter of 2013 was due primarily to a higher proportion of income before taxes that was taxed at the full statutory rate compared to tax exempt income.

### Operating Expense Performance

Management views the GAAP efficiency ratio as an important financial measure of expense performance and cost management. The ratio expresses the level of non-interest expenses as a percentage of total revenue (net interest income plus total non-interest income). Lower ratios indicate improved productivity.

### **Non-GAAP Financial Measures**

The Company also uses a traditional efficiency ratio that is a non-GAAP financial measure of operating expense control and efficiency of operations. Management believes that its traditional ratio better focuses attention on the operating performance of the Company over time than does a GAAP ratio, and is highly useful in comparing period-to-period operating performance of the Company's core business operations. It is used by management as part of its assessment of its performance in managing non-interest expenses. However, this measure is supplemental, and is not a substitute for an analysis of performance based on GAAP measures. The reader is cautioned that the non-GAAP efficiency ratio used by the Company may not be comparable to GAAP or non-GAAP efficiency ratios reported by other financial institutions.

In general, the efficiency ratio is non-interest expenses as a percentage of net interest income plus non-interest income. Non-interest expenses used in the calculation of the non-GAAP efficiency ratio exclude goodwill impairment losses, the amortization of intangibles, and non-recurring expenses. Income for the non-GAAP ratio includes the favorable effect of tax-exempt income, and excludes securities gains and losses, which vary widely from period to period without appreciably affecting operating expenses, and non-recurring gains. The measure is different from the GAAP efficiency ratio, which also is presented in this report. The GAAP measure is calculated using non-interest expense and income amounts as shown on the face of the Consolidated Statements of Income. The GAAP and non-GAAP efficiency ratios are reconciled and provided in the following table. Both ratios improved during the third quarter of 2013 compared to the prior year quarter and during the first nine months of 2013 compared to the prior year period. Excluding the effect of the recoveries on two non-performing commercial real estate loans, both ratios improved for the third quarter of 2013 compared to the third quarter of 2012, while both ratios increased for the comparative year-to-date periods.

In addition, the Company uses pre-tax pre-provision pre-merger expense income as a measure of the level of recurring income before taxes. Management believes this provides financial statement users with a useful metric of the run-rate of revenues and expenses which is readily comparable to other financial institutions. This measure is calculated by adding (subtracting) the provision (credit) for loan and lease losses, the provision for income taxes and merger expenses back to net income. This metric increased in the third quarter of 2013 compared to the prior year quarter due primarily to higher net interest income and non-interest income. Excluding the effect of the recoveries on the two non-performing commercial real estate loans mentioned previously, this metric decreased for the third quarter of 2013 compared to the prior year quarter due to an increase in noninterest expenses.



**GAAP and Non-GAAP Financial Measures**

(Dollars in thousands)	Three Months Ended September 30,		Nine Months Ended September 30,	
	2013	2012	2013	2012
Pre-tax pre-provision pre-merger expense income:				
Net income	\$ 12,089	\$ 10,990	\$ 34,809	\$ 26,673
Plus non-GAAP adjustment:				
Merger expenses	-	136	-	2,708
Income taxes	6,419	5,638	18,058	13,146
Provision for loan and lease losses	1,128	232	(1,670)	2,481
Pre-tax pre-provision pre-merger expense income	\$ 19,636	\$ 16,996	\$ 51,197	\$ 45,008
Efficiency ratio - GAAP basis:				
Non-interest expenses	\$ 26,893	\$ 27,167	\$ 82,224	\$ 82,708
Net interest income plus non-interest income	\$ 46,529	\$ 44,027	\$ 133,421	\$ 125,008
Efficiency ratio - GAAP basis	57.80	%	61.70	%
	61.63	%	66.16	%
Efficiency ratio - Non-GAAP basis:				
Non-interest expenses	\$ 26,893	\$ 27,167	\$ 82,224	\$ 82,708
Less non-GAAP adjustment:				
Amortization of intangible assets	462	476	1,384	1,403
Merger expenses	-	136	-	2,708
Non-interest expenses - as adjusted	\$ 26,431	\$ 26,555	\$ 80,840	\$ 78,597
Net interest income plus non-interest income	\$ 46,529	\$ 44,027	\$ 133,421	\$ 125,008
Plus non-GAAP adjustment:				
Tax-equivalent income	1,344	1,324	3,967	4,040
Less non-GAAP adjustments:				
Securities gains	-	296	118	459
OTTI recognized in earnings	-	(23)	-	(95)
Net interest income plus non-interest income - as adjusted	\$ 47,873	\$ 45,078	\$ 137,270	\$ 128,684
Efficiency ratio - Non-GAAP basis	55.21	%	58.91	%
	58.89	%	61.08	%

**FINANCIAL CONDITION**

The Company's total assets were \$4.1 billion at September 30, 2013, increasing \$98 million or 2% compared to \$4.0 billion at December 31, 2012. Interest-earning assets increased \$103 million to \$3.8 billion at September 30, 2013 compared to December 31, 2012. The increase in interest-earning assets was primarily due to organic growth in the loan portfolio.

**Analysis of Loans and Leases**

A comparison of loan portfolio at the dates indicated is presented in the following table:

(Dollars in thousands)	September 30, 2013		December 31, 2012		Period-to-Period Change	
	Amount	%	Amount	%	\$ Change	% Change
Residential real estate:						
Residential mortgage	\$ 595,180	22.4 %	\$ 523,364	20.7 %	\$ 71,816	13.7 %
Residential construction	118,316	4.4	120,314	4.8	(1,998)	(1.7)
Commercial real estate:						
Commercial owner occupied real estate	569,350	21.4	571,510	22.6	(2,160)	(0.4)
Commercial investor real estate	518,029	19.5	456,888	18.0	61,141	13.4
Commercial acquisition, development and construction	158,739	6.0	151,933	6.0	6,806	4.5
Commercial Business Leases	332,670	12.5	346,708	13.7	(14,038)	(4.0)
Leases	962	-	3,421	0.1	(2,459)	(71.9)
Consumer	368,764	13.8	356,990	14.1	11,774	3.3
Total loans and leases	\$ 2,662,010	100.0 %	\$ 2,531,128	100.0 %	\$ 130,882	5.2

Total loans and leases, excluding loans held for sale, increased 5% during the first nine months of 2013 compared to December 31, 2012. The commercial loan portfolio increased 3% at September 30, 2013 compared to the prior year end largely due to growth in the investor real estate segment of the portfolio which more than offset declines in commercial owner occupied and business loans.

The residential real estate portfolio, which is comprised of residential construction and permanent residential mortgage loans, reflected an 11% increase at September 30, 2013 compared to December 31, 2012. Permanent residential mortgages, most of which are 1-4 family, increased 14% due primarily to lower prepayments resulting from market conditions and increased originations of adjustable rate mortgage loans. The Company generally retains such adjustable rate mortgages in its portfolio and sells the fixed rate mortgages that it originates in the secondary mortgage market. Residential construction loans decreased 2% at September 30, 2013 compared to the balance at December 31, 2012 due to competition in the market and seasonality.

The consumer loan portfolio increased 3% at September 30, 2013 compared to December 31, 2012 due to growth in home equity lines of credit.

**Analysis of Investment Securities**

The composition of investment securities at the dates indicated is presented in the following table:

(Dollars in thousands)	September 30, 2013		December 31, 2012		Period-to-Period Change	
	Amount	%	Amount	%	\$ Change	% change
<b>Available-for-Sale:</b>						
<b>U.S. government agencies and corporations</b>						
	\$ 172,243	16.0 %	\$ 156,428	14.6 %	\$ 15,815	10.1 %
State and municipal	166,866	15.5	174,491	16.3	(7,625)	(4.4)
Mortgage-backed	472,269	43.8	490,479	45.6	(18,210)	(3.7)
Corporate debt	2,005	0.2	1,996	0.2	9	0.5
Trust preferred	1,439	0.1	1,465	0.1	(26)	(1.8)
Marketable equity securities	723	-	723	-	-	-
<b>Total available-for-sale</b>	<b>815,545</b>	<b>75.6</b>	<b>825,582</b>	<b>76.8</b>	<b>(10,037)</b>	<b>(1.2)</b>
<b>Held-to-Maturity and Other Equity</b>						
<b>U.S. government agencies and corporations</b>						
	64,503	6.0	64,498	6.0	5	-
State and municipal	161,231	15.0	150,995	14.1	10,236	6.8
Mortgage-backed	260	-	321	-	(61)	(19.0)
Other equity securities	36,412	3.4	33,636	3.1	2,776	8.3
<b>Total held-to-maturity and other equity</b>	<b>262,406</b>	<b>24.4</b>	<b>249,450</b>	<b>23.2</b>	<b>12,956</b>	<b>5.2</b>
<b>Total securities</b>	<b>\$ 1,077,951</b>	<b>100.0 %</b>	<b>\$ 1,075,032</b>	<b>100.0 %</b>	<b>\$ 2,919</b>	<b>0.3</b>

The investment portfolio, consisting of available-for-sale, held-to-maturity and other equity securities, remained virtually level at \$1.1 billion at September 30, 2013 compared to December 31, 2012.

The investment portfolio consists primarily of U.S. Agency securities, U.S. Agency mortgage-backed securities, U.S. Agency collateralized mortgage obligations and state and municipal securities. The duration of the portfolio was 4.1 years at September 30, 2013 and 3.4 years at December 31, 2012. This investment strategy has resulted in a portfolio with low credit risk that would provide the required liquidity needed to meet increased loan demand. The portfolio is monitored on a continuing basis with consideration given to interest rate trends and the structure of the yield curve and with constant assessment of economic projections and analysis.

At September 30, 2013, the trust preferred portfolio included one pooled trust preferred security backed by debt issued by banks and thrifts, which totaled \$1.7 million, with a fair value of \$1.4 million. The fair value of this security was determined by a third party valuation specialist due to the limited trading activity for this security in the marketplace. The specialist used an income valuation approach technique (present value) that maximizes the use of relevant observable inputs and minimizes the use of unobservable inputs. The methodology, observable inputs and significant assumptions employed by the specialist to determine fair value are provided in Note 3 Investment Securities in the Notes to the Condensed Consolidated Financial Statements.

As a result of this valuation, it was determined that the pooled trust preferred security had not incurred any credit-related OTTI for the nine months ended September 30, 2013. Non-credit related OTTI on this security, which is not expected to be sold and which the Company has the ability to hold until maturity, was \$0.3 million at September

30, 2013. This non-credit related OTTI was recognized in accumulated other comprehensive income (“OCI”) at September 30, 2013.

**Other Earning Assets**

Residential mortgage loans held for sale decreased \$25 million to \$11 million as of September 30, 2013 from \$36 million as of December 31, 2012 due to higher market interest rates which reduced mortgage loan origination volumes during the period. The aggregate of federal funds sold and interest-bearing deposits with banks decreased \$6 million to \$21 million at September 30, 2013. This decrease was due to activity in the loan and investment portfolios at quarter end.

## Deposits

The composition of deposits at the dates indicated is presented in the following table:

(Dollars in thousands)	September 30, 2013			December 31, 2012			Period-to-Period Change		
	Amount	%		Amount	%		\$ Change	% change	
Noninterest-bearing deposits	\$ 890,319	30.5	%	\$ 847,415	29.1	%	\$ 42,904	5.1	%
Interest-bearing deposits:									
Demand	435,458	14.9		428,048	14.7		7,410	1.7	
Money market savings	871,360	29.9		884,367	30.4		(13,007)	(1.5)	
Regular savings	240,210	8.3		228,384	7.8		11,826	5.2	
Time deposits of less than \$100,000	272,101	9.3		307,445	10.5		(35,344)	(11.5)	
Time deposits of \$100,000 or more	207,018	7.1		217,375	7.5		(10,357)	(4.8)	
Total interest-bearing deposits	2,026,147	69.5		2,065,619	70.9		(39,472)	(1.9)	
Total deposits	\$ 2,916,466	100.0	%	\$ 2,913,034	100.0	%	\$ 3,432	0.1	

Total deposits remained virtually level at September 30, 2013 compared to December 31, 2012. The total of non-interest-bearing and interest-bearing checking accounts increased 4% at September 30, 2013 compared to the prior year end. Regular savings accounts increased 5%, while money market accounts decreased 1% at September 30, 2013. The activity in these deposit products can be attributed primarily to clients' emphasis on safety and liquidity considering the current extended period of low interest rates and the volatility of alternative investments. Certificates of deposit decreased 9% compared to the prior year end, as the Company managed its deposit mix to maintain its net interest margin. Total borrowings increased 15% at September 30, 2013 compared to December 31, 2012. This increase was due primarily to the Company's decision to take advantage of extraordinarily low short-term interest rates to fund loan originations and investment securities purchases with short-term FHLB advances.

## Capital Management

Management monitors historical and projected earnings, dividends and asset growth, as well as risks associated with the various types of on- and off-balance sheet assets and liabilities, in order to determine appropriate capital levels. During the first nine months of 2013, total stockholders' equity increased to \$494 million at September 30, 2013, from \$484 million at December 31, 2012. This increase was due primarily to net income earned during the period which was somewhat offset by dividends and a decrease in unrealized gains on investment securities available for sale. The ratio of average equity to average assets was 12.19% for the first nine months of 2013 as compared to 12.31% for the first nine months of 2012.

Bank holding companies and banks are required to maintain capital ratios in accordance with guidelines adopted by the federal bank regulators. These guidelines are commonly known as Risk-Based Capital guidelines. The actual regulatory ratios and required ratios for capital adequacy, in addition to the ratios required to be categorized as "well capitalized", are summarized for the Company in the following table:

## Risk-Based Capital Ratios

	Ratios at	Minimum
	September 30, 2013	Regulatory
	December 31, 2012	Requirements

Edgar Filing: SANDY SPRING BANCORP INC - Form 10-Q

Total Capital to risk-weighted assets	15.70	%	15.40	%	8.00	%
Tier 1 Capital to risk-weighted assets	14.45	%	14.15	%	4.00	%
Tier 1 Leverage	11.29	%	10.98	%	3.00	%

Tier 1 capital of \$446.3 million and total qualifying capital of \$485.0 million each included \$35.0 million in trust preferred securities that are considered regulatory capital for purposes of determining the Company's Tier 1 capital ratio. As of September 30, 2013, the most recent notification from the Bank's primary regulator categorized the Bank as a "well-capitalized" institution under the prompt corrective action rules of the Federal Deposit Insurance Act. Designation as a well-capitalized institution under these regulations is not a recommendation or endorsement of the Company or the Bank by federal bank regulators.

In July 2013, the Federal Reserve Board approved revisions to its capital adequacy guidelines and prompt corrective action rules that implement the revised standards of the Basel Committee on Banking Supervision, commonly called Basel III, and address relevant provisions of the Dodd-Frank Act. The rules include new risk-based capital and leverage ratios, which are effective January 1, 2015, and revise the definition of what constitutes “capital” for calculating those ratios. The proposed new minimum capital level requirements applicable to the Company and the Bank will be: (1) a new common equity Tier 1 capital ratio of 4.5%; (2) a Tier 1 capital ratio of 6% (increased from 4%); (3) a total capital ratio of 8% (unchanged from current rules); and (4) a Tier 1 leverage ratio of 4%. The rules eliminate the inclusion of certain instruments, such as trust preferred securities, from Tier 1 capital. Instruments issued prior to May 19, 2010 will be grandfathered for companies with consolidated assets of \$15 billion or less. The rules also establish a “capital conservation buffer” of 2.5% above the new regulatory minimum capital requirements, which must consist entirely of common equity Tier 1 capital. The new capital conservation buffer requirement will be phased in beginning in January 2016 at 0.625% of risk-weighted assets and will increase by that amount each year until fully implemented in January 2019. An institution would be subject to limitations on paying dividends, engaging in share repurchases, and paying discretionary bonuses to executive officers if its capital level falls below the buffer amount. These limitations establish a maximum percentage of eligible retained income that could be utilized for such actions.

### Tangible Common Equity

Tangible equity, tangible assets and tangible book value per share are non-GAAP financial measures calculated using GAAP amounts. Tangible common equity and tangible assets exclude the balances of goodwill and other intangible assets from stockholder’s equity and total assets, respectively. Management believes that this non-GAAP financial measure provides information to investors that may be useful in understanding our financial condition. Because not all companies use the same calculation of tangible equity and tangible assets, this presentation may not be comparable to other similarly titled measures calculated by other companies. A reconciliation of the non-GAAP ratio of tangible equity to tangible assets and tangible book value per share are provided in the following table.

### Tangible Common Equity Ratio Non-GAAP

(Dollars in thousands, except per share data)	September 30, 2013	December 31, 2012
Tangible common equity ratio:		
Total stockholders' equity	\$ 493,882	\$ 483,512
Accumulated other comprehensive income (loss)	2,892	(11,312)
Goodwill	(84,171)	(84,808)
Other intangible assets, net	(1,792)	(3,163)
Tangible common equity	\$ 410,811	\$ 384,229
Total assets	\$ 4,052,969	\$ 3,955,206
Goodwill	(84,171)	(84,808)
Other intangible assets, net	(1,792)	(3,163)
Tangible assets	\$ 3,967,006	\$ 3,867,235
Tangible common equity ratio	10.36	% 9.94 %
Tangible book value per share	\$ 16.44	\$ 15.43

## Credit Risk

The fundamental lending business of the Company is based on understanding, measuring and controlling the credit risk inherent in the loan portfolio. The Company's loan and lease portfolio is subject to varying degrees of credit risk. Credit risk entails both general risks, which are inherent in the process of lending, and risk specific to individual borrowers. The Company's credit risk is mitigated through portfolio diversification, which limits exposure to any single customer, industry or collateral type. Typically, each consumer and residential lending product has a generally predictable level of credit losses based on historical loss experience. Home mortgage and home equity loans and lines generally have the lowest credit loss experience. Loans secured by personal property, such as auto loans, generally experience medium credit losses. Unsecured loan products, such as personal revolving credit, have the highest credit loss experience and for that reason, the Company has chosen not to engage in a significant amount of this type of lending. Credit risk in commercial lending can vary significantly, as losses as a percentage of outstanding loans can shift widely during economic cycles and are particularly sensitive to changing economic conditions. Generally, improving economic conditions result in improved operating results on the part of commercial customers, enhancing their ability to meet their particular debt service requirements. Improvements, if any, in operating cash flows can be offset by the impact of rising interest rates that may occur during improved economic times. Inconsistent economic conditions may have an adverse affect on the operating results of commercial customers, reducing their ability to meet debt service obligations.

Current economic data has shown that while the Mid-Atlantic region is one of the stronger markets in the nation, the Company is continuing to deal with the lingering impact of a very slowly recovering economy and its resulting effects on the Company's borrowers, particularly in the real estate sector. Total non-performing loans decreased 34% to \$38 million at September 30, 2013 compared to the balance at December 31, 2012. While the diversification of the lending portfolio among different commercial, residential and consumer product lines along with different market conditions of the D.C. suburbs, Northern Virginia and Baltimore metropolitan area has mitigated some of the risks in the portfolio, local economic conditions and levels of non-performing loans may continue to be influenced by the current slow and uneven economic recovery on both a regional and national level.

To control and manage credit risk, management has a credit process in place to reasonably ensure credit standards are maintained along with an in-house loan administration accompanied by oversight and review procedures. The primary purpose of loan underwriting is the evaluation of specific lending risks and involves the analysis of the borrower's ability to service the debt as well as the assessment of the value of the underlying collateral. Oversight and review procedures include the monitoring of portfolio credit quality, early identification of potential problem credits and the aggressive management of problem credits. As part of the oversight and review process, the Company maintains an allowance for loan and lease losses (the "allowance").

The allowance represents an estimation of the losses that are inherent in the loan and lease portfolio. The adequacy of the allowance is determined through careful and ongoing evaluation of the credit portfolio, and involves consideration of a number of factors, as outlined below, to establish an adequate allowance for loan losses. Determination of the allowance is inherently subjective and requires significant estimates, including estimated losses on pools of homogeneous loans and leases based on historical loss experience and consideration of current economic trends, which may be susceptible to significant change. Loans and leases deemed uncollectible are charged against the allowance, while recoveries are credited to the allowance. Management adjusts the level of the allowance through the provision for loan and lease losses, which is recorded as a current period operating expense.

The methodology for assessing the appropriateness of the allowance includes: (1) a general allowance that reflects historical losses, as adjusted, by credit category, and (2) a specific allowance for impaired credits on an individual or portfolio basis. This methodology is further described in the section entitled "Critical Accounting Policies" and in "Note 1 Significant Accounting Policies" of the Notes to the Consolidated Financial Statements of the Company's 2012 Form 10-K. The amount of the allowance is reviewed monthly and approved quarterly by the Credit and Investment Risk



Committee of the board of directors.

The Company recognizes a collateral dependent lending relationship as non-performing when either the loan becomes 90 days delinquent or as a result of factors (such as bankruptcy, interruption of cash flows, etc.) considered at the monthly credit committee meeting. When a commercial loan is placed on non-accrual status, it is considered to be impaired and all accrued but unpaid interest is reversed. Classification as an impaired loan is based on a determination that the Company may not collect all principal and interest payments according to contractual terms. Impaired loans exclude large groups of smaller-balance homogeneous loans that are collectively evaluated for impairment such as leases, residential real estate and consumer loans. Typically, all payments received on non-accrual loans are applied to the remaining principal balance of the loans. Integral to the assessment of the allowance process is an evaluation that is performed to determine whether a specific allowance on an impaired loan is warranted and, when losses are confirmed, a charge-off is taken to reduce the loan to its net realizable value. Any further collateral deterioration results in either further specific allowances being established or additional charge-offs. At such time an action plan is agreed upon for the particular loan and an appraisal will be ordered depending on the time elapsed since the prior appraisal, the loan balance and/or the result of the internal evaluation. A current appraisal on large loans is usually obtained if the appraisal on file is more than 12 months old and there has been a material change in market conditions, zoning, physical use or the adequacy of the collateral based on an internal evaluation. The Company's policy is to strictly adhere to regulatory appraisal standards. If an appraisal is ordered, no more than a 30 day turnaround is requested from the appraiser, who is selected by Credit Administration from an approved appraiser list. After receipt of the updated appraisal, the assigned credit officer will recommend to the Chief Credit Officer whether a specific allowance or a charge-off should be taken. The Chief Credit Officer has the authority to approve a specific allowance or charge-off between monthly credit committee meetings to insure that there are no significant time lapses during this process.

The Company's methodology for evaluating whether a loan is impaired begins with risk-rating credits on an individual basis and includes consideration of the borrower's overall financial condition, payment record and available cash resources that may include the sufficiency of collateral value and, in a select few cases, verifiable support from financial guarantors. In measuring impairment, the Company looks primarily to the discounted cash flows of the project itself or to the value of the collateral as the primary sources of repayment of the loan. The Company may consider the existence of guarantees and the financial strength and wherewithal of the guarantors involved in any loan relationship. Guarantees may be considered as a source of repayment based on the guarantor's financial condition and respective payment capacity. Accordingly, absent a verifiable payment capacity, a guarantee alone would not be sufficient to avoid classifying the loan as impaired.

Management has established a credit process that dictates that structured procedures be performed to monitor these loans between the receipt of an original appraisal and the updated appraisal. These procedures include the following:

- An internal evaluation is updated quarterly to include borrower financial statements and/or cash flow projections.
- The borrower may be contacted for a meeting to discuss an updated or revised action plan which may include a request for additional collateral.
- Re-verification of the documentation supporting the Company's position with respect to the collateral securing the loan.
- At the monthly credit committee meeting the loan may be downgraded and a specific allowance may be decided upon in advance of the receipt of the appraisal.
- Upon receipt of the updated appraisal (or based on an updated internal financial evaluation) the loan balance is compared to the appraisal and a specific allowance is decided upon for the particular loan, typically for the amount of the difference between the appraisal and the loan balance.
- The Company will specifically reserve for or charge-off the excess of the loan amount over the amount of the appraisal. In certain cases the Company may establish a larger reserve due to knowledge of current market conditions or the existence of an offer for the collateral that will facilitate a more timely resolution of the loan.

If an updated appraisal is received subsequent to the preliminary determination of a specific allowance or partial charge-off, and it is less than the initial appraisal used in the initial charge-off, an additional specific allowance or charge-off is taken on the related credit. Partially charged-off loans are not written back up based on updated appraisals and always remain on non-accrual with any and all subsequent payments applied to the remaining balance of the loan as principal reductions. No interest income is recognized on loans that have been partially charged-off.

Loans that have their terms restructured (e.g., interest rates, loan maturity date, payment and amortization period, etc.) in circumstances that provide payment relief or other concessions, to a borrower experiencing financial difficulty are considered troubled debt restructured loans (TDR's). All restructurings that constitute concessions to a borrower experiencing financial difficulties are considered impaired loans and may either be in accruing status or non-accruing status. Non-accruing restructured loans may return to accruing status provided there is a sufficient period of payment performance in accordance with the restructure terms. Loans may be removed from disclosure as an impaired loan in the year subsequent to the restructuring if their revised loans terms are considered to be consistent with terms that can be obtained in the credit market for loans with comparable risk.



The Company may extend the maturity of a performing or current loan that may have some inherent weakness associated with the loan. However, the Company generally follows a policy of not extending maturities on non-performing loans under existing terms. Maturity date extensions only occur under revised terms that clearly place the Company in a position to increase the likelihood of or assure full collection of the loan under the contractual terms and /or terms at the time of the extension that may eliminate or mitigate the inherent weakness in the loan. These terms may incorporate, but are not limited to additional assignment of collateral, significant balance curtailments/liquidations and assignments of additional project cash flows. Guarantees may be a consideration in the extension of loan maturities. As a general matter, the Company does not view extension of a loan to be a satisfactory approach to resolving non-performing credits. On an exception basis, certain performing loans that have displayed some inherent weakness in the underlying collateral values, an inability to comply with certain loan covenants which are not affecting the performance of the credit or other identified weakness may be extended.

Collateral values or estimates of discounted cash flows (inclusive of any potential cash flow from guarantees) are evaluated to estimate the probability and severity of potential losses. The actual occurrence and severity of losses involving impaired credits can differ substantially from estimates.

The determination of the allowance requires significant judgment, and estimates of probable losses in the loan and lease portfolio can vary significantly from the amounts actually observed. While management uses available information to recognize probable losses, future additions to the allowance may be necessary based on changes in the credits comprising the portfolio and changes in the financial condition of borrowers, such as may result from changes in economic conditions. In addition, federal and state regulatory agencies, as an integral part of their examination process, and independent consultants engaged by the Bank, periodically review the loan and lease portfolio and the allowance. Such reviews may result in adjustments to the allowance based upon their analysis of the information available at the time of each examination.

The Company makes provisions for loan and lease losses in amounts necessary to maintain the allowance at an appropriate level, as established by use of the allowance methodology discussed above. The provision for loan and lease losses was a credit of \$1.7 million in the first nine months of 2013 compared to a charge of \$2.5 million in the first nine months of 2012. Historical net charge-offs represent a principal component in the application of the Company's allowance methodology. A continued decrease in the confirmed losses over the related historical period in addition to a decline in problem loans and recoveries of \$ 3.2 million in the third quarter of 2013 on commercial real estate credits, served to reduce the overall provision for the period.

Substantially all of the fixed-rate residential mortgage loans originated by the Company are sold in the secondary mortgage market. Concurrent with such sales, the Company is required to make customary representations and warranties to the purchasers about the mortgage loans and the manner in which they were originated. The related sale agreements grant the purchasers recourse back to the Company, which could require the Company to repurchase loans or to share in any losses incurred by the purchasers. This recourse exposure typically extends for a period of nine to eighteen months after the sale of the loan although the time frame for repurchase requests can extend for an indefinite period. Such transactions could be due to a number of causes including borrower fraud or early payment default. The Company has seen a very limited number of repurchase and indemnity demands from purchasers for such events and routinely monitors its exposure in this regard. The Company maintains a liability of \$0.5 million for probable losses due to repurchases. Given its lack of history as to losses of this type, the Company believes that this reserve is adequate.

#### **Allowance for Loan and Lease Losses**

During the first nine months of 2013, there were no changes in the Company's methodology for assessing the appropriateness of the allowance for loan and lease losses from the prior year. Variations can occur over time in the estimation of the adequacy of the allowance as a result of the credit performance of borrowers.

At September 30, 2013, total non-performing loans and leases were \$38.3 million, or 1.44% of total loans and leases, compared to \$57.9 million, or 2.29% of total loans and leases, at December 31, 2012. Timely recognition and aggressive management of problem credits has resulted in the significant reduction of the migration of these loans into non-accrual status during this period. The allowance represented 103% of non-performing loans and leases at September 30, 2013 as compared to 74% at December 31, 2012. The increase in this ratio was due primarily to the decline in non-performing loans and leases mentioned above. The allowance for loan and lease losses as a percent of total loans and leases was 1.48% at September 30, 2013 as compared to 1.70% at December 31, 2012. This decrease was due to a combination of a lower level of both non-performing loans and historical losses at September 30, 2013 compared to the prior year end.

Continued analysis of the actual loss history on the problem credits in 2012 and 2013 provided an indication that the coverage of the inherent losses on the problem credits was adequate. The Company continues to monitor the impact of the economic conditions on our commercial customers, the reduced inflow of non-accruals, lower inflow in criticized loans and the significant decline in early stage delinquencies. The improvement in these credit metrics supports management's outlook for continued improved credit quality performance.

The balance of impaired loans was \$31.1 million, with specific allowances of \$4.2 million against those loans at September 30, 2013, as compared to \$48.8 million with allowances of \$5.1 million, at December 31, 2012.

The Company's borrowers are concentrated in nine counties in Maryland, three counties in Virginia and in Washington D.C. Commercial and residential mortgages, including home equity loans and lines, represented 76% of total loans and leases at September 30, 2013 compared to 74% at December 31, 2012. Certain loan terms may create concentrations of credit risk and increase the Company's exposure to loss. These include terms that permit the deferral of principal payments or payments that are smaller than normal interest accruals (negative amortization); loans with high loan-to-value ratios; loans, such as option adjustable-rate mortgages, that may expose the borrower to future increases in repayments that are in excess of increases that would result solely from increases in market interest rates; and interest-only loans. The Company does not make loans that provide for negative amortization or option adjustable-rate mortgages.

**Summary of Loan and Lease Loss Experience**

The following table presents the activity in the allowance for loan and lease losses for the periods indicated:

(Dollars in thousands)	Nine Months Ended September 30, 2013	Year Ended December 31, 2012		
Analysis of Allowance for Loan Losses:				
Balance, January 1	\$ 42,957	\$ 49,426		
Provision (credit) for loan and lease losses	(1,670)	3,649		
Charge-offs:				
Commercial business	(2,405)	(1,022)		
Commercial real estate:				
Commercial acquisition, development and construction	-	(3,281)		
Commercial investor real estate	(4,744)	(3,690)		
Commercial owner occupied real estate	(229)	(1,174)		
Leasing	-	(8)		
Consumer	(1,327)	(1,298)		
Residential real estate:				
Residential mortgage	(829)	(2,107)		
Residential construction	(105)	(224)		
Total charge-offs	(9,639)	(12,804)		
Recoveries:				
Commercial business	692	1,548		
Commercial real estate:				
Commercial acquisition, development and construction	3,080	528		
Commercial investor real estate	3,347	97		
Commercial owner occupied real estate	332	38		
Leasing	10	23		
Consumer	160	227		
Residential real estate:				
Residential mortgage	144	213		
Residential construction	9	12		
Total recoveries	7,774	2,686		
Net charge-offs	(1,865)	(10,118)		
Balance at end of period	\$ 39,422	\$ 42,957		
Allowance for loan losses to loans	1.48	%	1.70	%
Annualized net charge-offs to average loans and leases	0.10	%	0.42	%

**Analysis of Credit Risk**

The following table presents information with respect to non-performing assets and 90-day delinquencies for the periods indicated:

(Dollars in thousands)	September 30, 2013	December 31, 2012
<b>Non-Performing Assets:</b>		
<b>Loans and leases 90 days past due:</b>		
Commercial business	\$ -	\$ 24
Commercial real estate:		
Commercial AD&C	-	-
Commercial investor real estate	-	-
Commercial owner occupied real estate	-	209
Leasing	-	-
Consumer	10	14
Residential real estate:		
Residential mortgage	-	-
Residential construction	-	-
Total loans and leases 90 days past due	10	247
<b>Non-accrual loans and leases:</b>		
Commercial business	4,050	4,611
Commercial real estate:		
Commercial AD&C	5,086	6,332
Commercial investor real estate	6,877	11,843
Commercial owner occupied real estate	4,202	13,681
Leasing	-	865
Consumer	2,004	2,410
Residential real estate:		
Residential mortgage	5,643	4,681
Residential construction	2,327	3,125
Total non-accrual loans and lease	30,189	47,548
Total restructured loans - accruing	8,054	10,110
Total non-performing loans and leases	38,253	57,905
Other assets and real estate owned (OREO)	1,662	5,926
Total non-performing assets	\$ 39,915	\$ 63,831

**Market Risk Management**

The Company's net income is largely dependent on its net interest income. Net interest income is susceptible to interest rate risk to the extent that interest-bearing liabilities mature or re-price on a different basis than interest-earning assets. When interest-bearing liabilities mature or re-price more quickly than interest-earning assets in a given period, a significant increase in market rates of interest could adversely affect net interest income. Similarly, when interest-earning assets mature or re-price more quickly than interest-bearing liabilities, falling interest rates could result in a decrease in net interest income. Net interest income is also affected by changes in the portion of interest-earning assets that are funded by interest-bearing liabilities rather than by other sources of funds, such as non-interest-bearing deposits and stockholders' equity.

The Company's interest rate risk management goals are (1) to increase net interest income at a growth rate consistent with the growth rate of total assets, and (2) to minimize fluctuations in net interest margin as a percentage of interest-earning assets. Management attempts to achieve these goals by balancing, within policy limits, the volume of



floating-rate liabilities with a similar volume of floating-rate assets; by keeping the average maturity of fixed-rate asset and liability contracts reasonably matched; by maintaining a pool of administered core deposits; and by adjusting pricing rates to market conditions on a continuing basis.

The Company's board of directors has established a comprehensive interest rate risk management policy, which is administered by management's Asset Liability Management Committee ("ALCO"). The policy establishes limits on risk, which are quantitative measures of the percentage change in net interest income (a measure of net interest income at risk) and the fair value of equity capital (a measure of economic value of equity or "EVE" at risk) resulting from a hypothetical change in U.S. Treasury interest rates for maturities from one day to thirty years. The Company measures the potential adverse impacts that changing interest rates may have on its short-term earnings, long-term value, and liquidity by employing simulation analysis through the use of computer modeling. The simulation model captures optionality factors such as call features and interest rate caps and floors imbedded in investment and loan portfolio contracts. As with any method of gauging interest rate risk, there are certain shortcomings inherent in the interest rate modeling methodology used by the Company. When interest rates change, actual movements in different categories of interest-earning assets and interest-bearing liabilities, loan prepayments, and withdrawals of time and other deposits, may deviate significantly from assumptions used in the model. Finally, the methodology does not measure or reflect the impact that higher rates may have on adjustable-rate loan customers' ability to service their debts, or the impact of rate changes on demand for loan, lease, and deposit products.

The Company prepares a current base case and eight alternative simulations at least once a quarter and reports the analysis to the board of directors. In addition, more frequent forecasts are produced when interest rates are particularly uncertain or when other business conditions so dictate.

The statement of condition is subject to quarterly testing for eight alternative interest rate shock possibilities to indicate the inherent interest rate risk. Average interest rates are shocked by +/- 100, 200, 300, and 400 basis points ("bp"), although the Company may elect not to use particular scenarios that it determines are impractical in a current rate environment. It is management's goal to structure the balance sheet so that net interest earnings at risk over a twelve-month period and the economic value of equity at risk do not exceed policy guidelines at the various interest rate shock levels.

The Company augments its quarterly interest rate shock analysis with alternative external interest rate scenarios on a monthly basis. These alternative interest rate scenarios may include non-parallel rate ramps and non-parallel yield curve twists. If a measure of risk produced by the alternative simulations of the entire balance sheet violates policy guidelines, ALCO is required to develop a plan to restore the measure of risk to a level that complies with policy limits within two quarters.

Measures of net interest income at risk produced by simulation analysis are indicators of an institution's short-term performance in alternative rate environments. These measures are typically based upon a relatively brief period, usually one year. They do not necessarily indicate the long-term prospects or economic value of the institution.

#### Estimated Changes in Net Interest Income

Change in Interest Rates:	+ 400 bp	+ 300 bp	+ 200 bp	+ 100 bp	- 100 bp	- 200 bp	-300 bp	-400 bp
Policy Limit	23.50 %	17.50 %	15.00 %	10.00 %	10.00 %	15.00 %	17.50 %	23.50 %
September 30, 2013	(4.29) %	(1.87) %	(0.24) %	(0.26) %	N/A	N/A	N/A	N/A
December 31, 2012	(1.02) %	0.56 %	1.26 %	0.51 %	N/A	N/A	N/A	N/A

As shown above, measures of net interest income at risk increased from December 31, 2012 at all rising interest rate shock scenarios. All measures remained well within prescribed policy limits.

The increase in the risk position with respect to net interest income from December 31, 2012 to September 30, 2013 was the result of the impact of longer durations on securities, a decline in the securities that repriced within one year, an

increase in fixed rated loans and the increase in short-term FHLB borrowings of \$115 million which resulted in a significant increase in interest expenses in all rising shock bands.

The measures of equity value at risk indicate the ongoing economic value of the Company by considering the effects of changes in interest rates on all of the Company's cash flows, and by discounting the cash flows to estimate the present value of assets and liabilities. The difference between these discounted values of the assets and liabilities is the economic value of equity, which, in theory, approximates the fair value of the Company's net assets.

## Estimated Changes in Economic Value of Equity (EVE)

Change in Interest Rates:	+ 400 bp	+ 300 bp	+ 200 bp	+ 100 bp	- 100 bp	- 200 bp	-300 bp	-400 bp
Policy Limit	35.00 %	25.00 %	20.00 %	10.00 %	10.00 %	20.00 %	25.00 %	35.00 %
September 30, 2013	(13.11) %	(6.45) %	(3.17) %	(0.97) %	N/A	N/A	N/A	N/A
December 31, 2012	(0.39) %	1.87 %	3.29 %	2.65 %	N/A	N/A	N/A	N/A

Measures of the economic value of equity (“EVE”) at risk increased from December 31, 2012 in all rising shock scenarios. The significant negative impact in EVE was driven by longer durations on securities, an increase in fixed rate loans and higher market rates coupled with shorter durations on FHLB Advances.

### Liquidity Management

Liquidity is measured by a financial institution's ability to raise funds through loan and lease repayments, maturing investments, deposit growth, borrowed funds, capital and the sale of highly marketable assets such as investment securities and residential mortgage loans. The Company's liquidity position, considering both internal and external sources available, exceeded anticipated short-term and long-term needs at September 30, 2013. Management considers core deposits, defined to include all deposits other than time deposits of \$100 thousand or more, to be a relatively stable funding source. Core deposits equaled 00% of total interest-earning assets at September 30, 2013. In addition, loan and lease payments, maturities, calls and pay downs of securities, deposit growth and earnings contribute a flow of funds available to meet liquidity requirements. In assessing liquidity, management considers operating requirements, the seasonality of deposit flows, investment, loan and deposit maturities and calls, expected funding of loans and deposit withdrawals, and the market values of available-for-sale investments, so that sufficient funds are available on short notice to meet obligations as they arise and to ensure that the Company is able to pursue new business opportunities.

Liquidity is measured using an approach designed to take into account, in addition to factors already discussed above, the Company's growth and mortgage banking activities. Also considered are changes in the liquidity of the investment portfolio due to fluctuations in interest rates. Under this approach, implemented by the Funds Management Subcommittee of ALCO under formal policy guidelines, the Company's liquidity position is measured weekly, looking forward at thirty day intervals from thirty (30) to three hundred sixty (360) days. The measurement is based upon the projection of funds sold or purchased position, along with ratios and trends developed to measure dependence on purchased funds and core growth. Resulting projections as of September 30, 2013, show short-term investments exceeding short-term borrowings by \$28 million over the subsequent 360 days. This projected excess of liquidity versus requirements provides the Company with flexibility in how it funds loans and other earning assets.

The Company also has external sources of funds, which can be drawn upon when required. The main sources of external liquidity are available lines of credit with the Federal Home Loan Bank of Atlanta and the Federal Reserve. The line of credit with the Federal Home Loan Bank of Atlanta totaled \$1.2 billion, of which \$789 million was available for borrowing based on pledged collateral, with \$520 million borrowed against it as of September 30, 2013. The line of credit at the Federal Reserve totaled \$372 million, all of which was available for borrowing based on pledged collateral, with no borrowings against it as of September 30, 2013. Other external sources of liquidity available to the Company in the form of unsecured lines of credit granted by correspondent banks totaled \$55 million at September 30, 2013, against which there were no outstanding borrowings. In addition, the Company had a secured line of credit with a correspondent bank of \$20 million as of September 30, 2013. Based upon its liquidity analysis, including external sources of liquidity available, management believes the liquidity position was appropriate at September 30, 2013.

The parent company (“Bancorp”) is a separate legal entity from the Bank and must provide for its own liquidity. In addition to its operating expenses, Bancorp is responsible for paying any dividends declared to its common shareholders and interest and principal on outstanding debt. Bancorp’s primary source of income is dividends received from the Bank. The amount of dividends that the Bank may declare and pay to Bancorp in any calendar year, without the receipt of prior approval from the Federal Reserve, cannot exceed net income for that year to date plus retained net income (as defined) for the preceding two calendar years. Based on this requirement, as of September 30, 2013, the Bank could have declared a dividend of \$63 million to Bancorp. At September 30, 2013, Bancorp had liquid assets of \$11 million.

Arrangements to fund credit products or guarantee financing take the form of loans commitments (including lines of credit on revolving credit structures) and letters of credit. Approvals for these arrangements are obtained in the same manner as loans. Generally, cash flows, collateral value and risk assessment are considered when determining the amount and structure of credit arrangements.

Commitments to extend credit in the form of consumer, commercial real estate and business at the dates indicated were as follows:

(In thousands)	September 30, 2013	December 31, 2012
Commercial	\$ 197,203	\$ 186,014
Real estate-development and construction	102,339	79,480
Real estate-residential mortgage	17,484	56,445
Lines of credit, principally home equity and business lines	711,598	667,186
Standby letters of credit	81,119	72,008
Total Commitments to extend credit and available credit lines	\$ 1,109,743	\$ 1,061,133

### **Item 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK**

See “Financial Condition - Market Risk and Interest Rate Sensitivity” in Management’s Discussion and Analysis of Financial Condition and Results of Operations, above, which is incorporated herein by reference.

### **Item 4. CONTROLS AND PROCEDURES**

The Company’s management, under the supervision and with the participation of the Company’s Chief Executive Officer and Chief Financial Officer, evaluated as of the last day of the period covered by this report, the effectiveness of the design and operation of the Company’s disclosure controls and procedures, as defined in Rule 13a-15 under the Securities Exchange Act of 1934. Based on that evaluation, the Chief Executive Officer and Chief Financial Officer concluded that the Company’s disclosure controls and procedures were effective. There were no changes in the Company’s internal controls over financial reporting (as defined in Rule 13a-15 under the Securities Act of 1934) during the nine months ended September 30, 2013, that have materially affected, or are reasonably likely to materially affect, the Company’s internal control over financial reporting.

#### **PART II - OTHER INFORMATION**

##### **Item 1. Legal Proceedings**

In the normal course of business, the Company becomes involved in litigation arising from the banking, financial and other activities it conducts. Management, after consultation with legal counsel, does not anticipate that the ultimate liability, if any, arising from these matters will have a material effect on the Company’s financial condition, operating results or liquidity.

##### **Item 1A. Risk Factors**

There have been no material changes in the risk factors as discussed in the 2012 Annual Report on Form 10-K.

##### **Item 2. Unregistered Sales of Equity Securities and Use of Proceeds**

The Company approved a stock repurchase program in August 2011 that permits the repurchase of up to 3% of the Company's outstanding shares of common stock or approximately 730,000 shares. Repurchases which will be conducted through open market purchases or privately negotiated transactions, will be made depending on market conditions and other factors. There were no repurchase transactions executed during the nine months ended September 30, 2013.

**Item 3. Defaults Upon Senior Securities** None

**Item 4. Mine Safety Disclosures** Not applicable

**Item 5. Other Information** - None

**Item 6. Exhibits**

- Exhibit 31(a) Certification of Chief Executive Officer
- Exhibit 31(b) Certification of Chief Financial Officer
- Exhibit 32 (a) Certification of Chief Executive Officer pursuant to 18 U.S. Section 1350
- Exhibit 32 (b) Certification of Chief Financial Officer pursuant to 18 U.S. Section 1350
- Exhibit 101 The following materials from the Sandy Spring Bancorp, Inc. Quarterly Report on Form 10-Q for the quarter end September 30, 2013 formatted in Extensible Business Reporting Language (XBRL): (i) the Condensed Consolidated Statements of Condition; (ii) The Condensed Consolidated Statements of Income; (iii) The Condensed Consolidated Statements of Comprehensive Income; (iv) The Condensed Consolidated Statements of Cash Flows; (v) The Condensed Consolidated Statements of Changes in Stockholders' Equity; (vi) related notes.



**Signatures**

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

SANDY SPRING BANCORP, INC.  
(Registrant)

By: /s/ Daniel J. Schrider  
Daniel J. Schrider  
President and Chief Executive Officer

Date: November 8, 2013

By: /s/ Philip J. Mantua  
Philip J. Mantua  
Executive Vice President and Chief Financial Officer

Date: November 8, 2013