**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, 2020

**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 0-22345

**SHORE BANCSHARES, INC.**
(Exact name of registrant as specified in its charter)

| | |
|---|---|
| Maryland | 52-1974638 |
| (State or Other Jurisdiction of Incorporation or Organization) | (I.R.S. Employer Identification No.) |
| 18 E. Dover Street, Easton, Maryland | 21601 |
| (Address of Principal Executive Offices) | (Zip Code) |

(410) 763-7800
Registrant's Telephone Number, Including Area Code

N/A
(Former name, former address and former fiscal year, if changed since last report)

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

| Title of each class | Trading Symbol(s) | Name of each exchange on which registered |
|---|---|---|
| Common Stock | SHBI | NASDAQ |

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 periods that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes ☒ No ☐

Indicate by check mark whether the registrant has submitted electronically every Interactive Data File required to be submitted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit 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.

| | | | |
|---|---|---|---|
| Large accelerated filer | ☐ | Accelerated filer | ☒ |
| Non-accelerated filer | ☐ | Smaller reporting company | ☒ |
| | | Emerging growth company | ☐ |

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act. ☐

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

The number of shares outstanding of the registrant's common stock as of November 6, 2020 was 12,034,530.

**INDEX**

## PART I – FINANCIAL INFORMATION

### Item 1. Financial Statements.

SHORE BANCSHARES, INC.
CONSOLIDATED BALANCE SHEETS
(Dollars in thousands, except per share amounts)

| | September 30, 2020 (Unaudited) | December 31, 2019 |
|---|---|---|
| **ASSETS** | | |
| Cash and due from banks | **$ 17,577** | $ 18,465 |
| Interest-bearing deposits with other banks | **138,885** | 76,506 |
| Cash and cash equivalents | **156,462** | 94,971 |
| Investment securities: | | |
| Available-for-sale, at fair value | **139,349** | 122,791 |
| Held to maturity, at amortized cost - fair value of $20,254 (2020) and $8,654 (2019) | **20,174** | 8,786 |
| Equity securities, at fair value | **1,396** | 1,342 |
| Restricted securities | **3,626** | 4,190 |
| | | |
| Loans | **1,423,965** | 1,248,654 |
| Less: allowance for credit losses | **(12,777)** | (10,507) |
| Loans, net | **1,411,188** | 1,238,147 |
| | | |
| Premises and equipment, net | **24,679** | 23,821 |
| Goodwill | **17,518** | 17,518 |
| Other intangible assets, net | **1,844** | 2,252 |
| Other real estate owned, net | **38** | 74 |
| Right-of-use assets | **4,769** | 4,771 |
| Other assets | **47,129** | 40,572 |
| TOTAL ASSETS | **$ 1,828,172** | $ 1,559,235 |
| | | |
| **LIABILITIES** | | |
| Deposits: | | |
| Noninterest-bearing | **$ 465,304** | $ 356,618 |
| Interest-bearing | **1,128,817** | 984,716 |
| Total deposits | **1,594,121** | 1,341,334 |
| | | |
| Securities sold under retail repurchase agreements | **1,019** | 1,226 |
| Advances from FHLB - long-term | **—** | 15,000 |
| Subordinated debt | **24,399** | — |
| Total borrowings | **25,418** | 16,226 |
| | | |
| Lease liabilities | **4,840** | 4,792 |
| Other liabilities | **4,912** | 4,081 |
| TOTAL LIABILITIES | **1,629,291** | 1,366,433 |
| | | |
| COMMITMENTS AND CONTINGENCIES | | |
| | | |
| STOCKHOLDERS' EQUITY | | |
| Common stock, par value $.01 per share; shares authorized - 35,000,000; shares issued and outstanding - 12,217,501 (2020) and 12,500,372 (2019) | **122** | 125 |
| Additional paid in capital | **58,090** | 61,045 |
| Retained earnings | **138,765** | 131,425 |
| Accumulated other comprehensive income | **1,904** | 207 |
| TOTAL STOCKHOLDERS' EQUITY | **198,881** | 192,802 |
| TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY | **$ 1,828,172** | $ 1,559,235 |

See accompanying notes to Consolidated Financial Statements.

SHORE BANCSHARES, INC.
CONSOLIDATED STATEMENTS OF INCOME (Unaudited)
(Dollars in thousands, except per share amounts)

| | For Three Months Ended September 30, 2020 | For Three Months Ended September 30, 2019 | For Nine Months Ended September 30, 2020 | For Nine Months Ended September 30, 2019 |
|---|---|---|---|---|
| **INTEREST INCOME** | | | | |
| Interest and fees on loans | **$ 14,139** | $ 14,100 | **$ 41,879** | $ 41,348 |
| Interest and dividends on investment securities: | | | | |
| Taxable | **730** | 870 | **2,087** | 2,755 |
| Interest on deposits with other banks | **33** | 223 | **216** | 499 |
| Total interest income | **14,902** | 15,193 | **44,182** | 44,602 |
| **INTEREST EXPENSE** | | | | |
| Interest on deposits | **1,470** | 2,288 | **5,085** | 6,439 |
| Interest on short-term borrowings | **1** | 117 | **4** | 475 |
| Interest on long-term borrowings | **148** | 108 | **261** | 321 |
| Total interest expense | **1,619** | 2,513 | **5,350** | 7,235 |
| **NET INTEREST INCOME** | **13,283** | 12,680 | **38,832** | 37,367 |
| Provision for credit losses | **1,500** | 200 | **2,850** | 500 |
| **NET INTEREST INCOME AFTER PROVISION FOR CREDIT LOSSES** | **11,783** | 12,480 | **35,982** | 36,867 |
| **NONINTEREST INCOME** | | | | |
| Service charges on deposit accounts | **647** | 990 | **2,057** | 2,952 |
| Trust and investment fee income | **381** | 383 | **1,119** | 1,140 |
| Gains on sales and calls of investment securities | **—** | — | **347** | — |
| Other noninterest income | **1,553** | 1,156 | **4,179** | 3,234 |
| Total noninterest income | **2,581** | 2,529 | **7,702** | 7,326 |
| **NONINTEREST EXPENSE** | | | | |
| Salaries and wages | **4,143** | 3,853 | **10,569** | 11,411 |
| Employee benefits | **1,489** | 1,299 | **4,746** | 3,621 |
| Occupancy expense | **774** | 697 | **2,174** | 2,056 |
| Furniture and equipment expense | **294** | 263 | **858** | 821 |
| Data processing | **1,114** | 972 | **3,195** | 2,801 |
| Directors' fees | **132** | 140 | **386** | 342 |
| Amortization of other intangible assets | **125** | 144 | **407** | 461 |
| FDIC insurance premium expense | **132** | — | **347** | 386 |
| Other real estate owned expenses, net | **—** | 133 | **18** | 426 |
| Legal and professional fees | **447** | 495 | **1,634** | 1,655 |
| Other noninterest expenses | **1,181** | 1,388 | **3,509** | 3,732 |
| Total noninterest expense | **9,831** | 9,384 | **27,843** | 27,712 |
| Income from continuing operations before income taxes | **4,533** | 5,625 | **15,841** | 16,481 |
| Income tax expense | **1,142** | 1,411 | **3,997** | 4,211 |
| **Income from continuing operations** | **3,391** | 4,214 | **11,844** | 12,270 |
| Loss from discontinued operations before income taxes | **—** | (10) | **—** | (113) |
| Income tax benefit | **—** | (2) | **—** | (27) |
| **Loss from discontinued operations** | **—** | (8) | **—** | (86) |
| **NET INCOME** | **$ 3,391** | $ 4,206 | **$ 11,844** | $ 12,184 |
| Earnings per common share - Basic and diluted | | | | |
| Income from continuing operations | **$ 0.27** | **$** 0.33 | **$ 0.95** | **$** 0.96 |
| Loss from discontinued operations | **—** | — | **—** | (0.01) |
| Net income | **$ 0.27** | **$** 0.33 | **$ 0.95** | **$** 0.95 |
| Dividends paid per common share | **$ 0.12** | **$** 0.10 | **$ 0.36** | **$** 0.30 |

See accompanying notes to Consolidated Financial Statements.

SHORE BANCSHARES, INC.
CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (Unaudited)
(Dollars in thousands)

| | For Three Months Ended September 30, | | For Nine Months Ended September 30, | |
|---|---|---|---|---|
| | **2020** | 2019 | **2020** | 2019 |
| Net income | **$ 3,391** | $ 4,206 | **$ 11,844** | $ 12,184 |
| | | | | |
| Other comprehensive (loss) income: | | | | |
| Investment securities: | | | | |
| Unrealized holding (losses) gains on available-for-sale-securities | **(141)** | 303 | **2,668** | 4,083 |
| Tax effect | **39** | (83) | **(723)** | (1,116) |
| | | | | |
| Reclassification of (gains) recognized in net income | **—** | — | **(347)** | — |
| Tax effect | **—** | — | **88** | — |
| | | | | |
| Amortization of unrealized loss on securities transferred from available-for-sale to held-to-maturity | **3** | 8 | **15** | 22 |
| Tax effect | **(1)** | (2) | **(4)** | (6) |
| Total other comprehensive (loss) income | **(100)** | 226 | **1,697** | 2,983 |
| Comprehensive income | **$ 3,291** | $ 4,432 | **$ 13,541** | $ 15,167 |

See accompanying notes to Consolidated Financial Statements.

SHORE BANCSHARES, INC.
CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY (Unaudited)
For the Three and Nine months Ended September 30, 2020 and 2019
(Dollars in thousands)

| | Common Stock | Additional Paid in Capital | Retained Earnings | Accumulated Other Comprehensive Income | Total Stockholders' Equity |
|---|---|---|---|---|---|
| **Balances, January 1, 2020** | $ 125 | $ 61,045 | $ 131,425 | $ 207 | $ 192,802 |
| Net income | — | — | 3,118 | — | 3,118 |
| Other comprehensive income | — | — | — | 1,251 | 1,251 |
| Stock-based compensation | — | 61 | — | — | 61 |
| Vesting of restricted stock, net of shares surrendered | — | (39) | — | — | (39) |
| Cash dividends declared | — | — | (1,499) | — | (1,499) |
| **Balances, March 31, 2020** | $ 125 | $ 61,067 | $ 133,044 | $ 1,458 | $ 195,694 |
| Net Income | — | — | 5,335 | — | 5,335 |
| Other comprehensive income | — | — | — | 546 | 546 |
| Stock-based compensation | — | 62 | — | — | 62 |
| Cash dividends declared | — | — | (1,503) | — | (1,503) |
| **Balances, June 30, 2020** | $ 125 | $ 61,129 | $ 136,876 | $ 2,004 | $ 200,134 |
| Net Income | — | — | 3,391 | — | 3,391 |
| Other comprehensive (loss) | — | — | — | (100) | (100) |
| Retirement of common stock | (3) | (3,106) | — | — | (3,109) |
| Stock-based compensation | — | 67 | — | — | 67 |
| Cash dividends declared | — | — | (1,502) | — | (1,502) |
| **Balances, September 30, 2020** | $ 122 | $ 58,090 | $ 138,765 | $ 1,904 | $ 198,881 |

| | Common Stock | Additional Paid in Capital | Retained Earnings | Accumulated Other Comprehensive Income (Loss) | Total Stockholders' Equity |
|---|---|---|---|---|---|
| Balances, January 1, 2019 | $ 127 | $ 65,434 | $ 120,574 | $ (2,950) | $ 183,185 |
| Net Income | — | — | 3,754 | — | 3,754 |
| Other comprehensive income | — | — | — | 1,446 | 1,446 |
| Stock-based compensation | — | 63 | — | — | 63 |
| Exercise of options and vesting of restricted stock, net of shares surrendered | 1 | (89) | — | — | (88) |
| Cash dividends declared | — | — | (1,278) | — | (1,278) |
| Balances, March 31, 2019 | $ 128 | $ 65,408 | $ 123,050 | $ (1,504) | $ 187,082 |
| Net Income | — | — | 4,224 | — | 4,224 |
| Other comprehensive income | — | — | — | 1,311 | 1,311 |
| Stock-based compensation | — | (32) | — | — | (32) |
| Cash dividends declared | — | — | (1,278) | — | (1,278) |
| Balances, June 30, 2019 | $ 128 | $ 65,376 | $ 125,996 | $ (193) | $ 191,307 |
| Net Income | — | — | 4,206 | — | 4,206 |
| Other comprehensive income | — | — | — | 226 | 226 |
| Retirement of Common Stock | (1) | (558) | - | - | (559) |
| Stock-based compensation | — | 61 | — | — | 61 |
| Cash dividends declared | — | — | (1,278) | — | (1,278) |
| Balances, September 30, 2019 | $ 127 | $ 64,879 | $ 128,924 | $ 33 | $ 193,963 |

See accompanying notes to Consolidated Financial Statements.

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SHORE BANCSHARES, INC.
CONSOLIDATED STATEMENTS OF CASH FLOWS (Unaudited)
(Dollars in thousands)

| | For Nine Months Ended September 30, 2020 | 2019 |
|---|---|---|
| **CASH FLOWS FROM OPERATING ACTIVITIES:** | **$ 11,844** | $ 12,184 |
| Net Income | | |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Net accretion of acquisition accounting estimates | **(307)** | (414) |
| Provision for credit losses | **2,850** | 500 |
| Depreciation and amortization | **1,793** | 1,779 |
| Net amortization of securities | **330** | 396 |
| Amortization of debt issuance costs | **10** | — |
| Stock-based compensation expense | **190** | 92 |
| Deferred income (benefit) tax expense | **(1,925)** | 266 |
| (Gains) on sales and calls of securities | **(347)** | — |
| Losses on sales and disposals of premises and equipment | **40** | — |
| Losses on sales and valuation adjustments on other real estate owned | **18** | 417 |
| Fair value adjustment on equity securities | **(34)** | (47) |
| Bank owned life insurance income | **(908)** | — |
| Net changes in: | | |
| Accrued interest receivable | **(3,930)** | (162) |
| Other assets | **(511)** | 1,267 |
| Accrued interest payable | **(11)** | (154) |
| Other liabilities | **471** | (6,865) |
| Net cash provided by operating activities | **9,573** | 9,259 |
| **CASH FLOWS FROM INVESTING ACTIVITIES:** | | |
| Proceeds from maturities and principal payments of investment securities available for sale | **33,272** | 19,211 |
| Proceeds from sales and calls of investment securities available for sale | **13,019** | — |
| Purchases of investment securities available for sale | **(60,500)** | — |
| Proceeds from maturities and principal payments of investment securities held to maturity | **205** | 281 |
| Purchases of securities held to maturity | **(11,589)** | (4,000) |
| Purchases of equity securities | **(20)** | (23) |
| Net change in loans | **(175,669)** | (39,817) |
| Purchases of premises and equipment | **(1,786)** | (1,995) |
| Proceeds from sales of premises and equipment | **2** | — |
| Proceeds from sales of other real estate owned | **18** | 731 |
| Net redemption of restricted securities | **564** | 1,821 |
| Purchases of bank owned life insurance | **—** | (14,586) |
| Net cash (used in) investing activities | **(202,484)** | (38,377) |
| | | |
| **CASH FLOWS FROM FINANCING ACTIVITIES:** | | |
| Net changes in: | | |
| Noninterest-bearing deposits | **108,686** | 32,091 |
| Interest-bearing deposits | **144,186** | 81,205 |
| Short-term borrowings | **(207)** | (43,549) |
| Long-term borrowings | **(15,000)** | — |
| Proceeds from the issuance of subordinated debt, net of issuance costs | **24,389** | — |
| Common stock dividends paid | **(4,504)** | (3,834) |
| Retirement of common stock | **(3,109)** | (559) |
| Repurchase of shares for tax withholding on exercised options and vested restricted stock | **(39)** | (88) |
| Net cash provided by financing activities | **254,402** | 65,266 |
| Net increase in cash and cash equivalents | **61,491** | 36,148 |
| Cash and cash equivalents at beginning of period | **94,971** | 67,225 |
| Cash and cash equivalents at end of period | **$ 156,462** | $ 103,373 |
| Supplemental cash flows information: | | |
| Interest paid | **$ 5,436** | $ 7,521 |
| Income taxes paid | **$ 6,378** | $ 10,812 |
| Lease liabilities arising from right-of-use assets | **$ 419** | $ 5,243 |
| Unrealized gain on securities available for sale | **$ 2,321** | **$** (4,083) |
| Amortization of unrealized loss on securities transferred from available for sale to held to maturity | **$ 15** | $ 22 |

See accompanying notes to Consolidated Financial Statements.

Shore Bancshares, Inc.
Notes to Consolidated Financial Statements
For the Three and Nine Months Ended September 30, 2020 and 2019
(Unaudited)

Note 1 – Basis of Presentation

The consolidated financial statements include the accounts of Shore Bancshares, Inc. and its subsidiary with all significant intercompany transactions eliminated. The consolidated financial statements conform to accounting principles generally accepted in the United States of America ("GAAP") and to prevailing practices within the banking industry. The accompanying interim financial statements are unaudited; however, in the opinion of management all adjustments necessary to present fairly the consolidated financial position at September 30, 2020, the consolidated results of income and comprehensive income for the three and nine months ended September 30, 2020 and 2019, changes in stockholders' equity for the three and nine months ended September 30, 2020 and 2019 and cash flows for the nine months ended September 30, 2020 and 2019, have been included. All such adjustments are of a normal recurring nature. The amounts as of December 31, 2019 were derived from the 2019 audited financial statements. The results of operations for the three and nine months ended September 30, 2020 are not necessarily indicative of the results to be expected for any other interim period or for the full year. This Quarterly Report on Form 10-Q should be read in conjunction with the Annual Report of Shore Bancshares, Inc. on Form 10-K for the year ended December 31, 2019. For purposes of comparability, certain immaterial reclassifications have been made to amounts previously reported to conform with the current period presentation.

When used in these notes, the term "the Company" refers to Shore Bancshares, Inc. and, unless the context requires otherwise, its consolidated subsidiary, Shore United Bank (the "Bank").

Risks and Uncertainties

The novel coronavirus ("COVID-19") spread rapidly across the world in the first quarter of 2020 and was declared a pandemic by the World Health Organization. The government and private sector responses to contain its spread began to significantly affect our operations in March and continues to do so. The pandemic will likely adversely affect our operations in subsequent quarters, although such effects may vary significantly. The duration and extent of the effects over longer terms cannot be reasonably estimated at this time. The risks and uncertainties resulting from the pandemic most likely to affect our future earnings, cash flows and financial condition in future quarters primarily include the nature and duration of the financial effects felt by our customers and the related impact on the customers' ability to fulfill their financial obligations to the Company as well as the potential decline of real estate values resulting from market disruption which may impair the recorded values of collateral-dependent loans. Further, these factors, in addition to those pervasive to the industry and overall U.S. economy, may negatively impact the overall value of our Company in such a way that an impairment charge to the carrying value of goodwill is required. Accordingly, significant estimates used in the preparation of our financial statements related to the allowance for credit losses and valuation of goodwill may be subject to significant adjustments in future periods. The greater the duration and severity of the pandemic the more likely that estimates will be materially impacted by its effects.

Recent Accounting Standards and Other Authoritative Guidance

ASU No. 2016-13 – In June 2016, the FASB issued ASU No. 2016-13, "Financial Instruments – Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments." The amendments in this ASU, among other things, require the measurement of all expected credit losses for financial assets held at the reporting date based on historical experience, current conditions, and reasonable and supportable forecasts. Financial institutions and other organizations will now use forward-looking information to better inform their credit loss estimates. Many of the loss estimation techniques applied today will still be permitted, although the inputs to those techniques will change to reflect the full amount of expected credit losses. In addition, the ASU amends the accounting for credit losses on available-for-sale debt securities and purchased financial assets with credit deterioration. At the FASB's October 16, 2019 meeting, the Board affirmed its decision to amend the effective date of this ASU for many companies. Public business entities that are SEC filers, excluding those meeting the smaller reporting company definition, will retain the initial required implementation date of fiscal years, and interim periods within those fiscal years, beginning after December 15, 2019. All other entities will be required to apply the guidance for fiscal years, and interim periods within those years, beginning after December 15, 2022. At this time, the Company has established a project management team which meets periodically to discuss and assign roles and responsibilities, key tasks to complete, and a general timeline to be followed for implementation. The team has been working with an advisory consultant and has purchased a vendor model for implementation. Historical data has been collected and uploaded to the new model and the team is in the process of finalizing the methodologies that will be utilized. The team is currently running a parallel simulation to its current incurred loss impairment model. The Company is continuing to evaluate the extent of the potential impact of this standard and continues to keep current on evolving interpretations and industry practices via webcasts, publications, conferences, and peer bank meetings.

Effective November 25, 2019, the SEC adopted Staff Accounting Bulletin (SAB) 119. SAB 119 updated portions of SEC interpretative guidance to align with FASB ASC 326, "Financial Instruments – Credit Losses." It covers topics including (1) measuring current expected credit losses; (2) development, governance, and documentation of a systematic methodology; (3) documenting the results of a systematic methodology; and (4) validating a systematic methodology.

ASU No. 2019-12 – In December 2019, the FASB issued ASU 2019-12, "Income Taxes (Topic 740) – Simplifying the Accounting for Income Taxes." The ASU is expected to reduce cost and complexity related to the accounting for income taxes by removing specific exceptions to general principles in Topic 740 (eliminating the need for an organization to analyze whether certain exceptions apply in a given period) and improving financial statement preparers' application of certain income tax-related guidance. This ASU is part of the FASB's simplification initiative to make narrow-scope simplifications and improvements to accounting standards through a series of short-term projects. For public business entities, the amendments are effective for fiscal years beginning after December 15, 2020, and interim periods within those fiscal years. Early adoption is permitted. The Company is currently assessing the impact that ASU 2019-12 will have on its consolidated financial statements.

ASU No. 2020-01 – In January 2020, the FASB issued ASU 2020-01, "Investments – Equity Securities (Topic 321), Investments – Equity Method and Joint Ventures (Topic 323), and Derivatives and Hedging (Topic 815) – Clarifying the Interactions between Topic 321, Topic 323, and Topic 815." The ASU is based on a consensus of the Emerging Issues Task Force and is expected to increase comparability in accounting for these transactions. ASU 2016-01 made targeted improvements to accounting for financial instruments, including providing an entity the ability to measure certain equity securities without a readily determinable fair value at cost, less any impairment, plus or minus changes resulting from observable price changes in orderly transactions for the identical or a similar investment of the same issuer. Among other topics, the amendments clarify that an entity should consider observable transactions that require it to either apply or discontinue the equity method of accounting. For public business entities, the amendments in the ASU are effective for fiscal years beginning after December 31, 2020, and interim periods within those fiscal years. Early adoption is permitted. The Company does not expect the adoption of ASU 2020-01 to have a material impact on its consolidated financial statements.

ASU No. 2020-04 – In March 2020, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) No. 2020-04 "Reference Rate Reform (Topic 848): Facilitation of the Effects of Reference Rate Reform on Financial Reporting." These amendments provide temporary optional guidance to ease the potential burden in accounting for reference rate reform. The ASU provides optional expedients and exceptions for applying generally accepted accounting principles to contract modifications and hedging relationships, subject to meeting certain criteria, that reference the London Inter-bank Offered Rate ("LIBOR") or another reference rate expected to be discontinued. It is intended to help stakeholders during the global market-wide reference rate transition period. The guidance is effective for all entities as of March 12, 2020 through December 31, 2022. At present, the Bank has limited exposure to LIBOR based pricing. LIBOR based loans only comprise 14 loans or 2.6% of the loan portfolio. The Bank is confident it can successfully negotiate a migration to the Secured Overnight Financing Rate ("SOFR") between now and the implementation date. The Bank will notify customers within 120 days prior to migration to SOFR. The Bank acknowledges the replacement rate will be more volatile based on different countries migrating to different indexes and limited liquidity to support the rate. The Bank further acknowledges the volatility will be greatly influenced by the support provided by the Federal Reserve.

On March 12, 2020, the SEC finalized amendments to its "accelerated filer" and "large accelerated filer" definitions. The amendments increase the threshold criteria for meeting these filer classifications and were effective on April 27, 2020. Any changes in filer status are to be applied beginning with the filer's first annual report filed with the SEC subsequent to the effective date. Prior to these changes, the Company was required to comply with section 404(b) of the Sarbanes Oxley Act concerning auditor attestation over internal control over financial reporting as an "accelerated filer" as it had more than $75 million in public float but less than $700 million at the end of the Company's most recent second quarter. The rule change expands the category of "smaller reporting companies" to include entities with public float of less than $700 million and less than $100 million in annual revenues. The Company expects to meet this expanded category of small reporting company and will no longer be considered an accelerated filer after the 2020 Annual Report. If the Company's annual revenues exceed $100 million, its category will change back to "accelerated filer". The classifications of "accelerated filer" and "large accelerated filer" require a public company to obtain an auditor attestation concerning the effectiveness of internal control over financial reporting ("ICFR") and include the opinion on ICFR in its annual report on Form 10-K. Smaller reporting companies also have additional time to file quarterly and annual financial statements. All public companies are required to obtain and file annual financial statement audits, as well as provide management's assertion on effectiveness of internal control over financial reporting, but the external auditor attestation of internal control over financial reporting is not required for smaller reporting companies. As the Bank has total assets exceeding $1.0 billion, it remains subject to FDICIA, which requires an auditor attestation concerning internal controls over financial reporting. As such, other than the additional time provided to file quarterly and annual financial statements, this change does not significantly change the Company's annual reporting and audit requirements.

In October 2020, the FASB issued ASU 2020-08, "Codification Improvements to Subtopic 310-20, Receivables – Nonrefundable fees and Other Costs." This ASU clarifies that an entity should reevaluate whether a callable debt security is within the scope of ASC paragraph 310-20-35-33 for each reporting period. For public business entities, the ASU is effective for fiscal years beginning after December 15, 2021, and interim periods within those fiscal years. Early adoption is not permitted. All entities should apply ASU No. 2020-08 on a prospective basis as of the beginning of the period of adoption for existing or newly purchased callable debt securities. The Company does not expect the adoption of ASU 2020-08 to have a material impact on its consolidated financial statements.

*Recently Adopted Accounting Developments*

In January 2017, the FASB issued ASU 2017-04, "Intangibles - Goodwill and Other (Topic 350) - Simplifying the Test for Goodwill Impairment" ("ASU 2017-04"). ASU 2017-04 simplifies the accounting for goodwill impairment for all entities by requiring impairment charges to be based on the first step in the previous two-step impairment test. Under the new guidance, if a reporting unit's carrying amount exceeds its fair value, an entity will record an impairment charge based on that difference. The impairment charge will be limited to the amount of goodwill allocated to that reporting unit. The standard eliminates the prior requirement to calculate a goodwill impairment charge using Step 2, which requires an entity to calculate any impairment charge by comparing the implied fair value of goodwill with its carrying amount. ASU 2017-04 was effective for the Company on January 1, 2020. There was no material impact on the Company's consolidated financial statements.

In March 2020, (Revised in April 2020) various regulatory agencies, including the Board of Governors of the Federal Reserve System and the Federal Deposit Insurance Corporation, ("the agencies") issued an interagency statement on loan modifications and reporting for financial institutions working with customers affected by COVID-19. The interagency statement was effective immediately and impacted accounting for loan modifications. Under Accounting Standards Codification 310-40, "Receivables – Troubled Debt Restructurings by Creditors," ("ASC 310-40"), a restructuring of debt constitutes a troubled debt restructuring ("TDR") if the creditor, for economic or legal reasons related to the debtor's financial difficulties, grants a concession to the debtor that it would not otherwise consider. The agencies confirmed with the staff of the FASB that short-term modifications made on a good faith basis in response to COVID-19 to borrowers who were current prior to any relief, are not to be considered TDRs. This includes short-term (e.g., six months) modifications such as payment deferrals, fee waivers, extensions of repayment terms, or other delays in payment that are insignificant. Borrowers considered current are those that are less than 30 days past due on their contractual payments at the time a modification program is implemented. During the nine months ended September 30, 2020, the Company has offered payment deferrals for commercial and consumer customers for up to six months. The loan modifications offered to specific loan types are as follows:

- Full payment-balloon or full amortization loans – Once the deferral period has ended, the Company will go back to billing principal and interest. As payments are made, all funds will go towards interest until all accrued interest has been caught up. Once the accrued interest is satisfied, future payments will be broken out for both principal and interest. The amount of principal that had been deferred will be re-amortized when the balloon maturity/payoff date occurs.
- Full payment ARM loans – Once the deferral period has ended, the Company will go back to billing principal and interest. As payments are made, all funds will go towards interest until all accrued interest has been caught up. Once the accrued interest is satisfied, future payments will be broken out for both principal and interest. The amount of principal that had been deferred will be re-amortized when the ARM repricing occurs.
- Full Payment Rate Reset Loans - Once the deferral period has ended, the Company will go back to billing principal and interest. As payments are made, all funds will go towards interest until all accrued interest has been caught up. Once the accrued interest is satisfied, future payments will be broken out for both principal and interest. The amount of principal that had been deferred will be re-amortized when the rate reset occurs.
- Principal deferral only loans (any type) - Once the deferral period has ended, the Company will go back to billing principal and interest. The principal amount that has been deferred will be re-amortized when either the maturity, ARM repricing or rate reset occurs.
- Consumer loans – Borrowers are required to sign an amendment to the initial loan agreement at the time of deferral, which re-amortizes the loan and extends the maturity date based on the number of months deferred.

This interagency guidance is expected to have a material impact on the Company’s financial statements; however, this impact cannot be quantified at this time.

Note 2 – Discontinued Operations

On December 31, 2018, the Company completed the sale of the specific assets and activities related to its insurance agency, Avon-Dixon Agency, LLC (“Avon-Dixon”) to Avon-Dixon, an Alera Group Agency, LLC (“Alera”). Also, on this date the Company discontinued the operations of its premium finance company, Mubell Finance, LLC (“Mubell”). Together, Avon-Dixon and Mubell are referred to as the “Insurance Subsidiaries”. The Insurance Subsidiaries represented the Company’s insurance products and services segment, the activities of which related to originating, servicing and underwriting retail insurance policies. Certain other assets and liabilities to be sold or settled separately within one year, were classified as discontinued operations in the Company’s consolidated financial statements. All of the remaining assets and liabilities of discontinued operations were settled prior to December 31, 2019.

There were no assets or liabilities of discontinued operations at September 30, 2020 or December 31, 2019. The following table presents the financial information of discontinued operations for the periods indicated:

| | For Nine Months Ended September 30, | |
|---|---|---|
| **($ in thousands)** | **2020** | 2019 |
| Noninterest income | | |
| All other income | **$** — | $ 15 |
| Total noninterest income | — | 15 |
| Noninterest expense | | |
| Salaries and wages | — | 28 |
| Employee benefits | — | 7 |
| Occupancy expense | — | 14 |
| Furniture and equipment | — | 1 |
| Legal and professional fees | — | 73 |
| Other noninterest expenses | — | 5 |
| Total noninterest expense | — | 128 |
| Loss from discontinued operations before income taxes | — | (113) |
| Income tax benefit | — | (27) |
| **Loss from discontinued operations** | **$** — | $ (86) |

Note 3 – Earnings Per Share

Basic earnings per common share is calculated by dividing net income available to common stockholders by the weighted average number of common shares outstanding during the period. Diluted earnings per common share is calculated by dividing net income available to common stockholders by the weighted average number of common shares outstanding during the period, adjusted for the dilutive effect of potential common stock equivalents (stock-based awards). The following table provides information relating to the calculation of earnings per common share:

| (In thousands, except per share data) | For the Three Months Ended September 30, 2020 | 2019 | For the Nine Months Ended September 30, 2020 | 2019 |
|---|---|---|---|---|
| Net income from continuing operations | **$ 3,391** | $ 4,214 | **$ 11,844** | $ 12,270 |
| Net loss from discontinued operations | **-** | (8) | **-** | (86) |
| Net Income | **$ 3,391** | $ 4,206 | **$ 11,844** | $ 12,184 |
| Weighted average shares outstanding - Basic | **12,483** | 12,764 | **12,507** | 12,771 |
| Dilutive effect of common stock equivalents-options | **1** | 5 | **2** | 5 |
| Weighted average shares outstanding - Diluted | **12,484** | 12,769 | **12,509** | 12,776 |
| | | | | |
| Basic earnings per common share | | | | |
| Income from continuing operations | **$ 0.27** | $ 0.33 | **$ 0.95** | $ 0.96 |
| Loss from discontinued operations | **—** | — | **—** | (0.01) |
| Net income | **$ 0.27** | $ 0.33 | **$ 0.95** | $ 0.95 |
| | | | | |
| Diluted earnings per common share | | | | |
| Income from continuing operations | **$ 0.27** | $ 0.33 | **$ 0.95** | $ 0.96 |
| Loss from discontinued operations | **—** | — | **—** | (0.01) |
| Net income | **$ 0.27** | $ 0.33 | **$ 0.95** | $ 0.95 |

There were no weighted average common stock equivalents excluded from the calculation of diluted earnings per share for the three and nine months ended September 30, 2020 and 2019.

Note 4 – Investment Securities

The following tables provide information on the amortized cost and estimated fair values of debt securities.

| (Dollars in thousands) | Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses | Estimated Fair Value |
|---|---|---|---|---|
| Available-for-sale securities: | | | | |
| **September 30, 2020** | | | | |
| U.S. Government agencies | **$ 24,661** | **$ 54** | **$ 83** | **$ 24,632** |
| Mortgage-backed | **112,068** | **2,730** | **81** | **114,717** |
| Total | **$ 136,729** | **$ 2,784** | **$ 164** | **$ 139,349** |
| | | | | |
| December 31, 2019 | | | | |
| U.S. Government agencies | $ 23,854 | $ 3 | $ 31 | $ 23,826 |
| Mortgage-backed | 98,638 | 574 | 247 | 98,965 |
| Total | $ 122,492 | $ 577 | $ 278 | $ 122,791 |

During the three months ended September 30, 2020, no available for sale securities were sold. During the nine months ended September 30, 2020, the Company sold available for sale securities for proceeds of $13.0 million and recognized gross gains of $347 thousand in the second quarter of 2020. No available for sale securities were sold during the three and nine months ended September 30, 2019.

| (Dollars in thousands) | Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses | Estimated Fair Value |
|---|---|---|---|---|
| Held-to-maturity securities: | | | | |
| **September 30, 2020** | | | | |
| U.S. Government agencies | **$ 1,195** | **$ 40** | **$ —** | **$ 1,235** |
| States and political subdivisions | **400** | **1** | **—** | **401** |
| Other debt securities | **18,579** | **79** | **40** | **18,618** |
| Total | **$ 20,174** | **$ 120** | **$ 40** | **$ 20,254** |
| | | | | |
| December 31, 2019 | | | | |
| U.S. Government agencies | $ 1,386 | $ — | $ 5 | $ 1,381 |
| States and political subdivisions | 400 | 1 | — | 401 |
| Other debt securities | 7,000 | — | 128 | 6,872 |
| Total | $ 8,786 | $ 1 | $ 133 | $ 8,654 |

Equity securities with an aggregate fair value of $1.4 million at September 30, 2020 and $1.3 million at December 31, 2019 are presented separately on the balance sheet. The fair value adjustment recorded through earnings totaled $34 thousand for the nine months ended September 30, 2020 and $47 thousand for the nine months ended September 30, 2019, respectively.

The following tables provide information about gross unrealized losses and fair value by length of time that the individual securities have been in a continuous unrealized loss position at September 30, 2020 and December 31, 2019.

| | Less than 12 Months | | More than 12 Months | | Total | |
|---|---|---|---|---|---|---|
| (Dollars in thousands) | Fair Value | Unrealized Losses | Fair Value | Unrealized Losses | Fair Value | Unrealized Losses |
| **September 30, 2020** | | | | | | |
| Available-for-sale securities: | | | | | | |
| U.S. Government agencies | **$ 14,919** | **$ 81** | **$ 397** | **$ 2** | **$ 15,316** | **$ 83** |
| Mortgage-backed | **24,734** | **81** | **—** | **—** | **24,734** | **81** |
| Total | **$ 39,653** | **$ 162** | **$ 397** | **$ 2** | **$ 40,050** | **$ 164** |
| | | | | | | |
| Held-to-maturity securities: | | | | | | |
| Other debt securities | **$ 6,511** | **$ 40** | **$ —** | **$ —** | **$ 6,511** | **$ 40** |
| Total | **$ 6,511** | **$ 40** | **$ —** | **$ —** | **$ 6,511** | **$ 40** |

| | Less than 12 Months | | More than 12 Months | | Total | |
|---|---|---|---|---|---|---|
| (Dollars in thousands) | Fair Value | Unrealized Losses | Fair Value | Unrealized Losses | Fair Value | Unrealized Losses |
| December 31, 2019 | | | | | | |
| Available-for-sale securities: | | | | | | |
| U.S. Government agencies | $ 4,995 | $ 5 | $ 18,516 | $ 26 | $ 23,511 | $ 31 |
| Mortgage-backed | 12,180 | 27 | 22,282 | 220 | 34,462 | 247 |
| Total | $ 17,175 | $ 32 | $ 40,798 | $ 246 | $ 57,973 | $ 278 |
| | | | | | | |
| Held-to-maturity securities: | | | | | | |
| U.S. Government agencies | $ 1,381 | $ 5 | $ — | $ — | $ 1,381 | $ 5 |
| Other debt securities | 3,905 | 95 | 2,967 | 33 | 6,872 | 128 |
| Total | $ 5,286 | $ 100 | $ 2,967 | $ 33 | $ 8,253 | $ 133 |

All of the securities with unrealized losses in the portfolio have modest duration risk, low credit risk, and minimal losses when compared to total amortized cost. The unrealized losses on debt securities that exist are the result of market changes in interest rates since original purchase. Because the Company does not intend to sell these securities and it is not more likely than not that the Company will be required to sell these securities before recovery of their amortized cost bases, which may be at maturity for debt securities, the Company considers the unrealized losses to be temporary. There were twelve available-for-sale securities and two held-to-maturity securities in an unrealized loss position at September 30, 2020.

The following table provides information on the amortized cost and estimated fair values of investment securities by maturity date at September 30, 2020.

| | Available for sale | | Held to maturity | |
|---|---|---|---|---|
| **(Dollars in thousands)** | **Amortized Cost** | **Fair Value** | **Amortized Cost** | **Fair Value** |
| Due in one year or less | $ 9,000 | $ 9,051 | $ — | $ — |
| Due after one year through five years | 1,610 | 1,664 | 2,951 | 2,927 |
| Due after five years through ten years | 57,727 | 59,491 | 16,028 | 16,092 |
| Due after ten years | 68,392 | 69,143 | 1,195 | 1,235 |
| Total | $ 136,729 | $ 139,349 | $ 20,174 | $ 20,254 |

The maturity dates for debt securities are determined using contractual maturity dates.

Note 5 – Loans and Allowance for Credit Losses

The Company makes residential mortgage, commercial and consumer loans to customers primarily in Talbot County, Queen Anne's County, Kent County, Caroline County, Dorchester County, Wicomico County, Baltimore County and Howard County in Maryland, Kent County, Delaware and Accomack County, Virginia. The following table provides information about the principal classes of the loan portfolio at September 30, 2020 and December 31, 2019.

| (Dollars in thousands) | **September 30, 2020** | December 31, 2019 |
|---|---|---|
| Construction | **$ 106,040** | $ 99,829 |
| Residential real estate | **442,140** | 442,506 |
| Commercial real estate | **629,641** | 586,562 |
| Commercial | **218,596** | 102,020 |
| Consumer | **27,548** | 17,737 |
| Total loans | **1,423,965** | 1,248,654 |
| Allowance for credit losses | **(12,777)** | (10,507) |
| Total loans, net | **$ 1,411,188** | $ 1,238,147 |

Loans are stated at their principal amount outstanding net of any purchase premiums/discounts, deferred fees and costs. Loans included deferred fees, net of costs, of $12 thousand and discounts on acquired loans of $825 thousand at September 30, 2020. Loans included deferred costs, net of deferred fees, of $1.8 million and discounts on acquired loans of $1.1 million at December 31, 2019. At September 30, 2020 and December 31, 2019, included in total loans were $60.2 million and $79.2 million in loans, respectively, acquired as part of the NWBI branch acquisition in 2017. Interest income on loans is accrued at the contractual rate based on the principal amount outstanding. Fees charged and costs capitalized for originating loans are being amortized substantially on the interest method over the term of the loan. A loan is placed on nonaccrual (i.e., interest income is no longer accrued) when it is specifically determined to be impaired or when principal or interest is delinquent for 90 days or more, unless the loan is well secured and in the process of collection. Any unpaid interest previously accrued on those loans is reversed from income.

Interest payments received on nonaccrual loans are applied as a reduction of the loan principal balance unless collectability of the principal amount is reasonably assured, in which case interest is recognized on a cash basis. Loans are returned to accrual status when all principal and interest amounts contractually due are brought current and future payments are reasonably assured.

A loan is considered impaired if it is probable that the Company will not collect all principal and interest payments according to the loan's contractual terms when due. An impaired loan may show deficiencies in the borrower's overall financial condition, payment history, support available from financial guarantors and/or the fair market value of collateral. The impairment of a loan is measured at the present value of expected future cash flows using the loan's effective interest rate, or at the loan's observable market price or the fair value of the collateral if the loan is collateral dependent. Generally, the Company measures impairment on such loans by reference to the fair value of the collateral. Once the amount of impairment has been determined, the uncollectible portion is charged off. Loan payments received on nonaccrual impaired loans are generally applied to the outstanding principal balance. In certain circumstances, income may be recognized on a cash basis. Generally, interest income is not recognized on impaired loans unless the likelihood of further loss is remote. The allowance for credit losses may include specific reserves related to impaired loans. Specific reserves remain until charge offs are made. Impaired loans do not include groups of smaller balance homogenous loans such as residential mortgage and consumer installment loans that are evaluated collectively for impairment. Reserves for probable credit losses related to these loans are based on historical loss ratios and are included in the formula portion of the allowance for credit losses.

A loan is considered a TDR if a borrower is experiencing financial difficulties and a creditor has granted a concession. Concessions may include interest rate reductions or below market interest rates, principal forgiveness, restructuring amortization schedules and other actions intended to minimize potential losses. Loans are identified to be restructured when signs of impairment arise such as borrower interest rate reduction request, slowness to pay, or when an inability to repay becomes evident. The terms being offered are evaluated to determine if they are more liberal than those that would be indicated by policy or industry standards for similar, untroubled credits. In those situations where the terms or the interest rates are considered to be more favorable than industry standards or the Bank's current underwriting guidelines the loan is classified as a TDR. All loans designated as TDRs are considered impaired loans and may be on either accrual or nonaccrual status. In instances where the loan has been placed on nonaccrual status, six consecutive months of timely payments are required prior to returning the loan to accrual status.

All loans classified as TDRs which are restructured and accrue interest under revised terms require a full and comprehensive review of the borrower's financial condition, capacity for repayment, realistic assessment of collateral values, and the assessment of risk entered into any workout agreement. Current financial information on the borrower, guarantor, and underlying collateral is analyzed to determine if it supports the ultimate collection of principal and interest. For commercial loans, the cash flows are analyzed, both for the underlying project and globally. For consumer loans, updated salary, credit history and cash flow information is obtained. Current market conditions are also considered. Following a full analysis, the determination of the appropriate loan structure is made.

In the normal course of banking business, risks related to specific loan categories are as follows:

Construction loans – Construction loans are offered primarily to builders and individuals to finance the construction of single-family dwellings. In addition, the Bank periodically finances the construction of commercial projects. Credit risk factors include the borrower's ability to successfully complete the construction on time and within budget, changing market conditions which could affect the value and marketability of projects, changes in the borrower's ability or willingness to repay the loan and potentially rising interest rates which can impact both the borrower's ability to repay and the collateral value.

Residential real estate – Residential real estate loans are typically made to consumers and are secured by residential real estate. Credit risk arises from the borrower's continuing financial stability, which can be adversely impacted by job loss, divorce, illness, or personal bankruptcy, among other factors. Also impacting credit risk would be a shortfall in the value of the residential real estate in relation to the outstanding loan balance in the event of a default or subsequent liquidation of the real estate collateral.

Commercial real estate – Commercial real estate loans consist of both loans secured by owner occupied properties and non-owner occupied properties where an established banking relationship exists and involves investment properties for warehouse, retail, and office space with a history of occupancy and cash flow. These loans are subject to adverse changes in the local economy and commercial real estate markets. Credit risk associated with owner occupied properties arises from the borrower's financial stability and the ability of the borrower and the business to repay the loan. Non-owner occupied properties carry the risk of a tenant's deteriorating credit strength, lease expirations in soft markets and sustained vacancies which can adversely impact cash flow.

Commercial – Commercial loans are secured or unsecured loans for business purposes. Loans are typically secured by accounts receivable, inventory, equipment and/or other assets of the business. Credit risk arises from the successful operation of the business which may be affected by competition, rising interest rates, regulatory changes and adverse conditions in the local and regional economy.

Consumer – Consumer loans include home equity loans and lines, installment loans and personal lines of credit. Credit risk is similar to residential real estate loans above as it is subject to the borrower's continuing financial stability and the value of the collateral securing the loan.

The following tables include impairment information relating to loans and the allowance for credit losses as of September 30, 2020 and December 31, 2019.

| (Dollars in thousands) | Construction | Residential real estate | Commercial real estate | Commercial | Consumer | Total |
|---|---|---|---|---|---|---|
| **September 30, 2020** | | | | | | |
| Loans individually evaluated for impairment | **$ 333** | **$ 6,216** | **$ 8,746** | **$ 283** | **$ 28** | **$ 15,606** |
| Loans collectively evaluated for impairment | **105,707** | **435,924** | **620,895** | **218,313** | **27,520** | **1,408,359** |
| Total loans | **$ 106,040** | **$ 442,140** | **$ 629,641** | **$ 218,596** | **$ 27,548** | **$ 1,423,965** |
| | | | | | | |
| Allowance for credit losses allocated to: | | | | | | |
| Loans individually evaluated for impairment | **$ —** | **$ 142** | **$ 81** | **$ 14** | **$ —** | **$ 237** |
| Loans collectively evaluated for impairment | **1,558** | **3,142** | **5,018** | **2,207** | **615** | **12,540** |
| Total allowance | **$ 1,558** | **$ 3,284** | **$ 5,099** | **$ 2,221** | **$ 615** | **$ 12,777** |

| (Dollars in thousands) | Construction | Residential real estate | Commercial real estate | Commercial | Consumer | Total |
|---|---|---|---|---|---|---|
| December 31, 2019 | | | | | | |
| Loans individually evaluated for impairment | $ 41 | $ 7,072 | $ 12,006 | $ 298 | $ — | $ 19,417 |
| Loans collectively evaluated for impairment | 99,788 | 435,434 | 574,556 | 101,722 | 17,737 | 1,229,237 |
| Total loans | $ 99,829 | $ 442,506 | $ 586,562 | $ 102,020 | $ 17,737 | $ 1,248,654 |
| | | | | | | |
| Allowance for credit losses allocated to: | | | | | | |
| Loans individually evaluated for impairment | $ — | $ 395 | $ 580 | $ — | $ — | $ 975 |
| Loans collectively evaluated for impairment | 1,576 | 2,106 | 3,452 | 1,929 | 469 | 9,532 |
| Total allowance | $ 1,576 | $ 2,501 | $ 4,032 | $ 1,929 | $ 469 | $ 10,507 |

In the first quarter of 2020, the Company transitioned from its in-house allowance model to an external vendor's allowance model software for the calculation of the allowance for loan losses. Prior to the adoption of the new model, the Company ran both models parallel for multiple periods to confirm the reasonableness of the new model's output as compared to the old. The primary motivation for the change was to increase efficiencies in the calculation of the allowance estimate under the current incurred loss standard and also allow for a more seamless transition for the

Company's eventual adoption of the Current Expected Credit Loss standard in 2023. The Company's processes for loan segmentation, assessing qualitative factors, and determining specific reserves for impaired loans remained substantially unchanged when comparing the models. As part of the new model, more precise averages are utilized in the calculation of the net charge-off ratios used in the historical loss analysis and the historical loss rates are applied to all pools of loans accounted for under ASC 450. Additionally, the historical look-back periods for retail loan pools were adjusted to four years in the new model as compared to two years under the prior in-house model. While there were some variances between loan pools when comparing the two models, the Company's ending recorded allowance and provision for loan losses during the first three quarters of 2020 were not materially impacted as a result of the transition.

The following tables provide information on impaired loans and any related allowance by loan class as of September 30, 2020 and December 31, 2019. The difference between the unpaid principal balance and the recorded investment is the amount of partial charge-offs that have been taken and interest paid on nonaccrual loans that has been applied to principal.

| | | | | | September 30, 2020 | | |
|---|---|---|---|---|---|---|---|
| (Dollars in thousands) | Unpaid principal balance | Recorded investment with no allowance | Recorded investment with an allowance | Related allowance | Quarter-to-date average recorded investment | Year-to-date average recorded investment | Interest recorded investment |
| **September 30, 2020** | | | | | | | |
| Impaired nonaccrual loans: | | | | | | | |
| Construction | $ 297 | $ 297 | $ — | $ — | $ 297 | $ 231 | $ — |
| Residential real estate | 2,103 | 2,031 | — | — | 2,306 | 2,910 | — |
| Commercial real estate | 5,357 | 4,260 | 67 | 67 | 4,498 | 6,235 | — |
| Commercial | 420 | 269 | 14 | 14 | 355 | 429 | — |
| Consumer | 28 | 28 | — | — | 9 | 3 | — |
| Total | $ 8,205 | $ 6,885 | $ 81 | $ 81 | $ 7,465 | $ 9,808 | $ — |
| Impaired accruing TDRs: | | | | | | | |
| Construction | $ 36 | $ 36 | $ — | $ — | $ 37 | $ 38 | $ 2 |
| Residential real estate | 3,878 | 2,530 | 1,348 | 142 | 3,886 | 3,940 | 120 |
| Commercial real estate | 3,353 | 2,704 | 649 | 14 | 3,357 | 3,379 | 70 |
| Commercial | — | — | — | — | — | — | — |
| Consumer | — | — | — | — | — | — | — |
| Total | $ 7,267 | $ 5,270 | $ 1,997 | $ 156 | $ 7,280 | $ 7,357 | $ 192 |
| Other impaired accruing loans: | | | | | | | |
| Construction | $ — | $ — | $ — | $ — | $ — | $ 33 | $ — |
| Residential real estate | 307 | 307 | — | — | 389 | 393 | 1 |
| Commercial real estate | 1,066 | 1,066 | — | — | 830 | 854 | 3 |
| Commercial | — | — | — | — | 42 | 18 | — |
| Consumer | — | — | — | — | 19 | 12 | — |
| Total | $ 1,373 | $ 1,373 | $ — | $ — | $ 1,280 | $ 1,310 | $ 4 |
| Total impaired loans: | | | | | | | |
| Construction | $ 333 | $ 333 | $ — | $ — | $ 334 | $ 302 | $ 2 |
| Residential real estate | 6,288 | 4,868 | 1,348 | 142 | 6,581 | 7,243 | 121 |
| Commercial real estate | 9,776 | 8,030 | 716 | 81 | 8,685 | 10,468 | 73 |
| Commercial | 420 | 269 | 14 | 14 | 397 | 447 | — |
| Consumer | 28 | 28 | — | — | 28 | 15 | — |
| Total | $ 16,845 | $ 13,528 | $ 2,078 | $ 237 | $ 16,025 | $ 18,475 | $ 196 |

| (Dollars in thousands) | Unpaid principal balance | Recorded investment with no allowance | Recorded investment with an allowance | Related allowance | September 30, 2019 Quarter-to-date average recorded investment | Year-to-date average recorded investment | Interest income recognized |
|---|---|---|---|---|---|---|---|
| December 31, 2019 | | | | | | | |
| Impaired nonaccrual loans: | | | | | | | |
| Construction | $ — | $ — | $ — | $ — | $ — | $ 1,435 | $ — |
| Residential real estate | 2,660 | 678 | 1,797 | 215 | 2,642 | 2,904 | — |
| Commercial real estate | 8,242 | 5,680 | 2,137 | 561 | 10,221 | 9,717 | — |
| Commercial | 421 | 298 | — | — | 310 | 316 | — |
| Consumer | — | — | — | — | — | — | — |
| Total | $ 11,323 | $ 6,656 | $ 3,934 | $ 776 | $ 13,173 | $ 14,372 | $ — |
| | | | | | | | |
| Impaired accruing TDRs: | | | | | | | |
| Construction | $ 41 | $ 41 | $ — | $ — | $ 44 | $ 47 | $ 9 |
| Residential real estate | 4,041 | 2,583 | 1,458 | 180 | 4,052 | 4,193 | 130 |
| Commercial real estate | 3,419 | 2,748 | 671 | 19 | 3,479 | 3,515 | 93 |
| Commercial | — | — | — | — | — | — | — |
| Consumer | — | — | — | — | — | — | — |
| Total | $ 7,501 | $ 5,372 | $ 2,129 | $ 199 | $ 7,575 | $ 7,755 | $ 232 |
| | | | | | | | |
| Other impaired accruing loans: | | | | | | | |
| Construction | $ — | $ — | $ — | $ — | $ 72 | $ 24 | $ — |
| Residential real estate | 556 | 556 | — | — | 373 | 188 | 2 |
| Commercial real estate | 770 | 770 | — | — | 515 | 349 | 2 |
| Commercial | — | — | — | — | 43 | 21 | 1 |
| Consumer | — | — | — | — | 2 | 4 | — |
| Total | $ 1,326 | $ 1,326 | $ — | $ — | $ 1,005 | $ 586 | $ 5 |
| | | | | | | | |
| Total impaired loans: | | | | | | | |
| Construction | $ 41 | $ 41 | $ — | $ — | $ 116 | $ 1,506 | $ 9 |
| Residential real estate | 7,257 | 3,817 | 3,255 | 395 | 7,067 | 7,285 | 132 |
| Commercial real estate | 12,431 | 9,198 | 2,808 | 580 | 14,215 | 13,581 | 95 |
| Commercial | 421 | 298 | — | — | 353 | 337 | 1 |
| Consumer | — | — | — | — | 2 | 4 | — |
| Total | $ 20,150 | $ 13,354 | $ 6,063 | $ 975 | $ 21,753 | $ 22,713 | $ 237 |

The following tables provide a roll-forward for TDRs as of September 30, 2020 and September 30, 2019.

| (Dollars in thousands) | 1/1/2020 TDR Balance | New TDRs | Disbursements (Payments) | Charge-offs | Reclassifications/ Transfer In/(Out) | Payoffs | 9/30/2020 TDR Balance | Related Allowance |
|---|---|---|---|---|---|---|---|---|
| **For nine months ended September 30, 2020** | | | | | | | | |
| Accruing TDRs | | | | | | | | |
| Construction | **$ 41** | **$ —** | **$ (5)** | **$ —** | **$ —** | **$ —** | **$ 36** | **$ —** |
| Residential real estate | **4,041** | **—** | **(80)** | **—** | **—** | **(83)** | **3,878** | **142** |
| Commercial real estate | **3,419** | **—** | **(66)** | **—** | **—** | **—** | **3,353** | **14** |
| Commercial | **—** | **—** | **—** | **—** | **—** | **—** | **—** | **—** |
| Consumer | **—** | **—** | **—** | **—** | **—** | **—** | **—** | **—** |
| Total | **$ 7,501** | **$ —** | **$ (151)** | **$ —** | **$ —** | **$ (83)** | **$ 7,267** | **$ 156** |
| Nonaccrual TDRs | | | | | | | | |
| Construction | **$ —** | **$ —** | **$ —** | **$ —** | **$ —** | **$ —** | **$ —** | **$ —** |
| Residential real estate | **1,393** | **—** | **(51)** | **—** | **—** | **(1,342)** | **—** | **—** |
| Commercial real estate | **—** | **1,506** | **(401)** | **—** | **—** | **—** | **1,105** | **—** |
| Commercial | **299** | **—** | **(30)** | **—** | **—** | **—** | **269** | **—** |
| Consumer | **—** | **—** | **—** | **—** | **—** | **—** | **—** | **—** |
| Total | **$ 1,692** | **$ 1,506** | **$ (482)** | **$ —** | **$ —** | **$ (1,342)** | **$ 1,374** | **$ —** |
| Total | **$ 9,193** | **$ 1,506** | **$ (633)** | **$ —** | **$ —** | **$ (1,425)** | **$ 8,641** | **$ 156** |

| (Dollars in thousands) | 1/1/2019 TDR Balance | New TDRs | Disbursements (Payments) | Charge-offs | Reclassifications/ Transfer In/(Out) | Payoffs | 9/30/2019 TDR Balance | Related Allowance |
|---|---|---|---|---|---|---|---|---|
| For nine months ended September 30, 2019 | | | | | | | | |
| Accruing TDRs | | | | | | | | |
| Construction | $ 51 | $ — | $ (8) | $ — | $ — | $ — | $ 43 | $ — |
| Residential real estate | 4,454 | 41 | (73) | — | — | (353) | 4,069 | 185 |
| Commercial real estate | 4,158 | — | (682) | — | — | — | 3,476 | 22 |
| Commercial | — | — | — | — | — | — | — | — |
| Consumer | — | — | — | — | — | — | — | — |
| Total | $ 8,663 | $ 41 | $ (763) | $ — | $ — | $ (353) | $ 7,588 | $ 207 |
| Nonaccrual TDRs | | | | | | | | |
| Construction | $ 2,798 | $ — | $ (1,379) | $ (3) | $ — | $ — | $ 1,416 | $ 133 |
| Residential real estate | — | — | — | — | — | — | — | — |
| Commercial real estate | — | — | — | — | — | — | — | — |
| Commercial | 320 | — | (12) | — | — | — | 308 | 4 |
| Consumer | — | — | — | — | — | — | — | — |
| Total | $ 3,118 | $ — | $ (1,391) | $ (3) | $ — | $ — | $ 1,724 | $ 137 |
| Total | $ 11,781 | $ 41 | $ (2,154) | $ (3) | $ — | $ (353) | $ 9,312 | $ 344 |

There were no loans modified and considered TDRs during the three months ended September 30, 2020 and 2019. The following tables provide information on loans that were modified and considered TDRs during the nine months ended September 30, 2020 and September 30, 2019.

| (Dollars in thousands) | Number of contracts | Premodification outstanding recorded investment | Postmodification outstanding recorded investment | Related allowance |
|---|---|---|---|---|
| TDRs: | | | | |
| **For nine months ended September 30, 2020** | | | | |
| Construction | **—** | **$ —** | **$ —** | **$ —** |
| Residential real estate | **—** | **—** | **—** | **—** |
| Commercial real estate | **1** | **1,535** | **1,162** | **—** |
| Commercial | **—** | **—** | **—** | **—** |
| Consumer | **—** | **—** | **—** | **—** |
| Total | **1** | **$ 1,535** | **$ 1,162** | **$ —** |
| | | | | |
| For nine months ended September 30, 2019 | | | | |
| Construction | — | $ — | $ — | $ — |
| Residential real estate | **1** | **75** | **41** | **—** |
| Commercial real estate | — | — | — | — |
| Commercial | — | — | — | — |
| Consumer | — | — | — | — |
| Total | 1 | $ 75 | $ 41 | $ — |

For the nine months ended September 30, 2020, the Company had executed principal and/or interest deferrals on outstanding loan balances of $221.1 million, of which only $12.9 million remained on deferral as of September 30, 2020. These deferrals were no more than six months in duration and were for loans not more than 30 days past due as of December 31, 2019. As such, they were not considered TDRs based on the relief provisions of the CARES Act and recent interagency regulatory guidance.

There were no TDRs which subsequently defaulted within 12 months of modification for the three and nine months ended September 30, 2020 and 2019. Generally, a loan is considered in default when principal or interest is past due 90 days or more, the loan is placed on nonaccrual, the loan is charged off, or there is a transfer to OREO or repossessed assets.

Management uses risk ratings as part of its monitoring of the credit quality in the Company’s loan portfolio. Loans that are identified as special mention, substandard or doubtful are adversely rated. These loans and the pass/watch loans are assigned higher qualitative factors than favorably rated loans in the calculation of the formula portion of the allowance for credit losses. At September 30, 2020, there were no nonaccrual loans classified as special mention or doubtful and $7.0 million of nonaccrual loans were classified as substandard. Similarly, at December 31, 2019, there were no nonaccrual loans classified as special mention or doubtful and $10.6 million of nonaccrual loans were classified as substandard.

The following tables provide information on loan risk ratings as of September 30, 2020 and December 31, 2019.

| (Dollars in thousands) | Pass/Performing | Pass/Watch | Special Mention | Substandard | Doubtful | Total |
|---|---|---|---|---|---|---|
| **September 30, 2020** | | | | | | |
| Construction | **$ 84,506** | **$ 19,196** | **$ 2,041** | **$ 297** | **$ —** | **$ 106,040** |
| Residential real estate | **398,950** | **36,426** | **4,095** | **2,669** | **—** | **442,140** |
| Commercial real estate | **492,816** | **122,104** | **5,598** | **9,123** | **—** | **629,641** |
| Commercial | **187,876** | **27,247** | **3,174** | **299** | **—** | **218,596** |
| Consumer | **27,250** | **265** | **—** | **33** | **—** | **27,548** |
| Total | **$ 1,191,398** | **$ 205,238** | **$ 14,908** | **$ 12,421** | **$ —** | **$ 1,423,965** |

| (Dollars in thousands) | Pass/Performing | Pass/Watch | Special Mention | Substandard | Doubtful | Total |
|---|---|---|---|---|---|---|
| December 31, 2019 | | | | | | |
| Construction | $ 84,357 | $ 13,068 | $ 2,404 | $ — | $ — | $ 99,829 |
| Residential real estate | 404,500 | 29,223 | 5,549 | 3,234 | — | 442,506 |
| Commercial real estate | 455,388 | 115,190 | 4,822 | 11,162 | — | 586,562 |
| Commercial | 80,816 | 20,130 | 746 | 328 | — | 102,020 |
| Consumer | 17,347 | 383 | 2 | 5 | — | 17,737 |
| Total | $ 1,042,408 | $ 177,994 | $ 13,523 | $ 14,729 | $ — | $ 1,248,654 |

The following tables provide information on the aging of the loan portfolio as of September 30, 2020 and December 31, 2019.

| | Accruing | | | | | | |
|---|---|---|---|---|---|---|---|
| (Dollars in thousands) | Current | 30-59 days past due | 60-89 days past due | Greater than 90 days | Total past due | Nonaccrual | Total |
| **September 30, 2020** | | | | | | | |
| Construction | **$ 105,743** | **$ —** | **$ —** | **$ —** | **$ —** | **$ 297** | **$ 106,040** |
| Residential real estate | **438,917** | **240** | **645** | **307** | **1,192** | **2,031** | **442,140** |
| Commercial real estate | **623,256** | **992** | **—** | **1,066** | **2,058** | **4,327** | **629,641** |
| Commercial | **218,297** | **16** | **—** | **—** | **16** | **283** | **218,596** |
| Consumer | **27,519** | **—** | **1** | **—** | **1** | **28** | **27,548** |
| Total | **$ 1,413,732** | **$ 1,248** | **$ 646** | **$ 1,373** | **$ 3,267** | **$ 6,966** | **$ 1,423,965** |
| Percent of total loans | **99.3 %** | **0.1 %** | **— %** | **0.1 %** | **0.2 %** | **0.5 %** | **100.0 %** |

| | Accruing | | | | | | |
|---|---|---|---|---|---|---|---|
| (Dollars in thousands) | Current | 30-59 days past due | 60-89 days past due | Greater than 90 days | Total past due | Nonaccrual | Total |
| December 31, 2019 | | | | | | | |
| Construction | $ 99,234 | $ 595 | $ — | $ — | $ 595 | $ — | $ 99,829 |
| Residential real estate | 435,671 | 3,021 | 783 | 556 | 4,360 | 2,475 | 442,506 |
| Commercial real estate | 577,015 | 743 | 217 | 770 | 1,730 | 7,817 | 586,562 |
| Commercial | 101,476 | 246 | — | — | 246 | 298 | 102,020 |
| Consumer | 17,680 | 57 | — | — | 57 | — | 17,737 |
| Total | $ 1,231,076 | $ 4,662 | $ 1,000 | $ 1,326 | $ 6,988 | $ 10,590 | $ 1,248,654 |
| Percent of total loans | 98.6 % | 0.4 % | 0.1 % | 0.1 % | 0.6 % | 0.8 % | 100.0 % |

The following tables provide a summary of the activity in the allowance for credit losses allocated by loan class for the three and nine months ended September 30, 2020 and September 30, 2019. Allocation of a portion of the allowance to one loan class does not preclude its availability to absorb losses in other loan classes.

| (Dollars in thousands) | Construction | Residential real estate | Commercial real estate | Commercial | Consumer | Total |
|---|---|---|---|---|---|---|
| **For three months ended September 30, 2020** | | | | | | |
| Allowance for credit losses: | | | | | | |
| Beginning Balance | **$ 1,497** | **$ 2,639** | **$ 4,097** | **$ 2,355** | **$ 502** | **$ 11,090** |
| Charge-offs | **—** | **(10)** | **(1)** | **(89)** | **(1)** | **(101)** |
| Recoveries | **5** | **199** | **1** | **81** | **2** | **288** |
| Net (charge-offs) recoveries | **5** | **189** | **—** | **(8)** | **1** | **187** |
| Provision | **56** | **456** | **1,002** | **(126)** | **112** | **1,500** |
| Ending Balance | **$ 1,558** | **$ 3,284** | **$ 5,099** | **$ 2,221** | **$ 615** | **$ 12,777** |

| (Dollars in thousands) | Construction | Residential real estate | Commercial real estate | Commercial | Consumer | Total |
|---|---|---|---|---|---|---|
| For three months ended September 30, 2019 | | | | | | |
| Allowance for credit losses: | | | | | | |
| Beginning Balance | $ 2,443 | $ 2,155 | $ 3,367 | $ 2,057 | $ 283 | $ 10,305 |
| Charge-offs | — | (86) | — | (98) | — | (184) |
| Recoveries | 1 | 12 | 7 | 96 | 1 | 117 |
| Net (charge-offs) recoveries | 1 | (74) | 7 | (2) | 1 | (67) |
| Provision | (903) | 600 | 474 | (39) | 68 | 200 |
| Ending Balance | $ 1,541 | $ 2,681 | $ 3,848 | $ 2,016 | $ 352 | $ 10,438 |

| (Dollars in thousands) | Construction | Residential real estate | Commercial real estate | Commercial | Consumer | Total |
|---|---|---|---|---|---|---|
| **For nine months ended September 30, 2020** | | | | | | |
| Allowance for credit losses: | | | | | | |
| Beginning Balance | **$ 1,576** | **$ 2,501** | **$ 4,032** | **$ 1,929** | **$ 469** | **$ 10,507** |
| Charge-offs | **—** | **(201)** | **(601)** | **(208)** | **(8)** | **(1,018)** |
| Recoveries | **13** | **206** | **—** | **205** | **14** | **438** |
| Net (charge-offs) recoveries | **13** | **5** | **(601)** | **(3)** | **6** | **(580)** |
| Provision | **(31)** | **778** | **1,668** | **295** | **140** | **2,850** |
| Ending Balance | **$ 1,558** | **$ 3,284** | **$ 5,099** | **$ 2,221** | **$ 615** | **$ 12,777** |

| (Dollars in thousands) | Construction | Residential real estate | Commercial real estate | Commercial | Consumer | Total |
|---|---|---|---|---|---|---|
| For nine months ended September 30, 2019 | | | | | | |
| Allowance for credit losses: | | | | | | |
| Beginning Balance | $ 2,662 | $ 2,353 | $ 3,077 | $ 1,949 | $ 302 | $ 10,343 |
| Charge-offs | (3) | (509) | — | (260) | (29) | (801) |
| Recoveries | 8 | 23 | 114 | 248 | 3 | 396 |
| Net (charge-offs) recoveries | 5 | (486) | 114 | (12) | (26) | (405) |
| Provision | (1,126) | 814 | 657 | 79 | 76 | 500 |
| Ending Balance | $ 1,541 | $ 2,681 | $ 3,848 | $ 2,016 | $ 352 | $ 10,438 |

Foreclosure Proceedings

Consumer mortgage loans collateralized by residential real estate property that were in the process of foreclosure totaled $23 thousand as of September 30, 2020 and December 31, 2019, respectively. There were no residential real estate properties included in the balance of other real estate owned at September 30, 2020 and December 31, 2019.

All accruing TDRs were in compliance with their modified terms. Both performing and non-performing TDRs had no further commitments associated with them as of September 30, 2020 and December 31, 2019.

Note 6 – Leases

On January 1, 2019, the Company adopted ASU No. 2016-02 *"Leases (Topic 842)"* and all subsequent ASUs that modified Topic 842. The Company elected the prospective application approach provided by ASU 2018-11 and did not adjust prior periods for ASC 842. The Company also elected certain practical expedients within the standard and consistent with such elections did not reassess whether any expired or existing contracts are or contain leases, did not reassess the lease classification for any expired or existing leases, and did not reassess any initial direct costs for existing leases. As stated in the Company's 2019 Form 10-K, the implementation of the new standard resulted in recognition of right-of-use assets and lease liabilities totaling $3.8 million at the date of adoption, which are primarily related to the Company's lease of premises used in operations. During the course of 2019, the Company recognized additional right-of-use assets and lease liabilities of $1.4 million, primarily related to the lease of additional premises used in operations. During the first quarter of 2020, the Company renewed its copier lease for all locations which added approximately $419 thousand to right-of-use assets and lease liabilities.

Lease liabilities represent the Company's obligation to make lease payments and are presented at each reporting date as the net present value of the remaining contractual cash flows. Cash flows are discounted at the Company's incremental borrowing rate in effect at the commencement date of the lease. Right-of-use assets represent the Company's right to use the underlying asset for the lease term and are calculated as the sum of the lease liability and if applicable, prepaid rent, initial direct costs and any incentives received from the lessor.

The Company's long-term lease agreements are classified as operating leases. Certain leases offer the option to extend the lease term and the Company has included such extensions in its calculation of the lease liabilities to the extent the options are reasonably certain of being exercised. The lease agreements do not provide for residual value guarantees and have no restrictions or covenants that would impact dividends or require incurring additional financial obligations.

The following tables present information about the Company's leases:

| (Dollars in thousands) | September 30, 2020 | December 31, 2019 |
|---|---|---|
| Lease liabilities | $ 4,840 | $ 4,792 |
| Right-of-use assets | $ 4,769 | $ 4,771 |
| Weighted average remaining lease term | 10.73 years | 11.76 years |
| Weighted average discount rate | 2.94 % | 3.13 % |

| Lease cost (in thousands) | For the three months ended September 30, 2020 | For the nine months ended September 30, 2020 |
|---|---|---|
| Operating lease cost | $ 177 | $ 534 |
| Short-term lease cost | — | — |
| Total lease cost | $ 177 | $ 534 |
| | | |
| Cash paid for amounts included in the measurement of lease liabilities | $ 168 | $ 498 |

A maturity analysis of operating lease liabilities and reconciliation of the undiscounted cash flows to the total of operating lease liabilities is as follows:

| Lease payments due (in thousands) | As of September 30, 2020 |
|---|---|
| Three months ending December 31, 2020 | 164 |
| Twelve months ending December 31, 2021 | $ 637 |
| Twelve months ending December 31, 2022 | 633 |
| Twelve months ending December 31, 2023 | 606 |
| Twelve months ending December 31, 2024 | 558 |
| Twelve months ending December 31, 2025 | 427 |
| Thereafter | 2,853 |
| Total undiscounted cash flows | $ 5,878 |
| Discount | 1,038 |
| Lease liabilities | $ 4,840 |

Note 7 – Goodwill and Other Intangibles

Due to the COVID-19 pandemic and its impact on market conditions, the Company performed a qualitative assessment of goodwill as of September 30, 2020. As a result of management's qualitative evaluation of relevant events and circumstances as of September 30, 2020, the Company concluded that it was not more likely than not that fair value was less than carrying value. In addition, the Company will complete a full annual assessment of goodwill in the fourth quarter of 2020. Changes in the economic environment, operations, or other adverse events could result in future impairment charges which could have a material adverse impact on the Company's operating results. The following table provides information on the significant components of goodwill and other acquired intangible assets at September 30, 2020 and December 31, 2019.

| | September 30, 2020 | | | | |
|---|---|---|---|---|---|
| (Dollars in thousands) | Gross Carrying Amount | Accumulated Impairment Charges | Accumulated Amortization | Net Carrying Amount | Weighted Average Remaining Life (in years) |
| Goodwill | **$ 19,728** | **$ (1,543)** | **$ (667)** | **$ 17,518** | **—** |
| Other intangible assets | | | | | |
| Amortizable | | | | | |
| Core deposit intangible | **$ 3,954** | **$ —** | **$ (2,110)** | **$ 1,844** | **4.7** |
| Total other intangible assets | **$ 3,954** | **$ —** | **$ (2,110)** | **$ 1,844** | |

| | December 31, 2019 | | | | |
|---|---|---|---|---|---|
| (Dollars in thousands) | Gross Carrying Amount | Accumulated Impairment Charges | Accumulated Amortization | Net Carrying Amount | Weighted Average Remaining Life (in years) |
| Goodwill | $ 19,728 | $ (1,543) | $ (667) | $ 17,518 | — |
| Other intangible assets | | | | | |
| Amortizable | | | | | |
| Core deposit intangible | $ 3,954 | $ — | $ (1,702) | $ 2,252 | 5.7 |
| Total other intangible assets | $ 3,954 | $ — | $ (1,702) | $ 2,252 | |

The aggregate amortization expense included in continuing operations was $407 thousand for the nine months ended September 30, 2020 and $461 thousand for the nine months ended September 30, 2019.

At September 30, 2020, estimated future remaining amortization for amortizing intangibles within the years ending December 31, is as follows:

| (Dollars in thousands) | Amortization Expense |
|---|---|
| 2020 | $ 126 |
| 2021 | 461 |
| 2022 | 389 |
| 2023 | 317 |
| 2024 | 246 |
| 2025 | 174 |
| Thereafter | 131 |
| Total amortizing intangible assets | $ 1,844 |

Note 8 – Other Assets

The Company had the following other assets at September 30, 2020 and December 31, 2019.

| (Dollars in thousands) | September 30, 2020 | December 31, 2019 |
|---|---|---|
| Accrued interest receivable | $ 7,385 | $ 3,455 |
| Deferred income taxes | 4,041 | 2,754 |
| Prepaid expenses | 1,692 | 1,157 |
| Cash surrender value on life insurance | 30,690 | 29,782 |
| Income taxes receivable | 398 | 175 |
| Other assets | 2,923 | 3,249 |
| Total | $ 47,129 | $ 40,572 |

The following table provides information on significant components of the Company's deferred tax assets and liabilities as of September 30, 2020 and December 31, 2019.

| (Dollars in thousands) | September 30, 2020 | December 31, 2019 |
|---|---|---|
| Deferred tax assets: | | |
| Allowance for credit losses | $ 3,453 | $ 2,850 |
| Write-downs of other real estate owned | 2 | 9 |
| Nonaccrual loan interest | 411 | 353 |
| Unrealized losses on available-for-sale securities transferred to held to maturity | — | 4 |
| Other | 2,162 | 735 |
| Total deferred tax assets | 6,028 | 3,951 |
| Less valuation allowance | (120) | (63) |
| Deferred tax assets net of valuation allowance | 5,908 | 3,888 |
| Deferred tax liabilities: | | |
| Depreciation | 163 | 198 |
| Acquisition accounting adjustments | 669 | 508 |
| Deferred capital gain on branch sale | 188 | 194 |
| Unrealized gains on available-for-sale securities | 708 | 74 |
| Other | 139 | 160 |
| Total deferred tax liabilities | 1,867 | 1,134 |
| Net deferred tax assets | $ 4,041 | $ 2,754 |

Note 9 - Subordinated Debt

On August 25, 2020, the Company entered into Subordinated Note Purchase Agreements with certain Purchasers pursuant to which the Company issued and sold $25.0 million in aggregate principal amount with an initial interest rate of 5.375% Fixed-to-Floating Rate Subordinated Notes due September 1, 2030.

The Company plans to use the net proceeds of this offering for general corporate purposes, organic growth and to support the Bank's regulatory capital ratios. The Notes were structured to qualify as Tier 2 capital for regulatory capital purposes and bear an initial interest rate of 5.375% until September 1, 2025, with interest during this period payable semi-annually in arrears. From and including September 1, 2025, to but excluding the maturity date or early redemption date, the interest rate will reset quarterly to an annual floating rate equal to three-month SOFR, plus 526.5 basis points, with interest during this period payable quarterly in arrears. The Notes are redeemable by the Company at its option, in whole or in part, on or after September 1, 2025. Initial debt issuance costs were $611 thousand. The debt balance of $24.4 million is presented net of unamortized issuance costs of $601 thousand at September 30, 2020.

Note 10 – Other Liabilities

The Company had the following other liabilities at September 30, 2020 and December 31, 2019.

| (Dollars in thousands) | September 30, 2020 | December 31, 2019 |
|---|---|---|
| Accrued interest payable | $ 319 | $ 330 |
| Deferred compensation liability | 2,478 | 1,401 |
| Income taxes payable | — | — |
| Other liabilities | 2,115 | 2,350 |
| Total | $ 4,912 | $ 4,081 |

Note 11 - Stock-Based Compensation

At the 2016 annual meeting, stockholders approved the Shore Bancshares, Inc. 2016 Stock and Incentive Plan ("2016 Equity Plan"), replacing the Shore Bancshares, Inc. 2006 Stock and Incentive Plan ("2006 Equity Plan"), which expired on that date. The Company may issue shares of common stock or grant other equity-based awards pursuant to the 2016 Equity Plan. Stock-based awards granted to date generally are time-based, vest in equal installments on each anniversary of the grant date and range over a one- to five-year period of time, and, in the case of stock options, expire 10 years from the grant date. As part of the 2016 Equity Plan, a performance equity incentive award program, known as the "Long-term incentive plan" allows participating officers of the Company to earn incentive awards of performance share/restricted stock units if certain pre-determined targets are achieved at the end of a three-year performance cycle. Stock-based compensation expense based on the grant date fair value is recognized ratably over the requisite service period for all awards and reflects forfeitures as they occur. The 2016 Equity Plan originally reserved 750,000 shares of common stock for grant, and 611,664 shares remained available for grant at September 30, 2020.

The following tables provide information on stock-based compensation expense for the three and nine months ended September 30, 2020 and 2019.

| | For Three Months Ended September 30, | | For Nine Months Ended September 30, | |
|---|---|---|---|---|
| (Dollars in thousands) | 2020 | 2019 | 2020 | 2019 |
| Stock-based compensation expense | $ 67 | $ 61 | $ 190 | $ 92 |
| Excess tax benefits related to stock-based compensation | — | 2 | 11 | 5 |

| | September 30, | |
|---|---|---|
| (Dollars in thousands) | 2020 | 2019 |
| Unrecognized stock-based compensation expense | $ 143 | $ 90 |
| Weighted average period unrecognized expense is expected to be recognized | 0.5 years | 0.5 years |

The following table summarizes restricted stock award activity for the Company under the 2016 Equity Plan for the nine months ended September 30, 2020.

| | Nine Months Ended September 30, 2020 | |
|---|---|---|
| | Number of Shares | Weighted Average Grant Date Fair Value |
| Nonvested at beginning of period | 15,702 | $ 15.36 |
| Granted | 24,800 | 13.76 |
| Vested | (15,702) | 15.36 |
| Forfeited | (902) | 16.25 |
| Nonvested at end of period | 23,898 | $ 13.76 |

The fair value of restricted stock awards that vested during the first nine months of 2020 and 2019 was $254 thousand and $0, respectively.

Restricted stock units ("RSUs") are similar to restricted stock, except the recipient does not receive the stock immediately, but instead receives it upon the terms and conditions of the Company's long-term incentive plans which are subject to performance milestones achieved at the end of a three-year period. Each RSU cliff vests at the end of the three-year period and entitles the recipient to receive one share of common stock on a specified issuance date. The recipient does not have any stockholder rights, including voting rights, with respect to the shares underlying awarded RSUs until the recipient becomes the holder of those shares.

During 2017, the Company entered into a long-term incentive plan agreement with officers of the Company and its subsidiaries to award RSUs based on a performance metric to be achieved as of December 31, 2019. Based on the results for the year ended December 31, 2019, 6,451 shares were vested.

The following table summarizes restricted stock units activity at the end of the performance cycle for the Company under the 2016 Equity Plan for the nine months ended September 30, 2020.

| | **Nine Months Ended September 30, 2020** | |
|---|---|---|
| | Number of Shares | Weighted Average Grant Date Fair Value |
| Outstanding at beginning of period | **6,451** | **$ 16.57** |
| Granted | — | — |
| Vested | **(6,451)** | **16.57** |
| Forfeited | — | — |
| Outstanding at end of period | — | **$** — |

The fair value of restricted stock units that vested during the first nine months of 2020 and 2019 was $107 thousand and $241 thousand, respectively.

The following table summarizes stock option activity for the Company under the 2016 Equity Plan for the nine months ended September 30, 2020.

| | **Nine Months Ended September 30, 2020** | |
|---|---|---|
| | Number of Shares | Weighted Average Grant Date Exercise Price |
| Outstanding at beginning of period | **11,671** | **$ 9.25** |
| Granted | — | — |
| Exercised | — | — |
| Expired/Cancelled | — | — |
| Outstanding at end of period | **11,671** | **$ 9.25** |
| Exercisable at end of period | **11,671** | **$ 9.25** |

There were no stock options granted during the three and nine months ended September 30, 2020 and September 30, 2019.

At the end of the third quarter of 2020, the aggregate intrinsic value of the options outstanding under the 2016 Equity Plan was $20 thousand based on the $10.98 market value per share of the Company's common stock at September 30, 2020. Similarly, the aggregate intrinsic value of the options exercisable was $20 thousand at September 30, 2020. At September 30, 2020, the weighted average remaining contract life of options outstanding and exercisable was 4.1 years.

Note 12 – Accumulated Other Comprehensive Income

The Company records unrealized holding gains (losses), net of tax, on investment securities available for sale as accumulated other comprehensive income (loss), a separate component of stockholders' equity. The following table provides information on the changes in the components of accumulated other comprehensive income (loss) for the nine months ended September 30, 2020 and 2019.

| (Dollars in thousands) | Unrealized gains (losses) on available for sale securities | Unrealized gains (losses) on securities transferred from Available-for-sale to Held-to-maturity | Accumulated other comprehensive income (loss) |
|---|---|---|---|
| Balance, December 31, 2019 | **$ 218** | **$ (11)** | **$ 207** |
| Other comprehensive income before reclassifications | **1,945** | **11** | **1,956** |
| Reclassification of gains recognized | **(259)** | **—** | **(259)** |
| Balance, September 30, 2020 | **$ 1,904** | **$ —** | **$ 1,904** |
| | | | |
| Balance, December 31, 2018 | $ (2,918) | $ (32) | $ (2,950) |
| Other comprehensive income | 2,967 | 16 | 2,983 |
| Balances, September 30, 2019 | $ 49 | $ (16) | $ 33 |

Note 13 – Fair Value Measurements

Accounting guidance under GAAP defines fair value as the exchange price that would be received for an asset or paid to transfer a liability (an exit price) in the principal or most advantageous market for the asset or liability in an orderly transaction between market participants on the measurement date. This accounting guidance also establishes a fair value hierarchy, which requires an entity to maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair value.

The Company uses fair value measurements to record fair value adjustments to certain assets and liabilities and to determine fair value disclosures. Securities available for sale are recorded at fair value on a recurring basis. Additionally, from time to time, the Company may be required to record at fair value other assets on a nonrecurring basis, such as impaired loans, loans held for sale and other real estate owned (foreclosed assets). These nonrecurring fair value adjustments typically involve application of lower of cost or market accounting or write-downs of individual assets.

Under fair value accounting guidance, assets and liabilities are grouped at fair value in three levels, based on the markets in which the assets and liabilities are traded and the reliability of the assumptions used to determine their fair values. These hierarchy levels are:

Level 1 inputs – Unadjusted quoted prices in active markets for identical assets or liabilities that the entity has the ability to access at the measurement date.

Level 2 inputs – Inputs other than quoted prices included in Level 1 that are observable for the asset or liability, either directly or indirectly. These might include quoted prices for similar assets or liabilities in active markets, and inputs other than quoted prices that are observable for the asset or liability, such as interest rates and yield curves that are observable at commonly quoted intervals.

Level 3 inputs – Unobservable inputs for determining the fair values of assets or liabilities that reflect an entity's own assumptions about the assumptions that market participants would use in pricing the assets or liabilities.

Below is a discussion on the Company's assets measured at fair value on a recurring basis.

Investment Securities Available for Sale

Fair value measurement for investment securities available for sale is based on quoted prices from an independent pricing service. The fair value measurements consider observable data that may include present value of future cash flows, prepayment assumptions, credit loss assumptions and other factors. The Company classifies its investments in U.S. Treasury securities, if any, as Level 1 in the fair value hierarchy, and it classifies its investments in U.S. Government agencies securities and mortgage-backed securities issued or guaranteed by U.S. Government sponsored entities as Level 2.

Equity Securities

Fair value measurement for equity securities is based on quoted market prices retrieved by the Company via on-line resources. Although these securities have readily available fair market values, the Company determined that they should be classified as level 2 investments in the fair value hierarchy due to not being considered traded in a highly active market.

The tables below present the recorded amount of assets measured at fair value on a recurring basis at September 30, 2020 and December 31, 2019. No assets were transferred from one hierarchy level to another during the first nine months of 2020 or 2019.

| (Dollars in thousands) | Fair Value | Quoted Prices (Level 1) | Significant Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) |
|---|---|---|---|---|
| **September 30, 2020** | | | | |
| Securities available for sale: | | | | |
| U.S. Government agencies | **$ 24,632** | **$ —** | **$ 24,632** | **$ —** |
| Mortgage-backed | **114,717** | **—** | **114,717** | **—** |
| | **139,349** | **—** | **139,349** | **—** |
| Equity | **1,396** | **—** | **1,396** | **—** |
| Total | **$ 140,745** | **$ —** | **$ 140,745** | **$ —** |

| (Dollars in thousands) | Fair Value | Quoted Prices (Level 1) | Significant Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) |
|---|---|---|---|---|
| December 31, 2019 | | | | |
| Securities available for sale: | | | | |
| U.S. Government agencies | $ 23,826 | $ — | $ 23,826 | $ — |
| Mortgage-backed | 98,965 | — | 98,965 | — |
| | 122,791 | — | 122,791 | — |
| Equity | 1,342 | — | 1,342 | — |
| Total | $ 124,133 | $ — | $ 124,133 | $ — |

Below is a discussion on the Company's assets measured at fair value on a nonrecurring basis.

Impaired Loans

Loans are considered impaired when, based on current information and events, it is probable that the Company will be unable to collect all amounts according to the contractual terms of the loan agreement when due. 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 and these are considered Level 3 in the fair value hierarchy. 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, discounted 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 the 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 (Foreclosed Assets)

Foreclosed assets are adjusted for fair value upon transfer of loans to foreclosed assets establishing a new cost basis. Subsequently, foreclosed assets are carried at the lower of carrying value or fair value. The estimated fair value for foreclosed assets included in Level 3 are determined by independent market based appraisals and other available market information, less costs 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 the initial recognition, the Company records the foreclosed asset as a non-recurring Level 3 adjustment. Valuation techniques are consistent with those techniques applied in prior periods.

The following tables set forth the Company's financial and nonfinancial assets subject to fair value adjustments (impairment) on a nonrecurring basis at September 30, 2020 and December 31, 2019, 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.

| | Quantitative Information about Level 3 Fair Value Measurements | | | | |
|---|---|---|---|---|---|
| (Dollars in thousands) | Fair Value | Valuation Technique | Unobservable Input | Range | Weighted Average (3) |
| **September 30, 2020 Nonrecurring measurements:** | | | | | |
| Impaired loans | $ **610** | Appraisal of collateral | (1)Liquidation expense (2) | 10% | (10%) |
| Impaired loans | $ **1,231** | Discounted cash flow analysis | (1)Discount rate | 4% - 7.25% | (6%) |
| Other real estate owned | $ **38** | Appraisal of collateral | (1)Appraisal adjustments (2) | 0% - 19% | (19%) |

| (Dollars in thousands) | Fair Value | Valuation Technique | | Unobservable Input | | Range |
|---|---|---|---|---|---|---|
| | Quantitative Information about Level 3 Fair Value Measurements | | | | | |
| **December 31, 2019** | | | | | | |
| **Nonrecurring measurements:** | | | | | | |
| Impaired loans | $ 2,489 | Appraisal of collateral | (1) | Liquidation expense | (2) | 10% |
| | | | | | | |
| Impaired loans | $ 2,599 | Discounted cash flow analysis | (1) | Discount rate | | 4% - 7.25% |
| | | | | | | |
| Other real estate owned | $ 74 | Appraisal of collateral | (1) | Appraisal adjustments | (2) | 0% - 31% |
| | | | | Liquidation expense | (2) | 10% |

(1) Fair value is generally determined through independent appraisals of the underlying collateral (impaired loans and OREO) or discounted cash flow analyses (impaired loans), which generally include various level III inputs which are not identifiable.
(2) Appraisals may be adjusted by management for qualitative factors such as economic conditions and estimated liquidation expenses. The range and weighted average of liquidation expenses and other appraisal adjustments are presented as a percent of the appraisal.
(3) Unobservable inputs were weighted by the relative fair value of the instruments.

The carrying amounts and estimated fair values of the Company's financial instruments not carried at fair value on the Company's Consolidated Balance Sheets are presented in the following table. Fair values for September 30, 2020 and December 31, 2019 were estimated using an exit price notion.

| | **September 30, 2020** | | December 31, 2019 | |
|---|---|---|---|---|
| **(Dollars in thousands)** | Carrying Amount | Estimated Fair Value | Carrying Amount | Estimated Fair Value |
| Financial assets | | | | |
| Level 1 inputs | | | | |
| Cash and cash equivalents | **$ 156,462** | **$ 156,462** | $ 94,971 | $ 94,971 |
| | | | | |
| Level 2 inputs | | | | |
| Investment securities held to maturity | **$ 20,174** | **$ 20,254** | $ 8,786 | $ 8,654 |
| Restricted securities | **3,626** | **3,626** | 4,190 | 4,190 |
| Cash surrender value on life insurance | **30,690** | **30,690** | 29,782 | 29,782 |
| | | | | |
| Level 3 inputs | | | | |
| Loans, net | **$ 1,411,188** | **$ 1,415,862** | $ 1,238,147 | $ 1,242,867 |
| | | | | |
| Financial liabilities | | | | |
| Level 2 inputs | | | | |
| Deposits: | | | | |
| Noninterest-bearing demand | **$ 465,304** | **$ 465,304** | $ 356,618 | $ 356,618 |
| Checking plus interest | **411,742** | **411,742** | 302,227 | 302,227 |
| Money market | **273,775** | **273,775** | 262,050 | 262,050 |
| Savings | **168,910** | **168,910** | 143,322 | 143,322 |
| Club | **1,505** | **1,505** | 387 | 387 |
| Certificates of deposit, $100,000 or more | **126,704** | **128,810** | 127,600 | 128,167 |
| Other time | **146,181** | **147,738** | 149,130 | 149,209 |
| Securities sold under retail repurchase agreement | **1,019** | **1,019** | 1,226 | 1,226 |
| Advances from FHLB - long-term | — | — | 15,000 | 15,040 |
| Subordinated debt | **24,399** | **25,677** | — | — |

Note 14 – Financial Instruments with Off-Balance Sheet Risk

In the normal course of business, to meet the financial needs of its customers, the Bank is a party to financial instruments with off-balance sheet risk. These financial instruments include commitments to extend credit and standby letters of credit. Commitments to extend credit are agreements to lend to a customer as long as there is no violation of any condition established in the contract. Letters of credit are conditional commitments issued by the Bank to guarantee the performance of a customer to a third party. Letters of credit and other commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. Because many of the letters of credit and commitments are expected to expire without being drawn upon, the total commitment amount does not necessarily represent future cash requirements.

The following table provides information on commitments outstanding at September 30, 2020 and December 31, 2019.

| (Dollars in thousands) | September 30, 2020 | December 31, 2019 |
|---|---|---|
| Commitments to extend credit | **$ 257,009** | $ 211,652 |
| Letters of credit | **9,177** | 7,691 |
| Total | **$ 266,186** | $ 219,343 |

Note 15 – Revenue Recognition

Topic 606 does not apply to revenue associated with financial instruments, including revenue from loans and securities. Topic 606 is applicable to noninterest revenue streams such as trust and asset management income, deposit related fees, interchange fees and merchant income. Noninterest revenue streams in-scope of Topic 606 are discussed below.

**Service Charges on Deposit Accounts**

Service charges on deposit accounts consist of account analysis fees (i.e., net fees earned on analyzed business and public checking accounts), monthly service fees, check orders, and other deposit account related fees. The Company's performance obligation for account analysis fees and monthly service fees is generally satisfied, and the related revenue recognized, over the period in which the service is provided.

Check orders and other deposit account related fees are largely transactional based, and therefore, the Company's performance obligation is satisfied, and related revenue recognized, at a point in time. Payment for service charges on deposit accounts is primarily received immediately or at the end of the month through a direct charge to customers' accounts.

**Trust and Investment Fee Income**

Trust and investment fee income are primarily comprised of fees earned from the management and administration of trusts and other customer assets. The Company's performance obligation is generally satisfied over time and the resulting fees are recognized monthly, based upon the month-end market value of the assets under management and the applicable fee rate. Payment is generally received a few days after month end through a direct charge to customers' accounts. The Company does not earn performance-based incentives.

Optional services such as real estate sales and tax return preparation services are also available to existing trust and asset management customers. The Company's performance obligation for these transactional-based services is generally satisfied, and related revenue recognized, at a point in time (i.e., as incurred). Payment is received shortly after services are rendered.

**Other Noninterest Income**

Other noninterest income consists of: fees, exchange, other service charges, safety deposit box rental fees, and other miscellaneous revenue streams. Fees and other service charges are primarily comprised of debit and credit card income, ATM fees, merchant services income, and other service charges. Debit and credit card income is primarily comprised of interchange fees earned whenever the Company's debit and credit cards are processed through card payment networks such as Visa. ATM fees are primarily generated when a Company cardholder uses a non-Company ATM or a non-Company cardholder uses a Company ATM. Merchant services income mainly represents fees charged to merchants to process their debit and credit card transactions, in addition to account management fees. Other service charges include revenue from processing wire transfers, bill pay service, cashier's checks, and other services. The Company's performance obligation for fees, exchange, and other service charges are largely satisfied, and related revenue recognized, when the services are rendered or upon completion. Payment is typically received immediately or in the following month. Safe deposit box rental fees are charged to the customer on an annual basis and recognized upon receipt of payment. The Company determined that rentals and renewals of safe deposit boxes will be recognized on a monthly basis consistent with the duration of the performance obligation.

The following presents noninterest income from continuing operations, segregated by revenue streams in-scope and out-of-scope of Topic 606, for the three and nine months ended September 30, 2020 and 2019.

| | For Three Months Ended September 30, | | For Nine Months Ended September 30, | |
|---|---|---|---|---|
| (Dollars in thousands) | **2020** | 2019 | **2020** | 2019 |
| **Noninterest Income** | | | | |
| *In-scope of Topic 606:* | | | | |
| Service charges on deposit accounts | **$ 647** | $ 990 | **$ 2,057** | $ 2,952 |
| Trust and investment fee income | **381** | 383 | **1,119** | 1,140 |
| Interchange income | **808** | 702 | **2,169** | 1,979 |
| Other noninterest income | **455** | 316 | **1,141** | 1,026 |
| Noninterest Income (in-scope of Topic 606) | **2,291** | 2,391 | **6,486** | 7,097 |
| Noninterest Income (out-of-scope of Topic 606) | **290** | 138 | **1,216** | 229 |
| **Total Noninterest Income** | **$ 2,581** | $ 2,529 | **$ 7,702** | $ 7,326 |

**Contract Balances**

A contract asset balance occurs when an entity performs a service for a customer before the customer pays consideration (resulting in a contract receivable) or before payment is due (resulting in a contract asset). A contract liability balance is an entity's obligation to transfer a service to a customer for which the entity has already received payment (or payment is due) from the customer. The Company's noninterest revenue streams are largely based on transactional activity, or standard month-end revenue accruals such as asset management fees based on month-end market values. Consideration is often received immediately or shortly after the Company satisfies its performance obligation and revenue is recognized. The Company does not typically enter into long-term revenue contracts with customers, and therefore, does not experience significant contract balances. As of September 30, 2020, and December 31, 2019, the Company did not have any significant contract balances.

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

Unless the context clearly suggests otherwise, references to "the Company", "we", "our", and "us" in the remainder of this report are to Shore Bancshares, Inc. and its consolidated subsidiary.

**Forward-Looking Information**

This Quarterly Report on Form 10-Q contains forward-looking statements. These forward-looking statements reflect our current views with respect to, among other things, future events and our financial performance. These statements are often, but not always, made through the use of words or phrases such as "may," "should," "could," "predict," "potential," "believe," "will likely result," "expect," "continue," "will," "anticipate," "seek," "estimate," "intend," "plan," "project," "projection," "forecast," "goal," "target," "would," "aim" and "outlook," or the negative version of those words or other comparable words or phrases of a future or forward-looking nature. These forward-looking statements are not historical facts, and are based on current expectations, estimates and projections about our industry and management's beliefs and certain assumptions made by management, many of which, by their nature, are inherently uncertain and beyond our control. The inclusion of these forward-looking statements should not be regarded as a representation by us or any other person that such expectations, estimates and projections will be achieved. Accordingly, we caution you that any such forward-looking statements are not guarantees of future performance and are subject to risks, assumptions and uncertainties that are difficult to predict. New risks and uncertainties may emerge from time to time, and it is not possible for us to predict their occurrence. In addition, we cannot assess the impact of each risk and uncertainty on our business or the extent to which any risk or uncertainty, or combination of risks and uncertainties, may cause actual results to differ materially from those contained in any forward-looking statements.

Further, given its ongoing and dynamic nature, it is difficult to predict the full impact of the novel coronavirus ("COVID-19") outbreak on our business. The extent of such impact will depend on future developments, which are highly uncertain, including when the coronavirus can be controlled and abated and when and how the economy may be fully reopened. As the result of the COVID-19 pandemic and the related adverse local and national economic consequences, we could be subject to any of the following risks, any of which could have a material, adverse effect on our business, financial condition, liquidity, and results of operations: the demand for our products and services may decline, making it difficult to grow assets and income; if the economy is unable to substantially reopen, and high levels of unemployment continue for an extended period of time, loan delinquencies, problem assets, and foreclosures may increase, resulting in increased charges and reduced income; collateral for loans, especially real estate, may decline in value, which could cause loan losses to increase; our allowance for loan losses may increase if borrowers experience financial difficulties, which will adversely affect our net income; the net worth and liquidity of loan guarantors may decline, impairing their ability to honor commitments to us; as the result of the decline in the Federal Reserve's target federal funds rate to near 0%, the yield on our assets may decline to a greater extent than the decline in our cost of interest-bearing liabilities, reducing our net interest margin and spread and reducing net income; our cybersecurity risks are increased as the result of an increase in the number of employees working remotely; and FDIC premiums may increase if the agency experiences additional resolution costs.

If one or more of the factors affecting our forward-looking information and statements proves incorrect, then our actual results, performance or achievements could differ materially from those expressed in, or implied by, forward-looking information and statements contained in this Quarterly Report on Form 10-Q and other reports and registration statements filed by us with the Securities and Exchange Commission ("SEC"). For information on the factors that could cause actual results to differ from the expectations stated in the forward- looking statements, see "Risk Factors" under Part I, Item 1A of our 2019 Form 10-K in addition to Part II, Item 1A - Risk Factors of this Quarterly Report on Form 10-Q and other reports as filed with the SEC.

Any forward-looking statement speaks only as of the date of this report, and we do not undertake any obligation to publicly update or review any forward-looking statement, whether because of new information, future developments or otherwise, except as required by law.

**Introduction**

The following discussion and analysis is intended as a review of significant factors affecting the Company's financial condition and results of operations for the periods indicated. This discussion and analysis should be read in conjunction with the unaudited consolidated financial statements and related notes presented elsewhere in this report, as well as the audited consolidated financial statements and related notes included in the 2019 Annual Report.

Shore Bancshares, Inc. is the largest independent financial holding company headquartered on the Eastern Shore of Maryland. It is the parent company of Shore United Bank. The Bank operates 22 full-service branches in Baltimore County, Howard County, Kent County, Queen Anne's County, Talbot County, Caroline County, Dorchester County and Wicomico County in Maryland, Kent County, Delaware and Accomack County, Virginia. The Company engages in trust and wealth management services through Wye Financial Partners, a division of Shore United Bank.

The shares of common stock of Shore Bancshares, Inc. are listed on the NASDAQ Global Select Market under the symbol "SHBI".

Shore Bancshares, Inc. maintains an Internet site at www.shorebancshares.com on which it makes available free of charge its Annual Report on Form 10-K, Quarterly Reports on Form 10-Q, Current Reports on Form 8-K, and all amendments to the foregoing as soon as reasonably practicable after these reports are electronically filed with, or furnished to, the SEC.

**COVID-19 Pandemic**

The outbreak of COVID-19, which was declared a pandemic by the World Health Organization on March 11, 2020, has led to adverse impacts on economic conditions and created uncertainty in financial markets. Correspondingly, in early March 2020, the Company began preparing for potential disruptions and government limitations of activity in the markets in which we serve. Our team activated our Business Continuity Program and was able to quickly execute on multiple initiatives to adjust our operations to protect the health and safety of our employees and clients. Since the beginning of the crisis, we have been in close contact with our clients, assessing the level of impact on their businesses, and providing relief programs according to each client's specific situation and qualifications. We have also enhanced awareness of digital banking offerings, expanded services at our drive through locations, and allowed customers to make appointments in the branch for critical services. The Company's branches remain open and have taken steps to comply with various government directives regarding "social distancing," as well as, enhanced cleaning and disinfecting of all surface areas to protect its clients and employees.

Small Business Administration's Paycheck Protection Program

We established our process for participating in the Small Business Administration's Paycheck Protection Program ("PPP") that enabled our clients to utilize this valuable resource beginning in April 2020. Loans under the PPP are designed to provide assistance for small businesses during the COVID-19 pandemic to help meet the costs associated with payroll, mortgage interest, rent and utilities. These loans are guaranteed by the SBA and forgiveness of the loans, by the SBA, is granted to the borrower if the borrower uses at least 60% of the funds to cover payroll costs and benefits. Forgiveness is also based on the small business maintaining or quickly rehiring their employees and maintaining salary levels for their employees. Loans under the PPP do not require any collateral or personal guarantees, as such, these loans are included in the Company's commercial loans segment. Through August 8, 2020, our team was able to process 1,488 PPP loans for approximately $126.7 million in the first and second rounds of the program, which has allowed us to further strengthen and deepen our client relationships, while positively impacting thousands of individuals. We are also closely monitoring the credit quality of the loan portfolio and monitor lines of credit draws for deviation from normal activity to improve loan performance and reduce credit risk.

Short-term Modifications for Borrowers

In keeping with regulatory guidance to work with borrowers during this unprecedented situation and as outlined in Section 4013 of the Coronavirus Aid, Relief, and Economic Security Act ("CARES Act"), the Company is providing modifications where appropriate, including interest only payments or payment deferrals for clients that could be adversely affected by the COVID-19 pandemic. Section 4013 of the CARES Act also addressed COVID-19 related modifications and specified that such modifications made on loans that were current as of December 31, 2019 are not TDRs. In accordance with interagency guidance issued in April 2020, these short-term modifications made to a borrower affected by the COVID-19 pandemic and governmental shutdown orders, such as payment deferrals, fee waivers and extensions of repayment terms, do not need to be identified as TDRs if the loans were current at the time a modification plan was implemented. For the nine months ended September 30, 2020, the Company had executed principal and/or interest deferrals on outstanding loan balances of $221.1 million, of which only $12.9 million, or 0.91% of the total portfolio remained on deferral as of September 30, 2020.

| (Dollars in thousands) | Total Loan Balance as of September 30, 2020 | Total Loans Modified as of September 30, 2020 | Loans Modified to Interest Only Payments (6 months or less) | Loans Modified to Payment Deferral (3 months) | Percentage of Loans Modified |
|---|---|---|---|---|---|
| Hospitality Industry | $ 113,833 | $ 4,659 | $ - | $ 4,659 | 4.09 % |
| Non-owner occupied Retail Stores | 101,304 | - | - | - | — |
| Non-owner occupied Restaurants | 11,173 | - | - | - | — |
| Owner-occupied Retail Stores | 14,471 | 160 | 160 | - | 1.11 |
| Owner-occupied Restaurants | 9,215 | 220 | 220 | - | 2.39 |
| Oil & Gas Industry | - | - | - | - | — |
| Other Commercial Loans | 765,998 | 6,374 | 2,089 | 4,285 | 0.83 |
| Total Commercial Loans | 1,015,994 | 11,413 | 2,469 | 8,944 | 1.12 |
| | | | | | |
| Residential 1-4 family Personal | 231,547 | - | - | - | — |
| Residential 1-4 family Rentals | 100,852 | 1,073 | 300 | 773 | 1.06 |
| Home Equity Loans | 46,609 | - | - | - | — |
| Total Residential Real Estate Loans | 379,008 | 1,073 | 300 | 773 | 0.28 |
| | | | | | |
| Consumer Loans | 29,774 | 435 | - | 435 | 1.46 |
| Mortgage Warehouse Loans | - | - | - | - | — |
| Credit Card, Overdrafts and Other | (811) | - | - | - | — |
| TOTAL LOANS | $ 1,423,965 | $ 12,921 | $ 2,769 | $ 10,152 | 0.91 % |

Liquidity

We are vigilantly monitoring our liquidity position on an ongoing basis as the circumstances surrounding the pandemic continue to evolve. The Company has several available sources of on and off-balance sheet liquidity. Currently, the Company has not needed to tap into these available liquidity sources due to payment deferrals by customers, funding of PPP loans, or organic loan growth. The potential for increased reliance on available liquidity sources may be required based on the effects of the pandemic and their impact on the level of deposits and other factors. Additional discussion on our liquidity as of the report date is reflected in the “Liquidity and Capital Resources” section of management’s discussion and analysis.

Share Repurchases

We reinstated our common stock repurchase program on September 1, 2020. During the third quarter of 2020, we repurchased 288,400 shares of the Company’s common stock at an average cost of $10.56 per share or $3.1 million in the aggregate.

Dividends and Capital

We currently expect to maintain our quarterly cash dividend based on our strong capital position. At September 30, 2020, the Bank exceeded all the capital requirements to which it was subject, and based on the most recent notification from its primary federal regulator is considered to be well-capitalized. There are no conditions or events since that notification that management believes would change the Bank’s classification. We are closely monitoring our capital position and are taking appropriate steps to ensure our level of capital remains strong. Our capital, while significant, may deteriorate in future periods due to the impact of the pandemic and limit our ability to pay dividends.

**Critical Accounting Policies**

The Company's consolidated financial statements are prepared in accordance with GAAP and follow general practices within the industries in which it operates. Application of these principles requires management to make estimates, assumptions, and judgments that affect the amounts reported in the financial statements and accompanying notes. These estimates, assumptions, and judgments are based on information available as of the date of the financial statements; accordingly, as this information changes, the financial statements could reflect different estimates, assumptions, and judgments. Certain policies inherently have a greater reliance on the use of estimates, assumptions, and judgments and as such have a greater possibility of producing results that could be materially different than originally reported.

The most significant accounting policies that the Company follows are presented in Note 1 of the 2019 Annual Report. These policies, along with the disclosures presented in the notes to the financial statements and in this discussion, provide information on how significant assets and liabilities are valued in the financial statements and how those values are determined. Based on the valuation techniques used and the sensitivity of financial statement amounts to the methods, assumptions, and estimates underlying those amounts, management has determined that the accounting policies with respect to the allowance for credit losses and goodwill and other intangible assets are critical accounting policies. These policies are considered critical because they relate to accounting areas that require the most subjective or complex judgments, and, as such, could be most subject to revision as new information becomes available.

The allowance for credit losses represents management's estimate of credit losses inherent in the loan portfolio as of the balance sheet date. Determining the amount of the allowance for credit losses is considered a critical accounting estimate because it requires significant judgment and the use of estimates related to the amount and timing of expected future cash flows on impaired loans, estimated losses on pools of similar loans based on historical loss experience, and consideration of current economic trends and conditions, all of which may be susceptible to significant change. The loan portfolio also represents the largest asset type on the consolidated balance sheets. Note 1 to the 2019 Annual Report describes the methodology used to determine the allowance for credit losses. A discussion of the allowance determination and factors driving changes in the amount of the allowance for credit losses is included in the Provision for Credit Losses and Allowance for Credit Losses sections below.

Goodwill represents the excess of the cost of an acquisition over the fair value of the net assets acquired. Other intangible assets represent purchased assets that also lack physical substance but can be distinguished from goodwill because of contractual or other legal rights or because the asset is capable of being sold or exchanged either on its own or in combination with a related contract, asset or liability. Goodwill and other intangible assets are required to be recorded at fair value at inception. Determining fair value is subjective, requiring the use of estimates, assumptions and management judgment. Goodwill is tested at least annually for impairment, usually during the fourth quarter, or on an interim basis if circumstances dictate. Intangible assets that have finite lives are amortized over their estimated useful lives and also are subject to impairment testing. Impairment testing requires a qualitative assessment or that the fair value of each of the Company's reporting units be compared to the carrying amount of its net assets, including goodwill. If the fair value of a reporting unit is less than book value, an expense may be required to write down the related goodwill to record an impairment loss. As of September 30, 2020, the Company had only one banking reporting unit.

**OVERVIEW**

The Company reported net income of $3.4 million for the third quarter of 2020, or diluted income per common share of $0.27, compared to net income of $4.2 million, or diluted income per common share of $0.33, for the third quarter of 2019. For the second quarter of 2020, the Company reported net income of $5.3 million, or diluted income per common share of $0.43. When comparing net income for the third quarter of 2020 to the third quarter of 2019, the decrease was due to an increase in noninterest expense of $447 thousand, coupled with an increase in provision for credit losses of $1.3 million, partially offset by an increase in net interest income of $603 thousand. When comparing net income from continuing operations for the third quarter of 2020 to the second quarter of 2020, the decrease was primarily due to an increase in noninterest expenses of $2.2 million. Net interest income increased $252 thousand in the third quarter when compared to the second quarter, which was more than offset by an increase in provision for credit losses of $500 thousand and a decrease in noninterest income of $188 thousand.

For the first nine months of 2020, the Company reported net income of $11.8 million, or diluted income per common share of $0.95, compared to net income of $12.3 million, or diluted income per common share of $0.95, for the first nine months of 2019. When comparing net income from continuing operations for the first nine months of 2020 to the first nine months of 2019, the decrease was primarily due to increases in the provision for credit losses of $2.4 million and noninterest expenses of $131 thousand, partially offset by higher net interest income of $1.5 million and noninterest income of $376 thousand.

**RESULTS OF OPERATIONS**

**Net Interest Income**

Tax-equivalent net interest income is net interest income adjusted for the tax-favored status of income from certain loans and investments. As shown in the table below, tax-equivalent net interest income was $13.3 million for the third quarter of 2020 and $12.7 million for the third quarter of 2019. Tax-equivalent net interest income was $13.1 million for the second quarter of 2020. The increase in net interest income for the third quarter of 2020 when compared to the third quarter of 2019 was due to lower interest expenses on interest bearing deposits of $819 thousand, or 35.8% and the elimination of short and long-term advances from the Federal Home Loan Bank ("FHLB") which reduced interest expense by a combined $220 thousand. These improvements to net interest income were partially offset by decreases in interest income on taxable investment securities of $140 thousand, or 16.1%, and interest-bearing deposits with other banks of $190 thousand, or 85.2%. Net interest income increased for the third quarter of 2020 when compared to the second quarter of 2020 due to increases in the average balances in loans of $32.4 million, taxable investment securities of $28.1 million and interest-bearing deposits with other banks of $69.8 million. These increases in the average balances on earning assets contributed $304 thousand to interest income over the second quarter, despite a decline in the weighted average yield on these assets of 26 basis points (bps). In addition, the weighted average rate paid on interest-bearing deposits declined by 8bps in the third quarter when compared to the second quarter, reducing interest expense by $87 thousand. However, this decline was more than offset by the $148 thousand of additional interest expense related to subordinated debt issued during the third quarter. Net interest margin is tax-equivalent net interest income (annualized) divided by average earning assets. The net interest margin for the third quarter of 2020 was 3.17%, which was a decrease of 35bps when compared to 3.52% for the third quarter of 2019 and a decrease of 24bps when compared to 3.41% for the second quarter of 2020. The decline in net interest margin in the third quarter of 2020 when compared to the second quarter of 2020 and the third quarter of 2019, was significantly impacted by excess liquidity of approximately $100 million, which has yet to be fully invested. This excess liquidity was due to deposit inflows related to customers retaining PPP loan proceeds, customers improving their liquidity position by participating in our deferred loan program and the result of new business and municipal relationships acquired during 2020. Without this excess liquidity, the margin for the third quarter would have been 3.37%.

**Interest Income**

On a tax-equivalent basis, interest income decreased $302 thousand, or 2.0%, for the third quarter of 2020 when compared to the third quarter of 2019. The decrease was due to a decrease in the average yield on interest-bearing deposits with other banks of 203bps resulting from Federal Reserve interest rate cuts during 2020 and decreases in both the average balance and average yield of taxable investment securities of $19.3 million, or 12.4%, and 10bps, respectively. The average balance of loans increased $171.3 million, or 13.9%, between the comparable periods and the average yield on loans decreased 53bps, which was the direct result of adding 1,488 PPP loans with an average yield of 2.00%.

On a tax-equivalent basis, interest income increased $305 thousand, or 2.1%, for the third quarter of 2020 when compared to the second quarter of 2020. The increase was primarily due to increases in the average balance of loans of $32.4 million, or 2.4%, and the average balance of investment securities of $28.1 million, or 14.4%, despite the decrease in the average yield on these earning assets of a combined 31bps. The average balance on interest-bearing deposits increased $69.8 million, or 200.0%, while the average yield also increased 3bps, resulting in an additional $22 thousand in interest income. The significant volume increases in total deposits was the result of deposit inflows previously stated above.

**Interest Expense**

Interest expense decreased $895 thousand, or 35.6%, when comparing the third quarter of 2020 to the third quarter of 2019. The decrease was a direct result of lower interest expenses paid on interest-bearing deposits of $819 thousand and the elimination of short and long-term advances from FHLB borrowings of $220 thousand. The average rate paid on interest-bearing deposits decreased 44bps, partially offset by the addition of subordinated debt issued during the third quarter of 2020, which added $148 thousand of interest expense. The average balance of noninterest-bearing deposits increased $103.7 million, or 29.2% between the comparable quarters.

Interest expense increased $55 thousand, or 3.5%, when comparing the third quarter of 2020 to the second quarter of 2020. The increase in interest expense was mainly due to the addition of subordinated debt issued in the third quarter, which added $148 thousand of interest expense, partially offset by the decrease of $87 thousand in interest expense on interest-bearing deposits and the payoff of long-term advances from FHLB borrowings. The average balance of noninterest-bearing deposits increased $38.3 million, or 9.1%, when compared to the second quarter of 2020. The payoff of long-term advances from FHLB borrowings matured in April of 2020 which carried a rate of 2.82%. Due to the excess liquidity position of the Bank there was no need to renew these borrowings.

The following tables present the distribution of the average consolidated balance sheets, interest income/expense, and annualized yields earned and rates paid for the three months ended September 30, 2020 and 2019.

| (Dollars in thousands) | For Three Months Ended September 30, 2020 Average Balance | Income(1)/ Expense | Yield/ Rate | For Three Months Ended September 30, 2019 Average Balance | Income(1)/ Expense | Yield/ Rate |
|---|---|---|---|---|---|---|
| Earning assets | | | | | | |
| Loans (2), (3) | **$ 1,406,683** | **$ 14,173** | **4.01 %** | $ 1,235,374 | $ 14,145 | 4.54 % |
| Investment securities: | | | | | | |
| Taxable | **136,017** | **730** | **2.14** | 155,324 | 870 | 2.24 |
| Interest-bearing deposits | **127,494** | **33** | **0.10** | 41,554 | 223 | 2.13 |
| Total earning assets | **1,670,194** | **14,936** | **3.56 %** | 1,432,252 | 15,238 | 4.22 % |
| Cash and due from banks | **18,860** | | | 18,127 | | |
| Other assets | **94,755** | | | 73,823 | | |
| Allowance for credit losses | **(11,865)** | | | (10,412) | | |
| Total assets | **$ 1,771,944** | | | $ 1,513,790 | | |
| | | | | | | |
| Interest-bearing liabilities | | | | | | |
| Demand deposits | **$ 370,922** | **174** | **0.19 %** | $ 252,386 | 447 | 0.70 % |
| Money market and savings deposits | **442,322** | **229** | **0.21** | 389,268 | 658 | 0.67 |
| Brokered Deposits | — | — | — | 14,568 | 84 | 2.29 |
| Certificates of deposit $100,000 or more | **127,983** | **539** | **1.68** | 119,200 | 537 | 1.78 |
| Other time deposits | **148,223** | **528** | **1.42** | 149,708 | 563 | 1.49 |
| Interest-bearing deposits | **1,089,450** | **1,470** | **0.54** | 925,130 | 2,289 | 0.98 |
| Securities sold under retail repurchase agreements and federal funds purchased | **1,575** | **1** | **0.25** | 1,434 | 5 | 1.38 |
| Advances from FHLB - short-term | — | — | — | 16,295 | 112 | 2.73 |
| Advances from FHLB - long-term | — | — | — | 15,000 | 108 | 2.86 |
| Subordinated debt | **9,859** | **148** | **5.97** | — | — | — |
| Total interest-bearing liabilities | **1,100,884** | **1,619** | **0.59 %** | 957,859 | 2,514 | 1.04 % |
| Noninterest-bearing deposits | **458,622** | | | 354,927 | | |
| Other liabilities | **11,359** | | | 7,884 | | |
| Stockholders’ equity | **201,079** | | | 193,120 | | |
| Total liabilities and stockholders’ equity | **$ 1,771,944** | | | $ 1,513,790 | | |
| | | | | | | |
| Net interest spread | | **$ 13,317** | **2.97 %** | | $ 12,724 | 3.18 % |
| Net interest margin | | | **3.17 %** | | | 3.52 % |
| | | | | | | |
| Tax-equivalent adjustment | | | | | | |
| Loans | | **$ 34** | | | $ 44 | |
| Total | | **$ 34** | | | $ 44 | |

(1) All amounts are reported on a tax-equivalent basis computed using the statutory federal income tax rate of 21.0%, exclusive of nondeductible interest expense.
(2) Average loan balances include nonaccrual loans.
(3) Interest income on loans includes amortized loan fees, net of costs, and accretion of discounts on acquired loans, which are included in the yield calculations.

**Net Interest Income**

Tax-equivalent net interest income increased $1.5 million, or 3.9%, during the nine months ended September 30, 2020 compared to the nine months ended September 30, 2019. The increase in net interest income was due to decreases in interest expenses on interest-bearing deposits of $1.4 million, or 21.0% and short and long-term advances from FHLB borrowings of $679 thousand, or 85.3%, partially offset by the addition of subordinated debt issued in the third quarter of 2020, which added $148 thousand of interest expense. Also offsetting the cost savings in interest expenses was a decrease in the average yield on earning assets of 43bps. This resulted in a net interest margin of 3.35% for the nine months ended September 30, 2020 compared to 3.56% for the nine months ended September 30, 2019.

**Interest Income**

On a tax-equivalent basis, interest income decreased $433 thousand, or 1.0%, for the nine months ended September 30, 2020 when compared to the nine months ended September 30, 2019. The decrease was primarily due to a decline in the average balance of taxable investment securities of $35.5 million, or 22.2%, and the lower average yield on interest-bearing deposits with other banks of 192bps. The average balance of loans increased $128.7 million, or 10.6%, while the average yield declined 39bps, in part due to the funding of 1,488 PPP loans during the second and third quarters of 2020 which had an average yield of 2.00%.

**Interest Expense**

Interest expense decreased $1.9 million, or 26.1%, when comparing the nine months ended September 30, 2020 to the nine months ended September 30, 2019. The decrease in interest expense was due to a decline in the rates paid on interest-bearing deposits of 30bps and the payoff of short and long-term advances from FHLB borrowings of $32.8 million, or 86.2%. The payoff of long-term advances from FHLB borrowings matured in April of 2020 which carried a rate of 2.82%. Due to the excess liquidity position of the Bank there was no need to renew these borrowings. The decreases in both short and long-term advances from FHLB borrowings, were partially offset by the addition of subordinated debt issued in the third quarter of 2020 of $25 million and an increase in the average balance of noninterest-bearing deposits of $68.7 million, or 20.1%.

The following tables present the distribution of the average consolidated balance sheets, interest income/expense, and annualized yields earned and rates paid for the nine months ended September 30, 2020 and 2019.

| | **For Nine Months Ended September 30, 2020** | | | For Nine Months Ended September 30, 2019 | | |
|---|---|---|---|---|---|---|
| (Dollars in thousands) | **Average Balance** | **Income(1)/ Expense** | **Yield/ Rate** | Average Balance | Income(1)/ Expense | Yield/ Rate |
| Earning assets | | | | | | |
| Loans (2), (3) | **$ 1,348,362** | **$ 41,986** | **4.16 %** | $ 1,219,623 | $ 41,468 | 4.55 % |
| Investment securities: | | | | | | |
| Taxable | **124,487** | **2,087** | **2.24** | 160,035 | 2,755 | 2.30 |
| Interest-bearing deposits | **81,125** | **216** | **0.36** | 29,279 | 499 | 2.28 |
| Total earning assets | **1,553,974** | **44,289** | **3.81 %** | 1,408,937 | 44,722 | 4.24 % |
| Cash and due from banks | **18,302** | | | 17,520 | | |
| Other assets | **91,642** | | | 64,775 | | |
| Allowance for credit losses | **(11,042)** | | | (10,419) | | |
| Total assets | **$ 1,652,876** | | | $ 1,480,813 | | |
| | | | | | | |
| Interest-bearing liabilities | | | | | | |
| Demand deposits | **$ 318,083** | **714** | **0.30 %** | $ 242,364 | 1,188 | 0.66 % |
| Money market and savings deposits | **426,570** | **941** | **0.29** | 386,113 | 2,268 | 0.79 |
| Brokered Deposits | — | — | — | 19,144 | 344 | 2.40 |
| Certificates of deposit $100,000 or more | **129,319** | **1,722** | **1.78** | 108,504 | 1,251 | 1.54 |
| Other time deposits | **149,841** | **1,708** | **1.52** | 145,381 | 1,389 | 1.28 |
| Interest-bearing deposits | **1,023,813** | **5,085** | **0.66** | 901,506 | 6,440 | 0.96 |
| Securities sold under retail repurchase agreements and federal funds purchased | **1,613** | **4** | **0.33** | 964 | 12 | 1.66 |
| Advances from FHLB - short-term | — | — | — | 23,070 | 463 | 2.68 |
| Advances from FHLB - long-term | **5,255** | **113** | **2.87** | 15,000 | 321 | 2.86 |
| Subordinated debt | **3,310** | **148** | **5.97** | — | — | — |
| Total interest-bearing liabilities | **1,033,991** | **5,350** | **0.69 %** | 940,540 | 7,236 | 1.03 % |
| Noninterest-bearing deposits | **410,702** | | | 341,966 | | |
| Other liabilities | **10,088** | | | 9,213 | | |
| Stockholders' equity | **198,095** | | | 189,094 | | |
| Total liabilities and stockholders' equity | **$ 1,652,876** | | | $ 1,480,813 | | |
| | | | | | | |
| Net interest spread | | **$ 38,939** | **3.12 %** | | $ 37,486 | 3.21 % |
| Net interest margin | | | **3.35 %** | | | 3.56 % |
| | | | | | | |
| Tax-equivalent adjustment | | | | | | |
| Loans | | **$ 107** | | | $ 119 | |
| Total | | **$ 107** | | | $ 119 | |

(1) All amounts are reported on a tax-equivalent basis computed using the statutory federal income tax rate of 21.0%, exclusive of nondeductible interest expense.
(2) Average loan balances include nonaccrual loans.
(3) Interest income on loans includes amortized loan fees, net of costs, and accretion of discounts on acquired loans, which are included in the yield calculations.

**Noninterest Income**

Total noninterest income for the third quarter of 2020 increased $52 thousand, or 2.1%, when compared to the third quarter of 2019. The increase from the third quarter of 2019 was mainly due to additional income from BOLI purchased late in 2019 and other bank and loan fees, partially offset by lower service charges on deposit accounts. Noninterest income decreased $188 thousand, or 6.8%, when compared to the second quarter of 2020 primarily due to the sale of available for sale investment securities at a gain of $347 thousand in the second quarter. Absent the sale of these securities, noninterest income would have increased $159 thousand, or 6.6%, for the third quarter of 2020, which was primarily the result of increases in loan fee income and service charges on deposit accounts.

Total noninterest income from continuing operations for the nine months ended September 30, 2020 increased $376 thousand, or 5.1%, when compared to the same period in 2019. The increase in noninterest income primarily consisted of increases in BOLI income, gains on sales of available for sale securities and other bank services, partially offset by a decrease in service charges on deposit accounts which was primarily due to the effect of COVID-19 on activity.

**Noninterest Expense**

Total noninterest expense from continuing operations for the third quarter of 2020 increased $447 thousand, or 4.8%, when compared to the third quarter of 2019 and increased $2.2 million, or 28.3%, when compared to the second quarter of 2020. The increase in noninterest expenses when compared to the third quarter of 2019 was primarily due to higher salaries and wages, employee benefits and data processing fees, partially offset by decreases in other real estate owned expenses and other loan expenses. The increases in employee benefit expense and data processing fees when compared to 2019, are the result of higher health insurance claims and the increase level of new deposit and loan relationships in 2020. The increase in noninterest expense when compared to the second quarter of 2020 was primarily related to higher salaries and wages, due to the significant volume of PPP loans originated in the second quarter which resulted in heightened deferrals of direct origination costs during the second quarter of 2020. The deferred origination costs are being amortized over the lives of the related PPP loans and will be accelerated upon forgiveness or repayment.

Total noninterest expense from continuing operations for the nine months ended September 30, 2020 increased $131 thousand, or less than 1%, when compared to the same period in 2019. The increase was a result of higher costs related to employee benefits and higher data processing fees, which were almost entirely offset by decreases in salaries and wages due to the deferral of direct origination costs related to the origination of PPP loans, FDIC insurance premiums, other real estate owned expenses, and other loan related expenses. The deferred costs for salaries and wages are being recognized over the lives of the related loans as previously mentioned.

**Provision for Credit Losses**

The provision for credit losses was $1.5 million for the third quarter of 2020, $200 thousand for the third quarter of 2019 and $1.0 million for the second quarter of 2020. The ratio of the allowance for credit losses to period-end loans was 0.90% at September 30, 2020. Excluding PPP loans, the ratio of the allowance for credit losses to period-end loans was 0.98% at September 30, 2020, higher than both the 0.85% at September 30, 2019 and the 0.86% at June 30, 2020. The primary drivers of the increased percentage of the allowance to total loans, excluding PPP loans, and the increase in provision for loan losses as compared to both the prior periods were the new and elevated qualitative factors within the allowance model related to economic conditions and the COVID-19 pandemic. The Company reported net recoveries in the third quarter of 2020 of $187 thousand, compared to net charge-offs of $67 thousand for the third quarter of 2019 and $288 thousand for the second quarter of 2020.

The provision for credit losses for the nine months ended September 30, 2020 and 2019 was $2.9 million and $500 thousand, respectively, while net charge-offs were $580 thousand and $405 thousand, respectively. The increase in provision for credit losses was the result of new and elevated qualitative factors within the allowance model related to economic conditions and the COVID-19 pandemic. Excluding PPP loans, the ratio of the allowance for credit losses to period-end loans increased to 0.98% at September 30, 2020 from 0.84% at December 31, 2019. As previously discussed, this ratio increased primarily due to the addition of qualitative factors in the analysis of the allowance for loan losses. The ratio of annualized net charge-offs to average loans was 0.06% for the first nine months of 2020 and 0.04% for the first nine months of 2019. Management will continue to evaluate the adequacy of the allowance for credit losses as more economic data becomes available and the risk profile of the portfolio is more clearly defined.

**Income Taxes**

The Company reported income tax expense from continuing operations of $1.1 million for the third quarter of 2020, $1.4 million for the third quarter of 2019 and $1.8 million for the second quarter of 2020. Income tax expense decreased when compared to the third quarter of 2019 and the second quarter of 2020 due to lower pre-tax earnings. The effective tax rate on continuing operations for the third and second quarter of 2020 was 25.2%. The effective tax rate for the third quarter of 2019 was 25.1%. Income taxes from continuing operations for the nine months ended September 30, 2020 as compared to the nine months ended September 30, 2019 decreased $214 thousand or 5.1%, due to a decrease in pre-tax income.

ANALYSIS OF FINANCIAL CONDITION

**Loans**

Loans totaled $1.424 billion at September 30, 2020 and $1.249 billion at December 31, 2019, an increase of $175.3 million, or 14.0%. The increase was primarily due to the origination of 1,488 PPP loans totaling $126.7 million. Excluding PPP loans, organic growth for the first nine months of 2020 was $48.6 million, which consisted of increases in commercial real estate loans of $43.1 million, consumer loans of $9.8 million and construction loans of $6.2 million, partially offset by decreases in residential real estate loans of $366 thousand and commercial loans, excluding PPP loans, of $10.1 million. Loans included deferred fees, net of deferred costs, of $12 thousand and discounts on acquired loans of $825 thousand at September 30, 2020, compared to deferred costs, net of deferred fees, of $1.8 million and discounts on acquired loans of $1.1 million at December 31, 2019. We do not engage in foreign or subprime lending activities. See Note 5, "Loans and Allowance for Credit Losses", in the Notes to Consolidated Financial Statements and below under the caption "Allowance for Credit Losses" for additional information.

Our loan portfolio has a commercial real estate loan concentration, which is generally defined as a combination of certain construction and commercial real estate loans. Construction loans were $106.0 million, or 7.4% of total loans, at September 30, 2020 and $99.8 million, or 8.0% of total loans, at December 31, 2019. Commercial real estate loans were $629.6 million, or 44.2% of total loans, at September 30, 2020, compared to $586.6 million, or 47.0% of total loans, at December 31, 2019.

The federal banking regulators have issued guidance for those institutions which are deemed to have concentrations in commercial real estate lending. Pursuant to the supervisory criteria contained in the guidance for identifying institutions with a potential commercial real estate concentration risk, institutions which have (1) total reported loans for construction, land development, and other land acquisitions which represent 100% or more of an institution's total risk-based capital; or (2) total non-owner occupied commercial real estate loans representing 300% or more of the institution's total risk-based capital and the institution's non-owner occupied commercial real estate loan portfolio (including construction) has increased 50% or more during the prior 36 months are identified as having potential commercial real estate concentration risk. Institutions which are deemed to have concentrations in commercial real estate lending are expected to employ heightened levels of risk management with respect to their commercial real estate portfolios, and may be required to hold higher levels of capital. The Company, like many community banks, has a concentration in commercial real estate loans, and the Company has experienced significant growth in its commercial real estate portfolio in recent years. At September 30, 2020, non-owner-occupied commercial real estate loans (including construction, land and land development loans) represented 291.2% of total risk-based capital. At such time, construction, land and land development loans represented 56.0% of total risk-based capital.

The commercial real estate portfolio (including construction) has increased 52.1% during the prior 36 months. Management has extensive experience in commercial real estate lending, and has implemented and continues to maintain heightened risk management procedures, as well as strong underwriting criteria with respect to its commercial real estate portfolio. Monitoring practices include periodic stress testing analysis to evaluate changes to cash flows, owing to interest rate increases and declines in net operating income. We may be required to maintain higher levels of capital as a result of our commercial real estate concentrations, which could require us to obtain additional capital or be required to sell/participate portions of loans, which may adversely affect shareholder returns.

**Allowance for Credit Losses**

We have established an allowance for credit losses, which is increased by provisions charged against earnings and recoveries of previously charged-off loans and is decreased by current period charge-offs of uncollectible loans. Management evaluates the adequacy of the allowance for credit losses at least quarterly and adjusts the provision for credit losses based on this analysis. The evaluation of the adequacy of the allowance for credit losses is based primarily on a risk rating system of individual loans, as well as on a collective evaluation of smaller balance homogenous loans, each grouped by loan type. Each loan type is assigned allowance factors based on criteria such as past credit loss experience, local economic and industry trends, and other measures which may impact collectability. Please refer to the discussion above under the caption "Critical Accounting Policies" for an overview of the underlying methodology management employs to maintain the allowance.

The allowance for credit losses was $12.8 million at September 30, 2020, $10.4 million at September 30, 2019 and $11.1 million at June 30, 2020. Net recoveries for the third quarter of 2020 were $187 thousand, compared to net charge-offs of $67 thousand for the third quarter of 2019 and $288 thousand for the second quarter of 2020. The ratio of annualized net recoveries to average loans was 0.05% for the third quarter of 2020, compared to annualized net charge-offs of 0.02% for the third quarter of 2019 and 0.08% for the second quarter of 2020. Net charge-offs were $580 thousand for the nine months ended September 30, 2020, compared to $405 thousand for the nine months ended September 30, 2019. The ratio of net charge-offs to average loans was 0.06% and 0.04% for the nine months ended September 30, 2020 and September 30, 2019, respectively.

Management remains focused on its efforts to dispose of problem loans and to prudently charge-off nonperforming loans to enable the Company to continue to improve its overall credit quality. The allowance for credit losses as a percentage of period-end loans was 0.90% at September 30, 2020, 0.85% at September 30, 2019 and 0.84% at December 31, 2019. Excluding PPP loans, the ratio of the allowance for credit losses to period-end loans was 0.98% at September 30, 2020, higher than both the 0.85% and 0.84% at September 30, 2019 and December 31, 2019. The increase in the percentage of the allowance to total loans at September 30, 2020, compared to September 30, 2019 and December 31, 2019, was primarily due to new and elevated qualitative factors within the allowance model related to economic conditions and the COVID-19 pandemic. Management currently believes that the provision for credit losses and the resulting allowance were adequate to provide for probable losses inherent in our loan portfolio at September 30, 2020. However, management will continue to evaluate the adequacy of the allowance for credit losses as more economic data becomes available and as the impact of the COVID 19 pandemic on the Company's portfolio becomes known. Increases in unemployment, declines in consumer confidence, and a reluctance on the part of businesses to invest in and expand their operations, among other things, may result in additional weakness in economic conditions, place financial strain on our borrowers and ultimately impact the credit quality of our loan portfolio. As a result, we may experience increases in the level of past due, nonaccrual and classified loans, as well as higher net charge-offs. Deterioration in credit quality in conjunction with weakness in current and expected economic conditions, may require us to record additional provisions for credit losses in excess of historical levels.

The following table presents a summary of the activity in the allowance for credit losses at or for the three and nine months ended September 30, 2020 and 2019.

| | At or for Three Months Ended September 30, | | At or for Nine Months Ended September 30, | |
|---|---|---|---|---|
| (Dollars in thousands) | **2020** | 2019 | **2020** | 2019 |
| Allowance balance - beginning of period | **$ 11,090** | $ 10,305 | **$ 10,507** | $ 10,343 |
| Charge-offs: | | | | |
| Construction | — | — | — | (3) |
| Residential real estate | **(10)** | (86) | **(201)** | (509) |
| Commercial real estate | **(1)** | — | **(601)** | — |
| Commercial | **(89)** | (98) | **(208)** | (260) |
| Consumer | **(1)** | — | **(8)** | (29) |
| Total | **(101)** | (184) | **(1,018)** | (801) |
| Recoveries: | | | | |
| Construction | **5** | 1 | **13** | 8 |
| Residential real estate | **199** | 12 | **206** | 23 |
| Commercial real estate | **1** | 7 | **—** | 114 |
| Commercial | **81** | 96 | **205** | 248 |
| Consumer | **2** | 1 | **14** | 3 |
| Totals | **288** | 117 | **438** | 396 |
| Net recoveries (charge-offs) | **187** | (67) | **(580)** | (405) |
| Provision for credit losses | **1,500** | 200 | **2,850** | 500 |
| Allowance balance - end of period | **$ 12,777** | $ 10,438 | **$ 12,777** | $ 10,438 |
| Average loans outstanding during the period | **$ 1,406,683** | $ 1,235,374 | **$ 1,348,363** | $ 1,219,623 |
| Net (recoveries) charge-offs (annualized) as a percentage of average loans outstanding during the period | **(0.05)%** | 0.02 % | **0.06 %** | 0.04 % |
| Allowance for credit losses at period end as a percentage of total period end loans (1) | **0.90 %** | 0.85 % | **0.90 %** | 0.85 % |
| Allowance for credit losses at period end as a percentage of average loans | **0.91 %** | 0.84 % | **0.95 %** | 0.86 % |

(1) At September 30, 2020, the loan balances used to calculate the ratio include PPP loans of $126.7 million. Excluding PPP loans, the ratio is 0.98%.

**Nonperforming Assets and Accruing TDRs**

As shown in the following table, nonperforming assets decreased $3.6 million to $8.4 million at September 30, 2020 from $12.0 million at December 31, 2019, primarily due to a decrease in nonaccrual loans of $3.6 million, or 34.2%. Accruing TDRs decreased $234 thousand to $7.3 million at September 30, 2020 from $7.5 million at December 31, 2019. Additionally, other real estate owned decreased $36 thousand, or 48.6%, when compared to December 31, 2019. The decrease in nonaccrual loans was due to three loan relationships with commercial real estate customers with nonaccrual loans of approximately $3.5 million, for which the Bank received payoffs during the third quarter of 2020, resulting in net recoveries for the period. The decrease in accruing TDRs was due to normal payments. The ratio of nonaccrual loans and accruing TDRs to total loans decreased to 1.00% at September 30, 2020 from 1.45% at December 31, 2019.

The Company continues to focus on the resolution of its nonperforming and problem assets. The efforts to accomplish this goal include frequently contacting borrowers until the delinquency is cured or until an acceptable payment plan has been agreed upon; obtaining updated appraisals; provisioning for credit losses; charging-off loans; transferring loans to other real estate owned; aggressively marketing other real estate owned. The reduction of nonperforming and problem assets is and will continue to be a high priority for the Company.

The following table summarizes our nonperforming assets and accruing TDRs at September 30, 2020 and December 31, 2019.

| (Dollars in thousands) | **September 30, 2020** | December 31, 2019 |
|---|---|---|
| Nonperforming assets | | |
| Nonaccrual loans | | |
| Construction | **$ 297** | $ — |
| Residential real estate | **2,031** | 2,475 |
| Commercial real estate | **4,327** | 7,817 |
| Commercial | **283** | 298 |
| Consumer | **28** | — |
| Total nonaccrual loans | **6,966** | 10,590 |
| Loans 90 days or more past due and still accruing | | |
| Construction | **—** | — |
| Residential real estate | **307** | 556 |
| Commercial real estate | **1,066** | 770 |
| Commercial | **—** | — |
| Consumer | **—** | — |
| Total loans 90 days or more past due and still accruing | **1,373** | 1,326 |
| Other real estate owned | **38** | 74 |
| Total nonperforming assets | **$ 8,377** | $ 11,990 |
| | | |
| Accruing TDRs | | |
| Construction | **$ 36** | $ 41 |
| Residential real estate | **3,878** | 4,041 |
| Commercial real estate | **3,353** | 3,419 |
| Commercial | **—** | — |
| Consumer | **—** | — |
| Total accruing TDRs | **$ 7,267** | $ 7,501 |
| | | |
| As a percent of total loans: | | |
| Nonaccrual loans | **0.49 %** | 0.85 % |
| Accruing TDRs | **0.51 %** | 0.60 % |
| Nonaccrual loans and accruing TDRs | **1.00 %** | 1.45 % |
| | | |
| As a percent of total loans and other real estate owned: | | |
| Nonperforming assets | **0.59 %** | 0.96 % |
| Nonperforming assets and accruing TDRs | **1.10 %** | 1.56 % |
| | | |
| As a percent of total assets: | | |
| Nonaccrual loans | **0.38 %** | 0.68 % |
| Nonperforming assets | **0.46 %** | 0.77 % |
| Accruing TDRs | **0.40 %** | 0.48 % |
| Nonperforming assets and accruing TDRs | **0.85 %** | 1.25 % |

**Investment Securities**

The investment portfolio is comprised of debt and equity securities. Debt securities are classified as either available for sale or held to maturity. Investment securities available for sale are stated at estimated fair value based on quoted prices. They represent securities which may be sold as part of the asset/liability management strategy or in response to changing interest rates. Net unrealized holding gains and losses on these securities are reported net of related income taxes as accumulated other comprehensive income (loss), a separate component of stockholders' equity.

Investment securities in the held to maturity category are stated at cost adjusted for amortization of premiums and accretion of discounts. We have the intent and current ability to hold such securities until maturity. At September 30, 2020, 87.3% of the portfolio of debt securities was classified as available for sale and 12.7% was classified as held to maturity, compared to 93.5% and 6.5% respectively, at December 31, 2019. See Note 4 – "Investment Securities", in the Notes to Consolidated Financial Statements for additional details on the composition of our investment portfolio.

Investment securities including restricted stock totaled $164.5 million at September 30, 2020, a $27.4 million, or 20.0%, increase since December 31, 2019. The increase was primarily due to the purchases of available for sale securities of $60.5 million and held to maturity securities of $11.6 million, partially offset by proceeds from maturities and sales of these securities of $46.5 million, during 2020. Due to the excess liquidity experienced in 2020, the Company strategically purchased short duration available for sale securities and subordinated debt of other banks which earn significantly higher average yields than interest-bearing deposits with other banks. As loan demand begins to strengthen, the Company will redeploy proceeds and excess liquidity to fund loan growth. At September 30, 2020, 82.3% of the securities available for sale were mortgage-backed and 17.7% were U.S. Government agencies, compared to 80.6% and 19.4%, respectively, at year-end 2019. Our investments in mortgage-backed securities are issued or guaranteed by U.S. Government agencies or government-sponsored agencies.

**Deposits**

Total deposits at September 30, 2020 amounted to $1.59 billion, an increase of $252.8 million, or 18.8%, when compared to the level at December 31, 2019. The increase in total deposits consisted of increases in interest-bearing deposits of $144.1 million and noninterest-bearing deposits of $108.7 million. The growth in interest-bearing deposits was represented by increases in interest-bearing checking accounts of $109.5 million and savings and money market accounts of $37.3 million, partially offset by a decrease in other time deposits of $2.7 million. The overall increase in deposits can be attributed to a combination of factors which include, customers retaining PPP loan proceeds, customers improving their liquidity position by participating in our deferred loan program and the result of new business and municipal relationships acquired during 2020.

**Short-Term Borrowings**

Short-term borrowings consisted of securities sold under agreements to repurchase, which decreased by $207 thousand, or 16.9%, to $1.0 million at September 30, 2020 when compared to December 31, 2019. Securities sold under agreements to repurchase are issued in conjunction with cash management services for commercial depositors. Other short-term borrowings may consist of overnight borrowing from correspondent banks or advances from the FHLB. Short-term advances are defined as those with original maturities of one year or less. At September 30, 2020 and December 31, 2019, the Company had no outstanding short-term advances with FHLB.

**Long-Term Debt**

The Company uses long-term borrowings to meet longer term liquidity needs, specifically to fund loan growth when liquidity from deposit growth is not sufficient. During the third quarter of 2020, the Company sold and issued $25.0 million in aggregate principal amount of 5.375% Fixed-to-Floating Rate Subordinated Notes due September 1, 2030. The amount of outstanding long-term borrowings at December 31, 2019 consisted of long-term advances from FHLB borrowings of $15.0 million, which carried an interest rate of 2.82%. These advances were paid off in April of 2020.

**Liquidity and Capital Resources**

We derive liquidity through increased customer deposits, non-reinvestment of the cash flow from the investment portfolio, loan repayments, borrowings and income from earning assets. As seen in the Consolidated Statements of Cash Flows in the Financial Statements, the net increase in cash and cash equivalents was $61.5 million for the first nine months of 2020 compared to an increase of $36.1 million for the first nine months of 2019. The increase in cash and cash equivalents in

2020 was mainly due to the significant increase in deposits, the direct result of PPP loan proceeds deposited to and remaining in these accounts as of September 30, 2020. The Company expects these funds to be utilized over the coming months, which may or may not result in a decline in deposit balances. Furthermore, the increase in cash and cash equivalents was the result of the issuance of subordinated notes in the third quarter of 2020, which net of issuance costs resulted in $24.4 million in additional liquidity.

To the extent that deposits are not adequate to fund customer loan demand, liquidity needs can be met in the short-term fund markets. The Bank has arrangements with other corresponding banks whereby it has $15 million available in federal funds lines of credit and a reverse repurchase agreement available to meet any short-term needs which may not otherwise be funded by the Bank's portfolio of readily marketable investments that can be converted to cash. The Bank is also a member of the FHLB, which provides another source of liquidity. Through the FHLB, the Bank had collateral pledged of approximately $313.8 million and $270.1 million at September 30, 2020 and December 31, 2019, respectively. The Bank has pledged, under a blanket lien, all qualifying residential and commercial real estate loans under borrowing agreements with the FHLB.

Total stockholders' equity increased $6.1 million to $198.9 million at September 30, 2020 when compared to December 31, 2019 primarily due to the current year's retained earnings and a positive change in accumulated other comprehensive income of $1.7 million, or 819.8%, partially offset by dividends paid during the first nine months of 2020 and the repurchase of common stock in the third quarter of 2020.

*CBLR*

On September 17, 2019, the FDIC finalized a rule that introduces an optional simplified measure of capital adequacy for qualifying community banking organizations (i.e., the community bank leverage ratio ("CBLR") framework), as required by the Economic Growth, Regulatory Relief and Consumer Protection Act. The CBLR framework is designed to reduce burden by removing the requirements for calculating and reporting risk-based capital ratios for qualifying community banking organizations that opt into the framework.

On April 6, 2020, in a joint statement, the FDIC, Federal Reserve and the Office of Comptroller of the Currency ("OCC"), issued two interim final rules regarding temporary changes to the CBLR framework to implement provisions of the CARES Act. Under the interim final rules, the community bank leverage ratio will be reduced to 8% beginning in the second quarter and for the remainder of calendar year 2020, 8.5% for calendar year 2021, and 9% thereafter. In order to qualify for the CBLR framework, a community banking organization must have a tier 1 leverage ratio of greater than 8%, less than $10 billion in total consolidated assets, and limited amounts of off-balance-sheet exposures and trading assets and liabilities. A qualifying community banking organization that opts into the CBLR framework and meets all requirements under the framework will be considered to have met the well-capitalized ratio requirements under the Prompt Corrective Action regulations and will not be required to report or calculate risk-based capital.

The CBLR framework was available for banks to use in their March 31, 2020 Call Report. The Bank did not opt into the CBLR framework in the first, second or third quarter of 2020.

*Basel III*

Under final Federal Reserve and FDIC approved rules implementing the Basel Committee on Banking Supervision's capital guidelines for U.S. banks minimum requirements increased for both the quantity and quality of capital held by the Bank. The Basel III capital standards substantially revised the risk based capital requirements applicable to bank holding companies and their depository institution subsidiaries, including the definitions and the components of Tier 1 capital and Total Capital, the method of evaluating risk-weighted assets, institutions of a capital conservation buffer, and other matters affecting regulatory capital ratios. Strict eligibility criteria for regulatory capital instruments were also implemented under the rules.

The phase-in period for the final rules became effective for the Bank on January 1, 2015, with full compliance with all of the final rules' requirements phased in over a multi-year schedule, which was fully phased in on January 1, 2019. As of September 30, 2020, the Bank's capital levels remained characterized as "well-capitalized" under the rules.

The following tables present the applicable capital ratios as of September 30, 2020 and December 31, 2019.

| **September 30, 2020** | Tier 1 leverage ratio | Common Equity Tier 1 ratio | Tier 1 risk-based capital ratio | Total risk-based capital ratio |
|---|---|---|---|---|
| Shore United Bank | 10.07 % | 13.31 % | 13.31 % | 14.30 % |

| December 31, 2019 | Tier 1 leverage ratio | Common Equity Tier 1 ratio | Tier 1 risk-based capital ratio | Total risk-based capital ratio |
|---|---|---|---|---|
| Shore United Bank | 10.64 % | 13.00 % | 13.00 % | 13.87 % |

**Item 3. Quantitative and Qualitative Disclosures about Market Risk.**

Our primary market risk is interest rate fluctuation and management has procedures in place to evaluate and mitigate this risk. This risk and these procedures are discussed in Item 7 of Part II of the 2019 Annual Report under the caption "Market Risk Management and Interest Sensitivity". Management believes that there have been no material changes in our market risks, the procedures used to evaluate and mitigate these risks, or our actual and simulated sensitivity positions since December 31, 2019.

**Item 4. Controls and Procedures.**

We maintain disclosure controls and procedures that are designed to ensure that information required to be disclosed in the reports that Shore Bancshares, Inc. files under the Securities Exchange Act of 1934, as amended ("Exchange Act") with the SEC, such as this Quarterly Report, is recorded, processed, summarized and reported within the time periods specified in those rules and forms, and that such information is accumulated and communicated to management, including Shore Bancshares, Inc.'s principal executive officer ("PEO") and its principal financial officer ("PFO"), as appropriate, to allow for timely decisions regarding required disclosure. A control system, no matter how well conceived and operated, can provide only reasonable, not absolute, assurance that the objectives of the control system are met. Further, the design of a control system must reflect the fact that there are resource constraints, and the benefits of controls must be considered relative to their costs. These inherent limitations include the realities that judgments in decision-making can be faulty, and that breakdowns can occur because of simple error or mistake. Additionally, controls can be circumvented by the individual acts of some persons, by collusion of two or more people, or by management override of the control. The design of any system of controls also is based in part upon certain assumptions about the likelihood of future events, and there can be no assurance that any design will succeed in achieving its stated goals under all potential future conditions; over time, controls may become inadequate because of changes in conditions, or the degree of compliance with the policies or procedures may deteriorate.

An evaluation of the effectiveness of these disclosure controls and procedures as of September 30, 2020 was carried out under the supervision and with the participation of management, including the PEO and the PFO. Based on that evaluation, the Company's management, including the PEO and the PFO, has concluded that our disclosure controls and procedures are, in fact, effective at the reasonable assurance level at September 30, 2020.

There was no change in our internal control over financial reporting during the third quarter of 2020 that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

**PART II – OTHER INFORMATION**

**Item 1. Legal Proceedings**

From time to time the Company may become involved in legal proceedings. At the present time, there are no proceedings which the Company believes will have a material adverse impact on the financial condition or earnings of the Company.

## Item 1A. Risk Factors

The section titled Risk Factors in Part I, Item 1A of our 2019 Form 10-K includes a discussion of the many risks and uncertainties we face, any one or more of which could have a material adverse effect on our business, results of operations, financial condition (including capital and liquidity), or prospects or the value of or return on an investment in the Company. The information presented below provides an update to, and should be read in conjunction with, the risk factors and other information contained in our 2019 Form 10-K.

**The ongoing COVID-19 pandemic has led to periods of significant volatility in financial, commodities and other markets and could harm our business and results of operations.**

In December 2019, COVID-19 was first reported in Wuhan, Hubei Province, China. Since then, COVID-19 infections have spread to additional countries including the United States. In March 2020, the World Health Organization declared COVID-19 to be a pandemic. Given the ongoing and dynamic nature of the circumstances, it is difficult to predict the impact of the coronavirus pandemic on our business, and there is no guarantee that our efforts to address or mitigate the adverse impacts of the coronavirus will be effective. The impact to date has included periods of significant volatility in financial, commodities and other markets. This volatility has had and, if it continues, could continue to have an adverse impact on our customers and on our business, financial condition and results of operations as well as our growth strategy.

Our business is dependent upon the willingness and ability of our customers to conduct banking and other financial transactions. The spread of COVID-19 has caused and could continue to cause severe disruptions in the U.S. economy at large, and has resulted and may continue to result in disruptions to our customers' businesses, and a decrease in consumer confidence and business generally. In addition, recent actions by US federal, state and local governments to address the pandemic, including travel bans, stay-at-home orders and school, business and entertainment venue closures, have had and may continue to have a significant adverse effect on our customers and the markets in which we conduct our business. The extent of impacts resulting from the coronavirus pandemic and other events beyond our control will depend on future developments, which are highly uncertain and cannot be predicted, including new information which may emerge concerning the severity of the coronavirus pandemic and actions taken to contain the coronavirus or its impact, among others.

Disruptions to our customers could result in increased risk of delinquencies, defaults, foreclosures and losses on our loans. The escalation of the pandemic may also negatively impact regional economic conditions for a period of time, resulting in declines in local loan demand, liquidity of loan guarantors, loan collateral (particularly in real estate), loan originations and deposit availability. If the global response to contain COVID-19 escalates or is unsuccessful, we could experience a material adverse effect on our business, financial condition, results of operations and cash flows.

**The spread of the COVID-19 outbreak and the governmental responses may disrupt banking and other financial activity in the areas in which we operate and could potentially create widespread business continuity issues for us.**

The outbreak of COVID-19 and the U.S. federal, state and local governmental responses may result in a disruption in the services we provide. We rely on our third-party vendors to conduct business and to process, record, and monitor transactions. If any of these vendors are unable to continue to provide us with these services or experience interruptions in their ability to provide us with these services, it could negatively impact our ability to serve our customers. Furthermore, the coronavirus pandemic could negatively impact the ability of our employees and customers to engage in banking and other financial transactions in the geographic areas in which we operate and could create widespread business continuity issues for us. We also could be adversely affected if key personnel or a significant number of employees were to become unavailable due to infection, quarantine or other effects and restrictions of a COVID-19 outbreak in our market areas. Although we have business continuity plans and other safeguards in place, there is no assurance that such plans and safeguards will be effective. If we are unable to promptly recover from such business disruptions, our business and financial conditions and results of operations would be adversely affected. We also may incur additional costs to remedy damages caused by such disruptions, which could adversely affect our financial condition and results of operations.

**Our participation in the SBA PPP loan program exposes us to risks related to noncompliance with the PPP, as well as litigation risk related to our administration of the PPP loan program, which could have a material adverse impact on our business, financial condition and results of operations.**

The Company is a participating lender in the PPP, a loan program administered through the SBA, that was created to help eligible businesses, organizations and self-employed persons fund their operational costs during the COVID-19 pandemic. Under this program, the SBA guarantees 100% of the amounts loaned under the PPP. The PPP opened on April 3, 2020; however, because of the short window between the passing of the CARES Act and the opening of the PPP, there is some ambiguity in the laws, rules and guidance regarding the operation of the PPP, which exposes the Company to risks relating to noncompliance with the PPP. For instance, other financial institutions have experienced litigation related to their process and procedures used in processing applications for the PPP. Any financial liability, litigation costs or reputational damage caused by PPP related litigation could have a material adverse impact on our business, financial condition and results of operations. In addition, the Company may be exposed to credit risk on PPP loans if a determination is made by the SBA that there is a deficiency in the manner in which the loan was originated, funded, or serviced. If a deficiency is identified, the SBA may deny its liability under the guaranty, reduce the amount of the guaranty, or, if it has already paid under the guaranty, seek recovery of any loss related to the deficiency from the Company.

**Interest rate volatility stemming from COVID-19 could negatively affect our net interest income, lending activities, deposits and profitability.**

Our net interest income, lending activities, deposits and profitability could be negatively affected by volatility in interest rates caused by uncertainties stemming from COVID-19. In March 2020, the Federal Reserve lowered the target range for the federal funds rate to a range from 0 to 0.25 percent, citing concerns about the impact of COVID-19 on markets and stress in the energy sector. A prolonged period of extremely volatile and unstable market conditions would likely increase our funding costs and negatively affect market risk mitigation strategies. Higher income volatility from changes in interest rates and spreads to benchmark indices could cause a loss of future net interest income and a decrease in current fair market values of our assets. Fluctuations in interest rates will impact both the level of income and expense recorded on most of our assets and liabilities and the market value of all interest-earning assets and interest-bearing liabilities, which in turn could have a material adverse effect on our net income, operating results, or financial condition.

**We are subject to increasing credit risk as a result of the COVID-19 pandemic, which could adversely impact our profitability.**

Our business depends on our ability to successfully measure and manage credit risk. As a commercial lender, we are exposed to the risk that the principal of, or interest on, a loan will not be paid timely or at all or that the value of any collateral supporting a loan will be insufficient to cover our outstanding exposure. In addition, we are exposed to risks with respect to the risks resulting from changes in economic and industry conditions and risks inherent in dealing with individual loans and borrowers. As the overall economic climate in the U.S., generally, and in our market areas specifically, experiences material disruption due to the COVID-19 pandemic, our borrowers may experience difficulties in repaying their loans and governmental actions may provide payment relief to borrowers affected by COVID-19 and preclude our ability to initiate foreclosure proceedings in certain circumstances and, as a result, the collateral we hold may decrease in value or become illiquid, and the level of our nonperforming loans, charge-offs and delinquencies could rise and require significant additional provisions for credit losses. Additional factors related to the credit quality of certain commercial real estate and multifamily residential loans include the duration of state and local moratoriums on evictions for non-payment of rent or other fees. The payment on these loans that are secured by income producing properties are typically dependent on the successful operation of the related real estate property and may subject us to risks from adverse conditions in the real estate market or the general economy.

We are actively working to support our borrowers to mitigate the impact of the COVID-19 pandemic on them and on our loan portfolio, including through loan modifications that defer payments for those who experienced a hardship as a result of the COVID-19 pandemic. Although recent regulatory guidance provides that such loan modifications are exempt from the calculation and reporting of TDRs and loan delinquencies, we cannot predict whether such loan modifications may ultimately have an adverse impact on our profitability in future periods. Our inability to successfully manage the increased credit risk caused by the COVID-19 pandemic could have a material adverse effect on our business, financial condition and results of operations.

**We may incur impairments to goodwill or other intangibles as a result of the economic volatility resulting from the COVID-19 pandemic, which could adversely affect our financial condition, results of operations and stock price.**

As of September 30, 2020, we had approximately $17.5 million recorded as goodwill. We conducted an impairment assessment of goodwill and intangibles in the first three quarters of 2020 and the impairment evaluation did not identify any impairment in either quarter of 2020. In addition, the Company will complete a full annual assessment of goodwill in the fourth quarter of 2020, however there can be no assurances that prolonged significant negative economic trends resulting from the COVID-19 pandemic, including the lack of recovery in the market price of our common stock, or reduced estimates of future cash flows or disruptions to our business, will not result in impairments to goodwill or other intangibles, such as our core deposit intangibles. If our analysis results in impairment to goodwill or other intangibles, we would be required to record an impairment charge to earnings in our financial statements during the period in which such impairment is determined to exist. Any such change could have a material adverse effect on our financial condition, results of operations and stock price.

**Unpredictable future developments related to or resulting from the COVID-19 pandemic could materially and adversely affect our business and results of operations**.

Because there have been no comparable recent global pandemics that resulted in a similar global impact, we do not yet know the full extent of the COVID-19 pandemic's effects on our business, operations, or the global economy as a whole. Any future development will be highly uncertain and cannot be predicted, including the scope and duration of the pandemic, the effectiveness of our work from home arrangements, third party providers' ability to support our operation, and any actions taken by governmental authorities and other third parties in response to the pandemic. We are continuing to monitor the COVID-19 pandemic and related risks, although the rapid development and fluidity of the situation precludes any specific prediction as to its ultimate impact on us. However, if the pandemic continues to spread or otherwise results in a continuation or worsening of the current economic and commercial environments, our business, financial condition, results of operations and cash flows as well as our regulatory capital and liquidity ratios could be materially adversely affected and many of the risks described in our 2019 Form 10-K will be heightened.

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

On April 24, 2019 the Corporation's Board of Directors approved a stock repurchase program. Under the stock repurchase program, the Corporation is authorized to repurchase up to $10 million, or approximately 5%, of its common stock for 2019 and 2020. The program may be limited or terminated at any time without prior notice. During the three months ended September 30, 2020, the Corporation repurchased 288,400 shares of its common stock.

The following table provides information with respect to purchases made by or on behalf of us or any "affiliated purchaser" (as defined in Rule 10b-18(a)(3) under the Exchange Act) of our common stock during the third quarter of 2020.

| Period | Total Number Of Shares Purchased | Average Price Paid Per Share | Total Number of Shares Purchased as Part of the Publicly Announced Plans or Programs | Maximum Dollar Value Of Shares that May Yet Be Purchased Under the Plans or Programs |
|---|---|---|---|---|
| July 1, 2020 to July 31, 2020 | — | $ — | — | $ 5,551,624 |
| August 1, 2020 to August 31, 2020 | — | — | — | 5,551,624 |
| September 1, 2020 to September 30, 2020 | 288,400 | 10.56 | 288,400 | 2,442,624 |
| Total | 288,400 | $ 10.56 | 288,400 | |

The Company has purchased all shares under the current stock repurchase program as of October 26, 2020.

**Item 3. Defaults Upon Senior Securities**

None

**Item 4. Mine Safety Disclosures**

Not Applicable

**Item 5. Other Information**

None

**Item 6. Exhibits.**

| Exhibit Number | Description |
|---|---|
| 3.1(i) | Amended and Restated Articles of Incorporation (incorporated by reference to Exhibit 3.1 of the Company's Form 8-K filed on December 14, 2000). |
| 3.1(ii) | Articles Supplementary relating to the Fixed Rate Cumulative Perpetual Preferred Stock Series A (incorporated by reference to Exhibit 4.1 of the Company's Form 8-K filed on January 13, 2009). |
| 3.1(iii) | Articles Supplementary relating to the reclassification of the Fixed Rate Cumulative Perpetual Preferred Stock Series A, as common stock (incorporated by reference to Exhibit 3.1(i) of the Company's Form 8-K filed on June 17, 2009). |
| 3.2(i) | Amended and Restate By-Laws (incorporated by reference to Exhibit 3.2(i) of the Company's Form 10-K for the year ended December 31, 2010). |
| 3.2(ii) | First Amendment to Amended and Restate By-Laws (incorporated by reference to Exhibit 3.2(ii) of the Company's Form 10-K for the year ended December 31, 2010). |
| 3.2(iii) | Second Amendment to Amended and Restate By-Laws (incorporated by reference to Exhibit 3.2(iii) of the Company's Form 10-K for the year ended December 31, 2010). |
| 3.2(iv) | Third Amendment to Amended and Restate By-Laws (incorporated by reference to Exhibit 3.2(iv) of the Company's Form 10-K for the year ended December 3, 2010). |
| 31.1 | Certifications of the Principal Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act (filed herewith). |
| 31.2 | Certifications of the Principal Accounting Officer pursuant to Section 302 of the Sarbanes-Oxley Act (filed herewith). |
| 32 | Certification pursuant to Section 906 of the Sarbanes-Oxley Act (furnished herewith). |
| 101 | Inline Interactive Data File |
| 101.INS | Inline XBRL Instance Document (the instance document does not appear in the Interactive Data File because its XBRL tags are embedded within the Inline XBRL document) |
| 101.SCH | Inline XBRL Taxonomy Extension Schema (filed herewith) |
| 101.CAL | Inline XBRL Taxonomy Extension Calculation Linkbase (filed herewith) |
| 101.DEF | Inline XBRL Taxonomy Extension Definition Linkbase (filed herewith) |
| 101.LAB | Inline XBRL Taxonomy Extension Label Linkbase (filed herewith) |
| 101.PRE | Inline XBRL Taxonomy Extension Presentation Linkbase (filed herewith) |
| 104 | Cover Page Interactive Data File (formatted as Inline XBRL and contained in Exhibit 101). |

## SIGNATURES

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

**SHORE BANCSHARES, INC.**

Date: November 6, 2020

By: /s/ Lloyd L. Beatty, Jr.
Lloyd L. Beatty, Jr.
President & Chief Executive Officer
(Principal Executive Officer)

Date: November 6, 2020

By: /s/ Edward C. Allen
Edward C. Allen
Executive Vice President & Chief Financial Officer
(Principal Accounting Officer)

**EXHIBIT 31.1**

**Certifications of the Principal Executive Officer**
**Pursuant to Securities Exchange Act Rules 13a-1 and 15d-14**
**As adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002**

I, Lloyd L. Beatty, Jr., certify that:

1. I have reviewed this report on Form 10-Q of Shore Bancshares, Inc.;

2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;

3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;

4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:

   a. Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;

   b. Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;

   c. Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and

   d. Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and

5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):

   a. All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and

   b. Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: November 6, 2020

By: /s/ Lloyd L. Beatty, Jr.
Lloyd L. Beatty, Jr.
President and Chief Executive Officer
(Principal Executive Officer)

**EXHIBIT 31.2**

**Certifications of the Principal Accounting Officer**
**Pursuant to Securities Exchange Act Rules 13a-1 and 15d-14**
**As adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002**

I, Edward C. Allen, certify that:

1. I have reviewed this report on Form 10-Q of Shore Bancshares, Inc.;

2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;

3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;

4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:

   a. Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;

   b. Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;

   c. Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this annual report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and

   d. Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and

5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):

   a. All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and

   b. Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: November 6, 2020

By: /s/ Edward C. Allen
Edward C. Allen
Executive Vice President and Chief Financial Officer
(Principal Financial Officer)

**EXHIBIT 32**

**Certification of Periodic Report**
**Pursuant to 18 U.S.C. Section 1350**
**As adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002**

Pursuant to, and for purposes only of, 18 U.S.C. § 1350, the undersigned hereby certify that (i) the Quarter Report of Shore Bancshares, Inc. on Form 10-Q for the Quarter ended September 30, 2020 filed with the Securities and Exchange Commission (the "Report") fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934, and (ii) information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of Shore Bancshares, Inc.

Date: November 6, 2020

/s/ Lloyd L. Beatty, Jr.
Lloyd L. Beatty, Jr.
President and Chief Executive Officer
(Principal Executive Officer)

Date: November 6, 2020

/s/ Edward C. Allen
Edward C. Allen
Executive Vice President and Chief Financial Officer
(Principal Financial Officer)