

MERCANTILE BANKSHARES CORP  
Form 10-Q  
August 07, 2006

**UNITED STATES**

**SECURITIES AND EXCHANGE COMMISSION**

WASHINGTON, D.C. 20549

**FORM 10-Q**

(Mark One)

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

For the quarterly period ended June 30, 2006

**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: **0-5127**

**MERCANTILE BANKSHARES CORPORATION**

(Exact name of registrant as specified in its charter)

**Maryland**

(State or other jurisdiction of  
incorporation or organization)

**52-0898572**

(I.R.S. Employer  
Identification No.)

**2 Hopkins Plaza**

**Baltimore, Maryland 21201**

(Address of principal executive offices) (Zip Code)

**(410) 237-5900**

(Registrant's telephone number, including area code)

**NONE**

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

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes  No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act. (Check one).

Large accelerated filer

Accelerated filer

Non-accelerated filer

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes  No

As of July 31, 2006, there were 125,362,712 shares of registrant's Common Stock, \$2 par value per share, outstanding.

**MERCANTILE BANKSHARES CORPORATION**  
**Quarterly Report on Form 10-Q**  
**June 30, 2006**

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**Signatures**

**PART I FINANCIAL INFORMATION****Item 1. Financial Statements (Unaudited)****MERCANTILE BANKSHARES CORPORATION  
CONSOLIDATED BALANCE SHEETS**

(Dollars in thousands, except per share data)	June 30, 2006	December 31, 2005	June 30, 2005
<b>ASSETS</b>			
Cash and due from banks	\$ 380,476	\$ 369,536	\$ 382,695
Interest-bearing deposits in other banks	200	200	200
Federal funds sold	19,106	25,104	95,102
Total cash and cash equivalents	399,782	394,840	477,997
Investment securities available-for-sale (Note 4)	3,109,708	3,089,628	2,960,275
Investment securities held-to-maturity (Note 4) - fair value of \$15,871 (June 2006), \$17,181 (December 2005) and \$18,788 (June 2005)	15,532	16,659	18,056
Total investment securities	3,125,240	3,106,287	2,978,331
Loans held-for-sale	61,721	26,263	16,754
Loans:			
Commercial	2,935,369	2,957,301	2,923,419
Commercial real estate	3,826,335	3,703,297	3,585,592
Construction	1,855,110	1,607,095	1,560,149
Residential real estate	1,905,032	1,802,373	1,776,959
Home equity lines	479,011	505,508	517,342
Consumer	1,049,323	1,032,271	1,000,845
Total loans	12,050,180	11,607,845	11,364,306
Less: allowance for loan losses	(142,860)	(156,673)	(157,101)
Loans, net	11,907,320	11,451,172	11,207,205
Bank premises and equipment, less accumulated depreciation of \$147,264 (June 2006), \$146,585 (December 2005) and \$151,132 (June 2005)	139,007	137,419	147,774
Other real estate owned, net	49	667	777
Goodwill, net	679,710	670,028	667,465
Other intangible assets, net (Note 8)	42,403	46,653	49,830
Other assets	647,482	588,400	546,861
Total assets	\$ 17,002,714	\$ 16,421,729	\$ 16,092,994
<b>COMMITMENTS and CONTINGENCIES (Note 7)</b>			
<b>LIABILITIES</b>			
Deposits:			
Noninterest-bearing deposits	\$ 3,392,286	\$ 3,324,650	\$ 3,293,344
Interest-bearing deposits	9,051,736	8,752,700	8,537,407
Total deposits	12,444,022	12,077,350	11,830,751
Short-term borrowings	1,432,119	1,237,714	1,192,782
Accrued expenses and other liabilities	210,699	169,780	140,390
Long-term debt	650,829	742,163	807,954
Total liabilities	14,737,669	14,227,007	13,971,877
<b>SHAREHOLDERS EQUITY</b>			
Preferred stock, no par value; authorized 2,000,000 shares; issued and outstanding - None			
Common stock, \$2 par value; authorized 200,000,000 shares; issued shares - 123,523,069 (June 2006), 123,248,121 (December 2005) and 122,973,563 (June 2005)	247,046	164,331	163,965
Capital surplus	600,349	676,830	665,006
Retained earnings	1,466,852	1,386,405	1,302,869
Accumulated other comprehensive income (loss)	(49,202)	(32,844)	(10,723)
Total shareholders equity	2,265,045	2,194,722	2,121,117

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Total liabilities and shareholders' equity	\$	<b>17,002,714</b>	\$	16,421,729	\$	16,092,994
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See Notes to Consolidated Financial Statements.

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**MERCANTILE BANKSHARES CORPORATION**  
**STATEMENTS OF CONSOLIDATED INCOME**

(Dollars in thousands, except per share data)	For the 6 months ended		For the 3 months ended	
	June 30, 2006	2005	June 30, 2006	2005
<b>INTEREST INCOME</b>				
Interest and fees on loans	\$ 404,151	\$ 322,421	\$ 208,096	\$ 169,877
Interest and dividends on investment securities:				
Taxable interest income	60,930	50,366	31,135	25,374
Tax-exempt interest income	1,543	1,509	765	788
Other investment income	1,326	1,227	699	583
Total interest and dividends on investment securities	63,799	53,102	32,599	26,745
Other interest income	1,756	786	1,098	442
Total interest income	469,706	376,309	241,793	197,064
<b>INTEREST EXPENSE</b>				
Interest on deposits	106,846	56,689	57,603	31,384
Interest on short-term borrowings	24,523	9,526	13,500	5,484
Interest on long-term debt	18,614	14,644	9,280	7,829
Total interest expense	149,983	80,859	80,383	44,697
<b>NET INTEREST INCOME</b>	<b>319,723</b>	<b>295,450</b>	<b>161,410</b>	<b>152,367</b>
Provision for credit losses		756		
<b>NET INTEREST INCOME AFTER PROVISION FOR CREDIT LOSSES</b>	<b>319,723</b>	<b>294,694</b>	<b>161,410</b>	<b>152,367</b>
<b>NONINTEREST INCOME</b>				
Investment and wealth management	54,986	47,837	28,865	23,780
Service charges on deposit accounts	21,160	21,514	10,868	11,088
Mortgage banking-related fees	4,545	5,178	2,335	2,895
Investment securities (losses) gains	(13 )	490		76
Nonmarketable investments	12,233	9,493	5,964	4,222
Other income	32,163	33,423	16,436	18,005
Total noninterest income	125,074	117,935	64,468	60,066
<b>NONINTEREST EXPENSES</b>				
Salaries	96,331	96,734	47,232	50,180
Employee benefits	29,027	23,853	14,292	11,956
Net occupancy expense of bank premises	15,702	13,779	7,931	6,857
Furniture and equipment expenses	16,399	15,203	8,094	7,924
Communications and supplies	8,287	8,059	4,469	4,019
Other expenses	50,391	46,438	27,404	22,977
Total noninterest expenses	216,137	204,066	109,422	103,913
Income before income taxes	228,660	208,563	116,456	108,520
Applicable income taxes	84,809	78,063	43,364	40,647
<b>NET INCOME</b>	<b>\$ 143,851</b>	<b>\$ 130,500</b>	<b>\$ 73,092</b>	<b>\$ 67,873</b>
<b>NET INCOME PER SHARE OF COMMON STOCK (Note 3):</b>				
Basic	\$ 1.17	\$ 1.09	\$ 0.59	\$ 0.56
Diluted	\$ 1.16	\$ 1.08	\$ 0.59	\$ 0.56
<b>DIVIDENDS PAID PER COMMON SHARE</b>	<b>\$ 0.54</b>	<b>\$ 0.49</b>	<b>\$ 0.28</b>	<b>\$ 0.25</b>

See Notes to Consolidated Financial Statements.



**MERCANTILE BANKSHARES CORPORATION**  
**STATEMENTS OF CHANGES IN CONSOLIDATED SHAREHOLDERS EQUITY**

For the 6 months ended June 30, 2006 and 2005 (Dollars in thousands, except per share data)	Total	Common Stock	Capital Surplus	Retained Earnings	Accumulated Other Comprehensive Loss
BALANCE, DECEMBER 31, 2004	\$ 1,917,683	\$ 158,601	\$ 530,705	\$ 1,231,102	\$ (2,725 )
Net income	130,500			130,500	
Unrealized gains (losses) on securities available-for-sale, net of reclassification adjustment, net of taxes	(7,998 )				(7,998 )
Comprehensive income	122,502				
Cash dividends paid:					
Common stock (\$0.49 per share)	(57,897 )			(57,897 )	
Issuance of 2,444,408 shares for bank acquisition	124,335	4,889	119,446		
Fair value of 138,764 converted options related to employee stock option plan of acquired bank	5,182		5,182		
Issuance of 54,750 shares for dividend reinvestment and stock purchase plan	2,677	110	2,567		
Issuance of 11,740 shares for employee stock purchase dividend reinvestment plan	592	23	569		
Issuance of 132,034 shares for employee stock option plan	1,957	265	1,692		
Directors' deferred compensation plan:					
Issuance of 1,599 shares		2	(2 )		
Contribution	370		370		
Dividend			127	(127 )	
Nonvested stock awards					
Issuance of 37,338 shares	1,906	75	1,831		
Deferred compensation Expense	(2,000 )			(2,000 )	
Vested stock options	1,291			1,291	
BALANCE, JUNE 30, 2005	\$ 2,121,117	\$ 163,965	\$ 665,006	\$ 1,302,869	\$ (10,723 )
BALANCE, DECEMBER 31, 2005	\$ 2,194,722	\$ 164,331	\$ 676,830	\$ 1,386,405	\$ (32,844 )
Net income	143,851			143,851	
Unrealized gains (losses) on securities available-for-sale, net of reclassification adjustment, net of taxes	(16,358 )				(16,358 )
Comprehensive income	127,493				
Cash dividends paid:					
Common stock (\$0.54 per share)	(66,508 )			(66,508 )	
Issuance of 89,574 shares for dividend reinvestment and stock purchase plan	3,162	179	2,983		
Issuance of 16,685 shares for employee stock purchase dividend reinvestment plan	643	33	610		
Issuance of 50,606 shares for employee stock option plan	1,083	101	982		
Directors' deferred compensation plan:					
Issuance of 4,575 shares	143	9	134		
Contribution	690		690		
Dividend			102	(102 )	
Nonvested stock awards and units					
Issuance of 148,641 shares	375	297	78		
Repurchase of 37,252 shares for tax settlement Expense	(1,431 )	(74 )	(1,357 )		
Vested stock options	3,333		3,333		
	1,422		1,422		

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Adjustment for adoption of SFAS No. 123R			(3,206	)3,206		
Issuance of 41,084,826 shares for the 3 for 2 stock split	(82	)82,170	(82,252	)		
<b>BALANCE, JUNE 30, 2006</b>	<b>\$ 2,265,045</b>	<b>\$ 247,046</b>	<b>\$ 600,349</b>	<b>\$ 1,466,852</b>	<b>\$ (49,202</b>	<b>)</b>

See Notes to Consolidated Financial Statements.

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**MERCANTILE BANKSHARES CORPORATION**  
**STATEMENTS OF CONSOLIDATED CASH FLOWS**

Increase (decrease) in cash and cash equivalents (Dollars in thousands)	For the 6 months ended June 30,	
	2006	2005
<b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>		
Net income	\$ 143,851	\$ 130,500
Adjustments to reconcile net income to net cash provided by operating activities:		
Provision for credit losses		756
Depreciation	7,822	7,560
Amortization of other intangible assets	4,542	4,251
Tax benefit from the issuance of stock-based compensation	99	
Write-downs of other real estate owned		1
Gains on sales of other real estate owned	(7 )	(153 )
Loss (gains) on sales of investments securities	13	(490 )
Gains on sales of premises	(103 )	(4,541 )
Net increase in loans held-for-sale	(36,292 )	(5,754 )
Net increase in assets:		
Interest receivable	(3,754 )	(444 )
Nonmarketable investments	(9,829 )	(6,683 )
Other assets	(10,503 )	(4,472 )
Net increase (decrease) in liabilities:		
Interest payable	6,774	3,591
Other liabilities	(11,797 )	(27,356 )
Net cash provided by operating activities	90,816	96,766
<b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>		
Proceeds from maturities of investment securities held-to-maturity	1,127	2,120
Proceeds from maturities of investment securities available-for-sale	492,581	425,262
Proceeds from sales of investment securities available-for-sale	1,791	89,878
Purchases of investment securities held-to-maturity		(408,727 )
Purchases of investment securities available-for-sale	(540,550 )	
Net increase in loans	(440,535 )	(465,812 )
Proceeds from sales of other real estate owned	2,241	273
Capital expenditures	(10,426 )	(10,189 )
Proceeds from sales of premises	536	5,893
Business acquisitions (net of cash received)		(78,655 )
Business acquisitions contingent consideration	(8,806 )	
Purchases of nonmarketable investments	(5,866 )	(3,926 )
Net cash used in investing activities	(507,907 )	(443,883 )
<b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>		
Net increase in noninterest-bearing deposits	67,636	136,463
Net increase in interest-bearing deposits	299,421	268,181
Net increase in short-term borrowings	194,405	295,219
Repayment of long-term debt	(77,545 )	(67,212 )
Tax benefit from the issuance of stock-based compensation	983	
Excess tax benefit related to stock-based compensation	327	
Proceeds from issuance of shares	4,745	5,226
Repurchase of common shares	(1,431 )	
Dividends paid	(66,508 )	(57,897 )
Net cash provided by financing activities	422,033	579,980
Net increase in cash and cash equivalents	4,942	232,863
Cash and cash equivalents at beginning of period	394,840	245,134
Cash and cash equivalents at end of period	\$ 399,782	\$ 477,997
<b>SUPPLEMENTAL INFORMATION</b>		
Cash payments for interest	\$ 143,209	\$ 75,916
Cash payments for income taxes	87,998	91,109

See Notes to Consolidated Financial Statements.

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**MERCANTILE BANKSHARES CORPORATION**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

1. Basis of Presentation

The consolidated financial statements, which include the accounts of Mercantile Bankshares Corporation ( Bankshares ) (Nasdaq: MRBK) and all of its affiliates, are prepared in conformity with accounting principles generally accepted in the United States of America and follow general practice within the banking industry. In the opinion of management, the consolidated financial statements include all adjustments necessary for a fair presentation of the interim period. These adjustments are of a normal nature and include adjustments to eliminate all significant intercompany transactions. In view of the changing conditions in the national economy, the effect of actions taken by regulatory authorities and normal seasonal factors, the results for the interim period are not necessarily indicative of annual performance. For purposes of comparability, certain prior period amounts have been reclassified to conform to current period presentation.

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and contingent assets and liabilities in the financial statements, and the disclosure of revenue and expenses during the reporting period. These assumptions are based on information available as of the date of the financial statements and could differ from actual results. See Bankshares Annual Report on Form 10-K for more detail.

On January 10, 2006, Bankshares announced a three-for-two stock split on its common stock payable in the form of a stock dividend on January 27, 2006 to stockholders of record as of the close of business on January 20, 2006. For comparative purposes, certain share, average share and per share amounts have been restated.

2. Business Combinations / Restructuring

The following provides information concerning acquisitions and restructurings. Acquisitions were accounted for as purchases with the results of their operations subsequent to the acquisition date included in Bankshares Statements of Consolidated Income.

On March 27, 2006, Bankshares signed a definitive merger agreement with James Monroe Bancorp, Inc. ( James Monroe ). The acquisition of this Arlington, Virginia-based commercial bank was completed on July 17, 2006, and it was merged into Mercantile-Safe Deposit & Trust Company ( MSD&T ). Under the terms of the agreement, shareholders of James Monroe were entitled to elect to receive either cash in the amount of \$23.50 for each share, or .6033 shares of Bankshares common stock for each share of James Monroe common stock they held. The total consideration paid to James Monroe shareholders in connection with the acquisition was \$71.4 million and 1.8 million shares of Bankshares common stock. Bankshares acquisition of James Monroe, as of July 17, 2006, will add approximately \$552 million in total assets, \$414 million in gross loans, \$434 million in total deposits, and six full-service branches and a loan production office located in Northern Virginia and suburban Washington, D.C. For additional information, see the Form 8-K filed in connection with the merger on March 27, 2006.

On May 18, 2005, Bankshares completed its acquisition of Community Bank of Northern Virginia ( CBNV ), a bank headquartered in Sterling, Virginia, which was merged into MSD&T. The total consideration paid to CBNV shareholders in connection with the acquisition was \$82.9 million in cash and 3.7 million shares of Bankshares common stock. The transaction resulted in total assets acquired as of May 18, 2005 of \$888.2 million, including \$671.0 million of loans and leases; liabilities assumed were \$842.3 million, including \$626.9 million of deposits. Additionally, Bankshares recorded \$162.9 million of goodwill and \$4.6 million of core deposit intangibles. Bankshares expensed no merger-related costs for the six-month period ended June 30, 2006 and has expensed \$1.3 million since the inception of the merger.

3. Earnings per Share

Basic earnings per share ( EPS ) are computed by dividing income available to common shareholders by weighted average common shares outstanding. Diluted EPS are computed using the same components as basic EPS with the denominator adjusted for the dilutive effect of stock options, restricted stock awards, restricted stock units and vested directors' deferred compensation plan shares. The following tables provide reconciliations between the computation of basic EPS and diluted EPS for the six and three months ended June 30, 2006 and 2005, respectively.

(In thousands, except per share data)	For the 6 months ended June 30, 2006			2005		
	Net Income	Weighted Average Common Shares	EPS	Net Income	Weighted Average Common Shares	EPS
Basic EPS	\$ 143,851	123,133	\$ 1.17	\$ 130,500	119,812	\$ 1.09
Dilutive effect of :						
Stock options		768			603	
Restricted stock awards and units		112			112	
Vested directors' deferred compensation plan shares		292			255	
Diluted EPS	\$ 143,851	124,305	\$ 1.16	\$ 130,500	120,782	\$ 1.08

(In thousands, except per share data)	For the 3 months ended June 30, 2006			2005		
	Net Income	Weighted Average Common Shares	EPS	Net Income	Weighted Average Common Shares	EPS
Basic EPS	\$ 73,092	123,222	\$ 0.59	\$ 67,873	120,772	\$ 0.56
Dilutive effect of :						
Stock options		743			601	
Restricted stock awards and units		65			110	
Vested directors' deferred compensation plan shares		294			258	
Diluted EPS	\$ 73,092	124,324	\$ 0.59	\$ 67,873	121,741	\$ 0.56

Antidilutive options, awards and units excluded from the computation of diluted earnings per share were 311,207 and 314,961 for the six months ended June 30, 2006 and 2005, respectively and 581,790 and 468,483 for the second quarter of 2006 and 2005, respectively.

4. Investment Securities

At June 30, 2006 and December 31, 2005, securities with an amortized cost of \$1.4 billion and \$1.3 billion, respectively, were pledged as collateral for repurchase transactions and certain deposits as required by regulatory guidelines. The following table shows the amortized cost and fair value of investment securities at June 30, 2006 and December 31, 2005.

(Dollars in thousands)	June 30, 2006				December 31, 2005			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Investment securities held-to-maturity								
States and political subdivisions	\$ 15,532	\$ 366	\$ 27	\$ 15,871	\$ 16,659	\$ 541	\$ 19	\$ 17,181
Investment securities available-for-sale								
U.S. Treasury	\$ 439,856	\$	\$ 4,923	\$ 434,933	\$ 434,893	\$ 223	\$ 3,080	\$ 432,036
U.S. Government agencies	995,392		14,670	980,722	992,040	29	12,761	979,308
Mortgage-backed securities	1,623,647	346	58,014	1,565,979	1,581,845	685	38,269	1,544,261
States and political subdivisions	63,670	45	472	63,243	70,017	306	188	70,135
Other bonds, notes and debentures	16,137		263	15,874	19,083		215	18,868
Total bonds	3,138,702	391	78,342	3,060,751	3,097,878	1,243	54,513	3,044,608
Other investments	49,321	1,076	1,440	48,957	43,980	1,236	196	45,020
Total	\$ 3,188,023	\$ 1,467	\$ 79,782	\$ 3,109,708	\$ 3,141,858	\$ 2,479	\$ 54,709	\$ 3,089,628

The following table shows the unrealized gross losses and fair value of securities in the securities available-for-sale portfolio at June 30, 2006, by length of time that individual securities in each category have been in a continuous loss position.

(Dollars in thousands)	Less than 12 Months		12 months or more		Total	
	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses	Fair Value
U.S. Treasury	\$ 2,715	\$ 321,877	\$ 2,208	\$ 113,056	\$ 4,923	\$ 434,933
U.S. Government agencies	5,086	473,034	9,584	507,688	14,670	980,722
Mortgage-backed securities	17,330	798,954	40,684	767,025	58,014	1,565,979
States and political subdivisions	431	59,197	41	4,046	472	63,243
Other bonds, notes and debentures	87	6,751	176	9,123	263	15,874
Total bonds	25,649	1,659,813	52,693	1,400,938	78,342	3,060,751
Other investments	1,440	48,957			1,440	48,957
Total	\$ 27,089	\$ 1,708,770	\$ 52,693	\$ 1,400,938	\$ 79,782	\$ 3,109,708

At June 30, 2006, there were \$1.4 billion of individual securities that had unrealized losses for a period greater than 12 months. At June 30, 2006, these securities had an unrealized loss of \$52.7 million of which 54.7% were mortgage-backed securities. Management has assessed the impairment of these securities and determined that the impairment is temporary. All principal and interest payments on available-for-sale debt securities in an unrealized loss position for greater than 12 months are expected to be collected given the high credit quality of the U.S. government agency debt securities and Bankshares' ability and intent to hold the securities until the value recovers or they mature.



**5. Allowance for Loan Losses and Reserve for Unfunded Commitments**

During the first quarter of 2006, Bankshares refined the model used for determining certain components of the allowance for loan losses. The model refinement did not have a material impact on Bankshares' recorded allowance for loan losses. Additionally, Bankshares reclassified a portion of the allowance for loan losses to a reserve for unfunded lending commitments reflected in other liabilities in the consolidated balance sheet. As a result of the refinement of the modeling process for the allowance for loan losses, Bankshares was able specifically to identify risk inherent in unfunded commitments and make the reclassification noted above. As no model data existed for previous years, prior period data has not been reclassified for comparability.

The allowance for loan losses and reserve for unfunded commitments is presented below.

(Dollars in thousands)	For the 6 months ended June 30,		For the 3 months ended June 30,	
	2006	2005	2006	2005
<b><u>Allowance for Loan Losses</u></b>				
Balance, beginning of period	\$ 156,673	\$ 149,002	\$ 141,874	\$ 149,017
Allowance of acquired bank		7,086		7,086
Provision for credit losses	(990)	) 756		
Transfer to reserve for unfunded commitments	(13,968)	)		
Total	141,715	156,844	141,874	156,103
Charge-offs	(2,228)	) (3,115)	(850)	) (1,173)
Recoveries	3,373	3,372	1,836	2,171
Net recoveries (charge-offs)	1,145	257	986	998
Balance, end of period	\$ 142,860	\$ 157,101	\$ 142,860	\$ 157,101
<b><u>Reserve for Unfunded Commitments</u></b>				
Balance, beginning of period	\$	\$	\$ 14,958	\$
Provision for credit losses	990			
Transfer from allowance for loan losses	13,968			
Balance, end of period	\$ 14,958	\$	\$ 14,958	\$

**6. Impaired Loans**

When scheduled principal or interest payments are past due 90 days or more at quarter-end on any loan, the accrual of interest income is discontinued and subsequent receipts on these loans are recorded as a reduction of principal, and interest income is recorded only once principal recovery is reasonably assured. Previously accrued but uncollected interest on these loans is charged against interest income. Generally, a loan may be restored to accruing status when all past due principal, interest and late charges have been paid and the bank expects repayment of the remaining contractual principal and interest on a timely basis.

Under Statements of Financial Accounting Standards (SFAS) Nos. 114 and 118, Accounting by Creditors for Impairment of a Loan—an amendment of FASB Statements Nos. 5 and 15, a loan is considered impaired, based on current information and events, if it is probable that Bankshares will not collect all principal and interest payments according to the contractual terms of the loan agreement. The impairment of a loan is measured based on the present value of expected future cash flows discounted at the loan's effective interest rate, or the fair value of the collateral if the repayment is expected to be provided predominantly by the underlying collateral. Information with respect to impaired loans and the related valuation allowance (if the measure of the impaired loan is less than the recorded investment) at June 30, 2006, December 31, 2005 and June 30, 2005 is shown below. See Bankshares' Annual Report on Form 10-K for more detail.

(Dollars in thousands)	June 30, 2006	December 31, 2005	June 30, 2005
Impaired loans with a specific valuation allowance	\$ 2,474	\$ 11,512	\$ 16,460
All other impaired loans	25,030	9,086	8,746
Total impaired loans	\$ 27,504	\$ 20,598	\$ 25,206
Specific allowance for loan losses applicable to impaired loans	\$ 2,054	\$ 4,150	\$ 10,225
General allowance for loan losses applicable to other than impaired loans	140,806	152,523	146,876
Total allowance for loan losses	\$ 142,860	\$ 156,673	\$ 157,101
Year-to-date interest income on impaired loans recorded on the cash basis	\$ 76	\$ 128	\$ 53
Year-to-date average recorded investment in impaired loans during the period	\$ 22,448	\$ 26,703	\$ 27,887
Quarter-to-date interest income on impaired loans recorded on the cash basis	\$ 41	\$ 14	\$ 30
Quarter-to-date average recorded investment in impaired loans during the period	\$ 24,133	\$ 24,817	\$ 26,993

Impaired loans do not include large groups of smaller balance homogeneous loans that are evaluated collectively for impairment (e.g., residential mortgages and consumer installment loans). The allowance for loan losses related to these loans is included in the general allowance for loan losses applicable to other than impaired loans.

On May 18, 2005, Bankshares acquired, as part of the CBNV acquisition, two commercial real estate loans totaling \$4.9 million that were within the scope of American Institute of Certified Public Accountants issued Statement of Position ( SOP ) 03-3, Accounting for Certain Loans or Debt Securities Acquired in a Transfer. One of the loans was subsequently paid in full and the remaining loan is deemed to be immaterial for purposes of the required disclosures.

## 7. Commitments and Contingencies

Bankshares is a party to financial instruments that are not reflected in the balance sheet, which include commitments to extend credit and standby letters of credit. Various commitments to extend credit (lines of credit) are made in the normal course of banking business. Letters of credit are issued for the benefit of customers by affiliated banks. These commitments are subject to loan underwriting standards and geographic boundaries consistent with Bankshares' loans outstanding. Bankshares' lending activities are concentrated in Maryland, Delaware and Virginia.

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. Commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. Since many of the commitments are expected to expire without being drawn upon, the total commitment amounts do not necessarily represent future cash requirements. Total commitments to extend credit were \$4.9 billion at June 30, 2006, \$4.8 billion at December 31, 2005, and \$4.7 billion at June 30, 2005.

Letters of credit are commitments issued to guarantee the performance of a customer to a third party. Outstanding letters of credit were \$564.3 million at June 30, 2006, \$540.6 million at December 31, 2005 and \$438.3 million at June 30, 2005. Fees received for issuing letters of credit are deferred and amortized over the life of the commitment. The unamortized fees on letters of credit at June 30, 2006, December 31, 2005, and June 30, 2005 had a carrying value of \$2.9 million, \$2.7 million and \$2.3 million, respectively.

One of Bankshares' mortgage-banking subsidiaries is a Fannie Mae Delegated Underwriting and Servicing lender, and has a loss sharing arrangement for loans originated on behalf of and sold to Fannie Mae. The unamortized principal balance of the underlying loans totaled \$268.5 million, \$249.8 million and \$225.8 million at June 30, 2006, December 31, 2005 and June 30, 2005, respectively. The loss reserve for potential losses on loans originated and sold in the secondary market was \$84.0 thousand at June 30, 2006 and \$60.7 thousand at December 31, 2005. The mortgage subsidiary also has originated and sold loans with recourse in the event of foreclosure on the underlying real estate. The unamortized amount of principal balance of loans sold with recourse totaled \$1.0 million at June 30, 2006 and \$1.3 million at both December 31, 2005 and June 30, 2005. These mortgages are generally in good standing and are well collateralized; no loss has ensued and no future loss is expected.



Bankshares has committed to invest funds in third-party private equity investments. At June 30, 2006, December 31, 2005 and June 30, 2005, \$25.6 million, \$26.6 million and \$30.0 million, respectively, remained unfunded.

In the ordinary course of business, Bankshares and its subsidiaries are involved in a number of pending and threatened legal actions and proceedings. In certain of these actions and proceedings, claims for substantial monetary damages are asserted against Bankshares and its subsidiaries. In view of the inherent difficulty of predicting the outcome of such matters, Bankshares cannot state what the eventual outcome of pending matters will be. However, based on current knowledge, management does not believe that liabilities, if any, arising from pending litigation matters, will have a material adverse effect on the consolidated financial position, earnings or liquidity of Bankshares. If payment associated with a claim becomes probable and the cost can be reasonably estimated, a contingent liability would be established based on information currently available, advice of counsel and available insurance coverage.

#### 8. Goodwill and Other Intangible Assets

Goodwill, net, totaled \$679.7 million at June 30, 2006 and \$670.0 million at December 31, 2005. In 2005, Bankshares recorded \$162.9 million in goodwill in connection with the CBNV acquisition. In the first quarter of 2006, there was an increase in goodwill of \$8.8 million related to a payment made in contingent consideration to the management of Boyd Watterson Asset Management as they met the performance conditions outlined in the merger agreement.

The following table discloses the gross carrying amount and accumulated amortization of intangible assets subject to amortization at June 30, 2006 and December 31, 2005.

(Dollars in thousands)	June 30, 2006			December 31, 2005		
	Gross carrying amount	Accumulated amortization	Net amount	Gross carrying amount	Accumulated amortization	Net amount
Core deposits	\$ 54,509	\$ (23,765 )	\$ 30,744	\$ 54,509	\$ (20,790 )	\$ 33,719
Mortgage servicing	3,116	(1,258 )	1,858	2,902	(1,145 )	1,757
Customer lists and other	17,845	(8,044 )	9,801	17,845	(6,668 )	11,177
Total	\$ 75,470	\$ (33,067 )	\$ 42,403	\$ 75,256	\$ (28,603 )	\$ 46,653

In connection with the CBNV acquisition, Bankshares recorded \$4.6 million in core deposit intangibles. The core deposit intangible from CBNV is amortized over a weighted average remaining useful life of nine years on a straight-line basis.

Identifiable intangible assets are amortized based on estimated lives of up to 15 years. Management reviews other intangible assets for impairment yearly or whenever events or changes in circumstances indicate that their carrying amounts may not be recoverable. For those intangible assets subject to amortization, impairment is indicated if the sum of undiscounted estimated future net cash flows is less than the carrying amount of the asset. Impairment is recognized by writing down the carrying value or adjusting the estimated life of the asset. Any impairment recognized in a valuation account is reflected in the income statement in the corresponding period.

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The following table shows the current period and estimated future amortization expense for amortized intangible assets. The projections of amortization expense shown for mortgage servicing rights are based on asset balances and the interest rate environment as of June 30, 2006. Future amortization expense may be significantly different depending upon changes in the mortgage-servicing portfolio, mortgage interest rates and market conditions.

(Dollars in thousands)	Core Deposits	Mortgage Servicing	Customer Lists and Other	Total
Six months ended June 30, 2006 (actual)	\$ 2,975	\$ 180	\$ 1,387	\$ 4,542
Six months ended December 31, 2006 (estimated)	2,975	140	1,231	4,346
Twelve months ended December 31, 2006 (estimated)	\$ 5,950	\$ 320	\$ 2,618	\$ 8,888
Estimate for years ended December 31,				
2007	\$ 5,747	\$ 274	\$ 2,533	\$ 8,554
2008	4,653	257	1,637	6,547
2009	4,502	257	641	5,400
2010	4,502	236	505	5,243

9. Comprehensive Income

The following table summarizes the market value change and related tax effect of unrealized gains (losses) on securities available-for-sale for the six months and three months ended June 30, 2006 and 2005, respectively. Total comprehensive income is included in the Statements of Changes in Consolidated Shareholders' Equity.

(Dollars in thousands)	For the 6 months ended June 30, 2006			2005		
	Pretax Amount	Tax (Expense) Benefit	Net Amount	Pretax Amount	Tax (Expense) Benefit	Net Amount
Net Income			\$ 143,851			\$ 130,500
Other comprehensive income						
Unrealized holding gains (losses) arising during the period	(26,097 )	9,731	(16,366 )	(12,477 )	4,775	(7,702 )
Reclassification adjustment for (gains) losses included in net income	13	(5 )	8	(490 )	194	(296 )
Total other comprehensive income	(26,084 )	9,726	(16,358 )	(12,967 )	4,969	(7,998 )
Total comprehensive income			\$ 127,493			\$ 122,502

(Dollars in thousands)	For the 3 months ended June 30, 2006			2005		
	Pretax Amount	Tax (Expense) Benefit	Net Amount	Pretax Amount	Tax (Expense) Benefit	Net Amount
Net Income			\$ 73,092			\$ 67,873
Other comprehensive income						
Unrealized holding gains (losses) arising during the period	(11,265 )	4,192	(7,073 )	(19,744 )	(7,256 )	12,488
Reclassification adjustment for (gains) losses included in net income				(76 )	30	(46 )
Total other comprehensive income	(11,265 )	4,192	(7,073 )	(19,668 )	(7,226 )	12,442
Total comprehensive income			\$ 66,019			\$ 80,315



10. Capital Adequacy

Bankshares and its bank affiliates are subject to various regulatory capital adequacy requirements administered by federal and state banking agencies. These requirements include maintaining certain capital ratios above minimum levels. These capital ratios include Tier I Capital and Total Risk-Based Capital as percentages of net risk-weighted assets and Tier I Capital as a percentage of adjusted average total assets (leverage ratio). The minimum ratios for capital adequacy purposes are 4.00%, 8.00% and 4.00%, for the Tier I Capital, Total Capital and Leverage Ratios, respectively. To be categorized as *well capitalized*, a bank must maintain minimum ratios of 6.00%, 10.00% and 5.00%, for its Tier I Capital, Total Capital and Leverage Ratios, respectively. As of June 30, 2006, Bankshares and each of its bank affiliates exceeded all capital adequacy requirements to be considered well capitalized.

Actual capital amounts and ratios are presented in the following table for Bankshares and its affiliates.

<b>June 30, 2006</b> <b>(Dollars in thousands)</b>	<b>Tier I Capital</b>	<b>Total Risk-Based Capital</b>	<b>Net Risk-Weighted Assets</b>	<b>Adjusted Average Total Assets</b>	<b>Tier I Capital Ratio</b>	<b>Total Capital Ratio</b>	<b>Leverage Ratio</b>	
<b>Bankshares</b>	<b>\$ 1,597,978</b>	<b>\$ 2,049,782</b>	<b>\$ 13,346,820</b>	<b>\$ 16,000,332</b>	<b>11.97</b>	<b>% 15.36</b>	<b>% 9.99</b>	<b>%</b>
Annapolis Banking & Trust	43,962	51,224	340,939	478,732	12.89	15.02	9.18	
Citizens National Bank	107,036	154,814	1,176,819	1,324,604	9.10	13.16	8.08	
Farmers & Mechanics Bank	166,507	227,647	1,356,200	1,695,357	12.28	16.79	9.82	
Marshall National Bank & Trust	13,587	20,021	138,278	181,032	9.83	14.48	7.51	
Mercantile County Bank	81,471	118,289	732,072	941,815	11.13	16.16	8.65	
Mercantile Eastern Shore Bank	54,074	85,376	471,352	602,238	11.47	18.11	8.98	
Mercantile Peninsula Bank	148,022	219,360	1,396,872	1,763,519	10.60	15.70	8.39	
Mercantile-Safe Deposit & Trust Company	542,958	661,045	6,053,819	7,167,270	8.97	10.92	7.58	
Mercantile Southern Maryland Bank	95,251	132,077	679,647	980,757	14.01	19.43	9.71	
National Bank of Fredericksburg	38,737	49,492	384,705	473,753	10.07	12.86	8.18	
Westminster Union Bank	69,578	100,048	520,477	820,147	13.37	19.22	8.48	
<b>December 31, 2005</b> <b>(Dollars in thousands)</b>	<b>Tier I Capital</b>	<b>Total Risk-Based Capital</b>	<b>Net Risk-Weighted Assets</b>	<b>Adjusted Average Total Assets</b>	<b>Tier I Capital Ratio</b>	<b>Total Capital Ratio</b>	<b>Leverage Ratio</b>	
<b>Bankshares</b>	<b>\$ 1,518,454</b>	<b>\$ 1,975,313</b>	<b>\$ 12,848,926</b>	<b>\$ 15,471,385</b>	<b>11.82</b>	<b>% 15.37</b>	<b>% 9.81</b>	<b>%</b>
Annapolis Banking & Trust	43,148	50,382	331,167	484,567	13.03	15.21	8.90	
Citizens National Bank	103,600	151,903	1,139,217	1,281,737	9.09	13.33	8.08	
Farmers & Mechanics Bank	164,489	225,553	1,341,615	1,700,721	12.26	16.81	9.67	
Marshall National Bank & Trust	12,661	19,235	132,110	164,212	9.58	14.56	7.71	
Mercantile County Bank	77,489	116,005	728,884	916,864	10.63	15.92	8.45	
Mercantile Eastern Shore Bank	52,538	83,614	451,831	575,426	11.63	18.51	9.13	
Mercantile Peninsula Bank	141,149	214,251	1,336,315	1,677,958	10.56	16.03	8.41	
Mercantile-Safe Deposit & Trust Company	509,252	624,036	5,795,437	6,721,535	8.79	10.77	7.58	
Mercantile Southern Maryland Bank	94,717	131,461	620,898	954,636	15.25	21.17	9.92	
National Bank of Fredericksburg	37,081	48,169	353,718	455,590	10.48	13.62	8.14	
Westminster Union Bank	66,961	98,053	509,424	810,677	13.14	19.25	8.26	

Bankshares has an ongoing share repurchase program. Purchases may be made from time to time, subject to regulatory requirements, in open market or in privately negotiated transactions. Purchased shares are retired. During the six months ended June 30, 2006, Bankshares purchased 37,252 shares in net settlement of the minimum tax liability for vested restricted stock. On June 13, 2006, Bankshares Board of Directors authorized the repurchase of an additional 2,000,000 shares to the 677,000 shares remaining from a previously announced program. At June 30, 2006, there were approximately 2.68 million shares remaining available for repurchase under the program.

## 6. Impaired Loans



11. Segment Reporting

Operating segments as defined by SFAS No. 131, Disclosures about Segments of an Enterprise and Related Information, are components of an enterprise with separate financial information. The component engages in business activities from which it derives revenues and incurs expenses and the operating results of which management relies on for decision-making and performance assessment. Bankshares has two reportable segments Banking and Investment and Wealth Management ( IWM ). The Banking segment is comprised of 11 affiliate banks. During 2005, the Private Bank Group of Mercantile-Safe Deposit and Trust Company was consolidated into the Private Banking Group of IWM. The segment results have been reclassified to conform to current presentation for comparability. Additionally, as loans and deposits are now being reflected in the IWM segment, a funds transfer-pricing model was utilized to match the duration of the funding and investment of the IWM segment assets and liabilities.

The tables below present selected segment information for the six and three months ended June 30, 2006 and 2005. The components in the Other column consist of amounts for the nonbank affiliates, unallocated corporate expenses, including income taxes, and intercompany eliminations. Certain expense amounts such as operations overhead were reclassified from internal financial reporting in order to provide for full cost absorption. These reclassifications are shown in the Adjustments line.

(Dollars in thousands)	For the 6 months ended June 30, 2006				For the 6 months ended June 30, 2005			
	Banking	IWM	Other	Total	Banking	IWM	Other	Total
Net interest income	\$ 313,993	\$ 5,942	\$ (212)	\$ 319,723	\$ 291,444	\$ 4,222	\$ (216)	\$ 295,450
Provision for credit losses					(756)			(756)
Noninterest income	60,857	55,200	9,017	125,074	62,479	47,841	7,615	117,935
Noninterest expenses	(171,169)	(43,564)	(1,404)	(216,137)	(164,104)	(35,823)	(4,139)	(204,066)
Adjustments	10,916	(421)	(10,495)		7,965	(2,411)	(5,554)	
Income (loss) before income taxes	214,597	17,157	(3,094)	228,660	197,028	13,829	(2,294)	208,563
Income tax expense	(75,713)	(6,863)	(2,233)	(84,809)	(68,820)	(5,532)	(3,711)	(78,063)
Net income (loss)	\$ 138,884	\$ 10,294	\$ (5,327)	\$ 143,851	\$ 128,208	\$ 8,297	\$ (6,005)	\$ 130,500
Average loans	\$ 11,605,636	\$ 179,004	\$ 341	\$ 11,784,981	\$ 10,463,869	\$ 144,160	\$ 399	\$ 10,608,428
Average earning assets	14,917,768	179,004	(57,014)	15,039,758	13,372,528	144,160	16,125	13,532,813
Average assets	16,365,303	179,558	73,609	16,618,470	14,573,533	144,476	154,924	14,872,933
Average deposits	12,097,362	293,583	(324,681)	12,066,264	10,997,963	190,503	(190,934)	10,997,532
Average equity	2,019,791	37,321	228,417	2,285,529	1,818,552	33,504	144,388	1,996,444

(Dollars in thousands)	For the 3 months ended June 30, 2006				For the 3 months ended June 30, 2005			
	Banking	IWM	Other	Total	Banking	IWM	Other	Total
Net interest income	\$ 158,099	\$ 3,370	\$ (59)	\$ 161,410	\$ 150,336	\$ 2,236	\$ (205)	\$ 152,367
Provision for credit losses								
Noninterest income	30,791	29,006	4,671	64,468	32,988	23,528	3,550	60,066
Noninterest expenses	(85,897)	(22,045)	(1,480)	(109,422)	(83,653)	(18,977)	(1,283)	(103,913)
Adjustments	5,810	(164)	(5,646)		4,429	(742)	(3,687)	
Income (loss) before income taxes	108,803	10,167	(2,514)	116,456	104,100	6,045	(1,625)	108,520
Income tax expense	(38,598)	(4,067)	(699)	(43,364)	(36,532)	(2,419)	(1,696)	(40,647)
Net income (loss)	\$ 70,205	\$ 6,100	\$ (3,213)	\$ 73,092	\$ 67,568	\$ 3,626	\$ (3,321)	\$ 67,873
Average loans	\$ 11,739,031	\$ 182,202	\$ 307	\$ 11,921,540	\$ 10,751,944	\$ 146,944	\$ 375	\$ 10,899,263
Average earning assets	15,085,461	182,202	(70,667)	15,196,996	13,683,513	146,944	10,534	13,840,991
Average assets	16,556,117	182,808	60,047	16,798,972	14,936,074	147,288	150,209	15,233,571
Average deposits	12,209,522	316,777	(336,106)	12,190,193	11,280,789	189,692	(197,261)	11,273,220
Average equity	2,034,960	37,877	236,312	2,309,149	1,864,138	33,875	144,091	2,042,104



12. Derivative Instruments and Hedging Activities

SFAS No. 133, *Accounting for Derivative Instruments and Hedging Activities*, SFAS No. 138, *Accounting for Certain Derivative Instruments and Certain Hedging Activities* an amendment to FASB Statement No. 133, and SFAS No. 149, *Amendment of Statement No. 133 on Derivative Instruments and Hedging Activities* (collectively referred to as *derivatives*), establish accounting and reporting standards for derivative instruments and for hedging activities. Bankshares maintains an overall interest rate risk management strategy that incorporates the use of derivative instruments to minimize significant unplanned fluctuations in earnings that are caused by interest rate volatility. Currently, derivative instruments that are used as part of the interest rate risk management strategy have been restricted to interest rate swaps. Interest rate swaps generally involve the exchange of fixed-rate and variable-rate interest payments between two parties, based on a common notional principal amount and maturity date. At June 30, 2006, Bankshares had interest rate swaps to convert a portion of its nonprepayable fixed-rate debt to floating-rate debt. Bankshares also arranges interest rate swaps, caps and swaptions for commercial loan customers through its Capital Markets Group. Derivative transactions executed with loan customers are hedged by means of an offsetting derivative trade with a third party. In this way, Bankshares manages the market risk arising from capital markets-related derivative activity.

The fair value of derivative instruments is based on swap and option valuations. The swap value is estimated by using pricing models that incorporate quoted market prices for swap rates and futures contracts and assumes all counterparties have the same credit rating. The option valuation is estimated by using standard market models (such as the modified Black-Scholes model on interest rate options), incorporating quoted market prices and volatilities. The fair value of derivative instruments related to customer accommodations recorded in other assets was \$12.1 million (notional \$398.4 million) and \$5.3 million (notional \$345.5 million) at June 30, 2006 and December 31, 2005, respectively. The fair value of derivative instruments relating to hedges and customer accommodations recorded in other liabilities was \$30.9 million (notional \$690.8 million) and \$12.3 million (notional \$609.1 million) at June 30, 2006 and December 31, 2005, respectively.

Changes in the fair value of a derivative that is designated and qualifies as a fair value hedge, along with the gain or loss on the hedged asset or liability that is attributable to the hedged risk are recorded as other noninterest income in the results of operations. For all hedge relationships, ineffectiveness resulting from differences between the changes in fair values or cash flows of the hedged item and changes in fair value of the derivative are recognized as other noninterest income in the results of operations. The net interest settlement on derivatives designated as fair value or cash flow hedges is treated as an adjustment of the interest income or interest expense of the hedged assets or liabilities. The fair-value hedges of nonprepayable fixed-rate debt were effective for the reported periods and qualified for short-cut hedge accounting treatment. The impact of the hedges increased interest expense \$441 thousand in the first six months of 2006 as compared with a decrease of \$2.8 million for the same period in 2005.

The following tables summarize the gross position of derivatives relating to hedging activities at June 30, 2006 and December 31, 2005.

(Dollars in thousands)	June 30, 2006			December 31, 2005		
	Notional or Contractual Amount	Credit Risk Amount (1)	Estimated Net Fair Value	Notional or Contractual Amount	Credit Risk Amount (1)	Estimated Net Fair Value
<i>Asset/Liability Management Hedges</i>						
Interest Rate Contracts:						
Swaps	\$ 350,000	\$	\$ (23,573 )	\$ 350,000	\$	\$ (10,349 )
<i>Customer Accommodations</i>						
Interest Rate Contracts:						
Swaps	\$ 727,602	\$ 12,136	\$ 4,400	\$ 592,934	\$ 5,327	\$ 3,462
Swaptions/Caps Purchased	5,787	62	62	5,850	57	57
Swaptions/Caps Sold	5,787		(62 )	5,850		(57 )

(1) Credit risk amounts reflect the replacement cost for those contracts in a gain position in the event of nonperformance by all counterparties.

Mortgage loans held-for-sale have inherent forward contract (agreements to sell or purchase loans at a specific rate or yield) characteristics. Risk may arise from the corresponding parties' inability to meet the terms of their contracts and from movements in interest rates. Bankshares has forward commitments to sell individual fixed-rate and variable-rate mortgage loans that are on its balance sheet at fair value or are approved, but not yet funded. The fair value of the forward contracts was \$6.4 million at June 30, 2006 and \$0.2 million at December 31, 2005.

### 13. Stock-based Compensation Expense

Bankshares adopted SFAS No. 123(R), Share-Based Payment, effective January 1, 2006 under the modified version of prospective application. The following disclosures are provided pursuant to the requirements of SFAS 123(R).

Under SFAS 123(R), awards granted to retirement eligible employees are expensed immediately. Under Bankshares' Omnibus Stock Plan, retirement eligible is defined as employees reaching normal retirement at age 65. As a practice, Bankshares has not granted awards to retirement eligible employees. As of June 30, 2006, there were no retirement eligible employees with outstanding awards that had not been fully expensed. Prior to implementing SFAS 123(R), Bankshares accrued compensation cost for share-based compensation based on total awards granted, pursuant to SFAS 123. Any subsequent forfeitures were reversed from compensation expense when the performance or service requirement was not achieved. Upon implementation of SFAS 123(R), Bankshares is estimating forfeitures upon the grant of awards and reducing the amount to be charged to expense by this estimate.

We sponsor several share-based plans, which are described below. The compensation cost expensed for those plans was \$3.3 million and \$1.3 million for the quarters ended June 30, 2006 and 2005, respectively, and \$5.0 million and \$2.7 million for the six months ended June 30, 2006 and 2005, respectively. The total income tax benefit recognized in the income statement for share-based compensation arrangements was \$889 thousand and \$178 thousand for the quarters ended June 30, 2006 and 2005, respectively, and \$1.3 million and \$357 thousand for the six months ended June 30, 2006 and 2005, respectively. At June 30, 2006, unrecognized compensation cost related to nonvested stock options, restricted stock awards and restricted stock units ( RSUs ) totaled \$22.8 million. The cost of these nonvested awards is expected to be recognized over a weighted average period of 2.61 years.

The 1999 Omnibus Stock Plan permitted the grant of stock options and other stock incentives, including restricted stock awards and restricted stock units, to key employees of Bankshares and its affiliates. The 1999 Plan provided for the issuance of up to 4,500,000 shares (as adjusted for the stock split) of Bankshares authorized but unissued common stock. The number of shares of common stock that remained available for future grants under the Plan at June 30, 2006 was 933,983 shares. Options issued as a result of mergers or acquisitions are not considered to be part of the 1999 Omnibus Stock Plan. Options outstanding were granted at market value and included both performance-based and nonperformance-based options. Options became exercisable ratably over three or four years. All options terminate 10 years from date of grant if not exercised. The estimated forfeiture rate used to calculate the current quarter and year-to-date compensation cost was 2.0%. Because of the historically low forfeiture rate, the impact to compensation expense was immaterial as compared with the same periods of 2005.

On March 29, 2006, the Compensation Committee authorized the issuance of up to 317,802 performance based restricted stock units ( Performance RSUs ) pursuant to the 2006 Performance Stock Program. The vesting of the Performance RSUs will be determined based upon the percentage improvement in Bankshares' pre-tax operating income ( PTOI ) over a three-year performance period (the Performance Period ) ending December 31, 2008 (with no adjustments for acquisitions or other extraordinary events). In addition to the performance period, the awards earned are subject to an additional one-year service requirement. Depending on actual performance, the Performance RSUs will vest at levels from 0% to 100%. The estimated forfeiture rate used to calculate the current quarter and year-to-date compensation for RSUs was 33.3%. On the same date, the Committee also awarded 104,630 RSUs to Bankshares' chief executive officer. The award will vest ratably over four years. The RSUs do not convert into common stock and will not be available for sale until the employment of the chief executive officer terminates.

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The table below summarizes activity related to stock options during the six months ended June 30, 2006.

	Options issued and outstanding	Weighted average exercise price	Options exercisable	Weighted average exercise price
Balance, December 31, 2005	2,659,240	\$ 25.01	1,489,397	\$ 20.80
Granted	524,000	38.03		
Expired/Forfeited	(519 )	13.45		
Exercised	(60,215 )	20.16		
<b>Balance, June 30, 2006</b>	<b>3,122,506</b>	<b>\$ 27.28</b>	<b>2,045,469</b>	<b>\$ 23.15</b>

The total intrinsic value of stock options exercised during the six months ended June 30, 2006 and 2005 was \$1.1 million and \$4.7 million, respectively. Cash received from options exercised under all share-based payment arrangements for the six months ended June 30, 2006 and 2005 was \$0.9 million and \$2.0 million, respectively. The actual tax return benefit associated with the tax deductions recognized in the income statement from the option exercise of the share-based payment arrangements totaled \$1.0 million for the six months ended June 30, 2006; there was no actual tax return benefit for the six months ended June 30, 2005.

The following table provides selected information on nonvested stock options as of June 30, 2006, and changes during the six months ended June 30, 2006.

	Nonvested stock options	Weighted average grant-date fair value
Balance, December 31, 2005	1,164,825	\$ 30.36
Granted	524,000	38.03
Vested	(611,788 )	28.52
Forfeited		
<b>Balance, June 30, 2006</b>	<b>1,077,037</b>	<b>\$ 35.14</b>

The following table provides selected information on stock options outstanding and exercisable at June 30, 2006.

(Dollars in thousands, except per share data)	June 30, 2006	
	Outstanding	Exercisable
Number of options	3,122,506	2,045,469
Weighted-average exercise price	\$ 27.28	\$ 23.15
Aggregate intrinsic value	\$ 27,426	\$ 25,614
Weighted-average remaining contractual term, in years	7.30	6.42

The weighted average grant-date fair value of options granted during the six months ended June 30, 2006 and 2005 was \$7.15 and \$10.15, respectively. The total fair value of shares vested during the six months ended June 30, 2006 and 2005 was \$22.2 million and \$16.0 million, respectively.

The weighted average fair value of options granted is estimated as of the grant date using the Black-Scholes option-pricing model.

The following weighted average assumptions were used as inputs to the Black-Scholes model for grants in the six months ended June 30, 2006 and 2005, respectively:

- Dividend yields of 2.75% and 2.53%
- Volatilities of 20.62% and 17.24%
- Risk-free interest rates of 4.67% and 4.88%

- Expected terms of 4.73 and 4.57 years

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The expected volatility assumptions were derived by analyzing the historical price volatility of our stock over the past five years. The expected terms of options were determined by reviewing historically the time within which a minimum of 50% of shares granted to an employee were exercised over the past 6 years.

Restricted stock awards outstanding were granted at market value and vest ratably over three years or in total at the end of a specified three-year period. The number of restricted stock awards granted in the six months ended June 30, 2006 and 2005 was 148,641 and 54,386, respectively. Compensation expense is recognized on a straight-line basis over the vesting period. Relative to awards granted in the six months ended June 30, 2006, 85,309 shares are subject to a one-year vesting, and 54,015 vest over three years. Additionally, 9,317 shares, representing dividend equivalent shares related to previous awards that vested during the current period, were awarded and vested immediately.

The following table provides selected information related to restricted stock awards and restricted stock units as of June 30, 2006, and changes during the six months ended June 30, 2006.

	Restricted Stock Awards	Restricted Stock Units
Outstanding at December 31, 2005	249,090	
Granted	148,641	422,432
Vested	(147,584 )	
<b>Outstanding at June 30, 2006</b>	<b>250,147</b>	<b>422,432</b>

Another form of stock-based compensation is phantom stock, which is used for a portion of Bankshares' directors' deferred compensation plan. This plan provides for the issuance of up to 667,500 shares of Bankshares' authorized but unissued common stock. The Plan requires all deferred fees to be settled in Bankshares' stock.

#### 14. Pension & Other Postretirement Benefit Plans

Bankshares sponsors qualified and nonqualified pension plans and other postretirement benefit plans for its employees. The following table summarizes the components of the net periodic benefit cost for the pension plans for the six and three months ended June 30, 2006 and 2005, respectively.

(Dollars in thousands)	For the 6 months ended June 30, 2006			For the 6 months ended June 30, 2005		
	Qualified	Nonqualified	Total	Qualified	Nonqualified	Total
Service cost	\$ 3,799	\$ 428	\$ 4,227	\$ 3,660	\$ 304	\$ 3,964
Interest cost	5,977	215	6,192	5,638	80	5,718
Expected return on plan assets	(8,780 )		(8,780 )	(8,287 )		(8,287 )
Amortization of prior service cost	592	15	607	585	12	597
Recognized net actuarial loss (gain)	1,075	40	1,115	731	(93 )	638
Amortization of transition asset						
Net periodic benefit cost	\$ 2,663	\$ 698	\$ 3,361	\$ 2,327	\$ 303	\$ 2,630

(Dollars in thousands)	For the 3 months ended June 30, 2006			For the 3 months ended June 30, 2005		
	Qualified	Nonqualified	Total	Qualified	Nonqualified	Total
Service cost	\$ 1,904	\$ 255	\$ 2,159	\$ 1,882	\$ 139	\$ 2,021
Interest cost	3,069	172	3,241	2,825	45	2,870
Expected return on plan assets	(4,291 )		(4,291 )	(4,149 )		(4,149 )
Amortization of prior service cost	292	15	307	285	12	297
Recognized net actuarial loss (gain)	701	86	787	381	(93 )	288
Amortization of transition asset						
Net periodic benefit cost	\$ 1,675	\$ 528	\$ 2,203	\$ 1,224	\$ 103	\$ 1,327



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The following table summarizes the components of the net periodic benefit cost for the other postretirement benefit plans for the six and three months ended June 30, 2006 and 2005, respectively.

(Dollars in thousands)	For the 6 months ended June 30,		For the 3 months ended June 30,	
	2006	2005	2006	2005
Service cost	\$ 215	\$ 267	\$ 108	\$ 134
Interest cost	496	498	248	249
Expected return on plan assets				
Amortization of prior service cost				
Recognized net actuarial loss	152	176	76	88
Amortization of transition asset				
Net periodic benefit cost	\$ 863	\$ 941	\$ 432	\$ 471

As previously disclosed in its financial statements for the year ended December 31, 2005, Bankshares generally makes cash contributions to the pension plan in amounts up to that permitted by guidelines established under employee benefit and tax laws. Bankshares estimates that it could be able to contribute up to approximately \$19 million to the pension plan for 2006. Cash contributions are normally made after valuations have been finalized for the plan year and prior to the tax return filing date. As of June 30, 2006, total contributions of \$15 million had been made in 2006. No further contributions are expected to be made in the current year.

15. Recent Accounting Standards

On February 16, 2006, the Financial Accounting Standards Board ( FASB ) issued Statement No. 155, Accounting for Certain Hybrid Instruments. This standard amends the guidance in FASB Statements ( SFAS ) No. 133, Accounting for Derivative Instruments and Hedging Activities, and SFAS No. 140, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities. SFAS No. 155 allows financial instruments that have embedded derivatives to be accounted for as a whole (eliminating the need to bifurcate the derivative from its host) if the holder elects to account for the whole instrument on a fair value basis. SFAS No. 155 is effective for all financial instruments acquired or issued after the beginning of an entity's first fiscal year that begins after September 15, 2006. Bankshares does not anticipate this statement will have a material effect on its results of operations or financial condition.

In March 2006, the FASB issued SFAS No. 156, Accounting for Servicing of Financial Assets-An Amendment of FASB Statement No. 140. This standard amends the guidance in SFAS No.140, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities. Among other requirements, SFAS No. 156 requires an entity to recognize a servicing asset or servicing liability each time it undertakes an obligation to service a financial asset by entering into a servicing contract. The standard requires initial measurement of all newly purchased or issued separately recognized servicing assets and servicing liabilities at fair value, if practicable. Subsequent measurements may be made using either the fair value or amortization method. SFAS No. 156 is effective as of the beginning of an entity's first fiscal year that begins after September 15, 2006 with early adoption permitted in the quarter-ended March 31, 2006. Bankshares does not anticipate this statement will have a material effect on its results of operations or financial condition.

**On July 13, 2006, the FASB issued FASB Interpretation No. 48 ( FIN 48 ). FIN 48 clarifies the accounting for uncertainty in income taxes recognized in an enterprise's financial statements in accordance with SFAS No. 109, Accounting for Income Taxes. FIN 48 prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. FIN 48 also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure and transition. FIN 48 is effective for fiscal years beginning after December 15, 2006. An enterprise shall disclose the cumulative effect of the change on retained earnings in the statement of financial position as of the date of adoption and such disclosure is required only in the year of adoption. Bankshares is in the process of analyzing the implications of FIN 48.**

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

### MERCANTILE BANKSHARES CORPORATION

#### HIGHLIGHTS

##### Consolidated Financial Results

On January 10, 2006, Bankshares announced a three-for-two split on its common stock payable in the form of a stock dividend on January 27, 2006 to stockholders of record as of the close of business on January 20, 2006. For comparative purposes, certain share, average share and per share amounts have been restated.

Net income for the quarter ended June 30, 2006 was \$73.1 million, a 7.7% increase from net income of \$67.9 million for the same period in 2005 and a 3.3% increase from the \$70.8 million reported for the first quarter of 2006. For the quarter ended June 30, 2006, diluted net income per share was \$0.59, an increase of 5.4% from the \$0.56 reported for the same period last year and an increase of 3.5% from the \$0.57 reported for the first quarter of 2006. Adjusted weighted average shares outstanding increased from 121.7 million for the quarter ended June 30, 2005 to 124.3 million for the quarter ended June 30, 2006.

Net interest income, on a taxable equivalent basis, for the quarter ended June 30, 2006 increased 6.0% to \$163.3 million from \$154.0 million for the second quarter of last year. Compared with the first quarter of 2006, net interest income increased 1.9% over the \$160.1 million reported for that period. As noted in prior quarters, the competitive pressures on the lending and the funding fronts have not subsided. The result is that the net interest margin continues to be under pressure. The net interest margin for the current quarter was 4.31% as compared with 4.36% for the first quarter of 2006. The net interest margin for the second quarter of 2005 was 4.46%.

At June 30, 2006, nonperforming assets amounted to \$29.3 million, or 0.24%, of period-end loans and other real estate owned, an increase of \$1.6 million from the \$27.7 million at June 30, 2005. Nonperforming assets were \$23.6 million at March 31, 2006. The comparable nonperforming asset ratios were 0.24% and 0.20% at June 30, 2005 and March 31, 2006, respectively. The level of monitored loans, or loans with characteristics suggesting that they could be classified as nonperforming in the near future, amounted to \$13.5 million at June 30, 2006. Monitored loans were \$0.5 million at June 30, 2005 and \$13.9 million at March 31, 2006. The increase in nonperforming loans over the prior year is largely attributable to one relationship at the lead bank. The allowance for possible loan losses was 1.19% of loans outstanding at June 30, 2006.

Noninterest income, which includes investment and wealth management fees, service charges on deposit accounts, mortgage banking-related fees, securities gains and losses, nonmarketable investments income and other income, increased 7.3% to \$64.5 million for the second quarter of 2006 from \$60.1 million for the second quarter of 2005.

Noninterest income increased \$3.9 million, or 6.4%, in the second quarter of 2006 from the first quarter of 2006. The increase was primarily due to the \$2.7 million increase in IWM revenues, higher electronic banking fees and service charges on deposits. These increases were offset partially by seasonally lower insurance revenues.

During the quarter, Bankshares reached an agreement to sell its ownership interest in Columbia National Real Estate Finance, LLC ( CNREF ) to the minority partners. The transaction is not expected to have a material impact on future operating results. Bankshares will continue to operate in this business through its other subsidiary, HarborPoint Capital, which is a licensed Fannie Mae DUS lender. For the first six months of 2006, CNREF accounted for \$1.6 million in net interest income, \$3.5 million in noninterest income, and \$3.6 million in noninterest expense. The sale is expected to close on July 31, 2006.

Bankshares' IWM unit restructured its Real Estate Advisory Unit and a major advisory relationship within the unit. As a result of the changes, pretax income of \$1.4 million was recognized this quarter.

Noninterest expenses, which include salaries, employee benefits, net occupancy expense of bank premises, furniture and equipment expenses, communications and supplies and other expenses, increased by 5.3% for the quarter ended June 30, 2006 to \$109.4 million from \$103.9 million for the second quarter of 2005.

Noninterest expense increased \$2.7 million from the first quarter of 2006 primarily due to professional services and a licensing fee related to the restructured real estate pension advisory relationship.

Bankshares also reports cash operating earnings, defined as GAAP (Generally Accepted Accounting Principles) earnings excluding the amortization of intangible assets associated with purchase accounting for business combinations; securities gains and losses; and other significant gains, losses or expenses (such as those associated with integrating acquired entities operations into Bankshares) unrelated to Bankshares core operations. We believe these non-GAAP measures provide information useful to investors in understanding our ongoing core business and operational performance trends. These measures should not be viewed as a substitute for GAAP. Management believes presentations of financial measures excluding the impact of certain items provide useful supplemental information and better reflect core operating activities. In order to arrive at core business operating results, the effects of certain non-core business transactions such as gains and losses on the sale of securities, amortization of intangibles, restructuring charges and merger-related expenses, have been excluded. Management reviews these same measures internally. For instance, the cash operating efficiency ratio, rather than the GAAP basis efficiency ratio, is used to measure management's success at controlling ongoing, core operating expenses. We believe these measures are consistent with how investors and analysts typically evaluate our industry, and by providing these measures, we facilitate their analysis. Cash operating earnings totaled \$74.4 million for the second quarter of 2006, an increase of 10.8% over \$67.2 million for the same period in 2005.

Additionally, management believes that reporting several key measures based on tangible assets (total assets less intangible assets) and tangible equity (total equity less intangible assets) is important, as this more closely approximates the basis for measuring the adequacy of capital for regulatory purposes. The ratio of average tangible equity to average tangible assets was 9.88% for the quarter ended June 30, 2006 compared with 9.67% for the same period in 2005. See *Reconciliation of Non-GAAP Measures* for the reconciliation of GAAP measures to non-GAAP measures found at the end of this management's discussion.

For the first six months of 2006, net income was \$143.9 million, an increase of 10.2% over the \$130.5 million reported for the same period in 2005. Diluted net income per share was \$1.16, an increase of 7.4% from the \$1.08 reported for the same period last year. For the six months ended June 30, 2006, cash operating earnings were \$146.5 million compared with \$130.2 million for the same period last year. Average tangible equity to average tangible assets for the year-to-date 2006 and 2005 were 9.85% and 9.83%, respectively.

#### CRITICAL ACCOUNTING POLICIES AND RELATED ESTIMATES

In order to understand Bankshares' financial position and results of operations, it is important to understand Bankshares' significant accounting policies and the extent to which judgment and estimates are used in applying those policies. Bankshares' accounting and reporting policies are in accordance with accounting principles generally accepted in the United States (GAAP), and they conform to general practices within the applicable industries. Management uses a significant amount of judgment and estimates based on assumptions for which the actual results are uncertain when the estimate is made. Bankshares has identified five policies as being particularly sensitive in terms of judgments and the extent to which estimates are used: allowance for loan losses and the reserve for unfunded commitments; loans in nonaccrual status or deemed to be impaired; investment securities; income taxes; and valuation of goodwill and intangible assets. An update of our accounting policy for the allowance for loan losses and the reserve for unfunded commitments is provided below. For more information on our critical accounting policies, please refer to our 2005 Annual Report on Form 10-K.

### Allowance for Loan Losses and Reserve for Unfunded Commitments

Arriving at an appropriate level of allowance for loan losses involves a high degree of judgment. Bankshares' allowance for loan losses provides for probable losses based on evaluations of known and inherent risks in the loan portfolio. The allowance for loan losses is maintained at a level considered by management to be adequate to absorb losses inherent in the loan portfolio as of the date of the consolidated financial statements. We have developed appropriate policies and procedures for assessing the adequacy of the allowance for loan losses that reflect management's careful evaluation of credit risk considering all available information. Management uses historical quantitative information to assess the adequacy of the allowance for loan losses as well as qualitative information about the prevailing economic and business environment, among other things. In developing this assessment, management must rely on estimates and exercise judgment in assigning credit risk. Depending on changing circumstances, future assessments of credit risk may yield materially different results from the estimates, which may require an increase or decrease in the allowance for loan losses.

We employ a variety of modeling and estimation tools in developing the appropriate allowance. Bankshares' allowance consists of formula-based components for business and retail loans, an allowance for impaired loans and an unallocated component. The following provides a description of each of these components of the allowance, the techniques used and the estimates and judgments inherent in each. In the first quarter of 2006, management refined the methodologies for the formula-based components to align more appropriately the allowance methodology with our current framework for analyzing credit losses. Formula-based allowance calculations for business and retail components permit us to address specifically the current trends and events affecting the credit risk in the loan portfolio.

Business loans are comprised of commercial, commercial real estate and construction loans, which are evaluated separately for impairment. For business loans, the formula-based component of the allowance for loan losses is based on statistical migration estimates of the average losses observed for business loans classified by credit grade. Average losses for each credit grade are computed using the annualized historical rate at which loans in each credit grade have defaulted (probability of default rates or PD) and the historical average losses realized for defaulted loans (loss-given-default or LGD). We have developed default rates by analyzing four years of our default experience and more than 14 years of comparable external data. Default rates, which are validated annually, are estimates derived from long-term averages and are not based on short-term economic or environmental factors. LGD rates have been developed using industry benchmarks.

Retail loans are comprised of consumer installment and residential mortgage loans. For retail loans, the formula-based component of the allowance for loan losses is primarily based on the probability of default rates and LGD rates for specific groups of similar loans by product category. The probability of default rates are based on four years of our default experience and between 14 and 19 years of comparable industry data. LGD rates were developed using industry benchmarks.

For both business and retail loans, the formula-based components include additional qualitative amounts to establish reasonable ranges that consider observed historical variability in losses. Factors we may consider in setting these amounts include, but are not limited to, industry-specific data, portfolio-specific risks or concentrations, and macroeconomic conditions. Including these variability components in the model enables us to capture probable incurred losses that are not yet evident in current default rates, delinquencies and other credit-risk measurement tools.

The specific allowance allocation is based on an analysis of the loan portfolio. Each loan with an outstanding balance in excess of a specified threshold that is either in nonaccrual status or on the Watchlist is evaluated. The Watchlist includes loans identified and closely followed by management. These loans possess certain qualities or characteristics that may lead to collection and loss issues. The identified loans are evaluated for potential loss by analyzing current collateral values or present value of cash flows, as well as the capacity of the guarantor, as applicable. This is in accordance with SFAS No. 114, Accounting for Creditors for Impairment of a Loan, and SFAS No. 118, Accounting for Creditors for Impairment of a Loan - Income Recognition and Disclosure.

The allowance for loan losses also contains an unallocated component. The unallocated allowance recognizes the imprecision inherent in estimating and measuring inherent loss when allocating the allowance to individual, or pools of, loans. It also takes into consideration the allowance level deemed appropriate by each affiliate based on its local knowledge and input from bank regulators and their view from the standpoint of safety and soundness, among other factors. The amount of this component and its relationship to the total allowance for loan losses may change from one period to another.

In first quarter of 2006, we reclassified a portion of the allowance for loan losses to a reserve for unfunded commitments, which is included in the other liabilities section of the consolidated balance sheet. The modeling process used in the first quarter of 2006 for the determination of the reserve for unfunded lending commitments is consistent with the process described above for the formula-based component of the allowance for loan losses, also including as a key factor a benchmark average rate at which unfunded exposures have been funded at the time of default. The development of this modeling in 2006 enabled Bankshares to evaluate specifically the risk inherent in unfunded commitments and make the reclassification discussed above. As no model data existed in previous years, prior period data has not been reclassified for comparability.

## SEGMENT REPORTING

As noted in Note No. 11 Segment Reporting, Bankshares reports two business segments (1) Banking and (2) Investment and Wealth Management ( IWM ) for which financial information is segregated for use in assessing performance and allocating resources when reporting to the Board of Directors. Segment financial information is subjective and, unlike financial accounting, is not necessarily based on GAAP. As a result, the financial information of the reporting segments is not necessarily comparable with similar information reported by others and may not be comparable with Bankshares consolidated results. Certain expense amounts, such as operations overhead, have been reclassified for internal financial reporting purposes in order to provide for proper allocation of costs in the reported data.

A schedule disclosing the details of these operating segments can be found in Note No. 11 Segment Reporting.

### **Banking**

The Banking segment consists of 11 affiliate banks. Mortgage banking activities are not viewed as a separate business line due to their insignificant impact on the core business of Bankshares and, accordingly, are included in the Banking segment.

Net income for the six months ended June 30, 2006 increased 8.3%, to \$138.9 million, from the \$128.2 million earned during the same period last year. Net interest income for Banking increased 7.7% to \$314.0 million for the six months ended June 30, 2006. The growth in net interest income reflected an 11.6% increase in average earning assets, offset by an 11 basis point decline in the net interest margin from 4.45% at June 30, 2005 to 4.34% at June 30, 2006. Average loan balances increased 10.9% year-over-year. Commercial real estate loan balances increased 14.6%, residential real estate loan balances increased 6.8% and construction loan balances increased 25.9%. Average deposits included growth in money market accounts, time deposits greater than \$100,000 and noninterest-bearing checking, offset by a reduction in balances associated with savings accounts and checking plus interest accounts in the first half of 2006, compared with the first half of 2005. The decline in the net interest margin was primarily attributable to the impact of growth in premium money market accounts and certificates of deposit as customers shifted to these higher rate products, and yields on loans and investments lagging the increase in funding costs.

As a reflection of the favorable credit quality within the loan portfolio, Banking recorded no provision for credit losses for the first half of 2006 as compared with a \$756 thousand provision for the same period of 2005. During the first quarter of 2006, Banking established a reserve for unfunded commitments of \$15 million by a reclassification of \$14 million from the allowance for loan losses and the recording of a \$1.0 million provision related to increased unfunded commitments during the quarter. No provision for unfunded commitments was deemed necessary in the second quarter of 2006. The allowance for loan losses as a percent of loans was 1.19% at June 30, 2006 compared with 1.35% at December 31, 2005 and 1.38% at June 30, 2005.

Noninterest expenses were \$171.2 million for the first half of 2006 compared with \$164.1 million for the same period of 2005, an increase of \$7.1 million, or 4.3%. Noninterest expenses net of adjustments were \$160.3 million for the first half of 2006, a \$4.1 million increase, or 2.6%, over \$156.1 million for the same period of 2005. The increase in noninterest expenses was primarily related to the CBNV acquisition as well as normal merit and salary increases, higher benefit costs, higher professional fees and the addition of new branches. These increases were partially offset by an increase in the amount of deferred loan origination costs and a decrease in incentive compensation accruals based on lower growth in net income.

### Investment & Wealth Management

Investment and Wealth Management ( IWM ) includes Asset Management, Private Banking, Trust Services, Retail Brokerage Services and Custody Services. IWM provides a full line of investment products and retirement, tax and estate planning services. IWM products include:

- **Retail Brokerage Services:** Stocks, bonds, proprietary and nonproprietary mutual funds, fixed and variable annuities.
- **Asset Management Services:** Proprietary and nonproprietary mutual funds, proprietary and nonproprietary separate account management, customized wealth advisory services, defined benefit and defined contribution retirement services, family office services, individual and institutional trust services and custody services.
- **Private Banking Services:** Deposits, loans, and mortgages.

Net income for the first half of 2006 increased 24.1%, or \$2.0 million, to \$10.3 million over the \$8.3 million in the first half of 2005. Pretax profit margins, prior to corporate overhead allocations, were 28.1% and 26.6% for the first half of 2006 and 2005, respectively. During the second quarter of 2006, Bankshares IWM Real Estate Advisory Unit restructured a major advisory relationship. As a result, pretax income of \$1.4 million was recognized during the second quarter of 2006. For more information on corporate overhead see Other in Segment Reporting below.

While the equity markets rose during the past twelve months, this positive momentum reversed somewhat in the second quarter of 2006. The S&P 500 Index ended June 30, 2006 at 1,270, up 6.6% from 1,191 at the end of June 2005, but down 1.9% from the first quarter of this year. Between June 30, 2005 and June 30, 2006, the Dow Jones Industrial Average increased 8.5% to 11,150 and the Nasdaq rose 5.6 % to 2,172. The fixed income markets, as measured by the Lehman Brothers US Aggregate Bond Index, were down 5.8% for the twelve-month period ended June 30, 2006. Bankshares investment asset base is relatively balanced between equities (including real estate) and fixed income, cash and other securities. As of June 30, 2006, 48.5% of IWM managed assets were invested in equities, including real estate. Approximately 30.2% were invested in fixed income securities and 21.2% were invested in cash and other.

Market Indices	As of June 30, 2006	2005
Dow Jones Industrial Average	11,150	10,275
Year-over-Year % Change	8.5 %	-1.5%
S&P 500 Index-period-end	1,270	1,191
Year-over-Year % Change	6.6 %	4.4%
Nasdaq	2,172	2,057
Year-over-Year % Change	5.6 %	0.4%
Lehman Brothers US Aggregate Bond Index	98.5	104.6
Year-over-Year % Change	-5.8%	1.6%

Revenues in the first half of 2006 increased \$9.1 million, or 17.4%, to \$61.1 million from \$52.1 million in the same period last year. Solid revenue growth was realized in Institutional Management, Mercantile Funds, and Private Banking. Solid growth was also realized in Private Wealth Management and Brokerage.



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Private Wealth Management benefited from the rise in equity markets during the past year, the addition of net new assets and a fee increase on some accounts at the beginning of 2006. Personal Assets under Administration at June 30, 2006, increased \$0.8 billion, or 6.7%, to \$12.8 billion from June 30, 2005. At June 30, 2006 as compared with June 30, 2005, Personal Assets with Investment Responsibility increased \$0.7 billion, or 8.5%, to \$8.9 billion and Assets with No Investment Responsibility increased \$0.1 billion, or 2.6%, to \$3.9 billion.

Institutional Investment Management benefited principally from the restructuring of a major real estate pension advisory relationship. The impact of this change was to increase revenues \$3.5 million and to increase expenses \$2.1 million. Other Institutional Management revenues were essentially unchanged. Revenue declined in our Boyd Watterson Asset Management subsidiary due to lower assets under management. Additionally, higher terminations in our institutional business last year continued to impede institutional revenue growth in the first half of 2006. At June 30, 2006 as compared with June 30, 2005, Total Institutional Assets under Administration (including Boyd Watterson) declined \$2.0 billion, or 5.5%, to \$34.1 billion; Institutional Assets with Investment Responsibility declined \$1.1 billion, or 8.8%, to \$11.4 billion; and Assets under Administration with No Investment Responsibility declined \$0.9 billion, or 3.8%, to \$22.7 billion.

The Mercantile Funds benefited from higher asset flows into the funds, improved equity markets, and strong performance in the hedge funds of funds. Mercantile Fund assets increased \$336 million, or 8.9 %, to \$4.1 billion, driven by a 20% increase in personal trust assets, at June 30, 2006 compared with June 30, 2005.

Brokerage commissions and income benefited from growth in the number of accounts and assets held in accounts. Brokerage assets increased \$185 million, or 20%, to \$1.1 billion, at June 30, 2006 compared with June 30, 2005.

Private Banking revenues benefited from \$34.8 million and \$103.1 million in loan and deposit growth during the past year.

IWM Asset Data (Dollars in billions)	For the period ended June 30,	
	2006	2005
<i>Personal</i>		
Assets with Investment Responsibility	\$ 8.9	\$ 8.2
Assets with No Investment Responsibility	3.9	3.8
Total Personal	12.8	12.0
<i>Institutional</i>		
Assets with Investment Responsibility	11.4	12.5
Assets with No Investment Responsibility	22.7	23.6
Total Institutional	34.1	36.1
<i>Mutual Funds Not Included Above</i>	0.3	0.2
<i>Total</i>		
Assets with Investment Responsibility	20.6	20.9
Assets with No Investment Responsibility	26.6	27.4
Total Assets under Administration	\$ 47.2	\$ 48.3

At June 30, 2006, Assets under Administration by IWM were \$47.2 billion, a decrease of \$1.1 billion, or 2.3%, from the prior year. Bankshares had investment responsibility for \$20.6 billion, a decline of \$0.3 billion, or 1.4%, compared with last year.

Additional revenue growth will depend on continued new sales and increased distribution, equity and bond market conditions and acquisitions, if any.

In the first half of 2006, expenses increased 21.6%, or \$7.7 million, to \$43.6 million, compared with \$35.8 million in the first half of last year. Increases occurred in employee-related, technology, marketing, professional services, general operating and occupancy expenses, which were only partially offset by a modest decrease in communications and supplies expenses. The real estate advisory business restructuring-related expenses including marketing, incentive compensation, recruiting, and license fees totaled \$2.1 million.



**BANKSHARES EARNINGS PERFORMANCE****Analysis of Interest Rates and Interest Differentials**

The following table presents the distribution of the average consolidated balance sheet, interest income/expense and annualized yields earned and rates paid for the six months ended June 30, 2006 and 2005.

(Dollars in thousands)	2006 Average Balance (2)	Income (1) / Expense	Yield (1) / Rate		2005 Average Balance (2)	Income (1) / Expense	Yield (1) / Rate	
Earning assets								
Loans:								
Commercial	\$ 2,944,881	\$ 105,274	7.21	%	\$ 2,887,558	\$ 87,488	6.11	%
Commercial real estate	3,711,298	128,031	6.96		3,249,322	103,143	6.40	
Construction	1,745,346	69,072	7.98		1,385,942	44,403	6.46	
Residential real estate	1,854,029	56,640	6.16		1,736,644	51,096	5.93	
Home equity lines	490,428	18,120	7.45		499,446	13,890	5.61	
Consumer	1,038,999	29,670	5.76		849,516	24,638	5.85	
Total loans	11,784,981	406,807	6.96		10,608,428	324,658	6.17	
Federal funds sold, et al	64,422	1,755	5.49		36,404	785	4.35	
Securities:								
Taxable securities								
U.S. Treasury and government agencies	1,446,022	26,862	3.75		1,404,011	23,669	3.40	
Mortgage-backed	1,597,164	34,068	4.30		1,334,525	26,697	4.03	
Other investments	64,480	1,338	4.18		64,500	1,237	3.87	
Tax-exempt securities								
States and political subdivisions	82,489	2,552	6.24		84,750	2,495	5.94	
Total securities	3,190,155	64,820	4.10		2,887,786	54,098	3.78	
Interest-bearing deposits in other banks	200	1	1.44		195	1	1.23	
Total earning assets	15,039,758	473,383	6.35		13,532,813	379,542	5.66	
Cash and due from banks	302,726				296,227			